Estimates of Impact of H.R. 1956 on State and Local Business Tax Collections

Prepared for The Council On State Taxation

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ERNST & YOUNG

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Overview

The Business Activity Tax Simplification Act of 2005 (H.R. 1956) establishes a bright-line physical presence nexus standard for a number of state and local business activity taxes imposed on multistate firms. Business activity taxes identified in the bill include corporate net income taxes, as well as other direct taxes based on business activities conducted in a state, such as franchise, net worth, gross receipts, single business, and certain license taxes.

The Council On State Taxation (COST) asked Ernst & Young's Quantitative Economics and Statistics practice to estimate the expected impact of H.R. 1956 on state and local business tax collections. This paper presents the results of the study and includes appendices that describe the provisions of H.R. 1956 and the methodology used in deriving the impact estimates.

Summary of Results

Table 1 presents estimates of the expected loss in state and local tax collections from the adoption of H.R. 1956. Ernst & Young (E&Y) prepared detailed estimates of state-by-state impacts of the bill for the twelve states reported in Table 1. The states were chosen based on total state and local business tax collections and the significant features of a state's tax system, including types of taxes, state income tax filing options, apportionment formulas and other tax system parameters.[1] As explained below, the insights gained from the detailed modeling of the impacts for the included states are then used to extrapolate the results to all states.

As shown in the first column of Table 1, the provisions of H.R. 1956 are expected to apply to a total of $54.4 billion in state and local taxes collected in FY 2005. The taxes that may be affected by H.R. 1956 include corporate income taxes, gross receipts taxes, franchise taxes, and other business activity taxes. This total includes both state and local business activity taxes.[2]

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[1] Michigan and Washington are included in the list of twelve states due to their unique business tax structures. Michigan imposes a modified value-added state business tax and Washington relies heavily on a state gross receipts tax. H.R. 1956 will affect these states differently from the more typical states that rely primarily on corporate net income taxes.

[2] The $54.4 billion of business activity taxes that could potentially be affected by the proposed bill is comparable to the $57.7 billion estimate presented in the National Governors Association (NGA) analysis, "Impact of H.R. 1956, Business Activity Tax Simplification Act of 2005, on States," September 26, 2005. The composition differs, however. The E&Y total includes more local taxes and excludes taxes included in the NGA study that would not be affected by the bill, such as personal income taxes and sales taxes in a few states. It should be noted that the Ohio corporate franchise tax is being phased out over a 5-year period; the loss estimate is for the current system. In

The second set of columns shows that an estimated 2.1 percent of this total, $1,158 million, is paid by firms that have no instate establishments.[3] These are the taxes paid by multistate firms that may have nexus in a state under current law -- due to the physical presence of employees, contractors or tangible personal property located in a state or sales into a state -- but do not have a plant, store, office building or other structure ("establishment") in the state.

Table 1

Estimates of the State and Local Business Tax Impacts of H.R. 1956

(amounts in millions, fiscal year 2005 levels)

State	FY05 Total Business Taxes Subject to H.R. 1956	Business Taxes Paid by Firms without Instate Establishments		Estimated Tax Loss from H.R. 1956		Tax Loss as % of Total Business Taxes
		$ Amount	% of Total Business Taxes	$ Amount	% of Taxes Paid by Firms without Instate Estab.	
California	$8,678	$158	1.8%	$42	26.6%	0.48%
Florida	$3,948	$57	1.4%	$20	35.1%	0.50%
Georgia	$537	$6	1.1%	$2	30.8%	0.35%
Michigan	$2,301	$71	3.1%	$26	36.1%	1.12%
Minnesota	$589	$18	3.1%	$7	38.7%	1.19%
New Jersey	$2,791	$76	2.7%	$29	37.4%	1.02%
New York	$5,339	$129	2.4%	$35	27.1%	0.65%
Ohio	$1,904	$38	2.0%	$10	27.7%	0.55%
South Carolina	$224	$2	1.0%	$1	33.3%	0.34%
Texas	$2,731	$68	2.5%	$20	29.1%	0.73%
Virginia	$996	$15	1.5%	$3	21.0%	0.32%
Washington	$3,544	$95	2.7%	$34	36.3%	0.97%
12-State Total	$33,581	$734	2.2%	$229	31.2%	0.68%
Rest-of-States	$20,797	$424	2.0%	$205	48.4%	0.99%
Total All States	$54,378	$1,158	2.1%	$434	37.5%	0.80%

The $1,158 million figure could be viewed as a maximum revenue loss, based on the current distribution of economic activity across the states and current state and local tax laws. However, only a portion of this amount would be lost as a result of H.R. 1956. Tax liabilities would be reduced only for businesses that have levels of physical presence, specified in the bill, that fall

addition, the impact estimates for Texas reflect the current franchise tax, not the revised franchise tax based on taxable margin that first applies to business activity in 2007.

[3] An establishment is defined by the U.S. Census as a business or industrial unit at a single physical location which produces or distributes goods or performs services.

below the bill's *de minimis* protections or are attributable to activities specified in the bill. (See Appendix A for a detailed description of these provisions.) For example, if the only physical presence an out-of-state equipment manufacturer has in a state is having employees temporarily in the state to provide repair services, the firm would continue to have nexus under H.R. 1956 if it has one or more employees in the state on 22 or more days a year. A revenue loss would only occur in this case if the manufacturer's employees are currently in the state less than 22 days but more than the state's current *de minimis* number of allowed days before nexus is established.

The third set of columns in Table 1 presents the estimates of the actual state and local tax loss expected from H.R. 1956.[4] *For all states, the estimated revenue loss is $434 million at the FY 2005 level of current-law state and local business tax collections.* The revenue loss is 0.8 percent of the total state and local business activity taxes covered by H.R. 1956 ($54.4 billion). Compared to all state and local taxes paid by business in 2005, the revenue loss is less than one-tenth of one percent (0.1 percent).[5]

As shown in Table 1, the business tax loss for the twelve states examined in detail is $229 million in FY 2005. California accounts for $42 million of the loss, while New York accounts for $35 million.[6] At the other end of the distribution, there are three states with losses of $3 million or less. For the twelve states, the loss in revenue varies from 0.32 percent of business activity taxes in Virginia to 1.19 percent in Minnesota. The twelve states account for 62 percent of the business activity taxes collected by all states.

To extrapolate the $229 million twelve-state loss figure to all states, ratios of estimated tax loss to total business activity taxes for the twelve examined states were applied to the total business activity tax estimates in the remaining states. Different ratios were used for separate filing states and combined reporting states. In addition, the ratios were adjusted to recognize the differences in corporate income tax nexus and sourcing rules.[7] The estimated loss for the rest of the states is $205 million. As shown in the last line of Table 1, the total loss for all states is $434 million.

Further insights into the expected state and local business tax impacts of H.R. 1956 are provided in Table 2. The table presents estimates of the distribution of business tax reductions by specific provisions of the bill for the twelve states. For business taxpayers in all industries, 27 percent of the revenue loss is due to the non-employee physical presence provisions. The employee activity and modifications of P.L. 86-272 provisions each account for 24 to 26 percent; the remainder of the loss is spread over the remaining two provisions. The last line of Table 2 presents the distribution of the total $434 million loss for all states by four major industry groups. Business

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[4] As explained in more detail in Appendix B, the estimates of the percentage of total state and local taxes paid by firms with no instate establishments that would be eliminated by H.R. 1956 is based on a section-by-section analysis of the bill's provisions for each of the twelve states studied in detail.

[5] Businesses paid an estimated $497 billion in total state and local taxes in fiscal year 2005. See *Total State and Local Business Taxes: Nationally 1980-2005, by State 2002-2005, and by Industry 2005* (March 2006). This study was prepared by Ernst & Young LLP in conjunction with the Council on State Taxation.

[6] The relatively high level of tax loss in New York is partly due to the level of local business taxes, including New York City.

[7] The results show that the tax loss, per dollar of business activity taxes potentially affected by the bill, is higher for the other states not included in the 12-state group. This partly reflects the fact that a greater share of the taxes collected in the other state group comes from separate-filing corporate income tax states. The estimates for the included 12 states indicate that the tax loss is greater, relative to the level of economic activity, in separate filing states compared to combined reporting states.

taxpayers in the manufacturing sector account for the largest share of the revenue loss, 34.4 percent, followed by services at 31.9 percent.[8]

Table 2
Distribution of Tax Impacts by Industry and Provision of H.R. 1956
(amounts in millions, fiscal year 2005 levels)

Categories	Industry Groups					
					Total	
	Manufacturing	Trade	Services	Other	Amount	% Distribution
12-State Totals						
Current Taxes (FY 2005)						
Total Business Taxes Subject to H.R. 1956	$5,628	$6,110	$13,981	$7,863	$33,581	
Taxes Paid by Firms without Instate Establishments	$284	$94	$223	$133	$734	
Provisions of H.R. 1956						
Physical Presence Requirement	$1	$3	$9	$6	$19	8.4%
Employee Activities	$18	$7	$19	$11	$55	24.1%
Non-employees Activities	$24	$9	$18	$10	$62	27.0%
Real and Personal Property	$23	$5	$4	$3	$35	15.0%
Modification of P.L. 86-272	$10	$7	$20	$22	$58	25.5%
12-State Loss	$76	$32	$70	$51	$229	100.0%
Rest-of-States Loss	$74	$13	$68	$50	$205	
Total Loss All States	$149	$45	$138	$101	$434	
Percent Distribution	34.4%	10.3%	31.9%	23.3%	100.0%	

The Issue of Restructuring and Long-Run Impacts

The estimates of the state and local revenue impacts of H.R. 1956 reported in Tables 1 and 2 are based on current law and estimates of the current level of economic activities in a state.[9] This is the standard approach to estimating the revenue impacts of proposed tax changes at the state level. It is also standard practice to include behavioral responses by taxpayers to tax law changes if the responses can be predicted with some degree of certainty, such as a reduction in fuel consumption in response to an increase in excise taxes on gasoline. Behavioral responses to tax

[8] The services category includes finance, insurance, real estate, communications, professional and personal services. The "other" industry category includes construction, transportation, and electric and other utilities.
[9] Revenue impacts of state tax bills are generally estimated for the years included in the normal state budget process, two to four fiscal years in most states.

law changes result in changes in the level or distribution of economic activity that can change tax bases compared to current law.

The revenue estimates of the impact of H.R. 1956 presented in this study do include specific short-to-intermediate run anticipated behavioral responses to the law change. For example, it is anticipated that there may be some businesses that might, in response to the bill, substitute independent contractors or agents for their own employees and eliminate nexus in a state. This change would only be made if it is consistent with a firm's business operating conditions, practices and objectives. Estimates of this type of behavioral response for businesses that have no establishment in a state are incorporated into the estimated loss percentages for each provision of H.R. 1956. As discussed in more detail in Appendix A, any tax loss resulting from this type of behavioral change would be partly offset by increased levels of economic activity and business taxes for in-state firms, such as contractors and affiliates. These offsetting tax increases have been considered in the estimates presented in Table 1.

Over a longer period of time, it is possible that existing businesses operating in a state may consider restructuring their current activities to reduce state and local taxes in response to H.R. 1956 if the economic costs of restructuring are less than the potential tax savings. However, H.R. 1956 explicitly preserves the authority of states to use tools currently available to state tax administrators to reduce the tax loss from restructuring attributable to sham transactions that lack economic substance or business purpose. H.R. 1956 also would not restrict the ability of legislators to make statutory changes to reporting requirements and apportionment provisions. Given the uncertainty of predicting longer-run behavioral responses to H.R. 1956, net losses related to this type of further restructuring have not been included in the revenue estimates.[10]

[10] The uncertainty of projecting behavioral responses was clearly pointed out in the California Franchise Tax Board's preliminary analysis of the revenue impact of H.R. 3220, an earlier version of the bill introduced in 2003. Its memorandum on the bill's tax impacts noted: "It is not possible to measure the impact of this federal bill for existing business practices in the state let alone for opportunities presented to restructure operations in order to reduce or eliminate business nexus in California." (California Franchise Tax Board, "Federal Business Activity Tax Proposal HR 3220, December 11, 2003, p. 1). While we believe that the methodology used in this study does provide reasonable estimates of H.R. 1956's tax impacts for current levels of economic activities, we agree that estimates of possible long-run restructuring impacts are too speculative to include in the analysis.

Comparing Estimates of H.R. 1956's Tax Impacts

Estimating the expected impact of this complex bill on state and local business tax revenues presents revenue estimators with a formidable challenge. They must first determine which specific state and local taxes are affected by the bill and then identify which taxpayers in specific industries will no longer have nexus in a state. The final step is to estimate the change in tax payments for current taxpayers that no longer will be taxable in a state.

The biggest challenge for state revenue estimators is the fact that tax return information for current taxpayers does not provide sufficient information to identify these impacts with any degree of certainty. For example, while estimators may be able to identify taxpayers with no reported payroll and property in a state, there is no information on the return to identify what percentage of firms with "small" factors may no longer have nexus under the bill's *de minimis* thresholds for physical presence. In addition, in many states only a limited amount of information is actually "captured" in processing returns and available for analysis. Finally, there is no information available from tax returns that can be used to predict short- or long-run restructuring opportunities for taxpayers.

Given these data limitations, both private- and public-sector revenue estimators must make key assumptions in estimating expected revenue impacts. It is understandable that different assumptions and estimating methodologies will result in an unusually wide range of revenue estimates for the bill. The range reflects both the limited amount of information available to estimators and important differences in assumptions about the taxes affected and how taxpayers will respond to the bill.

The very large variation in estimates of the impact of H.R. 1956 reported by CBO, NGA and E&Y is summarized in the table below.*

Report	Short-Run Impact	Long-Run Impact
Congressional Budget Office (CBO)	$1 billion	$3 billion
National Governors Association (NGA)	$2.2 to $3.1 billion	$4.7 to $8 billion
Ernst & Young (E&Y)	$434 million	not estimated

The following points may help to understand why there is such a wide range of estimates across and within the studies:

- It is clear from the state survey responses used to do the NGA estimates that the states did not agree on their interpretations of the bill's provisions. For example, some states included excise taxes and certain gross receipts taxes that are not affected by H.R. 1956. This is due partly to the fact that the NGA estimates were based on early versions of the bill. The CBO and E&Y studies reflect the latest, amended version of H.R. 1956 that clarifies which taxes and activities are affected.

- The individual state estimates used in the NGA study differ significantly in their estimating methodologies and assumptions. For the states using tax model runs, there is wide variation in the minimum thresholds for payroll and property factors used to eliminate taxpayers assumed to have no physical presence. As a result of these differences, the short-run ("static") NGA tax losses, expressed as a percentage of business activity taxes, ranged from 0.0% to almost 40% for the 29 reporting states. The CBO and E&Y estimates applied more uniform assumptions and estimating methodologies across the states.

- The impacts of the bill are very sensitive to the composition of industries in a state. However, only a few states in the NGA study estimated the tax impacts industry-by-industry. The E&Y estimates were done on an industry-by-industry, provision-by-provision basis for the 12 selected states.

- The NGA and CBO analyses overstate the *net* short-run revenue loss from H.R. 1956 by not including increased instate activities and income for instate firms, such as independent contractors, that perform functions for firms that would no longer have nexus in a state. In addition, it appears that the NGA estimating methodology did not account for the fact that the majority of separate-filing states have now adopted add-backs of expenses related to the use of intangibles, such as interest and royalty payments paid to out-of-state affiliates. These add-back provisions will reduce any revenue loss from the bill's extension of P.L. 86-272 protections to intangibles.

- A comparison of the short-run and long-run impact figures in the table shows how significant the restructuring assumptions are in the revenue estimates. For CBO, roughly 67 percent of the long-run tax impact is due to restructuring; the comparable figure for NGA is as high as 73 percent. Because there is no information on current tax returns to predict these behavioral changes, these long-run estimates are more speculative than the revenue estimates normally used in the state legislative process.

[*] *Sources*: Congressional Budget Office (CBO) Cost Estimate, "H.R. 1956: Business Activity Tax Simplification Act of 2005" (July 11, 2006); National Governors Association (NGA), "Impact of H.R. 1956, Business Activity Tax Simplification Act of 2005, on States," (September 26, 2005); Ernst & Young (Estimates from Table 1.
Notes: 1) The short-run impacts for NGA are the minimum and maximum estimates of the "static" impact; the long-run impacts are the minimum and maximums sums for the static, dynamic and compliance impacts. 2) The CBO short-run impact is the reported first-year impact and the long-run impact is the reported fifth-year impact. 3) CBO describes the estimates as "more than $1 billion" and "about $3 billion."

Appendix A
Provisions of H.R. 1956

The following section provides an overview of the provisions of H.R. 1956 that may have a state and local tax revenue impact. In addition to describing the provisions, the discussion also provides additional details and examples of the expected revenue impacts of the provisions. The size of the revenue impact from these provisions would depend upon the economic structure of a state and specific tax system parameters, including tax rates, apportionment formulas, sourcing rules for sales and throwback provisions. As described in Appendix B, these factors were considered in deriving estimates of the revenue impacts of H.R. 1956.

I. Section 3: Jurisdictional Standard for State and Local Net Income Taxes and Other Business Taxes

3(a) Business must have a physical presence in a state to have jurisdiction to tax

This general provision establishes a physical presence nexus standard. In estimating the revenue impacts of H.R. 1956, the impact in this section is the loss in current revenue collections in selected states that assert nexus based on the concept of "economic" presence. In these states, businesses with no physical presence (in-state property or employees) may be currently subject to tax based solely on the presence of customers in the state. Revenue impacts for businesses that do have a physical presence in a state, including employees soliciting sales of services, are scored under the following sections of the bill.

3(b)(1) Employee Activities

H.R. 1956 establishes *de minimis* standards for certain in-state activities of employees that would not result in a physical presence in a state. The following employee activities are the source of potential revenue losses under the bill:

1. Employee activities in a state for less than 22 days

- States may lose taxes currently imposed on businesses because of in-state employees temporarily (fewer that 22 days) performing non-solicitation services. Examples that may create tax losses, assuming that the businesses are currently paying taxes when they have only such a temporary presence, include:
    - Engineers currently installing equipment or other employees servicing equipment in a state for less than 22 days.
    - Employees providing customer training in a state for less than 22 days.

2. Employees doing excepted activities (for any length of time), including:

- Activities relating to buying goods and services from instate businesses.
- Gathering news and covering events for media, such as reporters covering major sporting events.

- Meeting government officials for reasons other than selling goods and services. It is very unlikely that firms without an office or other physical presence in a state are currently subject to tax for this reason alone.
- Participating in educational or training sessions. This provision applies to employees merely attending sessions and does not apply to the firm presenting educational and training sessions. Any revenue loss related to this activity is expected to be minimal.
- Participating in charitable activities. These activities generally do not create nexus under current tax administration in most states, and, therefore, would not result in revenue losses.

3(b)(2) Non-Employee Activities

Nexus will not be established through the presence of non-employees (agents or contractors) in a state in the following situations:

1. Non-employee agents used to establish or maintain the market for more than 21 days if they work for *two* or more companies. (Non-employees working for one business for more than 21 days and providing activities to establish or maintain a market for more than 21 days will still establish nexus under H.R. 1956). This change may result in revenue reductions. Examples include:

    - Agents or contractors, including affiliates, accepting product returns or providing product pickups for the customers of out-of-state contracting firms.
    - Out-of-state power generators contracting with instate independent contractors to establish and maintain the market for selling electricity if the independent contractor provides such marketing services to at least two generators.

2. Non-employees providing other activities (i.e., non-market enhancing activities) as agents for a business will not establish nexus for the business, even if working for only one business. This will result in a revenue loss. Examples include:

    - Agents or contractors providing purchasing services to the out-of-state firm. These purchasing activities do not generally establish nexus under current law and administrative practices in most states. Therefore, any revenue loss from this activity is expected to be minimal.
    - Contractors, including subsidiaries, providing quality control manufacturing services or engineering support services for another business that does not have nexus in the state.

Any loss of revenue due to the fact that a contracting firm no longer has nexus because of the law change will be mitigated or partly offset by two factors. First, if the independent contractor and the contracting firm are members of a unitary group, the income of the two companies will still be combined in the states, such as California, that require combined unitary reporting for income tax purposes. While the change could result in the factors of the contracting firm that no longer has nexus being removed from the numerators of the apportionment formula in certain states, the combined income will not be reduced. Second, in the situation where a firm is no longer taxable in a state because of the transfer of work to an independent contractor, the independent contractor's increased economic activity, income and, possibly, factors would increase and generate offsetting additional tax collections.

3(b)(3) Physical Presence of Real and Personal Property

Nexus is not be established through the presence of real and personal property in a state in the following situations:

1. Leasing or owning real and tangible personal property in a state for less than 22 days. This will result in a revenue loss in some situations if states currently have a *de minimis* period less than 22 days. Examples include:

   - Maintaining samples and display rooms in a state for more than a state's current *de minimis* period but less than 22 days.
   - A state currently asserts nexus for inventories held in the state for less than 22 days. This provision could affect businesses in retail and manufacturing (equipment needed to install machinery and equipment, for example), that have inventories in the state for less than 22 days (but more than any current *de minimis* period) during the year. It is likely, however, that a firm storing inventory in the state as part of their on-going business activities will hold inventory for 22 or more days a year. There would be a negligible revenue loss in this case.

2. Exemptions from nexus for certain tangible property held in the state for any length of time, including:

   - Tangible property located in a state for the purpose of being assembled, manufactured, processed or tested for another person would not establish nexus. This also applies to tangible property provided to an instate company, including an affiliate, that is used to provide services to an out-of-state company. Examples of possible tax losses from this provision include:
     - Elimination of nexus for an out-of-state business where the only physical instate presence is the out-of-state company's inventories stored instate for assembly or manufacturing by an instate contract manufacturer.
     - This provision could reduce taxes paid by companies that provide computer equipment, telecommunications switching equipment used for internet access, or research equipment to a third party providing instate services to the out-of-state company.

   - Marketing or promotional materials distributed in the state would not create nexus.

   - Any tangible property owned or leased by a firm that is ancillary to protected employee or agent activities would not establish nexus. Examples include:
     - Equipment used to cover news events.
     - Tangible property used by an independent contractor, including an affiliate, to provide services to the instate customers of an out-of-state company without physical presence in the state.

The loss of revenue from this provision will be at least partly offset by higher taxes due to any increase in taxes paid by the instate affiliate or independent contractor through increased factors and income for a non-affiliate company or increased factors for an affiliate that is part of a unitary group (in states requiring combined unitary filing).

II. Removal of Certain Limitations on the Application of Public Law 86-272

Business taxes could be reduced through two provisions of H.R. 1956 that affect the application of P.L. 86-272.

1. Modification of P.L. 86-272 protections to solicitation of sales of services and intangibles (Sec. 2(a)).

This modification of P.L. 86-272 could reduce taxes for businesses that currently have nexus in a state based on solicitation activities related to the sale of services and intangibles (i.e., copyrights and trade marks). Any revenue loss from this provision would be mitigated, in many states, by income tax sourcing rules that source sales using the greater cost of performance of services or the location of actual costs of providing services. In these states, the sales factor, and taxable income, will be relatively small for firms that have nexus only because of solicitation activities. The loss could be more significant in states using market state sourcing rules for services, including financial services.

2. Application of P.L. 86-272 to other business activity taxes (Sec. 2(b)).

H.R. 1956 extends P.L. 86-272 protections to other business activity taxes, including direct taxes on gross receipts (excluding insurance premiums taxes), gross income or profits; business license and business occupation taxes; franchise taxes; Michigan's single business tax; and capital stock taxes. The term "other business activity taxes" does not apply to transaction taxes.

Appendix B
Study Methodology and Data Sources

The estimates of the revenue impact of H.R. 1956 start with an estimate of the fiscal year 2005 state and local tax collections by tax type that could be affected by the bill. These include corporate income and franchise taxes and other business activity taxes. In addition to including all states and the District of Columbia, the estimates include impacts for the states that have significant local taxes on business income, gross receipts or other business activity taxes. States with significant local business taxes include: Maryland, Michigan, Missouri, New York, Ohio, Oregon, Pennsylvania and Virginia.

The use of actual tax collections incorporates the level of compliance under current law and administration. In situations where taxpayers are litigating a state's nexus provisions and are not required to pay the contested liabilities, the actual collections do not include this disputed revenue. On the other hand, where taxpayers have paid taxes and are challenging the liability through refund actions, such amounts are included in actual collections. The revenue estimates reflect the level of state and local tax reductions that would have occurred in fiscal year 2005 if the provisions of H.R. 1956 applied to all tax years generating business tax collections during the fiscal year.

In addition to the data sources described in the following sections, individual state responses to a survey conducted by the Multistate Tax Commission, as part of the National Governors Association analysis of the impact of H.R. 1956, were also reviewed for this analysis. The survey responses provided additional information on the type and amounts of business activity taxes that could be affected by the bill, as well as possible revenue impacts for individual states.

The estimating steps are:

1. Estimate the *current state and local business taxes* that are covered by H.R. 1956 in each state.
2. Determine the sales, by industry, into a state by companies with no establishment in the state.
3. Estimate the effective state and local tax rate per dollar of sales and multiply by the sales for firms without an establishment to determine the *taxes paid by firms with no instate establishments*.
4. Determine the percentage reduction in these taxes that will occur due to the nexus changes related to each of the provisions in H.R. 1956.
5. Apply these percentages, by major industry group, to the taxes associated with sales into the state from companies with no establishment in the state to determine the *expected state and local tax losses* from H.R. 1956.
6. *Extrapolate* the results from the included states to all 50 states and the District of Columbia.

The following sections provide more detail on the methodology used to estimate the impact of the bill on corporate income tax collections, the primary source of the revenue loss, and other business activity taxes.

Current Taxes Paid by Multistate Business. The revenue impact of the bill will come primarily from multistate taxpayers that are paying corporate income and other business activity taxes affected by H.R. 1956. Fiscal year 2005 tax collections for the affected business taxes are from state forecasts and E&Y projections based on the latest available U.S. Census, *Governmental Finance* reports. In some cases, we also contacted state revenue agencies for additional details.

Sales into a State from Firms without Establishments in the State. To derive an estimate of the taxes reported by taxpayers with minimal physical presence in a state – taxpayers expected to be affected by H.R. 1956 -- we determine the sales coming into a state from companies that have no establishment in the state. These firms do not maintain an office, store, warehouse, or other facility in the state. The underlying information for these calculations is from the U.S. Bureau of the Census, *Enterprise Statistics* (1992). This information was combined with IRS Statistics of Income data to determine the share of U.S. sales made by firms without an establishment in a state.

The next step is to determine imports into the state, by industry, using data from state IMPLAN (Minnesota IMPLAN Group, Inc.) models for the twelve specific states. The import estimate is combined with the above share estimate, to estimate the percent of total import sales in each industry provided by firms with no instate establishments.

Effective Tax Rates per Dollar of Import Sales. The import sales figures from the prior step are multiplied by estimated effective tax rates per dollar of sales to determine the taxes paid by firms with no instate establishments. In determining the effective state and local tax rate on import sales, where available, actual state income tax data on sales and taxes for apportioning firms was used to determine taxes per dollar of sales. For other states, effective tax rates were determined by dividing taxes by sales for all taxpayers. The effective tax rates incorporate general tax system features, such as nominal tax rates and weights on apportionment formula factors.

Tax Losses. The final step is to determine, by industry, what percentage of the taxes paid by firms with no instate establishments are expected to be eliminated due to the nexus provisions of H.R. 1956. State-by-state information on current-law nexus provisions, as reported in Bureau of National Affairs, Inc., *Special Report: 2004 Survey of State Tax Departments* (April 23, 2004), were used to estimate these percentages. Based on this information, a review of each provision of H.R. 1956, and our experience in estimating state and local business taxes, state-by-state loss percentages, were assigned by bill provision to each of nine major industry groups. This step considers both the types of firms that will be affected and additional state tax features, such as income tax sourcing rules for sales and taxpayer filing options. For example, if a state requires combined reporting, the loss percentages for a specific industry are lower than the percentages assigned to firms in separate filing states. This reflects the fact that the combined income in a unitary state would not be reduced if an affiliated firm no longer has nexus due to H.R. 1956. The taxes associated with sales into a state by firms with no instate establishments were multiplied by the loss percentages for each provision to estimate the total state and local business tax losses expected from H.R. 1956.

Extrapolation to Other States. The estimated losses for the twelve included states were used to determine the tax losses in the remaining states. Ratios of estimated tax loss to total business activity taxes for the included states were applied to the total business activity tax estimates in the remaining states to estimate the losses in the non-included states. Different ratios were used for separate filing states and combined reporting states. In addition, the ratios were adjusted to recognize state-by-state differences in corporate income tax nexus and sourcing rules.