Is the Sky *Really* Falling?

By Arthur R. Rosen and Karen S. Dean[1]

The Multistate Tax Commission (the "MTC") has recently come under attack over its inflated estimation of the potential revenue impact that would result from the extension of the Internet Tax Freedom Act. This estimate has generated widespread concerns regarding the reliability of statements made by the MTC. Yet this is not the first time that the MTC has asserted such a drastic revenue impact. The MTC's estimates of revenue loss routinely take into account taxes that it believes are legally due based on its own interpretation of state law and federal constitutional principles, in spite of considerable case law to the contrary. These estimates are often used by the MTC in an attempt to support its knee-jerk, instigative criticism that "corporations are not paying their fair share of tax."

In the past ten years, there have been at least four instances in which the MTC has forecast state revenue loss well in excess of reasonable expectations. Only the most recent two forecasts were actually accompanied by reports explaining the MTC's "rationale." Whatever the basis of the MTC's estimates, there is one common thread – the MTC has mistaken an acorn for the sky in each instance.

Internet Tax Non-Discrimination Act

The MTC has received the most heated criticism2 concerning its claim that the permanent extension of the Internet Tax Freedom Act, as proposed by H.R. 49, the "Internet Tax Non-Discrimination Act of 2003," would result in an annual revenue loss of at least \$4 billion.3 The MTC also claimed that, if the language of H.R. 49 had been in effect in 2002 and the telecommunications industry had completed the transfer of its services to the Internet, the revenue loss to state and local governments would have been \$22 billion. This grossly overstated and unfounded figure was the result of the MTC's interpretation of the bill that merely extends the internet access tax ban to Internet access provided by traditional telecommunications businesses.

There is no doubt that, under the terms of both the House and Senate legislation, those states and several local governments currently collecting revenue under the grandfather clause would experience some revenue loss if the proposed legislation were enacted. The Congressional Budget Office ("CBO") estimated that repealing the grandfather clause would result in revenue losses totaling between \$80 million and \$120 million annually.[4] Somehow, the

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[2] *See* Robert Cline, *Critique Of Multistate Tax Commission's State And Local Revenue Impact Estimates Of H.R. 49*, 30 State Tax Notes 317 (Oct. 27, 2003).

[3] Dan Bucks, Elliott Dubin and Ken Beier, *Revenue Impact on State and Local Governments of Permanent Extension of the Internet Tax Freedom Act*, Multistate Tax Commission (Sept. 24, 2003). *See also* Michael Mazerov, *Making the Internet Tax Freedom Act Permanent in the Form Currently Proposed Would Lead to a Substantial Revenue Loss for States and Localities*, Center on Budget and Policy Priorities (Oct. 20, 2003).

[4] Congressional Budget Office Cost Estimate, H.R. 49, Internet Tax Nondiscrimination Act, as requested by the House Comm. on the Judiciary (July 21, 2003). *See also* CBO letter to Senator Alexander dated November 5, 2003,

(continued...)

MTC estimated that the repeal of the same grandfather clause would result in a revenue loss of $500 million per year. A spokesman supporting this number has stated that it would have been even higher "but for the fact that a number of Internet access providers are not paying these taxes because they claim they are not obligated to do so under *state* law."[5]

The MTC's estimates are significantly in excess of what the CBO forecasted with respect to the same legislation, which raises questions not only over the MTC's approach to revenue forecasting but also as to its reliability. More troublesome, the National Conference of State Legislatures (the "NCSL") has expressed its concern over the MTC's projection that the inclusion of telecommunications services in the Internet access tax ban would cost the states $22 billion each year. In a November 4, 2003 action alert regarding S. 150,[6] the Senate companion to H.R. 49, the NCSL stated that "[t]he $20 billion estimation runs counter to expressed congressional intent and the provisions of the Manager's amendment and as a result threatens to seriously harm the credibility of state governments before Congress and the Administration." Thus, the danger of credibility being lost as a result of the MTC's overblown revenue forecasting extends far beyond the MTC itself.

Corporate "Tax Shelters"

In another highly publicized – and criticized[7] – report, the MTC estimated that the states lost between $8.32 to $12.38 billion in 2001 as a result of "tax sheltering activity."[8] In light of events in recent years, it would be difficult for anyone to deny that tax shelters exist and have contributed to a reduction in tax revenue for both the states and the federal government. The MTC's view of what constitutes a "tax shelter" is, however, quite problematic because just about anything that reduces a taxpayer's state or federal tax liability that is not attributable to changes in explicitly articulated state or federal tax policy would be considered a "tax shelter." Yet, "[t]he expression 'tax shelter' does not have a generally accepted meaning, but the implication is that it involves an artificial transaction that, in the mind of the taxpayer at least, has the effect of reducing one's income tax liability without reducing one's real economic income."[9] The effect of the MTC's definition is to classify as a "tax shelter" virtually any transaction, including those

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estimating that the Senate version (S. 150) would have an actual revenue cost between $80 million and $120 million per year starting in 2007.

[5] Michael Mazerov, *Making the Internet Tax Freedom Act Permanent in the Form Currently Proposed Would Lead to a Substantial Revenue Loss for States and Localities*, Center on Budget and Policy Priorities (Oct. 20, 2003). This report cites Tennessee as an example of a state not collecting its full revenue because of the litigation with AOL. Interestingly, the Tennessee Department of Revenue recently indicated that it will no longer collect sales tax on Internet access charges. Kerrita McClaughlyn, *DOR: State Will No Longer Collect Tax on Internet Access*, 31 State Tax Notes 2 (Jan. 12, 2004).

[6] *See* Internet Tax Nondiscrimination Act, S. 150, 108th Cong. (2003).

[7] *See, e.g.,* Council on State Taxation, *Abusive Tax Shelters Should Be Curtailed, But The MTC's Exaggerated Numbers Aren't Helpful To The Debate*, 29 State Tax Notes 309 (July 22, 2003).

[8] *Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections*, Multistate Tax Commission (July 15, 2003).

[9] Peter L. Faber, *Planning Is Not 'Sheltering': A Practitioner's Response To The MTC*, 29 State Tax Notes 927 (Aug. 11, 2003).

in which tax implications were not even considered, simply because the transaction results in a reduction of state or federal tax liability. It is simply not the case that all such transactions are "tax shelters"; in fact, state and federal courts regularly uphold such transactions as legitimate. Clearly, then, the MTC's revenue loss estimates are grossly overstated.

The corporate "tax shelter" report was the MTC's attempt to account for the reduction of state corporate income tax as a percentage of the GDP from 1989 to 2001. Unfortunately, the MTC's estimates fail to consider the numerous other factors contributing to the decline of state tax revenues in 2001, both in actual dollars and relative to other types of taxes. Such factors include state recognition of the validity of the "integration" concept that the federal government has been adopting[10] and uneven corporate profits.[11] In fact, a recent study commissioned by the Council on State Taxation found that businesses (not including pass-through entities) paid $404.1 billion in state and local taxes in 2003, an amount that was considered to be at least business' fair share of tax.[12]

Business Activity Taxes

During the business activity tax nexus debate concerning H.R. 2526 in the last Congress, the MTC claimed that a "substantial physical presence" nexus standard would cost state coffers more than $9 billion in potential tax revenue.[13] This $9 billion estimate was not supported by a released study showing how the estimate was determined but MTC officials have indicated that the revenue estimate was based on a survey of state tax revenue departments. It is said that the MTC asked states how much revenue they would lose if no tax was paid by any business whose receipts from sales into a state were much greater relative to the business' property or payroll in that state. It is also said that the MTC took the resulting figure and arbitrarily multiplied it by three. Beyond these fundamental flaws, not only does the estimate include several taxes that H.R. 2526 would not have affected, such as insurance premiums taxes, but the estimate is also problematic because the MTC assumed that states could impose tax based on economic nexus principles, a notion with which recent cases, *J.C. Penney National Bank*[14] and *Lanco*,[15] have disagreed.

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[10] A recent study by the Center on Budget and Policy Priorities estimates that federal corporate income tax revenues fell to $132 billion in 2003, down 36 percent from $207 billion in 2000 and represent only 1.2 percent of GDP, which is the lowest level since 1983. Joel Friedman, *The Decline of Corporate Income Tax Revenues*, Center on Budget and Policy Priorities (October 16, 2003); Isaac Shapiro, *Federal Income Taxes, as a Share of GDP, Drop to Lowest Level Since 1942, According To Final Budget Data*, Center on Budget and Policy Priorities (October 21, 2003).

[11] *See, e.g.*, Robert Cline, William Fox, Thomas S. Neubig, and Andrew Phillips, *A Closer Examination of the Total State and Local Business Tax Burden*, 27 State Tax Notes 295 (Jan. 27, 2003).

[12] *See* Robert Cline, William Fox, Tom Neubig, and Andrew Phillips, *Total State and Local Business Taxes* (Jan. 2004), available at http://www.statetax.org/Content/ContentGroups/Home_Page_Content/Right_Column_Area/50-StateStudy.pdf

[13] *See, e.g., The Internet Tax Fairness Act of 2001: Hearing on H.R. 2526 Before the Subcommittee on Commercial and Administrative Law of the House Comm. on the Judiciary*, 107th Cong. (2001) (statements of June Summers Hass, Commissioner of Revenue, Michigan Department of Treasury).

[14] *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. App. 1999), *cert denied*, 531 U.S. 92 (2000).

It is interesting to note that a state official recently admitted that the MTC's estimate was based on the worst case scenario in which businesses would reorganize to take advantage of every tax sheltering possibility and would change their business operations by removing what property (including inventory) they had from the state and closing every office or other facility in the state. Even if the MTC's revenue estimate of H.R. 2526 did not have the problems noted above, the estimate still would not be appropriate for federal legislative purposes because Congress typically looks to revenue estimates based on what is currently occurring, not on what could potentially occur and not on revenue estimates based on conjecture.

The dubious nature of the MTC's estimate aside, it is difficult for many observers to believe that a physical presence nexus standard for business activity taxes would have anything more than a minimal revenue impact. Such a standard would have absolutely no effect on taxes derived from businesses that maintain a facility in the taxing jurisdiction. It is from these businesses that states clearly derive most – if not virtually all – of their business activity tax revenue. The only revenue loss, then, would be to the extent that states are actually collecting tax from businesses that maintain no office, store, warehouse, other facility, or inventory within the taxing jurisdiction. Based on feedback from tax practitioners, corporate tax managers, and several government officials, it does not appear that any state is collecting any material amount of revenue from such businesses. That being the case, it is clear that the MTC's $9 billion revenue estimate is overblown and that, in actuality, any revenue loss from a physical presence nexus standard would be negligible.

Transfer Pricing

An example of the MTC choosing the most disastrous estimate of revenue loss occurred in the early 1990s with respect to revenue loss from incorrect transfer pricing. Then a hot topic, estimates of annual federal tax revenue losses from the transfer pricing arrangements ranged from $3 billion to $10 billion. The lowest estimate was based on testimony of the IRS Commissioner before Congress;[16] the higher estimate was cited by then-candidate Bill Clinton during the 1992 presidential campaign.[17] True to form, based on "MTC staff research," the MTC seized on the higher estimate and concluded that the federal government was losing between $10 to $13 billion in tax revenue per year.[18] This resulted in the MTC's estimate that improper transfer pricing created an annual state revenue loss of $2 billion to $2.5 billion (as opposed to

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[15] *Lanco, Inc. v. Director, Division of Taxation,* N.J. Tax Ct. No. 005329-97 (Oct. 23, 2003).

[16] *Special Report: Financing State Government In The 1990s*, 94 State Tax Notes 38-29 (Feb. 25, 1994) (citing House Subcomm. on Oversight of the Comm. on Ways and Means, *Report on Issues Related to the Compliance with United States Tax Laws by Foreign Firms Operating in the United States* (April 9, 1992) at 100, (testimony of Shirley Peterson, Commissioner of Internal Revenue).

[17] *Id. See also* Martin A. Sullivan, *Transfer Pricing; Trouble Waiting To Happen?*, 71 Tax Notes 1823 (June 24, 1996) (citing Governor Bill Clinton, *Putting People First: A National Economic Strategy for America*, at 22 (June 12, 1992)).

[18] *See Hearings On President Clinton's Proposals For Public Investment And Deficit Reduction Before the House Comm. on Ways and Means*, 103rd Cong. (1993) (statement of Dan R. Bucks, Multistate Tax Commission); *Problems With Internal Revenue Service Enforcement Regarding Multinational Corporations: Hearing Before the Senate Comm. on Gov't Aff.*, 103rd Cong. (1993) (Statement of Dan R. Bucks, Multistate Tax Commission).

$600 million to $725 million based on the lower estimates).[19] Interestingly, President Clinton's claims later proved to be overstated, as indicated by the fact that the reforms enacted to address the perceived abuses were estimated to generate only $100 million per year instead of President Clinton's much higher estimate.[20]

So What's the Lesson?

What the MTC's revenue estimates consistently fail to recognize is that a true revenue impact is measured by amounts that the states are actually collecting and not what the MTC believes that the states should be collecting based on what the MTC would like the law to be. Moreover, the MTC's estimates are consistently based on definitions and other assumptions that are questionable at best. There is no doubt that states and localities are experiencing difficult times and that state revenue loss is a serious issue. But it would behoove the MTC – and, indeed, everyone with an interest in state tax revenues – to step back, take a deep breath, and then take a reasoned and considered look at what is really going on, rather than running off immediately with tales of impending doom.

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[19] *Id.*

[20] *See* Sullivan, *supra* note 18. It is interesting to note that a portion of the MTC's corporate "tax shelter" revenue loss estimate was based on these ten-year old, discredited estimates.