Constitutional and Other Jurisdictional Constraints On State and Local Taxation

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New York University
July 2011

<u>Constitutional and Other Jurisdictional Constraints On State and Local Taxation</u>

New York University
School of Continuing and Professional Studies
2011 Summer Institute in Taxation
Introduction to State and Local Taxation

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The United States' system of government is a federalism with federal, state and local governments sharing certain responsibilities and authorities and allocation others. Powers not delegated to the federal government under the U.S. Constitution are reserved for the states. Laws enacted by the various levels of government are not of equal weight. The U.S. Constitution prevails over both federal laws and treaties, as well as other state and local laws; and federal laws prevail over state and local laws. To the extent state tax laws do not conflict with the federal constitution and laws, the taxing rules of the state are supreme within the boundaries of the state's taxing jurisdiction. A state's constitution may impose restrictions on the state government's taxing power. This outline address the state and federal limitations on state taxation.

<u>*Part I: Federal Constitutional Limitations*</u>

"The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. Const. amend. X.

I. Due Process Clause

"[Nor] shall any state deprive any person of life, liberty, or property, without due process of law …." U.S. Const., amend. XIV, §1.

A. Fundamental Principles

1. <u>Exxon Corp. v. Wisconsin Dep't of Rev.</u>, 447 U.S. 207, 219-220 (1980). According to the U.S. Supreme Court's decision in <u>Exxon Corp. v. Wisconsin Dep't of Rev.</u>, 447 U.S. 207, 219-220 (1980):

> "The Due Process Clause of the Fourteenth Amendment imposes two requirements for such state taxation: a 'minimal connection' or

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'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" (Citing Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980)).

2. Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940). In Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940), the U.S. Supreme Court stated:

> "That test is whether property was taken without due process of law, or, if paraphrase we must, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return."

B. Nexus Standards

1. Transactional Nexus

a. Allied-Signal Inc. v. Director, Div. of Taxn., 504 U.S. 768 (1992). Petitioner corporation disputed liability of a gain realized on the sale of its stock interest to a New Jersey corporation. The two corporations were unrelated business enterprises, and petitioner's investment was passive rather than an integral operational one. The Supreme Court reversed the inclusion of the gain in petitioner's tax base, finding that in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax.

b. Connecticut General Life Insurance Co. v. Johnson, Treasurer of California, 303 U.S. 77 (1938). Appellant insurer claimed that a tax on its receipt in its home state, Connecticut, of reinsurance premiums from insurance companies operating in California on policies reinsuring them against loss on policies they issued in California to California residents violated the due process clause. Apart from the fact that appellant was privileged to do business in California, and that risks reinsured were originally insured against in that state by companies also authorized to do business there, California had no relationship to appellant or the contracts. The Supreme Court reversed the dismissal of appellant insurer's actions to recover state taxes paid under protest, finding a due process violation and that California had no relationship to appellant or to reinsurance contracts.

2. Presence Nexus

a. Bridges v. Autozone, 900 So.2d 784 (March 24, 2005), reh'g denied (May 13, 2005). The Louisiana Supreme Court provided an unusual twist to Due Process case law in Bridges v. Autozone, 900 So.2d 784 (March 24, 2005), reh'g denied (May 13, 2005). In Autozone, all seven of the court's justices held that due process protections did not prevent the state from taxing an out of state entity that owned intangible property arguably used in the state (an interest in an affiliated real estate investment trust). The taxpayer filed a petition for rehearing, which the court declined to hear due to procedural issues. However, the court's Chief Justice filed a concurring opinion arguing strenuously that in the Autozone decision the court misunderstood the issue. He argued that the due process personal jurisdiction issue involved principles distinct from the question of a state's ability to impose an income tax on an out of state business. In his Autozone concurrence, the Chief Justice was not joined by any of his colleagues. However, less than two months later, he was joined by two other justices in voting to accept a case that might have overturned Autozone. That is, three of the state's seven justices apparently are willing to reconsider Autozone's due process holding.

b. Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

(i) The Due Process Clause requires only that a corporation have "minimum contacts" with the taxing state. The intent of the Due Process Clause is to ensure fairness and notice to the corporation that its contacts with the State cause it to be subject to tax.

(ii) The presence in a state necessary to satisfy the Due Process Clause is comparable to that needed to support a state court's jurisdiction over a defendant in a civil matter. As articulated in cases such as Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985), that standard is met if the entity purposefully directs its activity into a jurisdiction. The Due Process Clause does not require physical presence in the taxing state.

c. Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985). The civil *in personam* standard is met if the entity purposefully directs its activity into a jurisdiction.

d. World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 298 (1980). A corporation can be sued in a state, under the Due Process Clause, when the corporation "delivers its products into the stream of commerce with the expectation that they will be purchased by consumers in the forum state," because the defendant's conduct and connection with the forum state are such that it should "reasonably anticipate being hauled into court there."

e. Asahi Metal Industry Co. v. Superior Court of California, 480 U.S. 102, 112 (1987). "The placement of a product into the stream of commerce, without more, is not an act of the defendant purposefully directed toward the forum State .... [A] defendant's awareness that the stream of commerce may or will sweep the product into the forum State does not convert the mere act of placing the product into the stream into an act purposefully directed toward the forum State."

f. International Harvester Co. v. Department of Treasury, 322 U.S. 435 (1944). "We think that Wisconsin may constitutionally tax the Wisconsin earnings distributed as dividends to the stockholders. It has afforded protection and benefits to appellants' corporate activities and transactions within the state. These activities have given rise to the dividend income of appellants' stockholders and this income fairly measures the benefits they have derived from these Wisconsin activities."

g. Geoffrey, Inc. v. South Carolina Tax Commission, 313 S.C. 15, 437 S.E.2d 13 (S.C. Sup. Ct. 1993), cert. denied, 510 U.S. 992 (1993). Delaware holding company that licensed its trademarks and trade names for use by its parent corporation, Toys 'R Us, in South Carolina was determined to have sufficient nexus under the Due Process Clause to subject it to the state's corporate income tax and corporate license fee.

h. Associated Electric & Gas Insurance Services, Ltd. v. Clark, 676 A.2d 1357 (R.I. Sup. Ct. 1996).

(i) The taxpayer collected premiums from four natural gas companies located in Rhode Island. The taxpayer had no physical presence in the state and received all insurance contracts directly from the insured by mail. The taxpayer was assessed Rhode Island's gross insurance premiums tax. The taxpayer argued that subjecting it to the tax violated the Due Process Clause of the U.S. Constitution.

(ii) The Rhode Island Supreme Court upheld imposition of the tax. Based on Quill, the court determined that the taxpayer had "purposefully availed" itself of the benefits of an economic market in Rhode Island and, thus, was subject to tax in Rhode Island.

(iii) Town Crier, Inc. v. Dep't of Revenue, 315 Ill. App. 3d 286, 733 N.E. 2d 780 (Ill. App. Ct., 1st Dist. June 30, 2000). An out-of-state retailer, whose only physical contact with Illinois during a 26 month audit period were 30 deliveries into the state using its own vehicles, and installation of window dressings on five occasions, was determined to have nexus. Taxpayer argued it did not "purposefully avail" itself of the Illinois market because it did not actively solicit customers from Illinois and that all contacts with the state were at the request of customers in the state. The Court found that although the taxpayer's contacts did not rise to the level of contacts in the Illinois Supreme Court's decision in Brown's Furniture, Inc. v. Wagner, 171 Ill. 2d 410, 665 N.E. 2d 795 (Ill. Sup. Ct. 1996), the number of deliveries would have satisfied the statutes cited in that decision and the frequency of the taxpayer's presence in Illinois was approximately equal to that of the taxpayer in the New York Court of Appeal's decision in Orvis Co., Inc. v. Tax Appeals Tribunal, 86 N.Y. 2d 165, 654 N.E. 2d 954, 630 N.Y.S. 2d 680 (N.Y. Ct. App. 1995), cert. denied, 516 U.S. 989 (1995).

II. Interstate Commerce Clause

"The Congress shall have the power ... to regulate commerce ... among the several States . . . ." U.S. Const., Art. I, § 8, cl. 2.

A. Fundamental Principles

1. The U.S. Supreme Court has held that the Commerce Clause not only gives the authority to Congress to regulate interstate commerce, but also prohibits the states from enacting laws that discriminate against or interfere with interstate commerce. Gibbons v. Ogden, 9 Wheat. 1 (1894).

2. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

   a. The Supreme Court rejected the rule that a state tax on the "privilege of doing business" is *per se* unconstitutional when it is applied to interstate commerce and overruled its earlier decision in Spector Motor Service, Inc. v. O'Connor, 340 U.S. 602 (1951), which had stood for that rule.

   b. The Supreme Court articulated a four-part test that must be satisfied for a tax not to violate the interstate Commerce Clause.

      (i) The tax must be applied to an activity with a substantial nexus with the taxing state;

      (ii) The tax must be fairly apportioned;

      (iii) The tax must not discriminate against interstate commerce; and

(iv) The tax must be fairly related to the services provided by the state.

(a) The states frequently argue, and courts have accepted, that the "fairly related" prong is satisfied by a showing that a business benefited from general state services such as police and fire protection, public roads and schooling. However, in a 2004 case a court held that the imposition of a state use tax violated this prong. See American River Transportation Company v. Glen Bower, 813 N.E.2d 1090, 351 Ill. App. 3d 208 (Ill. App. Ct., 2nd Dist. July 21, 2004), in which the Illinois Appellate Court ruled that the imposition of Illinois use tax on a company that operated tugboats on the Mississippi, Illinois and Ohio rivers was unconstitutional. Although the company's boats were on Illinois waters more than 50% of their time, the court concluded that "Illinois provided no services to those tugboats. The waters are all navigable waters of the United States and are maintained by the United States, not Illinois." The court analogized its decision to the treatment of an aircraft flying over Illinois.

B. Presence Nexus

1. Background

a. U.S. Supreme Court

(i) According to the Supreme Court's decision in Quill Corp. v. North Dakota, 504 U.S. 298 (1992):

(a) The Interstate Commerce Clause requires that a corporate taxpayer (or tax collector, in the case of use taxes) have "substantial nexus" with the taxing state;

(b) A corporation "may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause";

(c) In the area of use tax collection, a corporation must be physically present in a state for that state constitutionally to impose collection responsibilities upon the corporation. The degree of presence in a state necessary to satisfy the Commerce Clause is uncertain with respect to the imposition of gross receipts, income, and franchise taxes. (See National Geographic Society v. California Board of Equalization, 430 U.S. 551 (1977) and Felt & Tarrant Manufacturing Co. v. Gallagher, 306 U.S. 62 (1939) regarding support for the argument that a greater nexus standard is appropriate when a tax is being imposed, rather than merely a tax collection responsibility.)

(ii) National Geographic Society v. California Board of Equalization, 430 U.S. 551 (1977).

(a) The taxpayer was held to have use tax collection responsibility on its interstate mail order sales of maps because of the physical presence of its advertising sales offices for its magazine division in the taxing state.

(b) The Court held it to be irrelevant that the mail order sales activity being taxed did not have a physical presence in-state where taxpayer had otherwise established physical presence in the state through its magazine publication activity.

(c) The Court noted that an activity only of the "slightest presence" in the state would not be sufficient to establish taxable nexus in the state.

b. The test is substantial nexus, not substantial physical presence.

(i) Orvis Company, Inc. v. Tax Appeals Tribunal, 86 N.Y. 2d 165, 654 N.E. 2d 954, 630 N.Y.S. 2d 680 (N.Y. Ct. App. 1995), cert. denied, 516 U.S. 989 (1995).

(a) "We do not read Quill Corp. v. North Dakota to make a substantial physical presence of an out-of-state vendor in New York a prerequisite to imposing the duty upon the vendor to collect the use tax from its New York clientele." Orvis, 86 N.Y. 2d at 70, 654 N.E. 2d at 956 (1995) (emphasis added).

(ii) "[A]cceptance of the thesis urged by Orvis ... that Quill made the substantial nexus prong of the Complete Auto test an in-State substantial physical presence requirement - would destroy the bright-line rule the Supreme Court in Quill thought it was preserving in declining completely to overrule Bellas Hess.[3] Inevitably, a substantial physical presence test would require a 'case-by-case, evaluation of the actual burden imposed' on the individual vendor involving a weighing of factors such as number of local visits, size of local sales offices, intensity of direct solicitations, etc., rather than the clear-cut line of demarcation the Supreme Court sought to keep intact by its decision in Quill." Orvis, 86 N.Y. 2d at 177, 654 N.E. 2d at 960, 630 N.Y.S. 2d at (emphasis added, citation omitted).

(iii) Department of Revenue v. Share International Inc., 676 So. 2d 1362 (Fla. Sup. Ct. 1996), cert. denied, 519 U.S. 1056 (1997).

(a) The taxpayer manufactured and distributed chiropractic supplies and sold its product through direct mail. For three days every year, the taxpayer's president and vice president were speakers and coordinators at a national seminar in Florida. During the seminar, the taxpayer's products were displayed and sold. The taxpayer collected and remitted sales tax on these sales. The Department of Revenue determined that the taxpayer should be collecting sales tax on all sales, including mail order sales, to Florida.

(b) The Florida Supreme Court determined that the taxpayer did not have substantial nexus with Florida for other sales and, thus, could not be compelled to collect and remit use tax on mail order sales to Florida residents.

(c) Share provides guidance on the issue of the duration of tax presence. In Share, the court did not require the company to collect tax on sales occurring after it quit the state. In contrast, sales tax rule 3.286(b)(2) of the Texas Comptroller of Public Accounts, requires "out-of- state seller who has been engaged in business in Texas continues to be responsible for collection of Texas use tax on sales made into Texas for 12 months after the seller ceases to be engaged in business in Texas."

[3] National Bellas Hess v. Department of Revenue, 356 U.S. 753 (1967).

(iv) General Motors Corp. v. City of Seattle, 25 P.3d 1022 (Wash. Ct. App. 2001). The appellate court determined that two manufacturers and dealers of automobiles, GMC and Chrysler, with independent dealers in Seattle, but no offices there, had nexus for purposes of the city's business and occupation (B & O) tax. The court based its decision on the facts that both GMC and Chrysler directed national advertising to Seattle; sent sales, service, and parts managers there on a regular basis; and employed Seattle dealers to market warranties that serve an important marketing function. The companies' in-city advertising, marketing, sales, service calls, and service of warranties significantly impacted their ability to maintain a market in Seattle, and thereby justified a conclusion of nexus.

(v) In the Matter of Intercard, Inc., 270 Kan. 346, 14 P.3d 1111 (Kan. Sup. Ct. 2000). Eleven installations of card readers did not create nexus because such contacts were isolated and sporadic.

c. State Registration and Substantial Nexus

(i) Arco Building Systems, Inc. v. Chumley, M2004-01872-COA-R3-CV (Court of Appeals of Tennessee June 12, 2006). The taxpayer did not have property or employees in Tennessee but registered with the state so as to be able to issue resale certificates to its Tennessee vendors. Despite issuing resale certificates, the taxpayer argued that it did not have Tennessee tax presence and was not required to collect sales tax. The court rejected the argument, stating that "Whatever the merits of this argument, it is irrelevant here, for Arco did not simply register as a Tennessee dealer and file annual sales tax returns reporting no tax liability. Arco relied on its Tennessee registration to issue blanket certificates of resale" to prevent its vendors from charging Tennessee sales or use taxes.

(ii) Buehner Block Company, Inc. v. Wyoming Department of Revenue, 139 P.3d 1150, 2006 WY 90 (Wyoming Supreme Court July 27, 2006). The taxpayer was a manufacturer in Utah. It made sales to Wyoming customers, with delivery via common carrier. It had no physical presence in Wyoming but held a Wyoming sales and use tax vendor's license. The state Supreme Court held that the taxpayer's voluntary sales tax registration in combination with its delivery of goods by common carrier created substantial nexus for sales and use tax purposes.

(iii) Rylander v. Bandag Licensing Corp., 18 S.W. 3d 296 (Tex. App. Ct. 3d Dist. 2000). Appellee corporation held a certificate of authority to do business in Texas. Appellee licensed intangible property to its parent corporation, and the Comptroller argued that the licensing activity was taxable due to appellee's possession of a certificate of authority to do business. The court held that the mere possession of a license to do business did not create a substantial nexus, and further held that the holding of a passive interest in intangible property was not an "activity" within the meaning of the tax.

(iv) And see In the Matter of New Milford Tractor Co., Inc., New York State Tax Appeals Tribunal (September 1, 1994). Holding that a taxpayer's voluntary registration for sales and use taxes, allowing it to issue resale certificates on goods purchased in New York, did not create substantial nexus.

2. Specific Issues In Defining "Substantial Nexus"

a. Intangible Assets

(i) Geoffrey, Inc. v. South Carolina Tax Commission, 313 S.C. 15, 437 S.E.2d 13 (S.C. Sup. Ct.), cert. denied, 510 U.S. 992 (1993). Delaware holding company that licenses its trademarks and trade names for use by its parent corporation, Toys 'R Us, in South Carolina has sufficient nexus under the Commerce Clause to subject it to the state's corporate income tax and corporate license fee.

(ii) Rylander v. Bandag Licensing Corp., 18 S.W. 3d 296 (Tex. App. Ct., 3rd Dist., 2000). The Texas Court of Appeals rejected the Comptroller" Geoffrey type approach to nexus by holding that the possession of a certificate of authority and receipt of royalties without any physical presence, does not give rise to substantial nexus.

(iii) K-Mart Properties, Inc. v. Tax'n and Revenue Dept., 139 N.M. 172, 131 P.3d 172 (December 29, 2005). The New Mexico Supreme Court let stand a New Mexico Appellate Court decision allowing New Mexico to impose gross receipts tax and corporate income tax on Kmart Properties, Incorporated (KPI), a Michigan affiliate holding trademarks developed by the Kmart Corporation. KPI received royalty income calculated at 1.1 % of gross sales from all Kmart stores, including twenty-two in

New Mexico. For Due Process purposes, the appellate court said that allowing the marks to be used in New Mexico was purposeful availment of the economic market in the state. In its Commerce Clause analysis, the appellate court determined that the Quill physical presence requirement does not apply to the state income tax. In any event, the appellate court determined that a trademark has a "physical presence" where it is put to tangible use, i.e., where the stores are located, and that Kmart employees in New Mexico were essentially representing KPI's interests.

(iv) Acme Royalty Co. v. Director of Revenue, (consolidated with) Gore Enterprise Holdings, Inc. v. Director of Revenue, Nos. SC84225 and SC84226 (Mo. Sup. Ct. Nov. 26, 2002). In a 4-3 decision, the Missouri Supreme Court reversed two Administrative Hearing Commission (AHC) rulings that had adopted the nexus conclusions espoused in Geoffrey, and held that two intangible holding companies, while related to corporations that had nexus with the state, were separate legal entities that did not have property, payroll or sales in Missouri and thus were not subject to the state's corporate income tax. In order for a taxpayer to be liable for Missouri corporate income taxes, the taxpayer must have had some activity in the state. "The basic requirement for there to be Missouri source income is that there is some activity by the *taxpayer* in Missouri that justifies imposing tax. Although corporate activities can be immeasurably diverse, for multi-state income purposes they fall into three succinct categories: property, payroll and sales."

(v) Lanco, Inc. v. Dir., Div. of Taxation, 980 A.2d 176 (N.J. 2006), aff'g, 2005 N.J. Super. LEXIS 268 (N.J. Super. Ct. App. Div., Aug. 24, 2005), rev'g, N.J. Tax Ct., No. 005329-97 (Oct. 23, 2003), cert. denied, 127 S. Ct. 2974 (June 18, 2007).

Lanco is a Delaware corporation that owns and licenses intangible property (trademarks, trade names, and service marks) to its affiliate, Lane Bryant Inc. for use in its New Jersey retail business. Lanco had no officers, employees, or real or tangible personal property in New Jersey.

The New Jersey Tax Court held that New Jersey's corporation business tax ("CBT") does not apply to an out-of-state corporation that does not have a physical presence in the New Jersey but that has New Jersey-source income from a licensing agreement with a New Jersey retail business.

The New Jersey Tax Court determined that the Commerce Clause requires substantial nexus, which is not satisfied unless the business has a physical presence in the state. Citing *Quill Corp. v. North Dakota* (1992) and reviewing cases in other states that addressed the issue, the court determined that the difference between use tax liabilities and income tax liabilities are not significant enough to justify a different rule for physical presence and that U.S. Supreme Court decisions decided before *Quill* strongly suggested that physical presence was a necessary element of nexus for taxing income.

Reversing the decision of the New Jersey Tax Court, the Appellate Division of the Superior Court held that that *Quill's* physical presence nexus requirement is not applicable to income tax and that the New Jersey Corporation Business Tax may be constitutionally applied to income derived by plaintiff from licensing fees attributable to New Jersey.

On appeal, the Director of Taxation argued that the Commerce Clause does not require a corporation's physical presence to justify state taxation, provided that the state can establish that the corporation derives significant benefits from continued and deliberate in-state economic activity.

The Director also argued that, unlike the vendors in *Quill* (whose only connection with customers was by common carrier or the U.S. mail), Lanco had a long-term contractual relationship with a related corporation that operated outlets throughout New Jersey and Lanco and Lane Bryant enjoyed numerous benefits provided by New Jersey, including judicial protection, highway maintenance, and police and fire protection.

Reversing the decision of the New Jersey Tax Court, the Appellate Division of the Superior Court held that that *Quill's* physical presence nexus requirement is not applicable to income tax and that the New Jersey Corporation Business Tax may be constitutionally applied to income derived by plaintiff from licensing fees attributable to New Jersey

In reversing the Tax Court, the Appellate Division looked to recent state cases adopting the holding of the South Carolina Supreme Court in *Geoffrey*, namely North Carolina in its *A&F Trademark* decision and Louisiana in its *Gap (Apparel)* decision) (see below). After examining these cases, Appellate Division was "satisfied" that the physical presence requirement applicable to sales and use taxes is not applicable to income tax. As a result, it concluded that New Jersey corporation business tax may be constitutionally applied to income derived by Lanco from licensing fees attributable to New Jersey.

The New Jersey Supreme Court upheld the Appellate Division's decision and referred readers to that decision for a substantive analysis of the issue instead of issuing its own detailed analysis. The Court briefly analyzed the *Quill* decision and ruled that *Quill's* nexus application was limited to sales tax.

C. Decision making occurring in jurisdiction

(i) <u>In re Goldome Capital Investments, Inc.</u>, 1991 N.Y. Tax LEXIS 360 (N.Y.S. Div. Tax App. June 27, 1991).

(a) Taxpayer was a Delaware passive investment holding company. The majority of its income was interest from intercompany loans to its New York parent.

(b) The taxpayer maintained a statutory office in Delaware and had no office or address in New York. It generally had no activities anywhere.

(c) All of the taxpayer's officers were in New York; most of the taxpayer's income was from interest on loans to its New York parent; and all of its books and records were located in New York.

(d) The N.Y.S. Division of Tax Appeals determined that the taxpayer was "doing business" in New York state and thus subject to tax in the state.

(ii) Fla. Admin. Code R. 12C-1.011.

(a) The Florida Department of Revenue has issued a regulation which provides that a corporation will be considered to be conducting business in Florida if it has "corporate officers who have permanent or extended temporary residency (3 months in the aggregate of a 12 month period) within the state who make management decisions while residing in the state. If the only officer of the corporation or a key officer of the corporation is residing within the state, management of the corporation is presumed to be occurring within the state.

(b) In interpreting this regulation, the Department issued Technical Assistance Advisement No. 96(C)1-001 (Fla. Dep't of Revenue, May 1, 1996), in which the Department found that a corporation had nexus to Florida because eight of the company's fifteen officers resided in Florida, including its president, chief operating officer, controller, vice president of human resources, vice president of international affairs and another general vice president. In this ruling, the Department advised that the mere presence of a corporate officer in Florida is not sufficient to create nexus for Florida corporate income tax purposes. Instead, nexus is created when the corporation is deemed to be conducting business by having corporate officers in Florida who are involved in conducting the corporation's business. Furthermore, while the mere presence of a corporate officer is not sufficient to create nexus, the mere presence of a key officer creates a presumption that business is being conducted.

b. Customers in the states: "Economic Nexus"

(i) Tax Comm'r of West Virginia v. MBNA America Bank, N.A., 2006 W. Va. LEXIS 132 (2006), aff'g, No. 04-AA-157 (W. Va. Cir. Ct. June 27, 2005), rev'g, W.V. Office of Tax App. File No. 510331454001 (Oct. 22, 2004), No. 06-1228, *cert. denied* June 18, 2007. Please see subsection (d) below for an in-depth discussion.

(ii) Multistate Tax Commission's factor based nexus proposal. Under the MTC draft proposal, a company would be subject to a state's income or franchise tax if it (aggregated with its affiliates) had more than $50,000 in property in a state, or $50,000 in payroll in a state, or $500,000 in sales in a state, or 25% of total property, total payroll or total sales. *See* MTC Policy Statement 02-02, amended Oct. 17, 2002.

(iii) Oregon Nexus Statute, S.B. 177, 74th Or. Leg. Assem., Reg. Sess, (2007) generally follows the MTC approach. This bill specifies that nonresident individuals and business entities will have substantial nexus with Oregon if certain levels of payroll, property, or sales are exceeded in state. These levels are as follows:

(a) $50,000 in payroll

(b) $50,000 in real and tangible personal property owned or rented in state.

(c) $500,000 in gross sales in state.

Alternatively, if persons or entities have more than 25% of payroll, property, or sales in the state, that person or entity has substantial nexus with Oregon even though its total figures do not exceed those listed above.

This statute also provides for an aggregation approach for commonly owned enterprises. This aggregation approach calls for the aggregation of all commonly-held enterprises whose payroll, property, and sales exceed $5,000 in Oregon. Enterprises that independently meet the nexus tests are included in this aggregate determination.

(iv) A&F Trademark Inc. v. Secretary of Revenue, No. COA03-1203 (N.C. Ct. App. Dec. 7, 2004), *reviewed denied*, NOC0A03-1203 (N.C. Sup. Ct March 3, 2005). The North Carolina Court of Appeals held that Delaware intangible holding companies were doing business in the state and, therefore, were subject to corporate income and franchise taxes. Further, the Commerce Clause of the U.S. Constitution does not forbid the state from imposing the taxes at issue. Specifically, the court held that administrative Rule 17 NCAC 5C.0102 provides that the term "doing business" means the operation of any business in the state for economic gain, including owning or renting income producing property such as trademarks and trade names in the state. The holding companies argued that Rule 17 NCAC 5C.0102 "is of no consequence" because year 2001 amendments to the income tax statutes[4] indicate "that the agency's rule [improperly] expanded the income tax statute" instead of interpreting it, and that the only possible purpose for the 2001 amendments was to "cover the receipt of royalty income from the in-state use of

[4] N.C. Gen. Stat. §105-130.7A, as amended by 2001 N.C. Sess. Laws 327.

licensed trademarks." In rejecting this argument, the court found that the 2001 amendments endorsed rather than changed the scope of the income tax statute, stating that "the [2001] bill clearly denotes that its function was to enhance compliance 'with the State tax on income generated from using trademarks in [manufacturing and retailing] activities'… [and] the stated purpose was merely to add a reporting option to the income tax statute, not to modify or change what constituted taxable income."

The court also held that the imposition of franchise taxes by the revenue department does not exceed the department's statutory authority. The state's franchise tax is imposed on every corporation doing business in the state for the opportunity and privilege of transacting business in the state. The court held the "[i]t is beyond dispute that North Carolina has provided privileges and benefits that fostered and promoted the related retail companies. By affording these benefits to the related retail companies, additional benefits have inured to the [holding companies]." Further, the court agreed with the broad rationale accepted by the South Carolina Supreme Court in Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (1993), that by providing an orderly society in which the related retail companies conduct business, North Carolina has made it possible for the taxpayers to earn income pursuant to the licensing agreements.

The court also disagreed with the holding companies' argument that the presence of their intangible property in North Carolina is irrelevant in light of the lack of physical presence of offices, facilities, employees, and real or tangible property, and that National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753 (1967) and Quill Corp. v. North Dakota, 504 U.S. 298 (1992)[5] mandate that the court find the imposition of tax violates the Commerce Clause. In rejecting the holding companies contention, the court refused to expand the scope of the physical presence test of Quill beyond sales and use taxes, stating that "there are important distinctions between sales and use taxes and income and franchise taxes 'that makes the physical presence test of the vendor use tax collection cases inappropriate as a nexus test.'" Ultimately, the court rejected the contention that physical presence is the *sine qua non* of a state's jurisdiction to tax under the Commerce Clause for purposes of income and franchise taxes. Rather, the court held that "under facts such as these where a wholly owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause."

c. Tax Comm'r of West Virginia v. MBNA America Bank, N.A., 2006 W. Va. LEXIS 132 (2006), *aff'g*, No. 04-AA-157 (W. Va. Cir. Ct. June 27, 2005), *rev'g*, W.V. Office of Tax App. File No. 510331454001 (Oct. 22, 2004), No. 06-1228, *cert. denied* June 18, 2007.

[5] Both Bellas Hess and Quill involved attempts by a state to require out-of-state mail-order vendors to collect and pay use taxes on goods purchased within the state despite the fact that the vendors had no outlets or sales representatives in the state.

(i) West Virginia’s statute imposes tax on financial institutions based on the amount of the financial institutions’ economic activity with respect to West Virginia customers.

(ii) The Administrative Law Judge for the West Virginia Office of Tax Appeals determined that to meet the “substantial nexus” requirement of the Commerce Clause, there must be “a finding of a physical presence in the taxing state, not merely an economic exploitation of the market.”

(iii) The ALJ then ruled that MBNA’s use of the services of in-state lawyers and West Virginia courts for a *de minimis* number of credit card debt collection actions (three actions over a two year period) was insufficient to create nexus in West Virginia because it was merely the “slightest presence” and was not significantly associated with MBNA’s ability to establish and maintain a market in West Virginia.

(iv) The Circuit Court reversed the decision of the Office of Tax of Appeals and held that the corporate net income and business franchise taxes had been properly imposed on MBNA.

(a) The Court found that MBNA’s gross receipts attributable to a West Virginia source far exceeded the statutory threshold for nexus and concluded that MBNA had substantial nexus with the state for the years in question such that imposition of the corporate income and business franchise taxes was proper.

(b) The Court rejected the “bright-line physical presence test” established in Bellas Hess and adhered to in Quill because the taxes at issue in this case were not sales and use taxes. Specifically, the Court found as a matter of law that physical presence was not required to establish substantial nexus to satisfy the Commerce Clause when imposing corporate net income and business franchise taxes.

(c) In reaching its decision, the Court focused on the many benefits MBNA was deemed to receive from the state, such as the banking and consumer credit laws and access to the state’s courts, all of which enabled MBNA to generate income from West

Virginia customers. The Court noted in particular that because MBNA extends substantial unsecured credit to citizens of West Virginia, the fact that MBNA had access to West Virginia courts was essential to its business operations.

(d) The West Virginia Supreme Court affirmed the circuit court decision and introduced a "significant economic presence test" to hold MBNA liable for business franchise and corporate income taxes.

(1) The court began its analysis by determining that Quill applies only to sales and use taxes. It based this conclusion on four grounds. First, the Quill decision was primarily based on *stare decisis* and the need for a continuing bright-line standard for sales tax imposition. The court pointed to language in Quill stating that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today." Second, the West Virginia court read Quill so as to limit its decision to sales and use taxes. Third, the court cited Quill's foundation that without the Quill rule, compliance with the myriad of state and local sales tax rules and rates would be unduly difficult and burdensome on business. The court felt that because income taxes are remitted less frequently and to fewer jurisdictions, the compliance burden for income taxes was not as significant. Finally, the court cited changes in communication technology and electronic commerce leading to the declining viability of Quill's physical presence test in today's world.

(2) After refusing to apply Quill to income taxes, the court introduced a "significant economic presence test" as an indicator of whether businesses have nexus for Commerce Clause purposes. The court described the test as one that incorporates the due process requirements of purposeful direction towards a state while at the same time examining the degree of those directed

contacts. That degree is measured by "the frequency, quantity, and systematic nature of a taxpayer's economic contacts with a state." In applying this standard to MBNA, the court pointed to the systematic and continuous nature of the direct mail and telephone solicitation performed in West Virginia. Furthermore, MBNA's gross receipts of over $8,000,000 and $10,000,000 in 1998 and 1999 respectively were sizable and "attributable" to West Virginia, thus satisfying the significant economic presence test.

(3) In his dissenting opinion, Justice Benjamin argued that the majority opinion missed the mark by analyzing what type of tax this was rather than the effects imposition of the tax would have on interstate commerce. "Absent precedential support for differentiating 'substantial nexus' standards based upon tax types, this Court should resist the State's invitation for us to speculate based on semantics and, instead, focus on the effect which the state tax has on interstate commerce - here, attempting to levy an income tax on an out-of-state corporation with no property, tangible or intangible, in West Virginia where the income in question was generated from credit accounts held outside of this state." Justice Benjamin contended that policy considerations such as undue burden on companies and the need for a bright-line standard are equally as valid for income taxes as for sales taxes. Under this framework, he concluded that for the same reasons that sale tax imposition requires physical presence, imposition of an income tax also should require physical presence.

d. Capital One Bank v. Massachusetts Comm'r of Rev., 899 N.E.2d 76 (Mass. 2009).

(i) The highest court in Massachusetts affirmed the Appellate Tax Board's conclusion that credit card issuer Capital One

Bank had substantial nexus with Massachusetts and that imposition of the Massachusetts financial institution excise tax ("FIET") on Capital One was not unconstitutional.

(ii) The FIET presumed that financial institutions are engaged in business in Massachusetts, and hence are subject to the FIET, if there are transactions involving intangible property with "one hundred or more residents of the commonwealth during any taxable year or if the taxpayer has ten million dollars or more of assets attributable to sources within the commonwealth."

(iii) In its decision, the Massachusetts Supreme Judicial Court wrote that "[i]n addition to their consumer lending activities, the Capital banks were soliciting and conducting significant credit card business in the Commonwealth with hundreds of thousands of Massachusetts residents, generating millions of dollars in income for the Capital banks. In essence, the Capital banks were providing valuable financial services to Massachusetts consumers, for which the Capital banks were compensated in the form of interest payments, interchange fees, and finance charges."

e. Attributional Nexus

The states have generally been unsuccessful in their attempts to use an "attributional nexus" theory to establish sales/use tax nexus over taxpayers, but Matter of Borders Online Inc., No. A105488 (Cal. Ct. App., 1st App. Dist., May 31, 2005) (see below) and Matter of Barnes & Noble.com, No. 89872 (Cal. St. Bd. Equal. Sept. 12, 2002) cases are recent exceptions.

(i) Scripto Inc. v. Carson, 362 U.S. 207 (1960).

(a) The United States Supreme Court decision sustaining the power of a state to require an out-of state seller that made sales through independent contractors to collect the State's use tax on sales.

(b) Georgia company used independent contractors to solicit orders in Florida. The independent contractors forwarded any resulting orders to the home office for shipment of the ordered goods. The Supreme Court held that the company's relationship with a fleet of sales persons continually soliciting on its behalf within the state, taking orders and receiving commissions based on their sales, acted as the functional equivalent of a local sales force. The use of the salesmen to solicit orders for the sale of goods was to be attributed to the principal for purposes of determining the obligation to collect use tax.

(ii) SFA Folio Collections Inc. v. Commissioner, 73 Ohio St. 3d 119, 652 N.E. 2d 693 (Oh. Sup. Ct. 1995).

(a) The taxpayer sold clothes to Ohio customers through catalogs. An affiliate of the taxpayer, Saks Fifth Avenue of Ohio ("Saks-Ohio") operated stores in Ohio. Saks-Ohio stores received copies of the taxpayer's mail order catalogs and made copies available for store customers to review. Saks-Ohio stores also accepted returns of the taxpayer's mail order merchandise.

(b) The Ohio Tax Commissioner assessed the taxpayer use tax on its Ohio sales claiming that the taxpayer had substantial nexus with Ohio through its unitary relationship with Saks-Ohio.

(c) The Ohio Supreme Court determined that under Quill, the vendor itself must have physical presence in Ohio. Inasmuch as the taxpayer and Saks-Ohio were different legal entities and the retail stores did not conduct activities in Ohio on behalf of the taxpayer, the stores' physical presence in Ohio did not establish nexus. For the taxpayer.

(iii) In re Scholastic Book Clubs Inc., 260 Kan. 529, 920 P. 2d 947 (1996).

(a) The taxpayer was a mail-order seller of children's books. The taxpayer sent catalogs to schoolteachers who distributed the catalogs to their students and collected and submitted the orders to the taxpayer. Teachers received bonus merchandise in proportion to student purchases. Kansas asserted that the taxpayer was subject to use tax liability in Kansas because the teachers were acting as sales agents of the taxpayer and, thus, created physical presence for the taxpayer in the state.

(b) The Kansas Supreme Court determined that the teachers were the taxpayer's implied agents because the teachers acted under the taxpayer's authority once they chose to sell the books. The court determined that the taxpayer's use of the teachers created substantial nexus with Kansas and, thus, the taxpayer was required to collect sales tax on the book orders.

(c) This Kansas case is the latest in a series of state decisions addressing the same issue with a similar fact pattern. The state courts that have addressed the issue have come to widely divergent results. Cf. Scholastic Book Clubs, Inc. v. State Bd. of Equalization, 207 Cal. App. 3d 734, 255 Cal. Rptr. 77 (Cal. Ct. App. 1989) (once publisher accepted an order from a teacher, publisher ratified teacher's authority to act on its behalf, thus creating an agency relationship); Pledger v. Troll Book Clubs, Inc., 316 Ark. 195, 871 S.W.2d 389 (Ark. Sup. Ct. 1994) (no agency relationship existed because of lack of requisite control, thus, no nexus); Troll Book Clubs v. Tracy, Case No. 92-Z-590, 1994 Ohio Tax LEXIS 1374 (Ohio Bd. Tax App. Aug. 19, 1994) (Ohio teachers not controlled by publishing company, thus, no nexus).

(iv) Bloomingdale's By Mail, Ltd. v. Pennsylvania Dep't of Rev., 130 Pa. Commw. 190 at 198, 567 A.2d 773 at 778 (Pa. Commw. Ct. 1989) aff'd, 527 Pa. 347, 591 A. 2d 1047 (Pa. Sup. Ct. 1991).

(a) A corporation whose only connection with Pennsylvania was the solicitation of sales through catalogs mailed into Pennsylvania from outside of the state and the shipment of goods into Pennsylvania from outside of the state did not have an obligation to collect use tax on shipments of goods into Pennsylvania. Substantial nexus was not established through the presence of an affiliate's retail stores in Pennsylvania because the stores "do not solicit orders on [the catalog company's] behalf nor act as its agents in any fashion and [the catalog company] does not solicit orders for [the instate stores]."

(b) The only connections between the catalog company and the stores were two documented instances where a catalog item was returned to a store in Pennsylvania - even though the catalog specified that items should be returned only by mail - and the fact that the catalogs and the stores used the same advertising themes.

(v) Current, Inc. v. California State Board of Equalization, 24 Cal. App. 4th 382, (Cal. Ct. App. 1994). A corporation did not have sufficient nexus with California such that it was forced to collect California's use tax on sales of goods shipped into California merely because a corporation that did have nexus with California acquired it.

(vi) Commissioner of Revenue v. Jafra Cosmetics, 433 Mass. 255, 742 NE2d 54 (Mass. Sup. Jud. Ct. Jan. 25, 2001). Company with in-state consultants demonstrating and selling its cosmetics line had representatives in the state and, thus, had substantial nexus for sales and use tax purposes. Taxpayer had argued that consultants were representing their own, independent business, and were not acting on behalf of the out-of-state company. Cf. Shaklee Corp. v. Commissioner of Revenue, Nos. F245496, F24597 (Mass. App. Tax Bd. Feb. 7, 2000). A manufacturer of household products was not subject to Massachusetts excise tax or sales and use tax collection based on the sales activities of local independent contractors or a single sales convention in the state. The board found the local sales representatives operated independent businesses, and thus did not create nexus subjection Shaklee to sales/use tax collection obligations in the state.

(vii) State of Louisiana v. Quantex Microsystems, Inc., 809 So. 2d 246 (La. Ct. of App. July 3, 2001). The First Circuit Court of Appeal reversed and remanded a nexus case involving sales & use taxes. The trial court, citing Quill, had granted summary judgment in favor of the taxpayer, a foreign corporation that sells computer products into Louisiana by mail, telephone, and the Internet. The appellate court stated that Quantex's discovery responses gave inconsistent answers regarding whether Quantex itself provided onsite warranty service to customers in Louisiana or whether it was provided by the manufacturer. The court indicated that additional discovery was necessary to determine whether (or how much) on-site service performed by independent contractors would create nexus for Quantex. One judge dissented, finding no inconsistency and supporting the physical presence standard of Quill. Gateway, Inc. had filed an amicus curiae brief in the case.

(viii) Matter of Borders Online Inc., No. A105488 (Cal. Ct. App., 1st App. Dist., May 31, 2005). The California Court of Appeal, First Appellate District, held that an out-of-state online retailer has nexus with California through the activities of its "authorized representative," a brick-and-mortar affiliate that sells products similar to those sold by the online retailer, and therefore, is liable for use tax collection on goods purchased by customers in California. In reaching this decision, the California Court of Appeal concluded that the in-state retailer's activities on behalf of the online retailer were "for the purpose of selling" the online retailer's goods.

(ix) St. Tammany Parish v. Barnesandnoble.com, No. 05-5695 (United States District Court Eastern District of Louisiana 2007). A federal case involving facts similar to *Borders Online*. An Internet seller was alleged to have sales and use tax presence in Louisiana due to its affiliation with an entity owning bookstores in the state. The companies had separate management, employees and offices. However, they participated in gift card and membership programs operated by their parent, and benefited by advertising of the programs as well as certain other cross promotional activities. The brick and mortar stores also accepted returns of merchandise sold by the Internet seller, but also accepted returns of unrelated sellers' products. The Internet site listed store locations.

The federal court refused to attribute tax presence from brick and mortar stores to the Internet seller. The court stated that the contacts were not "of the order of magnitude necessary to establish that" the brick and mortar stores marketed the Internet company's sales in Louisiana. The sharing of a common name, brand identity and the joint marketing described did not establish nexus. This case has been appealed.

(x) Barnesandnoble.com v. State Bd. of Equalization, No. CGC-06-456465, (Superior Court, San Francisco County, Sept. 7, 2007). An out-of-state corporation that sells books, music, and movies in the state via the Internet does not engage in business in the state, for *use tax* collection purposes, even though limited marketing was done through brick-and-mortar stores in the state. The California Rev. & Tax. Cd. §6203 definition of a retailer engaged in business in the state includes a retailer having an agent within the state. The Superior Court ruled that Barnes & Noble, which owned brick-and-mortar stores in California, was not the agent of Barnesandnoble.com when the brick-and-mortar stores inserted the online retailer's coupons into its shopping bags and printed the name of the online retailer on one side of its shopping bags. The Superior Court distinguished the present case from that in the previous Borders case in that Barnesandnoble.com was not fully controlled by Barnes & Noble. Also, Barnes & Noble had no authority to bind Barnesandnoble.com, and Barnes & Noble owned only 40% of Barnesandnoble.com, whereas in Borders, the subsidiary was wholly owned by the parent.

D. Transactional Nexus

1. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). Appellant corporation challenged back taxes for the sales of transportation services. Appellant engaged in business of transporting motor vehicles from Jackson, Mississippi to dealers within the state of Mississippi. The Supreme Court in affirming the decision of the Mississippi Supreme Court, fashioned a four prong test to determine the constitutionality of state taxes on an out of state business. The first prong is whether the tax is applied to an activity with a substantial nexus with the taxing state.

2. Goldberg v. Sweet, 488 U.S. 252 (1989). Appellant individuals and corporation challenged the constitutionality of an Illinois telecommunications Tax Act. Appellant individuals are residents of Illinois who are subject and have paid the tax through their retailers, long distance telephone carriers. Appellant corporation is a long distance telephone carrier that does business in Illinois. Appellants conceded before the Supreme Court that interstate communications reached by the Tax Act constitute a sufficient nexus with Illinois.

3. Connecticut General Life Insurance Co. v. Johnson, Treasurer of California, 303 U.S. 77 (1938). Appellant insurer claimed that a tax on its receipt in its home state, Connecticut, of reinsurance premiums from insurance companies operating in California on policies reinsuring them against loss on policies they issued in California to California residents violated the due process clause. Apart from the fact that appellant was privileged to do business in California, and that risks reinsured were originally insured against in that state by companies also authorized to do business there, California had no relationship to appellant or the contracts. The Supreme Court reversed the dismissal of appellant insurer's actions to

recover state taxes paid under protest, finding a due process violation and that California had no relationship to appellant or to reinsurance contracts.

E. The Direct Aspect of the Commerce Clause. The Commerce Clause explicitly provides that Congress has the power to directly regulate commerce among the several states. Although Public Law 86-272 (discussed below) is the broadest and most general federal legislation restricting state taxation of interstate commerce, there are other federal statutes that either broaden or narrow state taxing powers affecting multistate businesses.

1. The Internet Tax Freedom Act (ITFA), P.L. 105-277, signed into law on October 21, 1998, imposed a three-year moratorium on state taxes on Internet access and multiple or discriminatory taxes on electronic commerce. An exception to the moratorium was provided for Internet access charges that were generally imposed and actually enforced by any state prior to October 1, 1998. On November 28, 2001, President Bush signed H.R.1552 into law and thereby extended the Internet Tax Freedom Act, as originally enacted, for two more years. The moratorium expired on November 28, 2003, but was extended in 2004 and again in 2007.

2. Telecommunications Act of 1996**,** Public Law 104-104 (S. 652), signed February 8, 1996, which substantially rewrote the 1935 Communications Act, exempts providers of direct-to-home satellite services from the collection and/or remittance of any tax or fee imposed by any local, but not state, taxing jurisdiction on direct-to-home satellite services, also known as direct broadcast satellite (DBS) services.

3. Public Law 104-95 (H.R. 394) (1996) (codified at 4 U.S.C. § 114) limits the states' ability to subject retirement income received by a former resident after 1995 to income taxation. The law specifically provides that states may not tax several types of retirement income of non-residents and non-domiciliaries, including income from IRC §403 annuities, §408(k) plans and §7701(a)(37) individual retirement plans. The new law is effective for payments received after December 31, 1995. H.R. 4019 amends Pub. L. 104-95, which prohibits states from taxing the retirement income of nonresidents, to clarify that retirement income of all retirees, regardless of whether they were employees, partners or self-employed prior to retirement, is treated the same for state tax purposes. This amendment applies to amounts received after December 31, 1995. Pub. L. No. 109-264 (H.R. 4019), enacted August 3, 2006.

4. Federal Aviation Administration Authorization Act of 1994, Public Law 103-305, 108 Stat. 1569, broadened the preemption of state authority to tax nonresident wages of airline employees to include in the definition of "compensation" those wages earned while performing union duties.

5. Aviation Safety and Capacity Expansion Act of 1990, Public Law 101-508, 104 Stat. 1388 (codified at 49 U.S.C. §1513(f)), prohibits states and their political subdivisions from imposing "any tax on or with respect to any flight of a commercial aircraft or any activity or service on board such aircraft unless such aircraft takes off or lands in such state or political subdivision as part of such flight. This legislation reversed the results of Republic Airlines, Inc. v. Wisconsin Department of Revenue, No. 89CV2916 (Wis. Cir. Ct. Dane County February 12, 1990) and, apparently, the Oregon Supreme Court's decision in Alaska Airlines, Inc. v. Department of Revenue, 769 P.2d 193 (Ore. 1989), cert. denied, No. 89-346 (U.S. Jan. 8, 1990) (use of overflight miles upheld in apportioning the system value of an airline for property tax purposes). See also Ruling of Virginia Commissioner, P.D. 91-41, March 19, 1991 (inclusion of overflight miles in a corporate income tax apportionment formula preempted by federal law).

6. Airline passenger tickets may not be taxed. 49 U.S.C. 1513(a) prohibits a state from taxing people traveling in air commerce or the sale of air transportation or on the gross receipts from air transportation.

   a. Any activity or service provided during airline overflights may not be taxed unless the aircraft takes off or lands in the taxing state or subdivision as part of such flight. 49 U.S.C. §1513(f)

7. Federal Interstate Commerce Commission (ICC) Termination Act of 1995, Public Law 104-88, 109 Stat. 803 (codified at 49 U.S.C. 14505), prohibits a state or its political subdivisions from collecting or levying a tax, fee, head charge, or other charge on (1) a passenger traveling in interstate commerce by motor carrier; (2) the transportation of a passenger traveling in interstate commerce by motor carrier; (3) the sale of passenger transportation in interstate commerce by motor carrier; or (4) the gross receipts derived from such transportation. The law, which became effective January 1, 1996, was apparently in response to the U.S. Supreme Court's decision in Jefferson Lines, Inc., 115 S. Ct. 1331 (1995) that Oklahoma's unapportioned tax on the purchase price of interstate bus tickets bought in state did not violate the Commerce Clause.

8. Railroad property may not be taxed more heavily than other commercial and industrial properties. Railroad Revitalization and Regulatory Reform Act of 1976 (4-R Act), P.L. 94-210, 49 U.S.C. §1503 (1978).

   a. Interstate railroad employees may not be subject to state and local taxes, except in their resident state. 49 U.S.C. §11504

9. Generation or transmission of electricity may not be taxed in a manner that discriminates against out-of-state manufacturers, producers, wholesalers, retailers, or consumers of that electricity. 15 U.S.C. § 391.

10. Employee Retirement Income Security Act of 1974 (ERISA), §514(a) provides that the provisions of ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan." 29 U.S.C. §1144(a)

    a. New York real property transfer gains tax imposed on gains derived by a qualified employee benefit plan from the sale of property was preempted by ERISA. Morgan Guaranty Trust Co. v. Tax Appeals Tribunal of Dep't of Taxation & Finance, 599 N.E.2d 656 (N.Y. 1992).

11. McCarran-Ferguson Act, 15 U.S.C. §§1011--1015 (1982), removed all Commerce Clause limitations on the authority of the States to regulate and tax the business of insurance. The purpose of the McCarran-Ferguson Act is to allow the States to regulate, directly or indirectly, interstate commerce between insurance companies of one state and the customers of another state. See S.E.C. v. National Securities, Inc., 393 U.S. 453 (1969), Feldman v. State, 615 P.2d 238 (Nev. 1980).

III. *Federal Statutory Limitation: P.L. 86-272*

A. General: P.L. 86-272, Title 1, §101, 73 Stat. 555 (codified as amended at 15 U.S.C. § 381 *et seq.* (1959)).

"No State, or political subdivision thereof, shall have power to impose, for any taxable year . . ., a net income tax on the income derived from within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

1. the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

2. the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1)."

B. Limited Applicability of P.L. 86-272.

1. Applies only to interstate commerce.

2. Applies only to net income taxes.

3. Only permissible business activity in the state is solicitation of orders.

- But see discussion of *Wrigley* below, which announces a *de minimis* exception.

4. Applies only to sales of tangible personal property.

5. Approval or rejection of orders must occur outside state.

6. Orders must be shipped or delivered from outside state.

7. Independent contractors are distinguished from employees.

C. Interpretation of the Scope of P.L. 86-272.

1. Definition of "solicitation": Until Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992) (see below), the question of what is "solicitation" had been subject to state controversy and differing opinions among state tax administrators. State court cases addressing the meaning of the term "solicitation" prior to the *Wrigley* decision were confusing and contradictory. The facts and presentation of the facts have always been critical in any case concerning the meaning of "solicitation".

2. Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214, 228-229 (1992). In Wrigley, the United States Supreme Court resolved many of these arguments by setting forth the standard to be utilized in determining what activities of a taxpayer will be considered protected "solicitation."

1. Wrigley, a gum manufacturer based in Illinois, sold its products in Wisconsin through a sales force consisting of a regional manager and various field representatives. The manager and representatives' activities included: replacement of stale gum, supplying of gum through "agency stock checks," storage of gum, training and evaluation of sales representatives, use of hotels for sales-related meetings, and intervention in credit disputes between customers and the company.

2. The Wisconsin Department of Revenue concluded that Wrigley's Wisconsin activities created sufficient nexus with the state to support imposition of a franchise tax. Wrigley claimed immunity under P.L. 86-272 and the Wisconsin Supreme Court agreed with Wrigley.

3. Wisconsin appealed and argued before the Court for a narrow interpretation of the term "solicitation," claiming that an out-of-state company forfeits immunity under P.L. 86-272 if it engages in activities other than requesting a customer to purchase merchandise. By contrast, Wrigley argued for a broad interpretation of the term "solicitation" based on the business practices of the particular industry being examined.

According to Wrigley, the term embraced activities that are "ordinary and necessary business activities accompanying the solicitation process" or are "routinely associated with deploying a sales force to conduct the solicitation" for the particular industry. Under Wrigley's argument, the standard of solicitation activity would vary depending on the type of merchandise being sold. Wrigley also argued that even if its activities were not "solicitation" within the meaning of P.L. 86-272, it was still not subject to Wisconsin's taxing jurisdiction since its in-state activities were de minimis.

4. The Court adopted neither the broad "industry" interpretation advanced by Wrigley nor the narrow interpretation of the federal statute offered by the state. Instead, the Court devised its own two-part test to determine what activities fit within the protected activities of "solicitation."

    (i) First, the demarcation between protected solicitation and other activities is the "clear line…between those activities that are *entirely ancillary* to requests for purchases - those that serve no independent business function apart from their connection to the soliciting of orders – and those activities that the company would have reason to engage in anyway but chooses to allocate to its in-state sales force."

    (ii) Second, an activity that is deemed to be more than solicitation can still be insufficient to create nexus with a state if that activity is de minimis when considered in the aggregate with all other non-ancillary actives conducted by the out-of-state vendor in the state. A de minimis activity is one that establishes only a trivial additional connection with the taxing state.

5. Applying this two-part test, the Court determined that the following activities conducted by Wrigley representatives in Wisconsin were not ancillary to the solicitation of orders and were not de minimis: replacing stale gum, supplying gum through agency stock checks and storing gum in the state. As a result of these activities, Wrigley was subject to Wisconsin income tax.

3. MTC Regulations.

1. The Uniformity Committee of the MTC has issued a resolution which recommends that states adopt its "Statement of Information Concerning Practices of Multistate Tax Commission States Under Public Law 86-272" as revised to reflect Wrigley.

2. The statement contains a list of activities, which are considered to be part of solicitation and, thus, exempt from taxation, and others deemed in excess of solicitation:

   (i) Soliciting orders for sales by any type of advertising.

   (ii) Carrying samples only for display or for distribution without charge or other consideration.

   (iii) Owning or furnishing autos to sales personnel.

   (iv) Passing inquiries and complaints on to the home office

   (v) Missionary sales activities.

   (vi) Checking of customers' inventories without a charge therefor.

   (vii) Maintaining a sample or display room for two weeks or less at any one location during the tax year.

   (viii) Soliciting of orders for sales by an in-state resident employee of the company; provided the employee maintains no in-state sales office or place of business that is attributable to the company or to the company's agents in their agency capacity.

   (ix) Recruitment, training or evaluation of sales personnel, including occasional use of homes, hotels or similar places for meetings with sales personnel.

   (x) Maintaining, by any sales employee, an in-home office that is not paid for directly or indirectly by the company and which is not attributable to the company or to the company's agents in their agency capacity.

   (xi) Mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating requests for orders.

D. State Decisions Applying P.L. 86-272

1. <u>Disney Enterprises, Inc. v. Tax Appeals Tribunal</u>, ___ NY (March 25, 2008). Disney Enterprises, Inc. was the parent of hundreds of subsidiaries and affiliates, including Buena Vista Home Video (Video). Disney included Video in its New York State combined report. As Video's New York activities were limited to sales solicitation for its tangible personal property, it claimed the protection of P.L. 86-272. The Court of Appeals

disagreed and held that the term "person" as used in P.L. 86-272 referred to the entire unitary group. Therefore, because other members of the Disney unitary group engaged in New York in activities not protected by P.L. 86-272, the court held that the entire Disney unitary group was unprotected by P.L. 86-272.

2. Muro Pharmaceutical v. Crystal, No. 524693 (Conn. Super. Ct., Tax Sess. 1994). An out-of-state pharmaceutical manufacturer's income from sales made toConnecticut companies was exempt from tax under the federal statute. The company's primary activity in the state, other than sales, consisted of in-person presentations to doctors in which a company representative provided free samples and product information. These presentations were intended to persuade doctors to prescribe these products. The court held that the representatives' activities were indirect solicitations within the meaning of the federal statute.

3. Nat'l Private Truck Council v. Comm'r, 426 Mass. 324 (1997). Members of the trade association solicited orders in the state that were sent outside the state to be approved and filled. The members also operated truck fleets to deliver products in the state. The association sought a declaratory judgment that they were not subject to state taxation. The court held that P.L. 86-272 precluded taxation of the members reasoning that the federal statute does not require that the transfer occur outside the state.

4. Amgen, Inc. v. Commissioner of Revenue, 427 Mass. 357 (1998). Pharmaceutical company's activities exceeded those permitted under P.L. 86-272. Its clinical support specialists made presentations regarding the company's products to nurses at hospitals and other health care facilities. Sometimes the specialists were asked to review patient charts or answer questions about proper dosage. The company had a reason to engage in these last two activities apart from assisting in the solicitation of sales. Namely, reducing the number of calls to its "hotline" that was staffed by physicians.

5. Schering-Plough Healthcare Prods. Sales Corp. v. Commonwealth, 861 A.2d 259 (Pa. 2004), *aff'g*, 805 A.2d 1284 (Pa. Commw. Ct. 2002). The Pennsylvania Supreme Court affirmed the decision of the Commonwealth Court ruling that P.L. 86-272 protected a corporation soliciting sales in Pennsylvania from liability for corporate net income tax. The sales company was not the owner of the goods for which it was soliciting sales. It was soliciting sales of the products of an affiliated corporation. Still, the Commonwealth Court rejected the Department of Revenue's argument that P.L. 86-272 only protects a corporation if it has title to the good for which it is soliciting sales, and found that the federal law need not be strictly construed against taxpayers.

6. In the Matter of the Protest of Dart Indus., Inc., Dkt. No. 02-152241-00-3 (New Mexico Taxation and Revenue Department, February 26, 2004). The Department determined that Dart, an out-of-state corporation, was not protected from New Mexico corporate income tax under P.L. 86-272 because (1) Dart's franchised distributor was acting on behalf of Dart in establishing, maintaining and protecting Dart's New Mexico market and because (2) these activities of the distributor which were attributed to Dart exceeded the scope of protected activities under P.L. 86-272.

1. Activities exceeding the scope of P.L. 86-272 ("mere solicitation of orders of tangible property") included:

   (i) The corporation's licensing of its trademark and confidential franchising system,

   (ii) The corporation's establishment of services for the New Mexico franchised distributorship,

   (iii) The distributor's maintenance of an in-state office,

   (iv) The distributor's promotion and protection of the corporation's trademarks and related goodwill, and

   (v) The distributor's handling of customer complaints and warranty services.

7. New York State United Teachers Benefit Trust (Advisory Opinion), TSB-A-05(3)(C), N.Y.S. Comm'r of Tax'n and Fin. (Mar. 10, 2005). The New York Department of Taxation and Finance found that a Pennsylvania based company whose sole activities in New York State consisted of having a telephone listing in a New York telephone directory and delivering concrete produced at its Pennsylvania facility was engaged in activity protected by P.L. 86-272 and therefore, was not subject to taxation. However, the department made a distinction between concrete that was "central mixed" (mixed entirely at the facilities before being transported and delivered to a customer's location in New York State) and concrete that was "transit mixed" (mixed during transportation in New York or at a delivery site in New York). The department specifically noted that if the company had been engaged in delivering transit mixed concrete, it would not have been protected from taxation under P.L. 86-272.

8. Upromise Invs., Inc. (Advisory Opinion), TSB-A-05(7)(C), N.Y.S. Comm'r of Tax'n and Fin. (Apr. 4, 2005). The New York Department of Taxation and Finance found that a company whose only activities within the boundaries of New York State were those conducted by one employee, a sales representative responsible for the solicitation of sales from within and without the state was protected from taxation under P.L. 86-272.

Specifically, it was determined that the company did not maintain an office in New York State at the sales representative's residence and that the activities of the sales representative were limited to mere solicitation.

9. Wausau Tile, Inc., TSB-A-05(17)(C), N.Y.S. Comm'r of Tax'n and Fin. (Dec. 12, 2005). The New York Department of Taxation and Finance found that a Wisconsin company whose New York State activities consisted of performing repairs to its products, being a defendant in a product liability case, and maintaining a licensee agreement with a university located in New York are activities that go beyond the mere solicitation of orders as contemplated by P.L. 86-272. However, the company was not subject to New York's franchise tax due to a *de minimis* activity exception for the repairs and the fact that the litigation and licensee did not constitute doing business within New York State.

10. Oklahoma Tax Commission Decision No. 2005-05-10-22 (May 10, 2005). The Oklahoma State Tax Commission ruled that an out-of-state partnership that delivers merchandise to Oklahoma customers using company owned or leased vehicles is protected by P.L. 86-272 and therefore not liable for Oklahoma income tax. Holding that P.L. 86-272's protection is not limited to "shipment or delivery by common carrier," the commission rejected the Audit Division's argument that delivery of products by company-owned trucks is an unprotected activity.

11. Chester A. Asher, Inc. v. Dir., Div. of Taxation, 004061-2003, 2006 N.J. Tax Lexis 1 (Jan. 5, 2006) The New Jersey Tax Court held that the activities of Chester A. Asher, Inc. (Asher) exceeded the protections of P.L. 86-272 and were not *de minimus*, thereby subjecting Asher to income taxation in New Jersey. Asher, a manufacturer of candy and confections, had its primary place of business in California. In each of the tax years between 1999 and 2001, Asher did business in New Jersey resulting in gross sales of over $2,500,000 each year. The court examined Asher's operations in New Jersey and held them beyond the protection of P.L. 86-272 because Asher's delivery drivers acted as more than mere delivery agents by collecting payment from some customers regularly and others less regularly, accepting returned candies, picking up baking supplies in New Jersey, and participating in Asher's "Chocolate Shop Program" (a program designed to help customers set up their own candy shops). Further, the court held that the cumulative effect of these actions was substantial and could not be considered *de minimus*.

12. Virginia Tax Commissioner Ruling, Public Document, 07-51 (04/26/2007) The Virginia tax commissioner ruled selling tangible personal property on behalf of third party clients constitutes a business services, not mere solicitation of sales, and is not protected by P.L. 86-272.

E. State Enforcement of P.L. 86-272 Limitation

1. Nexus Questionnaire. States produce detailed nexus questionnaires that are sent to businesses not currently filing income tax returns to obtain information concerning the out-of-state vendor's business activities.

2. Follow-up. Once the taxpayer's response is received, the state may follow-up with further examination, including discussions with customers and authorized service representatives.

3. Assessments. When a state has targeted a particular taxpayer as a non-complier, the state may issue an assessment. The assessment may be based on the taxpayer's figures or may be estimated by the state. The assessment will generally cover the period of time commencing with the date on which the taxpayer started doing business in the state.

4. Voluntary Disclosure Agreements.

1. A taxpayer that believes it owes an annual tax liability of which a state is unaware should consider entering into a voluntary disclosure agreement with the state. Under this agreement, the taxpayer agrees to pay back taxes and related interest, typically for the two or three most recent years, and further agrees to make timely filings and payments on a going forward basis. In return, the state agrees to abate in full penalties and related interest that would otherwise apply to those two or three years, and to abate in full taxes, penalties and interest for all earlier years. The agreement does not affect the taxpayer's liability for other types of taxes owed to the state.

    (i) A taxpayer seeking a voluntary disclosure agreement should do so anonymously through an attorney. The identity of the taxpayer should not be revealed until all other aspects of the voluntary disclosure arrangement have been agreed to in a signed writing.

    (ii) While most states will enter into such agreements, some will not. Massachusetts, for example, will not enter into a voluntary disclosure agreement. And Florida requires taxpayer identification before signing of the agreement, a condition that makes such an agreement impractical.

5. Dealing With State Enforcement Activities.

    a. Alternative to Questionnaire: Narrative responses in a letter can describe the taxpayer's activities and may also permit certain information, e.g. major customers, to be withheld until there has been an appropriate determination that the taxpayer is doing business in the state.

b. Other Problems: Questionnaires are frequently signed under penalties of perjury. Fraud claims cannot be discounted if the taxpayer's responses are not fair and accurate.

F. Planning to Come Within P.L. 86-272

1. Employee Manual. Consider detailed employee job descriptions placed in the company's employee manual specifically limiting sales representatives' activities to those permitted under P.L. 86-272.

2. Reorganization. If sales and service activities are in a single corporation, consider placing the service activities in a separate corporation.

3. Reduce Sales Factor. Decrease total state tax liabilities by selectively subjecting operations to tax in states that impose no tax or a low tax rate. Benefit is to avoid throwback of sales to high-tax jurisdictions.

G. Application of P.L. 86-272 to Gross Receipts Taxes and Other Non-Income Based Taxes

1. States with Multiple Tax Bases. Certain states, e.g., Pennsylvania and, through 2007, Texas, impose a combined franchise tax with several alternative bases (income, capital, minimum) and require the taxpayer to pay the higher of the taxes. Other states, *e.g.*, New Jersey, Michigan and Ohio, have enacted business taxes imposed on gross receipts instead of net income.

2. Limited Reach of P.L. 86-272. Some of the states with multiple bases have taken the position that P.L. 86-272 protects the taxpayer from net income taxes only; the taxpayer is still required to file the franchise return and pay the tax on capital (or other non-income-based alternatives) if the taxpayer has substantial nexus with the state (e.g., salespeople soliciting orders).

1. For example, the Texas Franchise Tax (under prior law) and Washington Business and Occupation Tax utilize a different nexus standard than that used by P.L. 86-272.

2. Texas. INOVA Diagnostics, Inc. v. Strayhorn, No. 03-04-00503-CV (Tex. Ct. App. May 26, 2005). A California corporation that employed one salesperson in Texas was required to pay the state franchise tax based on the activities of that salesperson. The Court based its decision on the bright line rule set forth in *Quill* requiring physical presence in a state to establish a sufficient nexus to allow taxation under the Commerce Clause. The Court held that INOVA had a permanent sales presence in Texas in the form of one sales representative who spent seven to ten days per month soliciting orders in the state. This was sufficient to establish nexus – while P.L. 86-272 exempts INOVA's earned surplus from

taxation, the taxpayer remained subject to the net taxable capital portion of the tax.

3. Note, however, that the California Franchise Tax uses the P.L. 86-272 standard in determining taxable nexus.

3. New Jersey. The New Jersey Corporation Business Tax was amended effective in 2002 to impose a gross profits/gross receipts tax. After June 2006, these "gross" taxes will apply only to businesses protected by Public Law 86-272.

4. MTC Factor Presence Nexus. Multistate Tax Commission Resolutions Committee Draft Policy Statement 2002-02, "Ensuring the Equity, Integrity and Viability of State Income Tax Systems," as amended October 17, 2002. In addition to its factor presence nexus standard, the MTC has also supported the repeal of P.L. 86-272 in states that enact the factor-based nexus standard (P.L. 86-272 currently protects certain business that merely have customers or certain payroll in a state).

   a. Ohio. Ohio enacted a new "Commercial Activity Tax" that, effective July 1, 2005, replaced its current income/franchise tax. The CAT is based on gross receipts and, thus, the protections of P.L. 86-272 are no longer be available to out-of-state businesses performing solicitation activities in Ohio.

   b. Illinois. Over a period of years, the Illinois Department of Revenue issued rulings asserting that an entity that had sales sitused to Illinois necessarily had tax presence in the state. The approach might have been a realistic rule of thumb when business largely consisted of the manufacturing and sale of merchandise. However, with growth of the service industry the rule of thumb drew objections. As a direct result, the Department amended its regulations to recognize that tax presence principles are different from the principles used to allocate and apportion income: See Ill. Reg. 100.9720(a). "However, the fact that Article 3 of the IITA requires a non-resident taxpayer to allocate or apportion income to this State does not create a presumption that the taxpayer has nexus."

   c. Ohio. Under Ohio's Commercial Activities Tax, a business having at least $500,000 of taxable gross receipts shall be treated as having tax presence n the state. Taxable gross receipts is defined as gross receipts sitused to this state under the tax law's sourcing provisions.

5. BATSA Business Activity Tax Simplification Act ("BATSA") legislation

a. Supporters of federal BAT nexus legislation are asking Congress to enact Business Activity Tax Simplification Act ("BATSA") legislation.

b. A hearing on the version of the bill before the 109th Congress ("H.R. 1956") was held before the U.S. House of Representatives Committee on the Judiciary Subcommittee on Commercial and Administrative Law on September 27, 2005.

c. A mark-up of H.R. 1956 was held by the U.S. House of Representatives Committee on the Judiciary Subcommittee on Commercial and Administrative Law on December 13, 2005 at which the Subcommittee approved by voice vote a substitute amendment.

d. H.R. 1956 was not voted on by the House, but it is anticipated that a new BATSA bill will be introduced in the 110th Congress and that the bill will contain substantially similar language. (See also S. 2721 Introduced May 4, 2006)

e. What does BATSA, H.R. 1956, do?

(i) Modernizes P.L. 86-272.

(a) Deletes "tangible personal property" language and adds the term "transactions." This ensures that the protection for solicitation activities extends to all sales, which recognizes the increased focus in the American economy on intangibles and services.

(b) Adds the concept of "fulfillment" to acknowledge that not all sales or transactions are "shipped or delivered"

(c) Adds "business activity taxes" in addition to "net income taxes." This ensures that protections of P.L. 86-272 extend to all business activity taxes, which recognizes the proliferation on business activity taxes not based on income (gross receipts taxes, capital taxes, etc.).

(d) Implements a physical presence standard for all business activity taxes.

(1) Provides qualitative and quantitative *de minimis* standards.

i) Quantitative: Employees in a state for less than 21 days.

ii) Qualitative: Acting as a customer in the state, *e.g.*, visiting vendors, attending conferences, media events, etc.

(e) Clarifies that certain situations subject a person to tax.

(1) Entertainers and athletes.

(2) Off-the-truck/over-the-counter sales; itinerate handymen

(3) Maintaining an office and storing inventory (this is property in a state).

(f) Addresses those situations when attribution of nexus to other persons is appropriate.

f. Why is Congress Being Asked to Act?

(i) Problems that the Federal Legislation seeks to Address

(a) Uncertainty

(1) There is no clear standard governing when a state or locality may impose its business activity taxes on an out-of-state business.

(2) The Supreme Court has declined to rule on the nexus standard as applied to business activity taxes, apparently preferring to leave the matter for resolution by Congress.

(3) The existing federal statute addresses only a subset of the issue.

(b) Controversy

(1) The lack of a clear standard has engendered contentious tension between the state taxing authorities and businesses.

(2) Many states and localities are trying to impose tax on businesses that merely have

customers in the taxing jurisdiction ("economic nexus").

(3) Businesses want to pay their fair share of tax where they receive the benefits and protections of the state government ("physical presence nexus").

(c) Wasted resources

(1) Compliance with increasingly complex and divergent state and local tax laws and rules places a large burden on interstate commerce.

(2) Litigation absorbs resources (management attention and expenses) that could be used to strengthen the economy.

(d) Chilling effect on interstate commerce

(1) Businesses are hesitant to expand their activities that may cross an invisible "threshold" and make them taxable in other states.

(2) Businesses are forced to construct inefficient business structures.

(e) International ramifications

(1) There is a dramatic, antithetical "disconnect" between the permanent establishment concept used by the U.S. in international tax treaties and the economic nexus standard favored by some state and local tax jurisdictions

(2) If economic nexus becomes an acceptable standard for state and local taxation:

i) U.S. businesses would be competitively disadvantaged because they will be subject to a greater tax burden than foreign businesses.

ii) The strength of the U.S. in treaty negotiations with countries that favor eliminating the permanent establishment standard would be significantly weakened.

(ii) How the Proposed Legislation Addresses the Problems

(a) Benefits and Protections.

(1) A physical presence nexus standard ensures that businesses are taxed only where they receive protections and benefits (fire, police, etc.) of the state.

(2) The argument that states "contribute to nation as a whole" is not a justification for taxing businesses that do not have a physical presence in a state.

(b) Bright-line Standard. A physical presence nexus standard is fair and administrable.

(1) Eases compliance burdens created by current complex and divergent state and local tax laws.

(2) Minimizes litigation, thereby freeing resources (management attention and expenses) that can otherwise be used to strengthen the economy.

(c) International Harmony.

(1) Ensures consistency with the permanent establishment concept used by the U.S. in international tax treaties.

i) Protects the strength of the U.S. in treaty negotiations with countries that favor eliminating the permanent establishment standard would be significantly weakened.

(2) Creates a level playing field for U.S. and foreign businesses.

(iii) Other Considerations

(a) No Effect on Federalism or Infringement on States' Rights

(1) U.S. Constitution grants Congress the authority to regulate interstate commerce.

(2) This is an issue of *when* a state can tax, not *what or how* a state can tax. State legislatures remain free to, among other things:

i) Decide the type of tax(es) imposed, *e.g.*, an income tax, a gross receipts tax, a value added tax, or a capital stock tax.

ii) Determine how to apportion the income that is taxed in the state, be it a single- or three-factor formula based on property, payroll and/or sales.

iii) Set the rate at which the tax chosen will be imposed.

iv) Determine whether to follow federal taxable income, *e.g.*, to choose whether to decouple from federal bonus depreciation.

v) To provide credits or deductions for certain types of expenses.

(b) No Material Effect on Revenue

(1) Businesses that have a facility and/or inventory in the state remain subject to tax

(2) Consensus is that few businesses that do not have a facility are actually paying tax

(3) Result is that businesses will continue to pay their fair share because they will be paying tax where income is earned.

(c) Not a Vehicle For Promoting Tax Shelters.

(1) Opponents of a physical presence nexus standard argue that economic nexus is required to combat "abusive" tax shelters, such as passive investment companies. *Lanco, Inc. v. Dir., Div. of Taxation*, 980 A.2d 176 (N.J. 2006), *aff'g*, 2005 N.J. Super. LEXIS 268 (N.J. Super. Ct. App. Div., Aug. 24, 2005), *rev'g*, N.J. Tax Ct., No. 005329-97 (Oct. 23, 2003); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 2005 US LEXIS 6033 (2005); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

(2) States have many other methods of attacking such perceived tax shelters.

i) Combined reporting. *See, e.g., Matter of Sherwin-Williams Co.*, N.Y.S. Div. of Tax App., Tax. App. Trib., DTA No. 816712 (June 5, 2003); Va. Dep't of Tax'n, Ruling of Comm'r, P.D. 05-139 (Aug. 23, 2005).

ii) Statutory addbacks, deduction denial. *See, e.g.*, Ala. Code § 40-18-35(b); Ark. Code Ann. § 26-51-423(g)(1); Conn. Gen. Stat. § 12-218c; Ga. Code Ann. § 48-7-28.3; Ky. Rev. Stat. Ann. § 141.205; Md. Code Ann., Tax § 10-306.1; Mass Gen. Laws ch. 63, §§ 31I, 31J, 31K; Miss. Code Ann. § 27-7-17(2); N.J. Stat. Ann. § 54:10A-4.4; N.Y. Tax Law § 208(9)(o); N.C. Gen. Stat. § 105-130.7A; Ohio Rev. Code Ann. § 5733.042; and Va. Code Ann. § 58.1-402B. *See also* Multistate Tax Commission Proposed Model Statute Requiring the Add-back of Certain Intangible and Interests Expenses, Multistate Tax Commission (Feb. 17, 2005 Draft).

iii) Common law principles, such as economic substance, sham transaction, lack of valid non-tax business purpose, and alter ego. *Syms Corp. v. Commissioner of Revenue*, 765 N.E.2d 758 (Mass. 2002); *Comptroller of the Treasury v. SYL, Inc.; Crown Cork & Seal Co. (Del.), Inc.*, 825 A.2d 399 (Md. 2003), *cert. denied*, 540 U.S. 9 and 540 U.S. 1090 (2003).

iv) I.R.C. § 482-type authority to make adjustments to properly reflect income.

(iv) Who are the Stakeholders?

(a) For. Many American businesses, some state government officials (mostly from the legislative branch), and economists believe that states should not be able to impose tax on an out-of-state business unless that business has a physical presence in the taxing state.

(1) American Legislative Exchange Council:

i) ALEC has adopted a resolution supporting enactment of federal legislation implementing a physical presence standard.

ii) ALEC has crafted model legislation enacting a physical presence standard, similar to the proposed federal legislation.

(b) Against. Some state government officials take the opposite position and assert that a state may impose tax on any business that has customers in the state. Opponents of such legislation argue that federal BAT nexus legislation is an infringement on state sovereignty, would reduce state tax revenue, and would facilitate "tax shelters."

(1) Multistate Tax Commission "factor-presence" nexus standard:

i) The MTC states that it objects to codification of the physical presence nexus standard for business activity taxes. Multistate Tax Commission Resolutions Committee Draft Policy Statement 2002-02, "Ensuring the Equity, Integrity and Viability of State Income Tax Systems," as amended October 17, 2002.

(2) The Federation of Tax Administrators approved a resolution to oppose federal efforts to establish nexus standards for state business activity taxes, such as H.R. 1956, at its annual business meeting on June 15, 2005.

i) At the meeting, FTA Executive Director Harley Duncan specifically noted that one major concern that states had with such legislation was that it would create significant opportunities to engage in a variety of tax planning activities.

ii) Also, the Executive Director criticized the bill for being internally inconsistent. "If a clear definition of physical presence is good, then there should be no need to carve out all sorts of activities that don't constitute physical presence. But the bill does just that."

(3) Montana resolution (S.J. 32) supported by the Commissioner of Revenue, Dan Bucks, opposed introduction of federal legislation implementing a physical presence standard for business activity taxes. The measure died in the House committee.