CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

July 11, 2006

H.R. 1956

Business Activity Tax Simplification Act of 2005

As reported by the House Committee on Judiciary on June 28, 2006

SUMMARY

H.R. 1956 would amend current law to prohibit state and local governments from taxing certain business activities that are currently taxable. Specifically, it would prohibit those governments from taxing certain services, intangible goods, media activities, and some financial activities unless businesses have a "substantial physical presence"—as defined in the bill—in a jurisdiction.

CBO estimates that enacting H.R. 1956 would increase federal revenues by $106 million in 2007, by $1.2 billion over the 2007-2011 period, and by $3.1 billion over the 2007-2016 period. The bill would have no other impacts on the federal budget.

By prohibiting state and local governments from taxing certain business activities, H.R. 1956 would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act (UMRA). CBO estimates that the costs—in the form of forgone revenues—to state and local governments would exceed $1 billion in the first full year after enactment and would likely grow to about $3 billion, annually, by 2011. These costs would exceed the threshold established in UMRA for intergovernmental mandates ($64 million in 2006, adjusted annually for inflation).

This bill contains no new private-sector mandates as defined in UMRA.

ESTIMATED EFFECT ON THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 1956 is shown in the following table.

	By Fiscal Year, in Millions of Dollars									
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
CHANGES IN REVENUES										
Estimated Revenues	106	225	280	301	319	340	355	367	379	390

CBO expects that enacting H.R. 1956 would reduce payments of certain state and local taxes by corporations. These lower payments would, in turn, reduce deductions made by corporations for federal taxes and raise taxable income for federal purposes. State and local governments are expected to adjust their finances as a result of these lost revenues. They would likely achieve this through some mix of reduced spending and higher taxes and fees—both deductible and non-deductible. This response by state and local governments would mute, but not eliminate, the revenue gain to the federal government. CBO estimates that, on balance, H.R. 1956 would increase federal revenues by $106 million in 2007, by $1.2 billion over the 2007-2011 period, and by $3.1 billion over the 2007-2016 period.

INTERGOVERNMENTAL MANDATES CONTAINED IN THE BILL

H.R. 1956 would amend current law to prohibit state and local governments from taxing certain business activities that are taxable under current law. Specifically, it would prohibit those governments from taxing certain services, intangible goods, media activities, and some financial activities unless businesses have a "substantial physical presence"—as defined in the bill—in a jurisdiction.

Current law (Public Law 86-272) and certain Supreme Court decisions prohibit states from levying a tax on the corporate (net) income tax of a company whose only activity in the state is pursuing and making sales that would be filled from outside the state (e.g., mail order sales). H.R. 1956 would expand the prohibition under Public Law 86-272 to certain other types of business activity taxes (BATs), including additional corporate income taxes, franchise taxes, single business taxes, capital state taxes, gross receipt taxes, and business and occupation taxes. Corporations currently pay these taxes to a state only if the state can establish "nexus" with the firm. ("Nexus" is the connection between a firm and a state that allows the state to legally impose taxes on the firm.) H.R. 1956 would redefine "nexus" and preempt state laws that are different from that definition. Such a preemption would constitute a mandate as defined in UMRA and would result in forgone revenues to state and local governments because of the new definition.

Specifically, provisions in the bill would:

- Define physical presence for firms not based in a state;
- Establish a uniform nexus standard nationwide—an entity would need to be physically present in a state for 21 or more days to establish nexus;
- Create "carve outs" from the 21-day standard that would allow certain industries or activities (including banking and media) to exceed the standard without establishing nexus with a state;
- Expand the prohibitions in Public Law 86-272 to include certain taxes not based solely on the income of a company (i.e., gross receipts taxes, franchises taxes and business and occupation taxes); and
- Expand the applicability of Public Law 86-272 to services and intangibles (e.g., the trademark for a retail store or the patent for a formula for soda).

ESTIMATED DIRECT COSTS OF MANDATES TO STATE AND LOCAL GOVERNMENTS

CBO estimates that enacting H.R. 1956 would result in revenue losses for states and some local governments and that such losses likely would total more than $1 billion in the first full year after enactment. We estimate that forgone revenues would grow to about $3 billion annually by 2011. These forgone revenues are about 2 percent of the total BATs collected by states in 2006 and about 4.5 percent of the amount expected to be collected in 2011, and would far exceed the threshold established in UMRA ($64 million in 2006, adjusted annually for inflation.) In 2005, states collected almost $650 billion in total taxes. In the year following enactment, the revenue losses resulting from H.R. 1956 would total significantly less than one percent of total state tax collections and about 3 percent of collections from corporate income taxes.

UMRA includes in its definition of the direct costs of a mandate the amounts that state and local governments would be prohibited from raising in revenues as a result of the mandate. The direct mandate costs of H.R. 1956 would be the tax revenues that state and local governments are currently collecting but would be precluded from collecting under the bill. Further, UMRA's definition of the net costs of a mandate excludes additional revenues that state and local governments might raise in reaction to enactment of that mandate.

CBO expects that all states and some local governments would see an immediate revenue loss because they are currently collecting taxes from firms that would be exempt from taxation under the bill. This initial effect would likely exceed $1 billion, annually, nationwide. Subsequently, it is likely that corporations would rearrange their business activities to take advantage of beneficial tax treatments that would result from the interaction of the new federal law and certain state taxing regimes. CBO expects that these reorganizations would occur during the first five years after enactment of the legislation and estimates that forgone revenues to state and local governments would likely total about $3 billion, annually, by 2011.

While virtually all states would lose revenues, about 70 percent of the estimated losses would come from ten states: California, Florida, Illinois, Michigan, New Jersey, New York, Pennsylvania, Tennessee, Texas, and Washington. These states would experience the largest losses because of the size and organization of their economies, or the current structure of their state tax systems.

BASIS OF ESTIMATE FOR INTERGOVERNMENTAL MANDATES COSTS

CBO used information from a variety of sources to estimate the state revenue losses that likely would result from enactment of this legislation.[1] Using data from the states, industry, and the Census Bureau, CBO estimated potential losses based on current receipts, projected receipts (when available), the industrial and commercial profile of state economies, and the structure of state taxing systems—including information from precedents issued by state tax departments.

States use a variety of rules to determine whether a company is subject to taxation—if it has nexus—and if so, how the activities in which that company engages are taxed. The differences in state taxing systems affect how much revenue each state or local government would likely forgo under the provisions of the bill. CBO examined both characteristics of the corporate tax structure of each state and data about the economic makeup of each state in order to estimate potential revenue losses.

To estimate the costs of enacting H.R. 1956 to state and local governments, CBO first estimated the total amount of BATs paid by corporations in each state. Such taxes totaled about $60 billion in 2005. Since certain industries are significantly less likely to be operating from outside the state than others, CBO used information about the industrial and commercial

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1. Although the bill's provisions also would affect collection of taxes by some local governments, CBO has not separately estimated the potential loss for such governments. Relatively few local governments (in fewer than 10 states) impose significant business taxes.

makeup of states to calculate BATs that could be at risk if H.R. 1956 is enacted. Overall, we estimate that about 75 percent of total income from BATs could be at risk under the bill. The portion at risk, however, would vary significantly from state to state.

As noted above, CBO expects that states would lose only a small percent of BATs—about 2 percent in the first year after enactment and about 4.5 percent in 2011, nationwide. Further, those loses would be a very small percentage of total state tax collections. To calculate losses for 2006 and 2011, CBO estimated the likely percentage that states would lose based on their current tax systems and applied that to the BATs potentially at risk.

Losses also would depend on the current characteristics of each state tax system. For example, a large state with a heavily information-based economy that does not currently require a company to have a physical presence to establish nexus and only assesses corporate income tax based on the amount of sales in the state would see a significant loss of revenue. In contrast, a small state that requires physical presence to establish nexus and that has a predominately agrarian or manufacturing economy would see a much smaller loss.

In the absence of this legislation, it is possible that some state and local governments would enact new taxes or change the way they tax businesses. Since such changes are difficult to predict, for the purposes of estimating the direct costs of the mandate, CBO considered only the revenues from taxes that are currently in place and actually being collected or estimates for changes that are already in statute and will be implemented over the next five years.

IMPACT ON THE PRIVATE SECTOR

The bill contains no new private-sector mandates as defined in UMRA.

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