

# Multistate Tax Commission



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## **Business Activity Taxes:** **Explanation and Potential Implications of Current Legislation**

**The Issue.** Proposals are being floated in Congress to limit state authority to impose income taxes (called Business Activity Taxes or BAT) on only those businesses that have a “substantial physical presence” in a state. If enacted, the proposed legislation would overturn current constitutional standards governing when states can impose income taxes on businesses. It would allow companies that operate electronically, especially via the Internet, to escape taxes they are already paying by sheltering much of their income in tax havens. This new tax sheltering would create substantial revenue shortfalls at the state and local level—robbing states of revenue used to fund essential services like education, transportation and infrastructure.

**Current Constitutional Standards.** Under current law, both in-state and out-of-state businesses that are doing business in a State pay BAT on the income earned in that state. “Doing business within the state” provides the necessary connection—the “nexus” in legal jargon—to justify the state taxing authority. The United States Supreme Court authorized states to impose income tax on nonresidents doing business in the state as long ago as 1920 in *Shaffer v. Carter*, and further, the Court authorized states to tax even where the taxpayer had no physical presence, but did business, in a state in the 1937 decision *New York ex rel. Whitney v. Graves*. In *Quill Corp. v. North Dakota*, the Court set out a bright-line test of “physical presence” to satisfy the necessary connection with a state—there called “substantial nexus”—but explicitly limited that test to the duty of mail order houses to collect use tax from customers. The Court acknowledged that as to other taxes—such as the two income tax cases mentioned—it had not applied the “physical presence” test.

**The Proposed Change:** Proponents want to bar states from imposing income tax on businesses that do not have a “substantial physical presence” in a state. They purport simply to be enacting current constitutional standards. ***Nothing could be farther from the truth.*** No case has ever imposed a nexus standard of “*substantial* physical presence” for taxing jurisdiction of the states. Proponents are “slicing and dicing” words, taking them out of context and mixing them up to produce a defective and deceptive product. They combine the terminology the courts use to describe the degree of connection to a state necessary for that state to have authority to impose tax—“substantial nexus”—with the requirement for use tax collection obligation on mail order houses of “physical presence.” They then apply this fictitious standard of “substantial physical presence” to income taxes where the Court has explicitly *not* required physical presence for states to tax. All this wordplay would be entertaining, except that it is dangerous. The proponent’s product will grant unjustified tax breaks to a few businesses and favor economic development in a few select states to the disadvantage of investment and job development in most other states. Further the proposals would endanger the financing of schools, transportation and other essential services in communities in the vast majority of the nation and would shift the tax burden to local taxpayers.

## **What is Really Going On and Who Will Benefit and Who Will Lose With the Propose Changes?**

***The Losers:*** Many businesses are inevitably local taxpayers by nature of their activity—manufacturing firms, main-street retailers, commercial real estate, and natural resource companies. They do not have the ability to do business in a state without being physically present there.

***The Winners:*** Certain other types of businesses are structurally mobile and flexible and can relocate easily while retaining their ability to do business in all states. These mobile businesses—banks, financial services companies, insurance companies, and Internet and media companies—project themselves into a state electronically by conducting much of their business via the Internet and other telecommunications media. This business structure allows them to do business nationwide and internationally while maintaining an actual physical presence in a few select areas. They can then choose their physical location in low-tax or no-tax states, and avoid paying income tax on all the income they earn from doing business in all the other states where they have no “substantial physical presence.” Company X, for instance, with \$100 Million in annual taxable income could locate its headquarters, and its computers, in a single state. \$99 Million of the company’s income is derived from business conducted in other states. If the BAT proposals were enacted, the company might only be required to pay taxes on the \$1 Million of income earned in the state where the headquarters is located—if it has any income tax at all—while the \$99 Million of income earned in other states would now escape taxation.

***The Real Losers:*** Business activity taxes are used by states to fund essential services such as education, transportation, and infrastructure that help support the state and national economies. If the BAT proposals are enacted, the revenue stream to support these essential services will be depleted by the sheltering of large amounts of income from tax—leaving state legislators little choice but to cut essential services or, in order to fund their operations, to increase the tax burden on individual taxpayers and in-state businesses. Thus the real losers are the citizens/customers in the states who are generating this income for Company X. As Company X stops paying tax on income earned off in-state citizens/customers, these citizens/customers will suffer the double indignity of a decline in government services and a shift in tax burden to them.

***The Extent of the Loss:*** State revenue agencies recently estimated the impact of the BAT proposals. If enacted, these proposals could cause states to lose approximately \$9 billion in revenue per year. This is a conservative estimate. Because of the lucrative nature of these proposals, it is anticipated that the tax-sheltering opportunities they afford would entice numerous companies to embark on extensive tax planning schemes to further shield currently taxable income. Thus, the actual revenue loss to states could increase dynamically and dramatically. In real-life terms that \$9 billion could buy per year: K-12 education for 1.1 million school children; or state university for 584,000 college kids; or 196,000 police officers on the street; or 193,000 firefighters on duty.

***Market Distortion Inhibits Balanced Economic Growth and Development:*** Not only will the states lose money, but the proposed nexus standards will distort investment decisions and create a barrier to the free flow of investment across state boundaries. If Congress allows states to tax businesses only where they are physically located even though they earn income in other states, the result will be a disincentive to businesses to create jobs and investments in those other states. Economic development will be frozen in places of initial investment. The benefits of new technology, industry and jobs will not spread in a balanced way to all geographic regions of the nation. In addition, the proposals will prevent optimal economic efficiency and reduce the economy’s long-term growth rate.

***International Flexibility Constrained:*** The U.S. and its foreign trading partners have not yet established any consensus regarding the taxability of income from multinational transactions conducted via the Internet. Recent statements by the OECD indicate that our trading partners are seeking to reach agreement with the U.S. to enact standards that would fairly distribute the taxation of income from these transactions among countries involved in the transaction. The U.S. should not create a domestic policy that it may not want to be tied to internationally or that could create awkward relationships with its trading partners.

**Summary.** Enactment of the business activity tax proposals could impart serious consequences on the marketplace and on the ability of state and local governments to provide services to taxpayers. However, the most serious impact could be on individual taxpayers and businesses deeply rooted in their communities. They may be forced to bear a greater share of the tax burden if mobile and flexible companies are allowed to shelter much of their income in tax havens. In order to make an informed decision on this issue, Members of Congress are strongly encouraged to educate themselves on how these proposals could impact their constituents by discussing the issue directly with your state's revenue officers and in-state businesses.

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