IMPACT OF H.R. 1956, BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2005, ON STATES

September 26, 2005

Executive Summary

On April 28, 2005, H.R. 1956, the "Business Activity Tax Simplification Act of 2005" was introduced in Congress by Representatives Rick Boucher and Bob Goodlatte of Virginia. The bill would impose a federal physical presence standard for determining when a state can impose a business activity tax (BAT). In order to determine the impact of a bright-line nexus for state business activity taxes, the National Governors Association worked with the Federation of Tax Administrators (FTA) and the Multi-state Tax Commission (MTC) to survey state revenue agencies asking them to estimate the impact of such legislation on their respective state.[1]

All of the 34 states responding to the survey have stated that the legislation would adversely affect their business activity tax (BAT) revenue. The range of taxes affected is broad and includes gross receipts, gross income (including Washington State's Business and Occupation Tax), taxes imposed on vendors for the privilege of doing business, taxes on receipts of public utilities, and taxes imposed in lieu of net income taxes and similar types of taxes. Based on information from responding states, H.R. 1956 would reduce BAT revenues by an average of 10.4%. Extrapolating to all states, H.R. 1956 would cost states and localities an estimated *$6.6 billion annually*.

Examples provided by responding states indicate H.R. 1956 would upset settled law regarding state business activities of numerous industries including publishing, interstate trucking, general and customized manufacturing, the sale of distributorships, licensing of trademarks, and leasing of computer hardware and software. Sellers of services and intangibles would come under a new physical presence standard that exceeds the provisions in PL 86-272 for sellers of tangible personal property. This extension, along with other provisions in the bill, would create new opportunities for businesses to structure their operations so as to avoid most state business activity taxes entirely. Certain provisions, (e.g., the ability for other parties to perform work on the company's behalf, the 21 day exemption, and carve outs for specific industries) present likely sources of revenue impact.

Although the sponsors have indicated their bill would achieve the goal of creating legal certainty that would minimize litigation, it appears that H.R. 1956 could have the opposite effect. Opportunities for businesses to reorganize in order to avoid taxes would shift the areas of litigation to new ground. The reorganizations and perhaps physical relocations would also burden the economy as businesses expend resources for non-productive purposes. In addition, H.R. 1956 would legalize certain tax sheltering practices and income shifting methods that several states consider questionable.

In this survey, state revenue estimators were asked to estimate the revenue impact on their state in three ways – the static effect, dynamic effect, and compliance effect. A static effect captures how the new law would allow some companies, currently filing, to be free to stop filing. The dynamic or behavioral effect asks what happens to revenue when companies restructure or change operations to use the provisions of H.R. 1956 to minimize their BAT liability. The

[1]This survey was originally conducted in response to a virtually identical bill introduced during the 108th Congress, H.R. 3220, the "Business Activity Tax Simplification Act of 2003." Because of the similarity between the two bills, several states used their original estimates to calculate the impact of H.R. 1956.

compliance effect is the loss of anticipated revenue from enforcement efforts to curb current illegal tax sheltering or income shifting activities that would be made legal if the bill were to become law. The estimates for the dynamic effect are somewhat larger than for the static effect, although the dynamic effect includes a wider range of estimates, representing less certainty. The compliance effect is significantly smaller than the static or dynamic estimates.

As the report indicates, the federally mandated physical presence standard in H.R. 1956 would have a significant impact on the revenues of nearly every state. The bill's extension of the physical presence standard beyond tangible personal property sales, and its addition of carve outs and exemptions for certain industries and practices, only increase its adverse impact. Governors urge Congress to oppose H.R. 1956 and leave decisions regarding state revenues to the states.