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The Business Activity Tax Simplification Act: A Good Standard for Multi-State Business

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I. Introduction

On July 25, the House of Representatives is expected to vote on H.R. 1956, the Business Activity Tax Simplification Act of 2005. This bill would forbid states from imposing a corporate tax (based on net income, gross receipts, net worth, etc.) on any corporation that has no physical presence (property or employees) in-state.

On July 11, 2006, the Congressional Budget Office (CBO) released a revenue estimate of H.R. 1956.[1] CBO anticipates that in the first year after passage, state tax revenues will drop by $1 billion and federal tax revenues will rise by $107 million. Some in Congress have asserted that because federal revenues are projected to rise after enactment, the bill as a whole must therefore be counted as a tax hike. But as CBO's cost estimates reveal, taxpayers would pay lower taxes overall under H.R. 1956. In 2007 alone, taxpayers would see net tax reductions of almost $900 million. Thus, H.R. 1956 should not be labeled a "tax hike" or opposed on that basis.

II. H.R. 1956 from the Taxpayer's Perspective

Currently, states can require companies to file and pay most corporate taxes just for selling products to state residents. This way of thinking about state tax liability is referred to as economic presence or nexus. A previous Tax Foundation report explained why physical presence is consistent with the benefit principle of taxation and is the more practical standard for reasonable tax enforcement.[2]

As the bill moves toward a vote in the House of Representatives, the always contentious issue of what tax changes should count as a tax hike or a tax cut has arisen. CBO estimates that H.R. 1956 will deplete state revenues overall but enhance federal revenues. The states would lose revenue because fewer firms would be paying business activity taxes; the federal government would gain revenue because corporations would have fewer state tax payments to deduct on their federal tax return. In subsequent years, CBO anticipates even greater state revenue losses and a corresponding boost in federal revenue.

Thus, while the federal treasury will grow as a result of this bill, affected taxpayers will actually see overall tax reductions. Since the intent of the bill is to protect state taxpayers from unwarranted imposition of state business activity taxes, it is more logical to view the revenue impact from the taxpayer's perspective rather than that of the federal tax collector.

For example, Ohio's new Commercial Activities Tax (CAT) applies a .26 percent tax rate (when fully phased in) to the Ohio-based sales of a corporation, regardless of the presence of property or payroll in Ohio (see Table 1). Thus, a corporation with $5 million in Ohio sales currently has to pay the CAT even if it has no Ohio property, no Ohio-based employees, and no physical presence in Ohio.

Table 1: The Impact of H.R. 1956 on the Overall Tax Bill of a Hypothetical Corporation in Ohio

Current Law	**H.R. 1956**
Ohio-based sales: $5 million	Ohio-based sales: $5 million
Ohio-based property: $0	Ohio-based property: $0
Ohio-based payroll: $0	Ohio-based payroll: $0
CAT liability: $13,000	CAT liability: $0
Federal deduction: $13,000	Federal Deduction: $0
Federal taxes saved: $4,550	Federal taxes saved: $0
Net taxes (CAT liability less value of federal deduction): **$8,450**	Net taxes (CAT liability less value of federal deduction): **$0**
Impact on federal treasury: **-$4,550**	Impact on federal treasury: **+$,4550**
Impact on state treasury: +**$13,000**	Impact on state treasury: **-$13,000**

Source: Tax Foundation.

H.R. 1956 would restrict Ohio from applying its CAT in this hypothetical situation, and thus reduce taxes for our hypothetical corporation by $8,450—even after it loses the federal deduction for CAT taxes paid. From the perspective of the taxpayer, this is a worthwhile change because state tax reductions will exceed federal tax increases. More importantly, the taxpayer will now be required to report and pay tax in fewer states, which means less litigation,3 fewer accountants and attorneys on the payroll, and more money spent on investment in labor and capital instead of state tax compliance.

Naturally, it's disconcerting for state legislators and tax collectors to have a revenue source pre-empted by the federal government. State budgets must be balanced, after all. However, while complaints on this score are understandable, the estimated revenue loss is so small—roughly 0.1 percent of state revenue—that it is well within the margin of error in every state's revenue estimate, and in any case, states will have time to make any adjustments they need. Furthermore, to the extent that states adjust to H.R. 1956 by shifting the burden of taxation back to their own resident individuals and corporations, they will enhance the transparency of their tax system.

III. Conclusion
H.R. 1956 would amend federal law to restrict states from imposing corporate taxes if the corporation lacks a physical presence in the state. Since companies that are physically present in a state are receiving the benefits of government services, it is appropriate to use such a nexus standard for imposing corporate tax. Of course, if H.R. 1956 became law it would reduce some of the revenue that states have received from out-of-state companies. Such a reduction would also have the secondary impact of increasing federal revenues, since those state taxes would no longer be deducted on companies' federal returns.

Lawmakers should not be concerned with such a federal revenue increase, nor should such an increase be labeled as a “tax hike.” Any business taxpayer that pays more federal tax as a result of H.R. 1956 will have an offsetting reduction in state taxes paid. Furthermore, business taxpayers will be able to spend less money on state tax compliance. That represents a win-win scenario for both interstate commerce and sound tax policy.

Footnotes:
1. *See* Congressional Budget Office Cost Estimate, “H.R. 1956, Business Activity Simplification Act of 2005" located at http://www.cbo.gov/ftpdocs/73xx/doc7370/hr1956.pdf.

2. *See* Chris Atkins, “Paying for ‘Civilized Society’ in the Global Marketplace: H.R. 1956’s Physical Presence Rule Accurately Matches Taxes Paid and Benefits Received”, *Tax Foundation Fiscal Fact* No. 31 (September 26, 2005).

3. H.R. 1956, as reported by the House Judiciary Committee, does contain some exceptions to the general standard of physical presence. These exceptions could be the source of future litigation.

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