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Interview

State Taxes

States Question Need for Shift to Nexus Standard Requiring Physical Presence, Fear Loss of Revenues

States Taxes

The Business Activity Tax Simplification Act (BATSA) of 2006 (H.R. 1956/S. 2721) would create a federal standard for business activity tax nexus based on physical presence in a state and would carve out a series of safe harbors protecting certain activities from taxation.

Proponents of the bill say the measure is necessary to modernize Pub. L. No. 86-272, which prohibits states and their political subdivisions from imposing a net income tax on nonresident taxpayers that operate primarily in interstate commerce and limit their activities in the state to the mere solicitation of orders, by including services and other BAT taxes within its legal protections.

States and other opponents of the bill say the legislation would lead to legalized tax sheltering and massive losses in state revenues. In the following interview, BNA talks with Dan Bucks, former executive director of the Multistate Tax Commission (MTC) and currently director of the Montana Department of Revenue, who recently testified before the Senate Finance Committee Subcommittee on International Trade about the potential negative impact of the bill on the states.

BNA: What is the current nexus standard for state business activity taxes?

BUCKS: The vast majority of state statutes are economic presence statutes. Very few require physical presence. A typical statute is Montana's, where the test is whether the taxpayer is actively engaged in any transaction for financial or pecuniary gain or profit. That's the statute; it's been in existence for several decades in Montana, and it's similar to the vast majority of states that have enacted general business laws.

BNA: So the notion of economic presence is not a new one.

BUCKS: Not at all. In 1937, and again in 1944, the U.S. Supreme Court upheld the application of business taxes to entities and individuals who had no physical presence in the state. As far back as the 1860s, the court approved the ability of states to apply an intangible property tax to business entities that had no physical presence in the state. And the court clearly recognized that in *Quill [v. North Dakota]*, because it said it had not established a physical presence standard. So, based on a reading of the Supreme Court and state statutes, economic presence in most states is the law. Most taxpayers understand that and comply with that.

BNA: Why, then, this push for a physical presence standard?

BUCKS: The states are not advocating this legislation. But the broad consensus of the states is that this legislation will dramatically reduce the tax payments of the largest multistate corporations to the states.

The decisionmakers being asked to legislate this are being told by its supporters that the impact isn't very big. The best thing that could be done to clear the air would be for the taxpayers who are advocating this legislation to open their books, so that everybody can see what effect this legislation would have on the tax filing positions they're taking. And secondly, the tax advisory firms involved in this need to reveal the kinds of tax shelter plans they believe would be approved by this legislation. They should open their books, too.

Let's have some sunshine, so the decisionmakers can make an informed decision on this. Rather than make this a "he said, she said" kind of debate, let's have some sunshine on this process.

BNA: How do you expect this legislation would affect Montana?

BUCKS: Right off the bat, this bill would remove nearly half our multistate taxpayers from our tax rolls.

BNA: Because of the physical presence standard?

BUCKS: Yes. In Montana, in 2004--which is the most recent year for which our records are completed--we received 3,413 tax returns from multistate corporations. Of those returns, 1,595--or 47 percent--had either no property or payroll in the state, or only de minimis levels of property and payroll.

BNA: And by de minimis do you mean the Multistate Tax Commission's proposed threshold?

BUCKS: Less than \$50,000 in property and payroll, and the factors were less than 25 percent. And interestingly enough, of those 1,595 returns, 991 had no--absolutely no--property or payroll in the state. So almost 30 percent of our multistate corporate taxpayers had only sales in the state of Montana. This bill would remove these multistate corporate taxpayers from our tax rolls.

And let me add, these are corporations that have voluntarily complied with our law. Montana has not engaged in any special enforcement efforts related to nexus over the past several years. The tax managers of these corporations and their tax advisers are reading our law and voluntarily complying with it.

BNA: In 2005, the National Governors' Association estimated that if H.R. 1956 were enacted, the states could lose up to \$3 billion in the first year and as much as \$8 billion annually in the long run. More recently, the Congressional Budget Office came out with much lower estimates--\$1 billion in the first year and \$3 billion in subsequent years--and an Ernst & Young study commissioned by the Council on State Taxation sets an even lower estimate. Given these recent studies, would you revise your estimated losses for Montana?

BUCKS: I think the estimates that have been made in the past are too low. We originally estimated losses of between \$3 million and \$6 million initially--mostly from losing the folks immediately who would be removed from the tax rolls. But back when we did those estimates, they were based on corporate tax revenue just shy of \$80 million. Our current revenues are running at about \$150 million.

BNA: So your estimated losses would be nearly doubled?

BUCKS: Initially. And then we'd be left with a few more than half our multistate companies, and that's when the tax shelter firms would go to work and the companies would restructure. Once that takes hold, the impact grows over time. That's what the CBO agreed with. Based on an examination of our returns by industry sector, we believe that within five or six years, 30 to 40 percent of our corporate tax base would be eliminated.

BNA: You've said that the BATSA bill would encourage tax sheltering. How exactly would it do that?

BUCKS: Take the simplest scenario: the intellectual property holding company issue, where a number of companies have restructured to put intangible assets in a holding company in a location where it would be favorably taxed. In South Carolina, North Carolina, New Mexico, Maryland, Massachusetts, and New Jersey--the places where this has been actively litigated--the courts have supported the tax administrators in saying these structures are not allowed under current law. This bill would reverse those rulings and would legalize that kind of tax sheltering.

Interestingly enough, the federal government has discovered that it has the same problem. The technique is the same--moving activity offshore. It's been publicly reported that Microsoft has been able to avoid close to \$500 million dollars in federal taxes using intellectual property holding companies in Ireland. So this bill would legalize the very intellectual property tax shelter scheme that the federal government has now discovered it needs to close down. It doesn't make any sense.

BNA: The push for the BATSA legislation is occurring at a time when many states have drifted away from the traditional, three-factor apportionment formula of property, payroll, and sales. In fact, many states have enacted a single-sales factor formula--basically eliminating physical presence as an element of apportionment.

BUCKS: Tax administrators haven't pushed for that. The changes in apportionment formulas have occurred at the urging of the multistate business community. They have lobbied the state legislatures to change the weighting of these factors. But the result is that, if you combine an overweighting of the sales factor with a physical presence standard, you create a lot of nowhere income.

BNA: As you know, H.R. 1956 had been up for a vote, but was pulled. Would there be any way to amend the legislation to your satisfaction?

BUCKS: Not really. The goal here, for states, is to equitably and fairly tax the income that is earned in a state. In its simplest terms, the BAT Simplification Act would prevent states from doing that. It would legalize tax shelters that are illegal under current law, and it would exempt broad numbers of companies that are currently voluntarily complying.

The way the bill would work, the general physical presence standard especially harms the equity and effectiveness of the separate-entity states and water's-edge combined reporting states with respect to overseas activity. Then the second part of the bill--the exemptions from the physical presence standard--significantly

harms states with combined reporting systems.

BNA: If there must be a federally imposed nexus standard for business activity taxes, what would you rather see?

BUCKS: We support the factor presence nexus standard as proposed by the MTC. The nexus standard would be based on dollar amounts and percentages of sales, payroll, and property--which are currently used to apportion net income among the states in which a company does business.

This standard would create a truly clear, simple, and equitable bright-line test for "doing business" in the states. So a multistate business would have nexus only if the level of sales, payroll, or property exceeded a certain threshold. This idea was first proposed by Professor Charles McLure--that the nexus standard ought to reflect the apportionment method. This standard would work most equitably as a replacement for Pub. L. No. 86-272, which was only supposed to be a temporary law.

BNA: If the BATSA bill were enacted, how would states make up lost revenue? Could they change their statutes to counteract the effect of the bill?

BUCKS: There really isn't any way the states can recover in terms of the loss of the multistate businesses. If the federal government removes this money from state treasuries, states will either cut services or shift the burden to their own residents or local business.

The bill really has a substantial negative effect, especially on rural states like Montana, where our economy is so based on local businesses. It's really a negative bill for all states, but especially for rural states. 🗑️

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