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State Corporate Income Taxes: A Description and Analysis

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June 23, 2008

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Updated June 23, 2008

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Prepared for Members and Committees of Congress

State Corporate Income Taxes: A Description and Analysis

Summary

State corporate income taxes have become a subject of interest to both state and federal policymakers. The cause of this elevated interest may be the expansion of electronic commerce and 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 a contributor to state finances. Over the last decade, state corporate income taxes generated approximately 5% of state tax revenue. The revenue generated by the tax — measured as a percentage of gross domestic product — gradually declined to its lowest point in FY2002. Since then, revenue has rebounded. Several explanations have been offered for these fluctuations including (1) state policy decisions to lower the tax burden on corporations, (2) aggressive tax planning by corporations, (3) broad economic cycles altering the base, and (4) federal corporate income tax policy.

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.

In the 110th Congress, S. 1726 and its twin H.R. 5267 would establish more-uniform standards — generally higher standards — for the level of business activity that would trigger nexus (or presence) and thus state corporate income taxability. The legislation is often identified as "brightline" legislation. In the 109th Congress, the House Judiciary Committee approved similar legislation, H.R. 1956. The Congressional Budget Office estimated that H.R. 1956 would have cost the states $3.1 billion over the 2007 to 2016 budget window.

Nexus issues are also addressed in what has been identified as "streamlining" legislation. Generally, the streamlining legislation would allow states to require out-of-state vendors to collect sales 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. This report will be updated as legislative events warrant.

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State Corporate Income Taxes: A Description and Analysis

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 is 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 and tax 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 7.1% of total state tax revenue in 2007. In contrast, general sales and use taxes, of which businesses pay a large portion, accounted for approximately 31.5% of state tax revenue.[2] Some estimate that businesses could have paid as much as 44% of total state and local taxes (an estimated $577 billion).[3] 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 $53.4 billion in 2007. And, in some states, the corporate income tax contributes a much larger share of total tax revenue. For example, from 1972 to 2007, the corporate income tax averaged 20.3% of annual state tax revenue in New Hampshire. In contrast, the corporate income tax contributed 3.8% of total tax revenue in South Dakota.[4] **Table 1** reports the average reliance on corporate income taxes for each state over the 36-year span, 1972 to 2007.

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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 are available at the following website: [http://www.census.gov/govs/www/statetax07.html].

[3] Andrew Phillips, Robert Cline, and Tom Neubig, "Total State and Local Business Taxes: 50 State Estimates for Fiscal Year 2007," *State Tax Notes*, May 12, 2008. They also estimated that businesses paid 44% of all state and local *sales* taxes.

[4] 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 2007

State	Annual Average Corporate Income Tax Share of Total Tax Revenue (1972 to 2007)	State	Annual Average Corporate Income Tax Share of Total Tax Revenue (1972 to 2007)
Alabama	4.9%	Montana	7.2%
Alaska	19.9%	Nebraska	5.3%
Arizona	5.9%	Nevada	no C.I.T.
Arkansas	6.0%	New Hampshire	20.3%
California	10.8%	New Jersey	9.7%
Colorado	5.0%	New Mexico	4.5%
Connecticut	10.2%	New York	8.6%
Delaware	9.2%	North Carolina	7.7%
Florida	5.6%	North Dakota	7.0%
Georgia	6.9%	Ohio	6.1%
Hawaii	3.1%	Oklahoma	4.0%
Idaho	6.4%	Oregon	7.3%
Illinois	8.2%	Pennsylvania	9.2%
Indiana	6.2%	Rhode Island	6.5%
Iowa	5.4%	South Carolina	5.7%
Kansas	7.7%	South Dakota	3.8%
Kentucky	6.4%	Tennessee	8.7%
Louisiana	6.5%	Texas	no C.I.T.
Maine	4.9%	Utah	4.8%
Maryland	4.8%	Vermont	5.2%
Massachusetts	10.7%	Virginia	5.2%
Michigan	12.5%	Washington	no C.I.T.
Minnesota	7.4%	West Virginia	5.9%
Mississippi	5.1%	Wisconsin	6.9%
Missouri	4.6%	Wyoming	no C.I.T.

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

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 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.

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The Mechanics of the State Corporate Income Tax

Generally, the state corporate income tax is levied on the accounting profits of a corporation.[5] 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. When calculating state tax liability, most states and the District of Columbia incorporate the federal income tax code as currently amended or as of a specific date. 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.

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

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[5] Net income is revenue less cost of goods sold and expenses, which is roughly equivalent to pre-tax accounting profits.

[6] Bureau of National Affairs, "2008 Survey of State Tax Departments," vol. 15, no. 4, Apr. 25, 2008. 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, six states have enacted UDITPA as written and 13 more states have generally adopted UDITPA with some modifications.

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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 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.

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

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

[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.

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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, 15 states (and the District of Columbia) reported that an out-of-state corporation that maintained a website on a server in the state had established nexus whereas 24 states reported that the activity would not.[12]

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 and nexus rules. The different state apportionment formulas and nexus rules, however, often lead to what is termed "nowhere income."[13] Nowhere income arises because not all states have the same apportionment formula or nexus rules, and some states do not levy a corporate income tax at all. However, if the destination state imposes a franchise tax or a business license tax that is based on some measure of business activity, then this does not apply. Thus, some states impose corporate income tax rules that stipulate that all sales to customers in states in which the firm does not have nexus (and are not obligated pay any tax based on economic activity) 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, nor any other tax based on business activity — 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 and the firm had established nexus, 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, New York City, and the District of Columbia; 19 states do not impose a throwback rule, and four states do not impose a corporate income tax (see **Table 2**).[14]

Combined Reporting. Combined reporting of income from all subsidiaries is an accounting rule states use to minimize corporate income tax avoidance arising from income shifting (or strategic transfer pricing). Generally, there are two "degrees" of combined reporting, water's edge (i.e., U.S.-based subsidiaries) and worldwide. Although combined reporting is required in roughly half the states, only California and Idaho require worldwide reporting. Montana and North Dakota require worldwide reporting unless water's edge is chosen. Nebraska employs a modified worldwide regime. From a tax compliance perspective, supporters of

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[11] Bureau of National Affairs, "2008 Survey of State Tax Departments," vol. 15, no. 4, Apr. 25, 2008.

[12] Several states indicated that a server did not create nexus only if an unrelated third party owned the server. Several states did not respond or do not have a corporate income tax.

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

[14] See BNA, Apr. 25, 2008. Delaware and Pennsylvania did not respond to this question and the question is not applicable to Texas.

combined reporting claim that the regime helps close several corporate tax loopholes.[15] Critics of combined reporting suggest that the increased compliance and administrative cost of combined reporting overshadow any increase in compliance and revenue.

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. A number of states will be moving to a single-factor sales formula in the near future. As of 2008, 10 states are using a single-factor sales formula.

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, Louisiana, New Mexico, Montana, North Dakota, and Rhode Island.
Even-weight hybrid (3)	Missouri, firms choose either even weight or single factor sales; Oklahoma, firms meeting certain investment criteria can choose double-weight sales, otherwise even-weight; Utah, even-weight with optional three-factor with double weighted sales.
Double-weight sales (13)	Arkansas, California, Florida, Idaho, Kentucky, Massachusetts, New Hampshire, New Jersey, North Carolina, Tennessee, Vermont, Virginia, and West Virginia.
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 dealers in tangible personal property, otherwise single-factor sales.
Single-factor sales (10)	Georgia, Illinois, Iowa, Maine, Michigan[a] (MBT), Nebraska, New York, Oregon, and Wisconsin.
Single-factor sales in the future (2)	*Indiana in 2011 and Minnesota in 2014.*
Other weight allocations (6)	(in percentages, sales- payroll-property) Arizona[b], 60-20-20; Indiana, 80-10-10; Michigan[a], 92.5-3.75-3.75 (SBT); Minnesota, 81-9.5-9.5; Ohio, 60-20-20; and Pennsylvania, 70-15-15.

[15] Michael Mazerov, "State Corporate Tax Shelters and the Need for Combined Reporting," *State Tax Notes*, Nov. 26, 2007, pp. 621-638.

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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[c] (gross receipts tax), Washington, and Wyoming.

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

a. In Arizona, firms may elect 70-15-15 in 2008 and 80-10-10 after 2008.
b. Michigan has two corporate income taxes, the Single Business Tax (SBT) and the Michigan Business Tax (MBT).
c. The Texas GRT is similar in practice to a single factor sales apportionment formula.

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 10 states that use a single-factor sales apportionment formula. The rates for each state are listed 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 and bracket amounts. 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, 2008

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	7.100%	one
Delaware	8.700%	one	North Carolina	6.900%	one
D.C.	9.975%	one	North Dakota[e]	6.500%	multiple
Florida	5.500%	one	Ohio[f]	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[a]	4.800%	one	Rhode Island	9.000%	one
Indiana	8.500%	one	South Carolina	5.000%	one
Iowa	12.000%	multiple	South Dakota[g]	6.000%	multiple
Kansas	4.000%	one	Tennessee	6.500%	one
Kentucky	6.000%	multiple	Texas[h]	4.500%	one
Louisiana	8.000%	multiple	Utah	5.000%	one

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Maine	8.930%	multiple	Vermont	8.500%	multiple
Maryland	8.250%	one	Virginia	6.000%	one
Massachusetts[b]	9.500%	one	Washington	no tax	n/a
Michigan[c]	4.950%	one	West Virginia	8.750%	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. S Corporations, partnerships, and trusts are taxed at a maximum 6.3% rate.
b. Corporations also pay a surtax on property located in Massachusetts and not taxed at the local level.
c. According to CCH, Michigan levies the 4.95% on business income and an additional 0.8% on modified gross receipts at and beyond $350,000.
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. ND instructs corporations making "water's edge" election to pay and additional 3.5%.
f. Ohio allows firms to choose an alternative of four mills (or 0.4%) multiplied by taxable net worth.
g. 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.
h. Texas has a revised franchise tax or "margin tax." The margin tax increases the effective tax rate though the details of the tax and its rate are too complicated to present in this table.

State Corporate Income Tax Revenue: 1972 to 2007

According to CRS calculations based on data from the U.S. Census Bureau, state corporate income tax revenue as a portion of gross domestic product (GDP) declined from an annual average of 0.43% of GDP over the FY1972 to FY1979 time frame to 0.31% of GDP over the FY2000 to FY2007 time frame. The percentage has, however, increased each year from FY2004 to FY2007. **Table 4** reports state corporate tax revenue and GDP for states that impose a state corporate income tax.[16] **Figure 1** exhibits the trend in state corporate tax revenue as a portion of state GDP.

Several causes were suggested for the decline in state corporate tax revenues in FY2001 and FY2002.[17] The most direct causes could 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.[18] Even though these tax cuts were not separated into types of tax (e.g. sales and income taxes) by the Fiscal Survey, it seems likely that state corporate income taxes were

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[16] The governments division of the Census Bureau collects and reports state tax collections by type of tax based on survey information from the states. For more on the methodology, see [http://www.census.gov/govs/www/statetaxtechdoc2007.html].

[17] 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*.)

[18] National Association of State Budget Officers, December 2003 Fiscal Survey of States, available at the following: [http://www.nasbo.org/Publications/fiscsurv/fsfall2003.pdf].

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included in the tax cuts. Empirical 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.[19]

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Table 4. State Corporate Income Tax Revenue and Gross Domestic Product, FY1972 to FY2007

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%	1990	$21.8	0.37%
1973	$5.4	0.39%	1991	$20.4	0.34%
1974	$6.0	0.40%	1992	$21.9	0.34%
1975	$6.6	0.41%	1993	$24.2	0.36%
1976	$7.3	0.40%	1994	$25.5	0.36%
1977	$9.2	0.45%	1995	$29.1	0.39%
1978	$10.7	0.47%	1996	$29.3	0.38%
1979	$12.1	0.47%	1997	$30.7	0.37%
1980	$13.3	0.48%	1998	$31.1	0.36%
1981	$14.1	0.45%	1999	$30.8	0.33%
1982	$14.0	0.43%	2000	$32.5	0.33%
1983	$13.2	0.37%	2001	$31.7	0.31%
1984	$15.5	0.39%	2002	$25.9	0.24%
1985	$17.6	0.42%	2003	$28.5	0.26%
1986	$18.4	0.41%	2004	$30.8	0.26%
1987	$20.5	0.43%	2005	$38.7	0.31%
1988	$21.6	0.42%	2006	$47.4	0.36%
1989	$23.9	0.44%	2007	$53.4	0.39%

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

A second explanation, alluded to above, was that corporations were more effectively avoiding, or even evading taxes through aggressive tax planning.[20] The Multistate Tax Commission (MTC) also concluded that "...various corporations are

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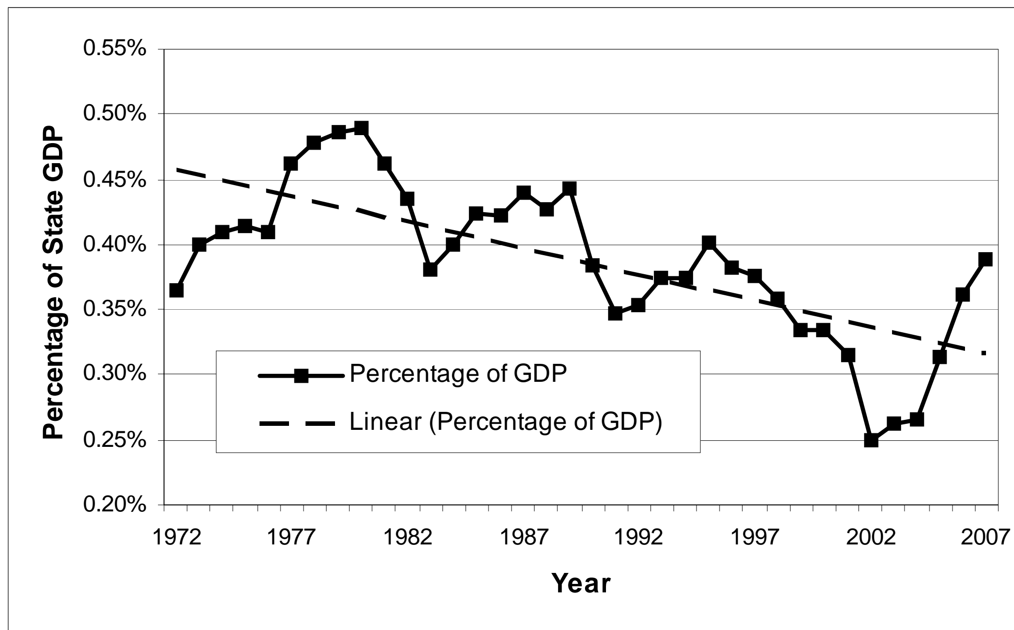
[19] Fox and Luna, *State Corporate Tax Revenue Trends*, p. 498.

[20] 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. For more, see Martin Sullivan, "State Corporate Tax Leakage: $14.5 Billion in 2006," *State Tax Notes*, Nov. 26, 2007, pp. 601-613.

increasingly taking advantage of structural weakness and loopholes in the state corporate tax systems."[21] Again, the MTC study could not definitively separate the revenue declines arising from policy changes and avoidance/evasion, but still concluded that tax avoidance and evasion is partly responsible for the decline in state corporate tax revenues.

Figure 2. State Corporate Tax Revenue as Percentage of State GDP, 1972 to 2007



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

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A third explanation was that cyclical economic changes 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 was 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...."[22] The implication of this finding was 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.

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

[22] 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.

Finally, changes to the federal corporate income tax code, which changes the base of most state corporate income tax systems, could explain part of the decline in state corporate income tax revenue. A report published in 2005, however, noted that "nearly two-thirds [of states] refused to go along with President Bush's 2001-2004 'bonus depreciation.'...."[23] The Center on Budget and Policy Priorities reported that "...some 18 states have disallowed the [domestic production] deduction...." in part to avoid the associated revenue loss.[24] 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.[25] 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.[26] Typically, the substantial nexus standard is satisfied if the vendor has a physical presence in the state.[27] 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.[28]

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

[24] Nick Johnson, "State Revenue Losses from the Federal 'Domestic Production Deduction' Will Double in 2007," *Center on Budget and Policy Priorities*, Jan. 2, 2007.

[25] 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.

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

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

[28] Donald Bruce and William F. Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004," *Center for Business and Economic Research*, University of Tennessee, July 2004. Bruce and Fox estimated this erosion from electronic

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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 identifies this agreement as the "Streamlined Sales and Use Tax Agreement" (SSUTA).[29] 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 110th Congress would grant states these rights.[30] If either of 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. 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 what became 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)[31]

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.[32]

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,

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[28] (...continued)
commerce alone will result in states losing between $21.5 billion and $33.7 billion in 2008. There is considerable debate, however, about the size of the revenue loss.

[29] For more on the SSUTA, see CRS Report RS22387, *The Streamlined Sales and Use Tax Agreement: A Brief Description*, by Steven Maguire.

[30] S. 34 and H.R. 3396.

[31] 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.

[32] Ibid.

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would not be sufficient to trigger nexus. Thus, for tangible goods shipped across state lines, state net corporate income taxes are levied at the *origin* 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 contributed to a revived 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 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.[33]

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.[34] 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").[35] Thus, when the federal definition of the tax base changes, so does the state definition of income.

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.[36] 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 would have generated a significant revenue loss in the short run for those states that remain linked to the federal definition of business income.[37] A second JGTRRA provision allowed for

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[33] 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."

[34] 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.

[35] 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.

[36] 26 U.S.C. § 179.

[37] According to an 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."

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"bonus depreciation" for certain capital expenditures. Businesses that bought qualified capital assets before January 1, 2005, could have immediately deducted 50% of the purchase price from gross income. As of 2008, just 13 states allow firms to fully utilize the federal bonus depreciation rules for purposes of calculating state corporate tax liability.[38]

Proponents of the accelerated depreciation provisions argued 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 affected 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

As noted earlier, two related issues have received legislative attention in the 110th Congress. One is so-called streamlined sales and use tax legislation and the other is identified as business activity tax (BAT) nexus legislation. S. 34 and H.R. 3396 were intended to address the streamline issue.[39]

The focus here will be on S. 1726 and its twin H.R. 5267. This legislation would establish more-uniform standards — generally higher standards — for the level of business activity that would trigger nexus (or presence) and thus state corporate income taxability. The legislation is often identified as "brightline" or "BAT" legislation.

H.R. 5267 and S. 1726. Under current law, sales of "tangible personal property" into a state are not sufficient to trigger tax liability. H.R. 5267 and S. 1726 would expand the protection beyond sales of tangible personal property to include transactions, furnishing or gathering of information, and services.[40] This expansion would have a significant effect on the 34 states where "... an employee's solicitation

[37] (...continued)
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.

[38] Commerce Clearing House, "Multistate Corporate Tax Guide (2008)," on-line edition.

[39] For more on the "Streamline" issue, see CRS Report RL34211, *State and Local Taxes and the Streamlined Sales and Use Tax Agreement,* by Steven Maguire.

[40] Sec. 2(a) of H.R. 5267.

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of services while in the state for six or fewer days would create nexus."[41] In addition, the legislation is somewhat unclear on what activities would be classified as "furnishing of information to customers" and "gathering of information."

In addition to the expansion of protected interactions, this legislation would also define "physical presence" as the standard for collecting business activity taxes.[42] 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 at least 15 days (not including trips to buy goods or services for the business or gathering and furnishing information);
- the individual or business uses the services of another individual or business for more than 15 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 15 days.

A provision in the legislation would define "physical presence" to exclude individuals whose activities are "limited or transient business activity."[43] Thus, activities need only be one or the other to avoid establishing nexus and thus taxation. This feature may prove confounding to state tax administrators as a clear definition of "limited" is not provided and "transient" is also somewhat ambiguous.

Analysis. The BAT legislation in the 110th Congress, H.R. 5267 and S. 1726, 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, (2) expanding the definition of goods and services subject to the nexus rules, and (3) creating a safe harbor for activities that are "limited *or* transient." 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.[44] 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

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[41] BNA, Apr. 25, 2008.

[42] Sec. 3(b) of H.R. 5267 and S. 1726.

[43] Sec. 3(b)(2)(B) of H.R. 5267 and S. 1726.

[44] For one such critique, see Tomalis, Matt, "Some Fatal Flaws of S. 1726, H.R. 5267, and All BAT Nexus Bills," *State Tax Notes*, Mar. 3, 2008, pp. 691-704.

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overlaps in taxation. The new regulations as proposed in H.R. 5267 and S. 1726, would exacerbate the underlying inefficiencies because the threshold for business — the 15-day rule and the safe harbor for limited or transient activity — would increase opportunities for tax planning and thus tax avoidance and possibly evasion. In addition, expanding the *types* of activities that are covered by P.L. 86-272 would also expand the opportunities for tax planning.

Supporters of the legislation counter that the legislation simply codifies the existing nexus rules as applied by most states and updates P.L. 86-272 to reflect changes in the economy and marketplace. In addition, the supporters of H.R. 5267 and S. 1726 suggest that the BAT legislation would eliminate the "double taxation" of businesses. The double taxation, they claim, arises from the various state apportionment and throwback rules.[45]

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[45] For more, see Rosen, Arthur R. and Jeffrey S. Reed, "Setting the Record Straight on the Business Activity Tax Simplification Act," *State Tax Notes*, May 26, 2008, pp. 653-659.