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## **Response to the National Governors Association Estimates of the State and Local Tax Impact of H.R. 1956**

**October 6, 2005**

The National Governors Association (NGA) recently released a report, “Impact of H.R. 1956 Business Activity Tax Simplification Act of 2005 On States” (September 26, 2005), that presents estimates of the impact of H.R. 1956 on state and local business tax collections. The report is based on revenue estimates provided to the Multistate Tax Commission (MTC) by 34 states.<sup>1</sup> A number of shortcomings in the estimating process raise serious questions about the quality of these estimates and thus the reliability of the NGA study itself. These shortcomings include:

- Inconsistent results across the states;
- Misinterpretations of H.R. 1956’s provisions;
- Significant differences in estimating methodology;
- Incomplete information to validate the estimates; and
- Estimating procedures that bias the estimates.

As explained in a discussion of these key points, the results presented in the NGA’s report do not provide consistent or credible estimates of the expected impact of H.R. 1956. The shortcomings in the study undermine the usefulness of the estimates in the tax policy debate.

### **About COST**

The Council On State Taxation (COST) is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of 575 major corporations engaged in interstate and international business. COST’s objective is to preserve and promote the equitable and nondiscriminatory State and local taxation of multijurisdictional business entities.

<sup>1</sup> The individual state estimates were provided in response to a survey (the “MTC survey”) distributed by the Multistate Tax Commission, “Estimating Potential Revenue Impact of H.R. 3220 on State and Local Business Activity Taxes,” Guidance and Methodology, May 14, 2004.

### Inconsistent Results

The actual results reported in the NGA study clearly show that the states themselves fundamentally disagree on how H.R. 1956 will affect their tax revenues. This disagreement is obvious from the study's results presented for the minimum static impacts (Appendix Table 1A, column 1).<sup>2</sup> Although any piece of legislation is subject to different interpretations by different parties, the range of difference between the states is difficult to explain by way of honest disagreement between neutral observers. Furthermore, because the static estimates provided by the states exclude the more speculative estimates of the dynamic and compliance effects, one would expect closer agreement on these revenue estimates than was the case in the NGA study.

- The published figures show a tremendous variation in the range of estimated revenue impact. Expressed as a percentage of total taxes affected by H.R. 1956 (business activity tax revenue), the static loss among the 29 reporting states ranges from 0.0% for Virginia to 39.7% for Missouri. *These results suggest that H.R. 1956 will have no effect on business tax collections in Virginia, but the same bill will result in a static loss (before any tax planning or restructuring) of almost 40% of Missouri's total business activity taxes.* This tremendous variation between states estimates results from significant differences in interpretation of the bill's provisions; not all of these interpretations can be correct.
- The variation between state results is even more dramatic when the dynamic and compliance effects are included. Although somewhat greater variation is understandable given the fact that the concepts ("dynamic" and "compliance" effects) themselves were not clearly defined in the Multistate Tax Commission's (MTC) survey instructions, the variation reported in the survey is extraordinarily wide. *With all three effects—static, dynamic and compliance—included, the estimated loss as a percent of the business activity tax revenue ranges from 0 to 64%.* In other words, some states estimate that H.R. 1956 will have almost no impact on their state's revenue while others estimate that it will result in a significant revenue decrease. As noted previously, the wide range of responses suggests that many of the estimates are far wide of the true mark.
- The large differences among the estimates cannot be explained by variations in state economies or business tax structures. For example, of the states that utilize combined reporting, five states estimated a total tax loss of 2% or less, but three states estimated losses of more than 20%. For another example of the lack of consistency among states, four states report dynamic effects 10 times or more than the static effects, while eight states report dynamic effects less than the static effect.
- As a minor point, there is also an inconsistency in the NGA's estimate of total business activity taxes that may be affected by the H.R. 1956. In the introduction (p. 4), the NGA report states that total business activity taxes were \$89.8 billion in 2004. This figure is significantly higher than the estimated fiscal year 2007 business activity tax total of \$57.7 billion (Table 3, p. 20) based on estimates from the states. There is no explanation for this inconsistency.

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<sup>2</sup> The MTC survey asked states to provide minimum, best and maximum impact estimates for three different components of the impacts: static, dynamic, and compliance effects. Only 7 out of the 34 states were able to provide estimates for the compliance effect impact.

More fundamentally, as discussed in the next section, this variation in state responses to the MTC survey upon which the NGA study was based represents a basic disagreement or misunderstanding over the expected impact of the bill and/or dramatically different revenue estimating methodologies that are not explained in the report. It would be very helpful to know what explains those differences, both to ensure the accuracy of the overall revenue estimate, and to understand how differences in states' tax laws and the expectations of taxpayer responses to the bill could produce such dramatic state-by-state differences.

Given the obvious uncertainty within the states about the effects of H.R. 1956, it is disappointing that the NGA did not use the survey information and contacts with state revenue departments to ensure greater consistency of the revenue analysis across states. The state revenue estimators were obviously not using the same concept of behavioral change (or other impacts) in analyzing the bill. Because, in effect, they were analyzing different interpretations of the bill and its impacts, it is not clear how the state estimates can be used to understand the impact of H.R. 1956.

### **Lack of Understanding of the Bill's Impact<sup>3</sup>**

The fact that the states do not agree on the interpretation of the provisions of H.R. 1956 or on taxpayer's likely behavioral response to the legislation is also clear from public analyses of the expected impact of the bill published by individual states. For example, California and Kansas differ substantially in their descriptions of the bill's expected impacts on their corporate income tax systems.

Both California and Kansas require companies that are unitary in operation to combine their incomes in determining their state corporate income taxes. Each taxpayer then apportions the combined income to the state based on the taxpayer's in-state share of the combined group's payroll, property and sales. California's analysis of the bill's impact<sup>4</sup> correctly points out that the federal legislation would not restrict the state's ability to require combined unitary filing for a unitary group (although it may affect the percentage of the combined income attributable to the state).

In sharp contrast, the Kansas analysis of H.R. 1956 implies that the bill could prevent the state from applying the unitary business principle. The analysis states: "If this [the assertion that the bill limits the unitary principle] is correct under H.R. 1956, then multi-state business enterprises could re-structure themselves to fit into one of more of the safe harbors and avoid the application of the unitary business principle. Their tax liability would be determined under separate accounting principles."<sup>5</sup> In fact, however, H.R. 1956 would not have any effect on a state's ability to require combined unitary filing. (The U.S. Supreme Court has condoned including entities that are not themselves subject to tax in the combined tax return.)

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<sup>3</sup> This section is generally limited to the states' differences of opinion regarding the impact of H.R. 1956. A more thorough discussion of this issue would include an analysis of the MTC's seriously flawed interpretations of the effect that H.R. 1956 would have on existing case law. The legal assumptions contained within the MTC's survey undoubtedly introduced further and significant bias into the revenue estimating process.

<sup>4</sup> California Franchise Tax Board, "Federal Business Activity Tax Proposal HR 3220," December 11, 2003. As pointed out in the NGA report (footnote 1, p. 1), the initial revenue estimate of the impact of the federal legislation was actually based on the provisions of H.R. 3220. The California analysis was also based on H.R. 3220.

<sup>5</sup> Kansas Department of Revenue, "Kansas Fiscal Impact Estimate of H.R. 1956," September 27, 2005, p.1.

This misunderstanding appears to have resulted in overstated losses from H.R. 1956 in Kansas. According to Appendix Table 1B, the states' best estimate of the total loss as a percent of business activity taxes, is 2 percent in California and 28.8 percent in Kansas. However, the NGA report includes another estimate of the same number for Kansas, 10.9 percent, in Table 3. It is not clear why the NGA report has two different numbers for Kansas.<sup>6</sup> In any case, one cannot expect consistent estimates of the bill's impact across states if states differ so significantly in their view of the fundamental impacts of the bill.

It appears that the MTC survey may have also contributed to this confusion. In a footnote in the glossary section of the survey instructions, the MTC provides examples of how firms might set up in-state affiliates to provide certain services and lead to the result, that while the affiliate has nexus in the state, "the rest of the business or corporate structure would be exempt [from taxation]."<sup>7</sup> This interpretation is, of course, inapplicable to unitary combined reporting states as the net income of the unitary group would still include the income of all the companies in the group, although the apportionment factors may be reduced under the bill.

### **Incomplete Information**

Although the NGA report includes a lengthy discussion of the possible impact of H.R. 1956 and a number of tables showing a wide range of tax losses, it contains little information on the actual estimating methodology. For this reason, it is not possible to judge the reasonableness of the estimates provided by the states. In other words, there is little explanation of how the states actually translated the anecdotal examples of revenue losses for a single firm—provided in the survey—into actual dollar losses for all of the state's business taxpayers.

It would be useful to have more information about the revenue estimates, such as:

- The states' estimates of the effect of H.R. 1956 by type of tax;
- The business activity taxes included in the states' analysis (For example, did the study include the New Mexico gross receipts tax, which has been recognized by state and federal courts as a transaction tax and thus not subject to the provisions of H.R. 1956?);
- The current thresholds for nexus used by the states (For example, did the states use a minimal dollar amount of payroll and property or a minimum percentage threshold? States were asked to provide this information, but it does not appear in the report.);
- How the states determined minimum, maximum and best point estimates; and
- How states differentiated between static and behavioral tax impacts.

The NGA should provide this information, which is critical in evaluating the validity of the report's results and which would be helpful for policy makers and analysts in understanding the size and composition of the revenue effects of H.R. 1956. More generally, the state-by-state estimates of the impact of H.R. 1956 should be subject to the same level of public scrutiny as any other bill analysis that a state revenue department would prepare for a tax bill. The additional information collected in the surveys and other feedback from the states should be made public to help policy makers understand these major differences between the state estimates and to reach a clear consensus on the likely tax effects of the bill.

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<sup>6</sup> The 10.9 percent figure seems more in line with the numbers included in the Kansas Department of Revenue September 27, 2005 public report on the estimated impact of H.R. 1956. It appears that the Kansas estimates of both the tax loss and business activity taxes are different in the two NGA report tables.

<sup>7</sup> Multistate Tax Commission, "Estimating Potential Revenue Impact of H.R. 3220 on State and Local Business Activity Taxes," Guidance and Methodology, May 14, 2004, p. 9.

### Biased Estimates

Even if the revenue estimators for the NGA study agreed—which they clearly do not—on the proper interpretation of the bill’s provisions and the probable behavioral responses of taxpayers, the NGA’s estimating process produced estimates that significantly overstate the revenue loss. The MTC survey explicitly instructed state revenue departments to use assumptions about the effects of H.R. 1956 that bias the estimate of the potential revenue impact upward. This bias is true both for the static impact estimates as well as the more speculative dynamic and compliance estimates. For example:

- The MTC survey asked state revenue departments to “assume that those businesses that are currently remitting business activity taxes but have \$0 *or de minimis* amounts of either property or payroll would not be subject to your states business activity taxes.”<sup>8</sup> Companies currently paying business activity taxes with “small” (*de minimis*) amounts of payroll or property are complying with current law thresholds for nexus. This MTC survey assumption is glaringly invalid because it is not the case that all such firms would automatically stop paying these taxes if H.R. 1956 is enacted.

If state revenue estimators actually eliminated taxes for all firms that had no or minimal payroll *or* property factors, they could be significantly overstating the potential revenue impact of H.R. 1956. A firm with no in-state property (or no payroll) may still have substantial amounts of the other factor that establishes nexus. For example, there are a number of state corporate income tax payers in each state with no property value in a state but payroll amounts that exceed several million dollars. For firms with this level of employees in a state, the change, for example, to a 22 day minimum threshold is highly unlikely to eliminate nexus and these firms should not be included in the revenue loss estimate.

Again, the MTC survey instructions asked states to report the *de minimis* level of the payroll and property factors. It would be useful to know what those *de minimis* levels were, by industry, and how they differ across states. Use of percentage thresholds for factors, for example, could significantly overstate revenue losses. A 0.01% property threshold for a large company, say \$10 billion of property nationally, would result in \$1 million of property in the state. This may be a very small fraction, but it is not a *de minimis* amount of in-state property. It is not reasonable to assume that this company would no longer have nexus in the state as soon as the bill is passed.

- It is not clear that the state revenue estimates included the positive impacts on state business taxes that would result from H.R. 1956. (The request from the MTC tellingly only asks about the revenue *lost* from the bill). For example, states with throwback rules should experience increased revenues if in-state firms have higher sales in states where they no longer have nexus. This will create a “windfall” of additional revenues in the throwback states that have more income apportioned to their state. While it may have been difficult for any one state to estimate this positive impact, the NGA should have included at least an aggregate estimate of this revenue increase.

As another example, it does not appear that estimators added in the additional revenues that would be created by the assumed additional business activities of in-state contractors and affiliates. The NGA report stresses the use of independent contractors as a possible behavioral change that reduces taxes. But, if a company switches to using in-state independent contractors rather than its

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<sup>8</sup> Multistate Tax Commission, p. 4.

own employees, then the independent contractors will have higher in-state receipts and income. This will naturally result in higher tax payments from those independent contractors, and those payments will partially offset the losses from other behavioral changes. If state estimators ignored this positive offset, the revenue losses in the NGA report are biased upward.

- The MTC instructions for estimating the “compliance” effects of H.R. 1956 are clearly biased toward higher impact estimates. The estimators were instructed to estimate any new dollars expected to be collected from current compliance activities that are not in current tax collections. In fact, current tax collections always include a compliance component. Because estimators do not know the size and composition of the current compliance dollars, they cannot estimate the “new” compliance amounts that could be precluded by the bill. In addition, given the on-going controversy over current nexus standards, it is just as likely that current tax collections contain compliance amounts that will have to be refunded to taxpayers because of court decisions favorable to taxpayers; these amounts should be subtracted from the baseline. Because of these estimating difficulties, the compliance estimates should not have been included at all.
- The estimates of tax losses may include revenue from taxes that are not affected by the bill or are expected to have little revenue impact due to the inability of firms to reduce physical presence in a state. Examples reported in the footnotes of the appendix tables in the NGA report include excise taxes that may be considered transaction taxes—which are not affected by the bill—and gross receipts taxes on specific industries, such as cigarette wholesalers, banks and public utilities—most taxpayers in these industries will have a significant physical presence in a state and thus those taxes are unlikely to be affected by the legislation. To avoid overstating the revenue losses for these specialized industry taxes, the revenue estimates should have been done on an industry-by-industry basis; if they were not, the revenue losses may be overstated.

### **Conclusion**

Credible estimates of the impact of federal legislation on state tax systems are critical to the full and fair debate of such legislation. Unfortunately, the recently released NGA study of H.R. 1956 is simply not credible. As discussed in this paper, the NGA study includes numerous shortcomings that seriously undermine its usefulness in the debate over H.R. 1956. Given their membership, the NGA and the MTC are in a unique position to provide meaningful data regarding the fiscal impact on the states of proposed federal legislation. In the case of H.R. 1956, however, the NGA and the MTC have widely missed the mark.

In an effort to enhance the public policy debate on H.R. 1956 and similar measures which are of critical import to both states and the business community, COST stands willing to work the NGA and the MTC prior to the release of any future revenue estimates.