Exhibit Number: 2

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Montana Department of Revenue

Dan Bucks
Director

Brian Schweitzer
Governor

SENATE TAXATION
EXHIBIT NO. 2
DATE 2-8-05
BILL NO. NA

Federal Legislation Undermining State Business Taxes
H.R. 3220 in the 108th Congress
(New version expected in 109th Congress)
February 1, 2005

Major business interests have been seeking federal legislation that would directly damage state corporate income and other business taxes. (The legislation in the last Congress was H.R. 3220.) A significant chance exists that such legislation could move forward in the new Congress. The legislation would:

1. Legalize corporate tax shelters on a large scale,
2. Discriminate against small Montana businesses by shifting the burden of state income taxes away from large multistate and multinational businesses to smaller local businesses,
3. Establish disincentives for investing in Montana, and
4. Preempt state laws and legislative authority to determine state tax policy.

The department is in the process of reviewing estimates of the fiscal impact of the legislation. On a preliminary basis, the corporate income tax impact would appear to $3 to $6 million in the first year and rising rapidly to $25 to $35 million annually in the fifth year as corporations adopt the expanded tax sheltering methods legalized under the legislation.

The bill is being advanced by business interests, in part, as a trade-off for legislation authorizing states to apply their sales taxes the sale of products over the Internet. For Montana and other states without a general sales tax, the legislation is all loss and no gain.

The legislation would restrict the ability of states to tax companies that conduct certain kinds of business activities in each state. The bill would allow companies without a physical presence to sell into a state or use intangible assets within a state without paying state income taxes—even though state law requires them to do so. More importantly for Montana it would allow companies to station employees or own property in the state on a temporary or permanent basis without incurring Montana corporate income taxes. Under the legislation even major manufacturing and materials processing plants could exempt themselves from Montana's corporate taxes through complex restructuring authorized under the legislation.

Montana Code Annotated 2003

15-31-101. Organizations subject to tax. (1) The term "corporation" includes an association, joint-stock company, common-law trust or business trust that does business in an organized capacity, all other corporations whether created, organized, or existing under and pursuant to the laws, agreements, or declarations of trust of any state, country, or the United States, and any limited liability company, limited liability partnership, partnership, or other entity that is treated as an association for federal income tax purposes and that is not a disregarded entity.

(2) The terms "engaged in business" and "doing business" both mean actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.

(3) Except as provided in 15-31-103 or 33-2-705(4) or as may be otherwise specifically provided, every corporation engaged in business in the state of Montana shall annually pay to the state treasurer as a license fee for the privilege of carrying on business in this state the percentage or percentages of its total net income for the preceding taxable year at the rate set forth in this chapter. In the case of corporations having income from business activity which is taxable both within and outside of this state, the license fee must be measured by the net income derived from or attributable to Montana sources as determined under part 3. Except as provided in 15-31-502, this tax is due and payable on the 15th day of the 5th month following the close of the taxable year of the corporation. However, the tax becomes a lien as provided in this chapter on the last day of the taxable year in which the income was earned and is for the privilege of carrying on business in this state for the taxable year in which the income was earned.

(4) Every bank organized under the laws of the state of Montana, of any other state, or of the United States and every savings and loan association organized under the laws of this state or of the United States is subject to the Montana corporation license tax provided for under this chapter. A foreign capital depository chartered under the laws of Montana is not subject to the Montana corporation license tax provided for under this chapter until October 1, 2012. For taxable years beginning on and after January 1, 1972, this subsection is effective in accordance with Public Law 91-156, section 2 (12 U.S.C. 548).

History: (1), (3)En. Sec. 1, Ch. 79, L. 1917; Subd. 16, amd. Sec. 1, Ch. 64, L. 1921; re-en. Sec. 2296, R.C.M. 1921; amd. Sec. 1, Ch. 166, L. 1933; re-en. Sec. 2296, R.C.M. 1935; amd. Sec. 1, Ch. 29, L. 1937; amd. Sec. 1, Ch. 92, L. 1937; amd. Sec. 1, Ch. 232, L. 1957; amd. Sec. 1, Ch. 264, L. 1959; amd. Sec. 1, Ch. 155, L. 1961; amd. Sec. 1, Ch. 269, L. 1965; amd. Sec. 1, Ch. 4, Ex. L. 1967; amd. Sec. 1, Ch. 11, Ex. L. 1969; amd. Sec. 1, Ch. 16, L. 1971; amd. Sec. 1, Ch. 333, L. 1971; amd. Sec. 1, Ch. 5, Ex. L. 1971; amd. Sec. 1, Ch. 7, 2nd Ex. L. 1971; amd. Sec. 1, Ch. 468, L. 1973; amd. Sec. 1, Ch. 484, L. 1973; amd. Sec. 1, Ch. 5, L. 1974; amd. Sec. 1, Ch. 257, L. 1977; Sec. 84-1501, R.C.M. 1947; (2)En. Sec. 4, Ch. 79, L. 1917; re-en. Sec. 2299, R.C.M. 1921; amd. Sec. 1, Ch. 146, L. 1923; re-en. Sec. 2299, R.C.M. 1935; amd. Sec. 1, Ch. 165, L. 1947; amd. Sec. 1, Ch. 235, L. 1961; amd. Sec. 3, Ch. 186, L. 1963; amd. Sec. 1, Ch. 372, L. 1973; amd. Sec. 56, Ch. 516, L. 1973; amd. Sec. 1, Ch. 161, L. 1975; Sec. 84-1504, R.C.M. 1947; (4)En. Secs. 1, 3, Ch. 23, L. 1971; Secs. 84-1501.6, 84-1501.7, R.C.M. 1947; R.C.M. 1947, 84-1501(part), 84-1501.6(part), 84-1501.7(part), 84-1504(part); amd. Sec. 2, Ch. 634, L. 1979; amd. Sec. 3, Ch. 664, L. 1979; amd. Sec. 1, Ch. 622, L. 1987; amd. Sec. 4, Ch. 659, L. 1987; amd. Sec. 1, Ch. 9, Sp. L. June 1989; amd. Sec. 69, Ch. 382, L. 1997; amd. Sec. 11, Ch. 143, L. 2001.

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January 26, 2005

FEDERAL "BUSINESS ACTIVITY TAX NEXUS" LEGISLATION:

HALF OF A TWO-PRONGED STRATEGY TO GUT STATE CORPORATE INCOME TAXES

By Michael Mazerov

Background and Summary

Major multistate corporations are engaged in a two-pronged strategy aimed at substantially increasing the share of their nationwide profit that is not taxed by any state. The strategy involves the enactment of complementary state and federal legislation. The state legislation — which corporations have already succeeded in enacting in ten states and are actively seeking in about a dozen more — is aimed at lowering the corporate taxes of in-state corporations and shifting these taxes onto out-of-state corporations. The federal legislation, which corporations have been seeking since 2000, would make it much more difficult for states to require many out-of-state corporations to pay *any* income tax. Together, the two changes in tax law would create a "heads I win, tails you lose" system of state corporate income taxation — with corporations the winners and states the losers.

The version of the federal legislation introduced in the 108th Congress was H.R. 3220, the "Business Activity Tax Simplification Act of 2005." (Similar legislation is expected to be introduced early in the 109th Congress.) H.R. 3220 was co-sponsored by representatives Bob Goodlatte and Rick Boucher. Like its predecessors, H.R. 3220 would have imposed what is usually referred to as a federally-mandated "nexus" threshold for state (and local) "business activity taxes" (BATs). State taxes on corporate profits collected by 45 states and the District of Columbia are the most widely-levied state business activity taxes and are the focus of this report. (The term also encompasses such broad-based business taxes as the Michigan Single Business Tax — a form of value-added tax — and the Washington Business and Occupations Tax — a state tax on a business' gross sales.) The "nexus" threshold is the minimum amount of activity a business must conduct in a particular state to become subject to taxation in that state.

Nexus thresholds are defined in the first instance by state law. State laws levying a tax on a business will set forth the types of activities conducted by a business within the state that obligate the business to pay some tax (which usually is proportional to the level of activity in the state). If a business engages in any of those activities within the state it is said to have "created" or "established" nexus with the state, and it therefore must pay the tax. Federal statutes can override state nexus laws, however, and H.R. 3220 proposed to do so in four key ways:

- H.R. 3220 declared that a business must have a "physical presence" within a state before that jurisdiction may impose a BAT on the business. This provision would nullify many state laws that assert that a non-physically-present business establishes nexus with the state when it makes economically-significant sales to the state's resident individuals and/or businesses. In establishing this true, "physical presence" nexus threshold, H.R. 3220 proposed to resolve in favor of business a lingering question as to whether state laws declaring nexus to be created by sales alone are valid under the U.S. Constitution.

- Under H.R. 3220, however, some businesses could have had a physical presence in a state *without* creating nexus. The bill would have created a number of nexus "safe harbors." These are categories and quantities of clear physical presence that a corporation or other business could have in a state that nonetheless would be deemed no longer sufficient to create BAT nexus for the business. For example, the bill allowed a corporation to have an unlimited amount of employees and property in a state without creating nexus, so long as neither were present in the state for more than 21 days within a particular year.

- H.R. 3220 substantially expanded an existing nexus "safe harbor," federal Public Law 86-272. P.L. 86-272 provides that a corporation cannot be subjected to a state corporate income tax if its only activity within a state is "solicitation of orders" of tangible goods, followed by delivery of the goods from an out-of-state origination point. The protected "solicitation" may be conducted by advertising alone or through the use of traveling salespeople. H.R. 3220 would have expanded the coverage of P.L. 86-272 to the entire service sector of the economy and applied it to all types of BATs, not just income taxes.

- H.R. 3220 would have imposed new restrictions on the ability of a state to assert BAT nexus over an out-of-state corporation based on activities conducted within its borders by a (non-employee) individual or other business acting on behalf of the out-of-state business.

In short, H.R. 3220 was intended to substantially *raise* the nexus threshold for corporate income taxes and other BATs — that is, to make it much more difficult for states to levy these taxes on out-of-state corporations.

The fact that state corporate income tax nexus thresholds would be raised by legislation like H.R. 3220 means that the profits of particular corporations would no longer be subject to tax in particular states. While that may raise equity concerns, it does not inherently mean that the states as a group would lose corporate income tax revenue. In fact, however, many of the same corporations pushing for the enactment of legislation like H.R. 3220 at the federal level are lobbying at the state level for complementary changes in state corporate income tax laws. These state laws *would* ensure that the enactment of legislation like H.R. 3220 would result in a substantial corporate tax revenue loss for states in the aggregate:

- Multistate corporations are lobbying in numerous states for a switch to a so-called single sales factor apportionment formula. (They have already obtained enactment of the single sales factor formula in 10 states.) Apportionment formulas embedded in each state's corporate income tax law determine *how much* of a multistate corporation's nationwide profit is subject to tax in a state in which it *does* have nexus. If a corporation makes 10 percent of its sales to customers in a single sales factor state, then 10 percent of its nationwide profit will be subject to tax in that state.

- Under a single sales factor formula, a corporation that produces all of its goods in a state but has all of its customers in other states will have *no* corporate income tax liability to the state in which it does its production. However, if this same corporation did not have nexus in its customers' states, because the activities it conducted in those states would be deemed no longer nexus-creating under H.R. 3220, then *all* of this corporation's profit would become "nowhere income" — profit not subject to tax by *any* state.

- In reality, of course, most corporations do have at least some customers in the states in which they produce their goods and services, and even under legislation like H.R. 3220 they would often have nexus in some of the other states in which their customers are located. So most multistate corporations would continue to pay some state corporate income taxes even if legislation like H.R. 3220 were to be enacted.

- Nonetheless, if the state corporate income tax nexus threshold were raised sharply by new federal legislation, and if multistate corporations continue to make progress in their campaign to get large industrial states to switch to a single sales factor formula, the two policies would interact in a way that would vastly expand the share of total nationwide corporate profit that escapes taxation entirely.

The creation of more "nowhere income" is a major goal of the multistate corporate community in seeking the enactment of bills like H.R. 3220, notwithstanding claims that the legislation is only intended to regulate *which* states can tax a corporation and not to affect the aggregate taxation of corporate income. The evisceration of state corporate income taxes — the source of $28 billion in annual revenue — would harm states already struggling to provide adequate education, health, and homeland security-related services.

It is not at all clear that congressional action to clarify and harmonize state BAT nexus thresholds is warranted, but if Congress is determined to act, viable alternatives to bills like H.R. 3220 are available that would do less damage to state finances. Congress could implement the proposed model nexus threshold carefully crafted by the Multistate Tax Commission, which would base the existence of BAT nexus on relatively objective measures of the amount of a corporation's property, payroll, or sales present in a state.

Two Leading State Tax Experts Debunk "Taxation without Representation" Argument Offered in Support of BAT Nexus Legislation

Proponents of federal BAT nexus bills like H.R. 3220 argue that such legislation must be enacted to stop (alleged) state "taxation without representation" of out-of-state corporations. Leaving aside that such rhetoric is inconsistent with the pursuit by many of these same corporations of "single sales factor" apportionment rules (as discussed in the body of this report), the argument is dubious on its own terms. In a 2004 paper, two leading experts on state tax policy thoroughly debunked the "taxation without representation" argument:

> A second invalid argument [offered in support of federal BAT nexus legislation] relies on the Revolutionary War rallying cry "no taxation without representation." Opponents of tighter nexus rules suggest that those rules would violate the basic American principle that there should be no taxation without representation. That argument fails on several grounds. First, not all rallying cries of the Revolutionary War made their way into the Constitution. An inviolate link between the right to vote and the duty to pay tax is not among those that did. Individuals who lack the right to vote due to nonresidence are nonetheless (properly) taxable. Second, virtually all of the taxes under discussion here are (or would be, under a tighter nexus standard) paid or collected by corporations, not by individuals. Because corporations do not vote, this argument is something of a red herring. Beyond that, out-of-state taxpayers, whether actual or potential and whether corporations or individuals, have the same right to be represented by lobbyists as do in-state corporate and individual taxpayers. Indeed, corporate officials can probably do their own lobbying without running afoul of existing nexus standards, let alone sensible ones. Thus, this charge lacks substance. Third, the same argument could be made against payment of property taxes. Finally, and most fundamentally, the type of taxation that would occur under sensible nexus rules would not discriminate against out-of-state business (something the U.S. Supreme Court would not countenance). Rather, sensible nexus rules would prevent discrimination in favor of out-of-state business by subjecting them to the same rules as in-state businesses, except as required to prevent excessive complexity. Even if it were true that out-of-state businesses had no representation, it is difficult to see the harm in requiring that they pay or collect the same taxes as their in-state competitors. (With uniform taxation, in-state businesses can be expected to help protect the interests of their out-of-state competitors in the political arena, because they will pay the same taxes.)

Source: Charles E. McLure Jr. and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," *State Tax Notes*, March 1, 2004, p. 735. The article was sponsored by the National Governors' Association. McLure is a Senior Fellow with the Hoover Institution at Stanford University and was a Deputy Assistant Secretary of the Treasury for Tax Analysis during the Reagan Administration. Walter Hellerstein is Francis Shackelford Professor of Taxation at the University of Georgia Law School and author of the most well-known legal treatise on state taxation.