Order Code RL32297

CRS Report for Congress
Received through the CRS Web

State Corporate Income Taxes: A Description and Analysis

Updated December 22, 2005

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Summary

Recently, state corporate income taxes have become the subject of renewed interest to both state and federal policymakers. The cause of this elevated interest may be the gradual decline in revenue generated by the tax, the expansion of electronic commerce, and/or federal tax policy that affects state corporate income taxes. Congress has had a role in state corporate income taxes for at least two reasons: (1) interstate commerce regulatory oversight and (2) federal and state corporate income tax interaction. Congress may become more involved in state corporate tax issues because of recent changes in interstate commerce and how states administer corporate taxes.

The state corporate income tax is not a major source of revenue for states, but is still an important contributor to state finances. Over the last decade, state corporate income taxes generated approximately 5% of state tax revenue. However, the revenue generated by the tax — measured as a percentage of gross domestic product — has been gradually declining. Several explanations have been offered for this gradual decline including (1) state policy decisions to lower the tax burden on corporations; (2) aggressive tax planning by corporations; (3) broad economic cycles diminishing the base; and (4) federal corporate income tax policy. Most research has identified the first two factors as the primary cause for the recent decline.

Many corporations operate in multiple tax jurisdictions which makes the state corporate income tax a relatively complex tax to administer. The base of the corporate income tax (net income or profits) must be fairly apportioned to all of the states where the firm has established a presence (or nexus). A mosaic of nexus standards has been created through multistate tax compacts, state and federal legal decisions, and congressional actions. At present, states do not use a uniform definition of taxable profits or use a uniform method of apportioning income.

Legislation was introduced in the 108th Congress that would have addressed some of the issues identified above. Nexus issues were addressed in what was identified as "streamlining" legislation. Generally, the streamlining legislation would have allowed states to require out-of-state vendors to collect sales and use taxes even if the out-of-state vendor does not have nexus in the taxing state. Participating states would have to simplify sales and use taxes before Congress would confer collection enforcement authority. Interstate commerce has complicated the nexus issue for sales and use tax administration and how this issue is resolved may have broader implications for state corporate income taxes.

On December 13, 2005, the House Judiciary Commercial and Administrative Law Subcommittee approved H.R. 1956. This legislation addresses nexus issues for state corporate income taxes directly, and is often identified as "brightline" legislation. H.R. 1956 would establish more uniform standards — generally higher standards — for the level of business activity that would trigger nexus and thus corporate income taxability. This report will be updated as legislative events warrant.

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Congressional interest in state corporate income taxes arises from two distinct issues. First, Congress has a direct role in the oversight and regulation of interstate economic activity. State taxation of multi-state corporations would certainly be included in this jurisdiction. Second, federal corporate income tax policy changes have a direct effect on state (and local) tax structure.[1] Congressional activity, or in some cases inactivity, in these two areas can have a pronounced effect on state budget decisions. After an overview of state corporate income taxes, this report analyzes both the interstate commerce oversight and tax interaction issues. The last section of the report describes and analyzes legislation that would affect state corporate income taxes.

State Corporate Income Taxes: Overview

For most observers, state corporate income taxes are the most familiar state tax that businesses pay. However, corporate income taxes generated less than 5.2% of total state tax revenue in 2004. In contrast, general sales and use taxes, of which businesses pay a large portion, accounted for approximately 33.4% of state tax revenue.[2] Even though state corporate income taxes represent a relatively small portion of total state tax revenue in most states, the state corporate income tax still generated $30.8 billion in 2004. And, in some states, the corporate income tax contributes a much larger share of total tax revenue. For example, from 1972 to 2004, the corporate income tax averaged approximately 19.8% of total state tax revenue in New Hampshire. In contrast, the corporate income tax contributed 3.7% of total tax revenue in South Dakota.[3] **Table 1** reports the average reliance on corporate income taxes for each state over the 33-year span, 1972 to 2004.

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[1] State taxation of international firms and individuals is also of interest to Congress. International tax policy, however, extends beyond the scope of this report.

[2] Data are CRS calculations based on U.S. Census of Governments data. These data is available at the following website [http://www.census.gov/govs/www/statetax04.html]. Robert Cline, Tom Neubig, Andrew Phillips, and William Fox, "Total State and Local Business Taxes: Nationally 1980-2004 and by State 2000-2004," *State Tax Notes*, May 9, 2005, estimated that businesses paid approximately 43% of total state and local taxes. A separate estimate of the portion of total sales tax revenue collected from businesses was not provided.

[3] CRS calculations based on U.S. Census of Governments data; see above for website link.

Table 1. Average State Corporate Income Tax Revenue as Share of Total Tax Revenue, 1972 to 2004

State	Corporate income tax share of total tax revenue	State	Corporate income tax share of total tax revenue
Alabama	4.84%	Montana	7.28%
Alaska	19.01%	Nebraska	5.30%
Arizona	5.77%	Nevada	no C.I.T.
Arkansas	6.15%	New Hampshire	19.77%
California	10.98%	New Jersey	9.70%
Colorado	5.04%	New Mexico	4.27%
Connecticut	10.62%	New York	8.68%
Delaware	9.09%	North Carolina	7.75%
District of Columbia*	5.47%	North Dakota	6.98%
Florida	5.59%	Ohio	6.23%
Georgia	7.11%	Oklahoma	4.06%
Hawaii	3.15%	Oregon	7.49%
Idaho	6.46%	Pennsylvania	9.40%
Illinois	8.19%	Rhode Island	6.58%
Indiana	6.14%	South Carolina	5.90%
Iowa	5.45%	South Dakota	3.71%
Kansas	7.84%	Tennessee	8.67%
Kentucky	6.25%	Texas	no C.I.T.
Louisiana	6.57%	Utah	4.71%
Maine	4.92%	Vermont	5.42%
Maryland	4.74%	Virginia	5.23%
Massachusetts	10.85%	Washington	no C.I.T.
Michigan	12.91%	West Virginia	5.45%
Minnesota	7.53%	Wisconsin	7.00%
Mississippi	5.03%	Wyoming	no C.I.T.
Missouri	4.75%		

Source: CRS calculations based on U.S. Census Bureau, Governments Division, *Federal, State, and Local Governments: State Government Tax Collections*. These data is available at the following website [http://www.census.gov/govs/www/statetax.html].

* Data for the District of Columbia are from the District of Columbia Government, *FY2006 Proposed Budget and Financial Plan*, and represent the years 1994 to 2004.

As New Hampshire and South Dakota show, the dependence on corporate income taxes varies considerably from state to state; thus, federal corporate income tax policy does not have a uniform effect on all states. The remainder of this section describes the mechanics behind state corporate income taxes, highlighting the differences among states. Understanding the nuances of state corporate income taxes is necessary for a complete discussion and analysis of interstate commerce issues and the link between federal and state tax policy.

The Mechanics of the State Corporate Income Tax

Generally, the state corporate income tax is levied on the accounting profits of a corporation.[4] The portion of profit that can be attributed to a state serves as the base for that state's corporate income tax. Profits are allocated to a state based on the amount of economic activity that occurs in that state. Following is a more detailed description of the state corporate income tax structure.

Federal Starting Point. Most states and the District of Columbia incorporate the federal income tax code as currently amended (20 states) or as of a specific date (17 states).[5] The remaining states typically use a measure of income that closely follows the federal definition of taxable income. Using the federal starting point likely eases the compliance burden for corporations, particularly those that have nexus in several states. Nevertheless, many states still require corporations to "add-back" to income exclusions that are allowed under federal corporate income tax rules.[6]

The Uniform Division of Income for Tax Purposes Act (UDITPA). The Uniform Division of Income for Tax Purposes Act (UDITPA) is a model act drafted and adopted by the Commissioners on Uniform State Laws and the American Bar Association. The act sets standards for separating income into business income, which is apportioned to states, and non-business income, which is allocated entirely to the entity's home state.[7] Generally, non-business income is defined as passive income on corporate owned assets; income from these assets could include dividends, rents, and royalties. Corporations could avoid paying taxes on non-business income by locating in states without a corporate income tax.[8] Some states, through the Multistate Tax Compact (MTC), have voluntarily adopted uniform rules and procedures for the allocation and apportionment of income — as defined under UDITPA — to ease the compliance burden on multistate businesses.[9] Many of the states that have not formally adopted UDITPA standards still closely adhere to the UDITPA standards.

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[4] Net income is revenue less expenses, which is roughly equivalent to pre-tax accounting profits.

[5] These 37 states directly incorporate the federal tax code, however, all states except for Arkansas and Mississippi, use federal income for the starting point for purposes of calculating income tax liability.

[6] Bureau of National Affairs, "Multistate Tax Report: 2003 Survey of State Tax Departments," vol. 10, no. 4, Apr. 25, 2003. The report identifies the add-backs and other special corporate income tax rules for each state.

[7] For more on UDITPA, see John S. Warren, "UDITPA — A Historical Perspective," *State Tax Notes*, Oct. 3, 2005, pp. 133-136.

[8] A "throwback" or unitary accounting rules would limit this type of tax planning to avoid taxation of non-business income.

[9] According to the Commerce Clearing House (CCH) publication, State Corporate Income Tax Guide, seven states have enacted UDITPA as written and 12 more states have adopted UDITPA with some minor modifications.

The Profit Apportionment Formula. Typically, three factors of economic activity are used in the apportionment formula to measure the economic presence of a firm in a state: the percentage of property, the percentage of sales, and the percentage of payroll. Not all states weigh factors equally; some over-weight sales or use only sales to allocate income (often called single-factor sales apportionment). In theory, the weighting should accurately portray the economic presence of the firm. There is no consensus on the definition of "economic presence," and hence there is variation among state apportionment formulas.

Some analysts have suggested that a formula that double-weights sales is the ideal formula because it gives equal weight to input factors (property and payroll), and an output factor (sales).[10] Others have argued that the business tax should be levied based on the business's use of government services provided by the firm's resident state. For example, a corporate income tax that is levied according to the value of one input only, such as property, could be justified because the value of property is closely related to the level of government services provided to the business by the home state. However, corporations also receive benefits from an out-of-state customer's well functioning legal system and public infrastructure. An apportionment formula that includes just the property factor would not compensate the out-of-state customer's government for the benefit to the corporation of those public services.

The general form of the apportionment formula is reproduced below. The superscript *i* represents the profits (π), sales (*s*), property (*p*), and labor (*l*), a state attributes to the *i*-th firm. The superscript *T* represents the total value of each factor and profits for the firm in a given tax year. The subscript *w* represents the weight of each respective factor as defined by state law; the weights sum to one.

For example, states that use an even-weight formula would use 0.33 for each *w*, meaning each factor contributes equally to the determination of profits attributable to a state. If the state were to "double-weight" sales, that means that the w_s is twice

$$\pi^i = \pi^T \times \left[\left(\frac{s^i}{s^T} \right) \times w_s + \left(\frac{p^i}{p^T} \right) \times w_p + \left(\frac{l^i}{l^T} \right) \times w_l \right]$$

the amount of each of the other two weights. In the case of double-weight sales, w_s=0.50; w_p=0.25; and w_l=0.25.

Nexus. The apportionment formula does not imply that a business that sells goods and services into a state, owes taxes to that state. A state can levy a corporate income tax on a business only if the business maintains a substantial nexus in the state. The nexus rules governing the corporate income tax were partially circumscribed by Congress through P.L. 86-272, (the act). The act established that the mere solicitation of the sale of *tangible* goods by a firm in a state was not

[10] James Francis and Brian H. McGavin, "Market Versus Production States: An Economic Analysis of Apportionment Principles," in *State Taxation of Business: Issues and Policy Options*, Thomas Pogue, ed. (New York: Praeger Publishers, 1992), p. 61.

substantial nexus for corporate income tax purposes. However, for intangible goods and services, there is significant variation from state to state in how physical presence is defined.

The Bureau of National Affairs periodically surveys state revenue departments about activities that could create nexus.[11] The responses highlight the differential treatment from state-to-state of business activities deemed to create nexus. For example, according to the report, 24 states reported that an out-of-state corporation that reimbursed its in-state salespersons had established nexus whereas 19 states reported that activity would not. Establishing a web server in a state created nexus in 16 states whereas 23 states did not indicate that maintaining a web server would establish nexus.

Throwback Rule. Because of the state-by-state variation in nexus rules, the first step for corporations before apportioning income is to determine the states where the firm has established nexus. The firm then allocates profits to these states based on each respective state's apportionment formula. The different state apportionment formulas and nexus rules, however, often lead to what is termed "nowhere income."[12] Nowhere income arises because not all states have the same apportionment formula and some states do not levy a corporate income tax. For this reason, some states impose corporate income tax rules that stipulate that all sales to customers in states that do not tax the sales (through a corporate income tax) are "thrown back" to the home state.

For example, a California firm that sells goods to customers in Nevada — which does not have a corporate income tax — would include Nevada sales in the numerator of the sales factor component of the California apportionment formula. If Nevada had a corporate income tax with a sales factor in the apportionment formula, California would not require the firm to include the Nevada sales in the California corporate income tax apportionment formula. The throwback rule is applied in 24 states and the District of Columbia; 22 states do not impose a throwback rule; and four states do not impose a corporate income tax (see **Table 2**).[13]

State Apportionment Formulas. **Table 2** groups states based on their corporate income tax apportionment formula. "Even-weight" implies that the each factor is weighted the same or one-third. The hybrid arrangements allow firms to choose the type of apportionment scheme that minimizes tax burden or instructs the firm to use different types of allocation based on the source of income. The most common apportionment formula is the double weighted sales scheme.

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[11] Bureau of National Affairs, *Multistate Tax Report: 2003 Survey of State Tax Departments*, vol. 10, no. 4, Apr. 25, 2003.

[12] The converse is also true. Income could also be *overtaxed* because of the variety of apportionment formulas employed by states.

[13] Commerce Clearing House, *Multistate Corporate Income Tax Guide*. Texas imposes a gross receipts tax that operates as a corporate income tax although it is not technically a corporate income tax. Texas uses a throwback rule for the gross receipts tax.

Table 2. State Corporate Income Tax Apportionment Formulas

Apportionment scheme (number of states)	States
Even-weight (11)	Alabama, Alaska, Delaware, District of Columbia, Hawaii, Kansas, Montana, North Dakota, Rhode Island, Utah, and Vermont.
Even-weight hybrid (3)	Missouri, firms choose either even weight or single factor sales; New Mexico, certain manufacturing firms can choose double-weight sales, otherwise even-weight; Oklahoma, firms meeting certain investment criteria can choose double-weight sales, otherwise even-weight.
Double-weight sales (19)	Arizona, Arkansas, California, Florida, Georgia, Idaho, Indiana, Kentucky, Louisiana, Maine, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Tennessee, Virginia, West Virginia, Wisconsin.
Double-weight sales hybrid (3)	Connecticut, double-weight sales for income derived from the sale or use of tangible personal or real property, single-factor sales for other income; Maryland, manufacturers use single-factor sales, otherwise double-weight sales; South Carolina, double-weight sales for manufacturers and dealers in tangible personal property, otherwise single-factor sales.
Single-factor sales (3)	Illinois, Iowa, and Nebraska.
Other weight allocations (5)	(in percentages, sales- payroll-property) Michigan, 90-5-5; Minnesota, 75-12.5-12.5; Ohio, 60-20-20; Oregon, 80-10-10; and Pennsylvania, 60-20-20.
Other hybrids (2)	Colorado, firms choose between a three-factor even-weight and a two-factor (sales and property) even-weight; Mississippi, retailers, wholesalers, service companies, lessors use single-factor sales, wholesale manufacturers use even-weight three factor, retail manufacturers use three-factor, double-weighted sales.
No general corporate net income tax (5)	Nevada, South Dakota (bank & financial corporation excise tax), Texas (gross receipts tax), Washington, and Wyoming.

Source: Commerce Clearing House, Multistate Corporate Income Tax Guide.

State Corporate Income Tax Rates. Rates on corporate income taxes vary considerably. The state with highest rate, Iowa, taxes all taxable income in excess of $250,000 at 12%. Iowa is also one of three states (Nebraska and Illinois being the others) that use a single-factor sales apportionment formula. The rates for each state are listed on the following page in **Table 3**. The highest marginal rates listed in **Table 3** do not necessarily represent the relative burden of state corporate income taxes in each state. The best measure of the relative corporate income tax burden for each state is the *average effective* marginal tax rate (AEMTR). The AEMTR would incorporate differences among states in the definition of taxable income. Nevertheless, the marginal rates do provide some information about the relative burden of corporate income taxes across states.

Table 3. State Corporate Income Tax Rates, 2005

State	Highest rate	Number of rates	State	Highest rate	Number of rates
Alabama	6.500%	one	Montana	6.750%	one
Alaska	9.400%	multiple	Nebraska	7.810%	multiple
Arizona	6.968%	one	Nevada	no tax	n/a
Arkansas	6.500%	multiple	New Hampshire	8.500%	one
California	8.840%	one	New Jersey	9.000%	multiple
Colorado	4.630%	one	New Mexico	7.600%	multiple
Connecticut	7.500%	one	New York	7.500%	one
Delaware	8.700%	one	North Carolina	6.900%	one
D.C.[a]	9.975%	one	North Dakota	10.500%	multiple
Florida	5.500%	one	Ohio[e]	8.500%	multiple
Georgia	6.000%	one	Oklahoma	6.000%	one
Hawaii	6.400%	multiple	Oregon	6.600%	one
Idaho	7.600%	one	Pennsylvania	9.990%	one
Illinois[b]	4.800%	one	Rhode Island	9.000%	one
Indiana	8.500%	one	South Carolina	5.000%	one
Iowa	12.000%	multiple	South Dakota[f]	6.000%	multiple
Kansas	4.000%	one	Tennessee	6.500%	one
Kentucky	8.250%	multiple	Texas[g]	4.500%	one
Louisiana	8.000%	multiple	Utah	5.000%	one
Maine	8.930%	multiple	Vermont	9.750%	multiple
Maryland	7.000%	one	Virginia	6.000%	one
Massachusetts[c]	9.500%	one	Washington	no tax	n/a
Michigan	1.900%	one	West Virginia	9.000%	one
Minnesota[d]	9.800%	one	Wisconsin	7.900%	one
Mississippi	5.000%	multiple	Wyoming	no tax	n/a
Missouri	6.250%	one			

Source: Commerce Clearing House, Multistate Corporate Income Tax Guide.

a. The D.C. rate is new beginning with the 2004 tax year.
b. S Corporations, partnerships, and trusts are taxed at a maximum 6.3% rate.
c. Financial institution net income is taxed at 10.5%. Corporations also pay a surtax on property located in Massachusetts and not taxed at the local level.
d. Minnesota also levies a fee based on the total payroll, property, and sales of the corporation. The fee raises the maximum tax rate and creates very slight progressivity.
e. Ohio allows firms to choose an alternative of four mills (or 0.4%) multiplied by taxable net worth.
f. South Dakota taxes only banks and financial institutions. The rates fall as net income rises from a high of 6.0% for the first $400 million to 0.25% for the amount over $1.2 billion.
g. Texas taxes “net taxable earned surplus” and adds a surtax of 0.25% on net taxable capital.

State Corporate Income Tax Revenue: 1972 to 2004

According to CRS calculations based on data from the U.S. Census Bureau, state tax revenue from state corporate income taxes grew (in nominal dollars) in all fiscal years except for 1982, 1983, 1992, 1993, 1999, 2001, and 2002. As a portion of gross domestic product (GDP), however, corporate tax revenue has declined from an annual average of 0.43% of GDP over the FY1972 to FY1982 time frame to 0.33% of GDP over the FY1994 to FY2004 time frame. State corporate income tax revenue has become a significantly smaller part of the economy over the last decade. **Table 4** reports state corporate tax revenue and GDP for states that impose a state corporate income tax.[14]

Table 4. State Corporate Income Tax Revenue and Gross Domestic Product, FY1972 to FY2004

Fiscal year	State corporate tax revenue (in billions)	State corporate tax revenue as percentage of GDP	Fiscal year	State corporate tax revenue (in billions)	State corporate tax revenue as percentage of GDP
1972	$4.4	0.36%	1989	$23.9	0.44%
1973	$5.4	0.39%	1990	$21.8	0.37%
1974	$6.0	0.40%	1991	$20.4	0.34%
1975	$6.6	0.41%	1992	$21.9	0.34%
1976	$7.3	0.40%	1993	$24.2	0.36%
1977	$9.2	0.45%	1994	$25.5	0.36%
1978	$10.7	0.47%	1995	$29.1	0.39%
1979	$12.1	0.47%	1996	$29.3	0.38%
1980	$13.3	0.48%	1997	$30.7	0.37%
1981	$14.1	0.45%	1998	$31.1	0.36%
1982	$14.0	0.43%	1999	$30.8	0.33%
1983	$13.2	0.37%	2000	$32.5	0.33%
1984	$15.5	0.39%	2001	$31.7	0.31%
1985	$17.6	0.42%	2002	$25.9	0.24%
1986	$18.4	0.41%	2003	$28.5	0.26%
1987	$20.5	0.43%	2004	$30.8	0.26%
1988	$21.6	0.42%			

Source: CRS calculations based on U.S. Census Bureau, Governments Division and Bureau of Economic Analysis.

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[14] The governments division of the Census Bureau collects and reports state tax collections by type of tax based on survey information from the states.

Several causes have been suggested for the relatively decline in state corporate tax revenues in FY2001 and FY2002.[15] The most direct causes would be legislated changes in the tax rate, the tax base, or the compliance rules. The decline in revenue could be the result of state governments, in the aggregate, attempting to lower the tax burden on corporations. The December 2003 Fiscal Survey of States reported that states, in the aggregate, enacted net tax cuts every year from FY1995 through FY2001.[16] Even though these tax cuts were not separated into types of tax by the Fiscal Survey, it seems likely that state corporate income taxes were included in the tax cuts. Recent research has reached a similar conclusion, noting that "[S]tate tax bases have deteriorated further than the federal base because of a combination of **explicit state actions** [emphasis added] and tax avoidance/evasion by businesses."[17]

A second explanation, alluded to above, is that corporations are more effectively avoiding, or even evading taxes through aggressive tax planning.[18] The Multistate Tax Commission (MTC) concluded in a recent study that "...various corporations are increasingly taking advantage of structural weakness and loopholes in the state corporate tax systems."[19] Again, the MTC study cannot definitively separate the revenue declines arising from policy changes and avoidance/evasion, but still concludes that tax avoidance and evasion is partly responsible for the decline in state corporate tax revenues.

A third explanation is that cyclical economic changes have led to the decline in state corporate tax revenues. Note that cyclical economic effects are unrelated to the behavior of policymakers or corporations. The effect of economic cycles on revenue is difficult to identify because the legislated changes and the corporate behavior described above likely exacerbated (or attenuated) the cyclical economic changes. Recent research into the causes of state budget deficits, suggested that "the current [cumulative state] deficit is largely structural...."[20] The implication of this finding is that policy (structural) changes like tax cuts and discretionary spending increases generated state budget deficits in FY2002 and FY2003, not the machinations of the economic cycle.

Finally, changes to the federal corporate income tax code, which have reduced the base of most state corporate income tax systems, could explain part of the decline in state corporate income tax revenue. A recent report, however, noted that "nearly

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[15] William F. Fox and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," *National Tax Journal*, vol. LV, no. 3, Sept. 2002, pp. 491-508. (Hereafter cited as Fox and Luna, *State Corporate Tax Revenue Trends*.)

[16] National Association of State Budget Officers, December 2003 Fiscal Survey of States.

[17] Fox and Luna, *State Corporate Tax Revenue Trends*, p. 498.

[18] Tax avoidance is a legal means of reducing tax liability, such as buying tax-exempt bonds. In contrast, tax evasion is illegal, such as not claiming otherwise taxable income.

[19] Multistate Tax Commission, "Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections," July 15, 2003, from the *Executive Summary.*

[20] Brian Knight, Andrea Kusko, and Laura Rubin, "Problems and Prospects for State and Local Governments," paper presented at Urban Institute Seminar, State Fiscal Crises: Causes, Consequences, and Solutions, Apr. 5, 2003.

two-thirds [of states] refused to go along with President Bush's 2001-2004 'bonus depreciation.'...."[21] The next section discusses the interaction between federal and state corporate income taxes in more detail.

Issues for Congress

State corporate income taxes are of interest to Congress for primarily two reasons: interstate commerce oversight and tax interaction. The following section analyzes these two aspects of state corporate income taxation that are most directly affected by congressional action.

Interstate Commerce Regulation and Oversight

The interstate commerce regulation and tax interaction issues have attracted interest for three principal reasons: (1) the complex Internet sales tax debate; (2) the recent federal business tax cuts; and (3) state fiscal issues. The link between the Internet sales tax debate and state corporate income taxes is complicated and centers on the prohibition on states reaching beyond their borders to compel out-of-state vendors to collect sales and use taxes.[22] As a general rule, a state can require a vendor to collect sales and use taxes only if the vendor has "substantial nexus" in the state.[23] Typically, the substantial nexus standard is satisfied if the vendor has a physical presence in the state.[24] Thus, remote Internet transactions, where the vendor has no physical presence in the customer's home state, do not have the sales and use tax added to the price of the good by the vendor. These types of transactions have grown considerably over the last several years and have contributed to the erosion of the sales and use tax base of most states.[25]

In an effort to persuade Congress to allow states to compel remote vendors to collect use taxes, a coalition of states has been working together to establish a uniform sales and use tax agreement. The coalition of states identify this effort as the "Streamlined Sales and Use Tax Project." States that sign onto the sales tax compact would have already implemented uniform definitions and compliance rules, thus easing the administrative burden of remote vendor collection. Two bills in the 108th

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[21] McIntyre, Robert S and T.D. Coo Nguyen, "State Corporate Income Taxes 2001-2003," *State Tax Notes*, March 7, 2005, pp. 685-712.

[22] A *sales* tax is levied at the time of transaction and is tax on the sale. The companion *use* tax is a tax on the *use* of a good or service. Technically, remote vendors would collect a use tax because the product is going to be used in the customer's home state.

[23] The limitation arises from the due process and commerce clauses in the U.S. Constitution.

[24] For more on the sales tax issue, see CRS Report RL31252, *Internet Commerce and State Sales and Use Taxes,* by Steve Maguire.

[25] Donald Bruce and William F. Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," *Center for Business and Economic Research*, University of Tennessee, September 2001. Bruce and Fox estimated this erosion from electronic commerce alone will result in states losing approximately $24.2 billion in 2006 and $29.2 billion in 2011. There is considerable debate, however, about the size of the revenue loss.

Congress would have granted states these rights.[26] If these bills were enacted and the states satisfied the requirements for qualification, remote vendors in the compact states would collect use taxes for shipments to states where the vendor does not have a substantial nexus.

Some vendors are concerned that collecting use taxes for a state in which they do not have nexus, could trigger income or other business tax liability. However, past court decisions and the landmark P.L. 86-272 established physical presence as the standard for sufficient nexus for corporate income taxes for firms selling tangible goods. The law, P.L. 86-272, was passed shortly after the Supreme Court issued a ruling that seemed to offer an ambiguous definition of "sufficient nexus." The Supreme Court language that generated this concern (as cited in the Senate report on S. 2524, the Senate version of the eventual P.L. 86-272) is reproduced below:

> We conclude that the net income from the interstate operations of a foreign corporation may be subjected to State taxation provided the levy is not discriminatory and is properly apportioned to *local activities within the taxing State forming sufficient nexus to support the same.* [Emphasis added] (358 U.S. 450 at 452)[27]

The term "local activities" was deemed too ambiguous by policy makers and businesses. The Senate report provided the following as reasoning behind the enacted legislation (P.L. 86-272) that clarified the definition:

> Persons engaged in interstate commerce are in doubt as to the amount of local activities within a State that will be regarded as forming a sufficient "nexus," that is, connection, with the State to support the imposition of a tax on net income from interstate operations and "properly apportioned" to the State.[28]

The legislation passed by Congress clarified nexus by identifying those activities which would *not* establish nexus. Generally, soliciting sales of tangible goods in a state for shipment by common carrier from locations outside the state into the state, would not be sufficient to trigger nexus. Thus, for tangible goods shipped across state lines, state net corporate income taxes are levied at the *source* not the *destination* of the product. The home state of the customer receiving the goods cannot levy a state corporate income tax on the remote business by virtue of the transaction. The issue of intangible goods and services was not addressed directly by P.L. 86-272.

The Internet sales and use tax debate has revived a discussion of what constitutes nexus for a corporate income tax. Clarified nexus standards, however, do not seem destined to fundamentally alter the administration of state corporate income taxes. As noted above, current laws would already shield out-of-state vendors from

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[26] S. 1736 and H.R. 3184 in the 108th Congress.

[27] U.S. Congress, Senate Committee on Finance, *State Income Taxes — Interstate Commerce*, Senate report to accompany S. 2524, S.Rept. 658, 86th Cong., 1st sess. (Washington: GPO, Aug. 11, 1959) p. 2549.

[28] Ibid.

corporate income tax liability if the business were only soliciting the sale of tangible goods into the state. As for intangibles goods and services, policymakers would likely insert language to ensure that a corporation would not establish nexus by virtue of collecting sales and use taxes.[29]

Tax Interaction

The "Jobs and Growth Tax Relief Reconciliation Act of 2003" (JGTRRA, P.L. 108-27), included several provisions that reduce the federal tax burden on business investment.[30] The federal tax changes also affected state taxes because of the interaction between federal taxes and state taxes on corporations. Generally, states use the federal tax code as the base for the state income tax (see the background section titled "federal starting point").[31] Thus, when the federal definition of the tax base changes, so does the state definition of income.[32]

JGTRRA included two temporary provisions designed to accelerate the depreciation of capital assets purchased by businesses. The first is a temporary increase in the amount of a capital expenditure that a small business can deduct in the year of purchase.[33] The larger deduction reduces the base of the federal corporate income tax and thus the state corporate income tax base for those states that link directly to the federal tax code. The change in federal law may generate a significant revenue loss in the short run for those states that remain linked to the federal definition of business income.[34] This provision would have expired on December 31, 2005, but was extended through December 31, 2007, by the *American Jobs Creation Act of 2004*, (P.L. 108-357).

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[29] Section 7(a) of S. 1736 from the 108th Congress states that "[N]othing in this Act shall be construed as subjecting sellers to franchise taxes, income taxes, or licensing requirements of a state or political subdivision thereof, nor shall anything in this Act be construed as affecting the application of such taxes or requirements or enlarging or reducing the authority of any State to impose such taxes or requirements."

[30] For more on the business tax cuts in P.L. 108-27, see CRS Report RL32034, *The Jobs and Growth Tax Relief Reconciliation Act of 2003 and Business Investment*, by Gary Guenther.

[31] Many states, as noted earlier, have decided not to incorporate recent federal changes. For more, see McIntyre, Robert S and T.D. Coo Nguyen, "State Corporate Income Taxes 2001-2003," *State Tax Notes*, Mar. 7, 2005, pp. 685-712.

[32] Another issue is fiscal policy coordination between the federal, state, and local governments. If state governments do not adopt the federal tax changes, then the fiscal stimulus of federal tax policy is muted by state non-compliance. For more on the countervailing fiscal stimulus effects, see CRS Report RL31936, *General Revenue Sharing: Background and Analysis*, by Steven Maguire.

[33] 26 U.S.C. § 179.

[34] According to a recent analysis by the Center on Budget and Policy Priorities, "... 17 states stand to lose an estimated $1.1 billion in 2004 and another $600 million by the end of 2005." Nicholas Johnson, "Federal Tax Changes Likely to Cost States Billions of Dollars in Coming Years," *Center on Budget and Policy Priorities*, June 5, 2003, p. 5.

A second JGTRRA provision allowed for "bonus depreciation" for certain capital expenditures. Businesses that buy qualified capital assets before January 1, 2005 could have immediately deducted 50% of the purchase price from gross income. The combined effect of the two original provisions (not including the 2004 extension of the small business deduction described above) would cost states an estimated $2.7 billion. If the provisions were made permanent, the cost to the states has been estimated to rise to $17.7 billion over the 2004-2013 budget window.[35]

Proponents of the accelerated depreciation provisions, however, would argue that over the long run, increased business investment would likely lead to stronger economic growth and in turn *more* corporate income tax revenue. The long run net budget outcome of the two countervailing forces is uncertain and relies on debatable assumptions about the response of businesses to investment incentives delivered through the federal tax code.

The JGTRRA provisions adversely affect state budgets in the short run because the tax relief is delivered through changes in the base. If Congress were concerned primarily with the impact of federal corporate income tax law changes on the states, changes in corporate income tax *rates* would have minimal impact on the states. Unlike changes in the tax base, a federal tax rate change would not directly affect state corporate income taxes.

Legislative Activity

Some legislation in the 108th Congress would have authorized states to compel remote vendors to collect sales and use taxes.[36] Even though the bills address the collection of state sales and use taxes, not state corporate income taxes, some policymakers believe that the issues are similar to those surrounding the state corporate income tax. Related legislation would have established a "physical presence" standard for business activity taxes (BATs, primarily state corporate income taxes). Following is a brief overview of selected legislation introduced in the 108th Congress that would have affected state corporate income taxes. In the 109th Congress, H.R. 1956, which on December 13, 2005, was approved by the House Judiciary Commercial and Administrative Law Subcommittee, addresses the nexus standards for purposes of levying a state corporate income tax.

H.R. 3184 and S. 1736 (108th Congress). Two identical bills (H.R. 3184 and S. 1736), each given the title of the "Streamlined Sales and Use Tax Act (SSUTA)," would have authorized states to require out-of-state vendors to collect sales and use taxes. The authority would only be granted once "... 10 states comprising at least 20 percent of the total population of States imposing a sales tax ... have petitioned for membership under the Streamlined Sales and Use Tax

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[35] Nicholas Johnson, "Federal Tax Changes Likely to Cost States Billions of Dollars in Coming Years," *Center on Budget and Policy Priorities*, June 5, 2003, Tables 2 and 3.

[36] S. 1736 and H.R. 3184 in the 108th Congress.

Agreement...."[37] Businesses with less the $5 million in sales would have been exempt from the requirement.[38] And, businesses that collect the tax would have received "reasonable compensation" from the states for expenses incurred for "administration, collection and remittance of sales and use taxes."[39] The connection to states through the sales and use tax administration has raised concern that implementing the SSUTA would pave the way for states to claim that out-of-state vendors have established nexus. Section 7 of H.R. 3184 (and S. 1736), however, outlines the limitations of the proposed SSUTA. The legislation explicitly states that "No obligation imposed by virtue of the authority granted by section 4 shall be considered in determining whether a seller has a nexus with any State for any tax purpose."[40]

H.R. 1956 (109th Congress). Under current law, sales of "tangible personal property" into a state are not sufficient to trigger tax liability. H.R. 1956 would expand the protection beyond tangible personal property to include services.[41] This expansion would have had a significant effect on the 32 states where "... an employee's solicitation of services while in the state for six or fewer days would create nexus."[42]

In addition to the expansion of protected interactions, this legislation would have also defined "physical presence" as the standard for collecting business activity taxes. Under this proposal, physical presence would be established and a business activity tax allowable if:

- the individual or business is physically within the state for 21 days (not including trips to buy goods or services for the business; gathering news for print or other media; meeting with government officials for purposes other than selling goods and services; attending training or educational purposes; or participating in charitable events),

- the individual or business uses the services of another individual or business for 21 days and the hired individual or business does not do business for any other entity, or

- the individual or business leases or owns tangible personal property or real property in the state for more than 21 days.

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[37] Section 4(a).

[38] Section 4(b).

[39] Section 4(c).

[40] Section 7(b).

[41] Generally, H.R. 1956 strikes the "tangible personal property" identifier and inserts "or transaction." This change would presumably expand the "protected" activity to include service transactions.

[42] BNA, Apr. 25, 2003.

An important exception to the "21-day rule" is included in the legislation and is related to live performances and sporting events. Generally, the 21-day minimum is replaced with one day for live performances and participation in sporting events where at least 100 spectators are present. There is not a uniform number of days under current state laws, but, most states impose a minimum that is less than 21 days.

Analysis. The streamlined sales tax legislation, H.R. 3184 and S. 1736, would have required states to simplify their sales and use tax systems before granting them the authority to compel remote vendors to collect the sales and use tax. From an economic perspective, reduced complexity and compliance costs for businesses, not just those engaged in interstate commerce, would likely increase the efficiency of the tax system. To the extent that the changes imposed by the legislation would treat all transactions neutrally, they would also increase the equity of the tax system.

The critical concern is how stringent the SSUTA enforcement will be if implemented. If the agreement is not strictly enforced, then any gains in economic efficiency are lost and the anticipated improved equity diminished. The de minimus standards could be administratively difficult to enforce and could create loopholes through which businesses could circumvent the intent of the SSUTA. These standards could be eliminated if the SSUTA were strictly enforced and the rules on what was taxable were truly uniform from state to state. The ease of compliance with a truly uniform base would render seemingly arbitrary minimum sales thresholds unnecessary.[43] Even though the statutory burden of the sales and use tax falls on consumers, the SSUTA legislation may be considered in conjunction with other legislation that more directly addresses how states tax businesses.

The BAT legislation in the 109th Congress, H.R. 1956, is intended to further modify the state taxation of businesses engaged in interstate commerce. The legislation would impose new regulations on how states impose taxes on multi-state businesses, through (1) imposing uniformity on the time component of nexus determination and (2) expanding the definition of goods and services subject to the nexus rules. The legislation would not directly address the complexity of the state corporate income tax structure — in particular, the various apportionment formulas (and allocation rules) described earlier.

Many economists and other researchers who analyze state corporate income taxes agree that the critical issue with the current state corporate income tax structure is the variability in the allocation and apportionment of corporate income from state to state. The current mosaic of state corporate income tax rules creates economic inefficiencies for the following reasons: (1) relatively high compliance costs, (2) increased opportunities for tax planning by businesses, and (3) potential gaps and overlaps in taxation. The new regulations as proposed in H.R. 1956 would have exacerbated the underlying inefficiencies because the threshold for business — the 21-day rule, higher than currently exists in most states — would increase opportunities for tax planning leading to more "nowhere income." In addition, expanding the number of transactions that are covered by P.L. 86-272 would have

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[43] Charles McClure and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," *State Tax Notes*, Mar. 1, 2004, p. 732.

expanded the opportunities for tax planning and thus tax avoidance and possibly evasion.