



Partnership for New York City

TESTIMONY SUBMITTED TO THE HOUSE JUDICIARY COMMITTEE
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

BUSINESS ACTIVITY TAX SIMPLIFICATION ACT

TUESDAY, JUNE 24, 2008

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Thank you Chairwoman Sanchez, and members of the Subcommittee, for the opportunity to submit testimony.

The Partnership for New York City is a nonprofit organization of international business leaders and major employers who are dedicated to keeping our city the center of world commerce, culture and innovation. We strongly support H.R. 5267, the Business Activity Tax Simplification Act of 2008 ("BATSA"), and its Senate version, S. 1726, the Business Activity Tax Simplification Act of 2007.

BATSA would ensure that companies are subject to state business taxes only in those states where they have a physical presence and from which their business operations and employees derive benefits. It would stop the practice begun recently by some states of taxing corporations based on where their customers, rather than their businesses, are located. This practice has resulted in significant new impositions on companies, in terms of both tax payments and compliance costs associated with responding to widely varying and constantly changing taxing schemes adopted by various jurisdictions.

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New York City is a major hub for interstate commerce and many New York-headquartered companies transact business in all fifty states and around the world. New York City and State incur huge expenses to supply the infrastructure and services necessary to accommodate these companies. Traditional practice in the U.S. has been that states levy business activity taxes only on those businesses that have some type of physical presence (i.e., labor force or property) in the state. We support this tradition, which is based on the premise that a business should pay tax only to those jurisdictions that have provided it with meaningful benefits and protections (e.g., education, roads, police and fire protection, water and sewers). Businesses receive these benefits only from the jurisdictions where they are actually located. Businesses should only pay tax where they actually earn income, and economists agree that income is earned where a business employs its labor and capital.

BATSA would provide the clarity and discipline required to maintain a rational and hospitable business environment in the United States. It will also protect the tax base of America's major commercial centers that are absorbing the costs associated with the demands of major commercial operations.

A memorandum discussing these issues in more detail follows this testimony. Thank you for your consideration.

The Partnership for New York City Supports the Business Activity Tax Simplification Act

The Partnership for New York City strongly supports H.R. 5267, the Business Activity Tax Simplification Act of 2008 (“BATSA”), introduced on February 7, 2008 by Representatives Boucher and Goodlatte, and S. 1726, the Business Activity Tax Simplification Act of 2007, previously introduced by Senators Schumer and Crapo.

With a mission to maintain the City’s position as the global center of commerce and innovation, the Partnership for New York City is an organization of the leaders of New York City’s top corporate, investment, and entrepreneurial firms. They work in partnership with City and State government officials, labor groups, and the nonprofit sector to enhance the economy and culture of the City. The Partnership focuses on research, policy formulation, and issue advocacy at the City, State, and federal levels by leveraging its network of CEO partners. Through its affiliate, the New York City Investment Fund, the Partnership directly invests in economic development projects in all five boroughs of the City.

I. The Issues Confronted by Multistate Businesses

With advances in modern technology and the advent of the Internet and electronic commerce, businesses today are able to engage in a variety of business transactions with customers throughout the country with fewer geographical constraints than ever before. As the American economy has become more integrated, the debate surrounding the issue of when a state or local taxing authority has jurisdiction to impose a direct tax on the activities of an out-of-state business has intensified. The cause of much of this debate is the lack of a uniform nexus standard and the outdated provisions of a federal statute known as Public Law 86-272.¹

Traditionally, states and localities have levied business activity taxes only on those businesses that have some type of physical presence (i.e., labor force or property) in the jurisdiction. However, in recent years, some states have asserted that a business’s economic presence in the state – for example, merely having customers in a state – is sufficient to subject that business to tax.² Members of the business community continue to believe that some type of physical presence in a state or locality is necessary before tax may justifiably be imposed on an out-of-state business.³ The issue of a proper

¹ Public Law 86-272, 73 Stat. 555 (codified at 15 U.S.C. §§ 381 *et seq.*).

² A survey conducted by BNA Tax Analysts demonstrates the extent to which the states are asserting the right to impose tax on out-of-state businesses based on so-called “economic nexus” grounds. *Special Report: 2006 Survey of State Tax Departments*, 13 Multistate Tax Rep’t 4 (April 28, 2006).

³ See Business Activity Tax Simplification Act of 2003: Hearing on H.R. 3220 Before the Subcommittee on Commercial and Administrative Law of the House Comm. Of the Judiciary, 108th Cong. (2004) (statements of Arthur R. Rosen on Behalf of the Coalition for Rational and Fair

jurisdictional standard has been litigated, but state courts and tribunals have rendered conflicting decisions.⁴ Unfortunately, the U.S. Supreme Court has declined to rule on the issue, which has created an environment of uncertainty and unpredictability for multistate businesses.⁵ As states become more aggressive in their attempts to assert taxing jurisdiction based on economic nexus principles, the need for certainty has become more urgent.⁶

Further exacerbating the jurisdictional issues faced by multistate businesses are the outdated provisions of Public Law 86-272. Public Law 86-272 is a federal law that prohibits states from imposing a net income tax on businesses whose activities in the state are limited to the solicitation of sales of tangible personal property, provided that the orders are accepted outside the state and the goods are shipped or delivered from outside the state. The law was enacted over forty-five years ago and it has not been amended to keep pace with the changing nature of the American economy. Specifically, Public Law 86-272 only protects the solicitation of orders for tangible personal property, but over the last few decades the economy has shifted its focus from tangible goods to services and intangibles, such as intellectual property. Further, Public Law 86-272 only protects businesses from net income taxes and the number of states that have enacted non-income based business activity taxes, such as gross receipts taxes, has grown dramatically in recent years. These outdated provisions of Public Law 86-272 must be adapted for our modern economy.

These issues are of particular concern to the Partnership because of our concern about New York City's economy. New York City has long been a major hub for interstate commerce and is home to over 200,000 business establishments.⁷ New York City companies transact business in all fifty states and around the world. These problems faced by multistate businesses have reached a critical point and should be addressed by Congress.

II. Summary of BATSA

Taxation, Jamie Van Fossen, Chair of Iowa House Ways and Means Committee, and Vernon T. Turner, Smithfield Foods, Inc.).

⁴ Compare *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), cert. denied 546 U.S. 821 (2005); *Lanco, Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006), cert. denied 127 S. Ct. 2974 (2007); and *Tax Comm'r of West Virginia v. MBNA America Bank, N.A.*, 640 S.E.2d (W. Va. 2006), cert. denied 127 S. Ct. 2997 (2007); with *Acme Royalty Co. v. Dir. Of Revenue*, 96 S.W.2d 72 (Mo. 2002); *J.C. Penny Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), cert. denied 531 U.S. 927(2000); and *Rylander v. Bandag Licensing Corp.*, 18 S.W. 3d 296 (Tex. App. 2000).

⁵ See, e.g., *Lanco, Inc. v. Director, Division of Taxation*, 188 N.J. 830 (2006), cert. denied, 127 S. Ct. 2974 (2007); *Tax Comm'r of West Virginia v. MBNA America Bank, N.A.*, 220 W. Va. 163, cert. denied, 127 S. Ct. 2997 (2007).

⁶ For example, New Jersey recently attempted to impose tax on a family-owned software company based in South Carolina, which had no physical presence in New Jersey, solely because the company sold licensed software to a New Jersey entity. See Floor Statement of Congressman Rick Boucher on Introduction of The Business Activity Tax Simplification Act of 2008 (Feb. 7, 2008).

⁷ See Baruch College, "NYCdata" available at <https://www.baruch.cuny.edu/nycdata/>.

BATSA has two main components. First, BATSA adopts a physical presence jurisdictional standard. Specifically, a state or local taxing authority may not impose a business activity tax on an out-of-state business unless the business has a physical presence (i.e., employees, property, or the use of third parties to perform certain activities) in the taxing jurisdiction. BATSA also provides exceptions for certain quantitatively and qualitatively *de minimis* activities. Quantitatively, a business must have physical presence in a taxing jurisdiction for at least 15 days to be subject to tax in the jurisdiction. Additionally, a business's presence in a state to conduct limited or transient business activities is viewed as being qualitatively *de minimis* and will be disregarded in determining whether the business has met that 15-day physical presence threshold.

Second, BATSA modernizes the provisions of Public Law 86-272. BATSA extends the protections of Public Law 86-272 to the solicitation of orders for services and intangible property, rather than just tangible personal property. BATSA also treats certain qualitatively *de minimis* activities in the same manner as mere solicitation. These protected activities include those conducted for the purpose of patronizing the local market (i.e., acting as a customer), as opposed to exploiting the local market or those involving the furnishing of information to customers or affiliates. BATSA also broadens the scope of Public Law 86-272 to apply for purposes of all business activity taxes, rather than just net income taxes. BATSA does not apply to transaction taxes such as sales and use taxes.

III. BATSA Provides the Proper Solution to the Issues Faced by Multistate Businesses

BATSA provides the appropriate solution to the two major state tax jurisdictional issues currently faced by multistate businesses by adopting a uniform physical presence nexus standard and modernizing Public Law 86-272.

It has long been accepted that taxes should, at least in part, be payments for benefits and services received from the government.⁸ Proponents of an economic nexus standard argue that an out-of-state seller receives the benefit of a "viable marketplace" from a remote market state, which justifies the imposition of a tax on the activities of that out-of-state business.⁹ However, focusing solely on the seller "exploiting" a market fails to recognize the basic economic truth that the customer derives as much benefit from a voluntary transaction as does the seller and the basic political truth that state governments maintain a "viable marketplace" for the benefit of their constituents, the in-state customers, and not for the benefit of out-of-state sellers.

Further, the imposition of a business activity tax on an out-of-state seller cannot be justified on the basis that the government has provided some nebulous and incidental benefit. Rather, the benefits and protections provided by a taxing jurisdiction must be meaningful. Businesses only receive meaningful benefits and protections (e.g., education, roads, police and fire protection, water and sewers) in the jurisdictions where

⁸ *Wisconsin v. J.C. Penny Co.*, 311 U.S. 435 (1940).

⁹ See Tax Section of the New York State Bar Association, "Nexus Requirements for Imposition of Business Activity Taxes" (January 25, 2008).

they are actually located due to the presence of a labor force or property. Thus, businesses should only pay tax where they have a physical presence.

Proponents of an economic nexus standard further argue that without sales businesses would have no income. But, businesses should only pay tax where they *earn* income, and economists agree that income is earned where a business employs its labor and capital (i.e., where a business is physically present). This is abundantly clear when one considers an individual “telecommuter” whose employer is in a different state. Where does the telecommuter “earn” his or her income? He or she earns that income where he or she actually performs business activities, rather than where the employer, which is the customer for the individual’s services, is located. Like telecommuters, the location of a business’s customers is irrelevant because a business earns its income where it actually engages in business activities. Those who say that income is earned where customers are located because without customers there can be no profit would have to say that an employee earns income where his or her employer is located because without an employer there can be no wages, which obviously makes no sense.

A physical presence nexus standard is also desirable because an economic nexus standard would increase compliance costs and administrative burdens for both taxpayers and taxing authorities. Over 3,000 state and local taxing jurisdictions currently impose some type of business activity tax and over 9,000 more have the authority to impose such taxes but do not currently do so.¹⁰ With today’s modern technology, even the smallest companies can transact business with customers in all fifty states. As more state and local taxing authorities attempt to assert jurisdiction over out-of-state businesses based solely on economic nexus grounds, these small companies could be subject to business activity taxes in thousands of state and local taxing jurisdictions. Taxing schemes (e.g., filing methods, tax base computation, apportionment formulas) vary widely from jurisdiction to jurisdiction,¹¹ and taxpayers would have to track these differences, as well as any legislative and regulatory developments, in each of these jurisdictions. Although some opponents of BATSA have claimed that the provisions favor big businesses,¹² it is small and medium sized businesses that would be disparately impacted if states continued to shift towards an economic nexus standard due to the regressive nature of compliance costs.¹³ Some state tax administrators have acknowledged that an economic nexus standard is more difficult and costly for state taxing authorities to administer and enforce.¹⁴ Proponents of economic nexus ignore these very real practical considerations.¹⁵

¹⁰ Ernst & Young, “State and Local Jurisdictions Imposing Income, Franchise, and Gross Receipts Taxes on Business,” March 7, 2007.

¹¹ See Brief of Amici Curiae Council on State Taxation, et. al., *MBNA America Bank, N.A., v. Tax Commissioner of the State of West Virginia*, 127 S. Ct. 2997 (cert denied) (No. 06-1228) and *Lanco, Inc. v. Director, Division of Taxation*, 127 S. Ct. 2974 (2007) (cert. denied) (No. 06-1236).

¹² See, e.g., Matt Tomalis, *Some Fatal Flaws of S. 1726, H.R. 5267 and All BAT Nexus Bills*, 47 State Tax Notes 691 (Mar. 3, 2008).

¹³ Sanjay Gupta and Lillian Mills, *How Do Difference in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, March 2002.

¹⁴ See, e.g., Eugene F. Corrigan, *States Should Consider Trade-Off on Remote Sales Problem* (letter to the editor), 27 State Tax Notes 523 (Feb. 10, 2003).

¹⁵ See Tax Section of the New York State Bar Association, “Nexus Requirements for Imposition of Business Activity Taxes” (January 25, 2008).

The BATSA physical presence test would also provide clarity and predictability for businesses. Companies must be able to predict and estimate future tax burdens with some degree of accuracy in order to engage in strategic planning and budgeting. Companies must also be able to accurately quantify future tax liabilities for financial reporting purposes.¹⁶ Under an economic nexus standard, both the particular jurisdictions and the number of jurisdictions in which a business must pay tax can change solely because a new customer located in a particular state chooses to buy its product or because an existing customer decides to migrate to a different state. If businesses cannot accurately predict their future tax liabilities, they cannot be expected to provide meaningful disclosures to investors.

A physical presence nexus standard is also consistent with the jurisdictional standard that has been used and relied upon in the international tax context for over 80 years. The United States, along with most other countries, has adopted a “permanent establishment” standard in its bilateral tax treaties. The permanent establishment standard requires taxpayers to have a fixed place of business through which the business of the enterprise is wholly or partly carried on – in other words, a physical presence – in order for a foreign country to impose an income tax on the business’s profits.¹⁷ Hundreds of bilateral international tax treaties have adopted this “permanent establishment” standard, providing uniformity, predictability and certainty for multinational businesses for decades.¹⁸ If states were to decouple from this physical presence standard, it would likely result in reduced inbound investment and trade and, more alarmingly, retaliation by foreign countries against U.S. corporations abroad.

Along with providing a physical presence nexus standard, BATSA would modernize the provisions of Public Law 86-272. Public Law 86-272 was originally enacted in the wake of a U.S. Supreme Court decision that authorized the taxation of an out-of-state corporation whose only contacts with the state were salespeople permanently assigned to the company’s in-state sales office.¹⁹ Members of the business community were concerned that, as a result of this decision, states would begin to tax out-of-state businesses with unfettered authority. Congress responded by enacting Public Law 86-272, indicating clear policy judgments that solicitation activities create an insufficient connection with a jurisdiction to justify the imposition of a direct tax and that protecting such activities would help build a strong and unified American economy. These policy concerns remain just as strong today, and to carry out these policies in today’s modern economy the provisions of Public Law 86-272 should be updated.

¹⁶ The Financial Accounting Standards Board (“FASB”) recently issued FASB Interpretation Number 48 (“FIN 48”) which provides rigorous criteria for accounting for uncertain income tax positions (including the decision not to file a return in a particular jurisdiction) for financial statement purposes.

¹⁷ See Testimony of Michael F. Mundaca Before the Senate Committee on Finance, Subcommittee on International Trade, “How Much Should Borders Matter?: Tax Jurisdiction in the New Economy” (July 25, 2006).

¹⁸ *Id.*

¹⁹ *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).

In today's economy, more and more businesses are selling intangible products and services rather than tangible goods. Because Public Law 86-272 only protects the solicitation of orders for tangible personal property, many important sectors of the economy are not receiving the protections of the law. BATSA appropriately extends the protections of Public Law 86-272 to sales of all types of property and services, rather than just tangible goods.

BATSA would also modernize the provisions of PL 86-272 to apply to all types of business activity taxes. An increasing number of states are adopting non-income based taxing schemes. For example, Ohio has implemented a Commercial Activity Tax, effective July 1, 2005, which imposes a business activity tax based on gross receipts.²⁰ More recently, Texas enacted a Margins Tax that imposes a business activity tax based on gross margin (i.e., gross receipts less either cost of goods sold or compensation).²¹ What is most distressing about this trend is that many of these non-income based taxing schemes are specifically intended to circumvent the restrictions of Public Law 86-272. For example, New Jersey imposes an alternative minimum assessment based on gross receipts, but *only* on businesses that are exempt from corporate income tax pursuant to Public Law 86-272.²² In light of many states' current fiscal situations, more states will likely explore the option of adopting these non-income based taxes. Allowing states to avoid the restrictions of Public Law 86-272 by enacting taxes that are not calculated based on income, but that essentially have the same effect (i.e., imposing a direct tax on a business's activities), would undermine the original purposes of the law.

The bright-line physical presence test in BATSA provides the most fair and equitable standard for multistate taxpayers, and the modernization of Public Law 86-272 is necessary in light of the changes that have occurred in our national economy.

²⁰ See Ohio Rev. Code §5751.01 *et. seq.*

²¹ See Texas Code § 171.0001 *et seq.*

²² See N.J. Stat. Ann. 54:10A-5ae.