Quill by Affiliation

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I. INTRODUCTION

The Supreme Court has never fully addressed the jurisdictional question of when a state can subject an out-of-state taxpayer to its taxing authority. For an out-of-state taxpayer to be subject to a state's taxing authority, it must have "substantial nexus" to the taxing state.[1] The Supreme Court attempted to provide a straightforward resolution of the issue in *Quill Corp. v. North Dakota*.[2] That decision was issued in response to a state supreme court opinion that concluded that the Supreme Court's previous decision in *National Bellas Hess v. Department of Revenue of Illinois*[3] was obsolete due to twenty-five years of "social, economic, commercial, and legal innovations."[4] Twenty years

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1. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977) (holding that a tax is sustained "against [a] Commerce Clause challenge when the tax is applied to an activity with a *substantial nexus* with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.") (emphasis added).

2. 504 U.S. 298 (1992).

3. 386 U.S. 753 (1967), *overruled by* Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

4. Heitkamp v. Quill Corp., 470 N.W.2d 203, 208 (N.D. 1991).

after the Supreme Court's decision in *Quill*, which reaffirmed the physical presence requirement of *Bellas Hess,* states persist with the argument that requiring a taxpayer to have physical presence in a state in order to be subject to tax under the dormant Commerce Clause is obsolete.[5]

Part of the problem is attributable to the Supreme Court's opinion in *Quill*, which can be read as a weak affirmation of the physical presence requirement and limiting its applicability to sales and use taxes. The problem is exacerbated by the Court not granting a petition for certiorari that dealt with the issue of substantial nexus since its decision in *Quill*. While the Supreme Court might have hoped that Congress would provide a definitive statement on the issue,[6] Congress has yet to comply with the Court's request for a legislative answer.[7] As a result, the time has come for the Supreme Court to define "substantial nexus."[8]

Two recent cases provided the Supreme Court with an opportunity to finally define "substantial nexus."[9] One case dealt with state income taxes,[10] while the other dealt with business and occupation taxes.[11] One addressed "economic nexus," while the other analyzed the outer limits of physical presence. Both cases provided the Court with good, straightforward facts that dealt with regularly occurring business conduct. Further, neither case dealt with tax-motivated transactions. As a result, the

5. *See* Arthur R. Rosen & Matthew P. Hedstrom, *Quill* — Stare *at the* Decisis*ion*, 60 ST. TAX NOTES 931, 932 (2011).

6. *Quill*, 504 U.S. at 318. In 1959, Congress passed Public Law 86-272, which addresses states' ability to impose state income taxes regarding the sale of tangible personal property in interstate commerce. Public Law 86-272 only applies to state income taxes and does not apply to income from intangible property. Act of Sept. 14, 1959, Pub. L. No. 86-272, §§ 101, 102, 73 Stat. 555, 555–56.

7. *See, e.g.*, Business Activity Tax Simplification Act of 2011, H.R. 1439, 112th Cong. (2011); Business Activity Tax Simplification Act of 2009, H.R. 1083, 111th Cong. (2009); Business Activity Tax Simplification Act of 2008, H.R. 5267, 110th Cong. (2008); Business Activity Tax Simplification Act of 2007, S. 1726, 110th Cong. (2007); Business Activity Tax Simplification Act of 2006, S. 2721, 109th Cong. (2006); Business Activity Tax Simplification Act of 2006, H.R. 1956, 109th Cong. (2006); Innovation and Competitiveness Act, H.R. 4845, 109th Cong. (2006); Business Activity Tax Simplification Act of 2003, H.R. 3220, 108th Cong. (2003); Internet Tax Fairness Act of 2001, H.R. 2526, 107th Cong. (2001); New Economy Tax Fairness Act, S. 664, 107th Cong. (2001); New Economy Tax Simplification Act, S. 2401, 106th Cong. (2000).

8. For a practitioner's brief perspective on the issue following the Supreme Court's rejection of petitions for certiorari in 2009, see Jeffrey A. Friedman et al., *The U.S. Supreme Court Should Accept a Nexus Case*, 53 ST. TAX NOTES 42 (2009). *See also* John Buhl, *Federal Inaction Encouraging More Aggressive Nexus Statutes*, 63 ST. TAX NOTES, 199 (2012).

9. *See* Lamtec Corp. v. Dep't of Revenue, 246 P.3d 788 (Wash. 2011), *cert. denied*, 132 S. Ct. 95 (2011); KFC Corp. v. Iowa Dep't of Revenue, 792 N.W.2d 308 (Iowa 2010), *cert. denied*, 132 S. Ct. 97 (2011).

10. *See KFC*, 792 N.W. 2d at 310.

11. *Lamtec*, 246 P.3d at 790. Business and occupation tax is a tax that is imposed on a business' gross revenue rather than net income and is employed by some states that do not have a corporate income tax.

Supreme Court had the opportunity to clearly define "substantial nexus" in a way that left less room for manipulation by state courts and legislatures. This would have enabled businesses to more accurately assess their state tax obligations when making operational decisions and preparing financial statements.[12] If Congress did not like the Supreme Court's definition of "substantial nexus," it would have been free to provide the legislative response that the Court requested in *Quill*.[13] However, the Supreme Court denied certiorari in those cases on October 3, 2011.[14]

The Supreme Court should have explicitly extended the physical presence requirement to all types of taxes. This would enable multistate businesses to plan more effectively. They would have some certainty with regards to whether they would be subject to tax in a state before receipt of a tax deficiency notice. Businesses would also be able to more accurately evaluate the full costs of a transaction in advance. Further, publicly traded companies would not need to set up substantial reserves on their financial statements for uncertain state income tax positions. Thus, businesses would have more certainty with regards to their potential tax obligations and be able to plan accordingly.

Section II of this article discusses the Supreme Court's case law on personal jurisdiction due process and state tax dormant Commerce Clause substantial nexus. Section III surveys post-*Quill* state court developments and the rise of the economic nexus doctrine. Section IV explains why the physical presence requirement is more consistent with the Supreme Court's jurisprudence and is a superior standard. Finally, Section V concludes with how the Supreme Court should have ruled in *KFC Corp. v. Iowa Department of Revenue* and *Lamtec Corp. v. Department of Revenue*.

12. *See generally,* Friedman, *supra* note 8; Stephen W. Long et al., *The State Tax Game of Chicken Continues: Economic Nexus Claims Another State With* KFC, 18 TAX MGMT. WKLY. ST. REP. (2011). Public companies are required to create a full reserve for uncertain income tax positions that management does not believe are more likely than not to be sustained on audit under Financial Accounting Standards Board Interpretation Number 48, "Accounting for Uncertainty in Income Taxes."

13. *See* Quill Corp. v. North Dakota, 504 U.S. 298, 318 (1992).

14. *See* Jennifer Carr, *U.S. Supreme Court Denies Certiorari in State Tax Cases*, 62 ST. TAX NOTES 81, 81 (2011).

II. Supreme Court Case Law

A. *Personal Jurisdiction Due Process*

The Supreme Court's case law on personal jurisdiction due process, which prior to *Quill* was viewed as similar and applicable to Commerce Clause nexus, has evolved more significantly than its Commerce Clause jurisprudence. Initially, physical presence in a state was required before a person had sufficient contact with a forum to be required to submit to its jurisdiction.[15] The physical presence requirement was abandoned by the Court in *International Shoe Co. v. Washington*,[16] and replaced with a more flexible approach that allowed a state to assert jurisdiction over a person that had sufficient minimum contacts with it such that asserting jurisdiction would be consistent with "traditional notions of fair play and substantial justice."[17]

Since *International Shoe*, the Supreme Court's due process jurisprudence has continued to expand jurisdiction beyond physical presence. Twelve years after its decision in *International Shoe*, the Court found sufficient contact with a state for it to assert jurisdiction based on an insurance contract involving an out-of-state insurance company and an insured in the state.[18] The Supreme Court expanded the applicability of the minimum contacts approach when it concluded that the standard applied to both in personam and in rem jurisdiction.[19] In *World-Wide Volkswagen Corp. v. Woodson,*[20] the Supreme Court held that an out-of-state corporation is subject to jurisdiction in a state when it "delivers its products into the stream of commerce with the expectation that they will be purchased by consumers in the forum State."[21] Under the Supreme Court's due process jurisprudence as long as a business' "efforts are 'purposefully directed' toward residents of another State, [the Court has] consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there."[22]

B. *State Tax Dormant Commerce Case Law*

The Constitution expressly authorizes Congress "[t]o regulate Commerce with foreign Nations, and among the several States."[23] Initially, the Supreme Court hinted at the existence of a negative implica-

15. Pennoyer v. Neff, 95 U.S. 714, 723–24 (1877).
16. 326 U.S. 310 (1945).
17. *Id.* at 316.
18. McGee v. Int'l Life Ins. Co., 355 U.S. 220, 223 (1957).
19. Shaffer v. Heitner, 433 U.S. 186, 212 (1977).
20. 444 U.S. 286 (1980).
21. *Id.* at 298.
22. Burger King Corp. v. Rudzewicz, 471 U.S. 462, 476 (1985).
23. U.S. Const. art. I, § 8, cl. 3.

tion of the Commerce Clause that protects interstate commerce from state action even without the action of Congress.[24] The Supreme Court later explicitly stated that the Commerce Clause prohibits state actions that interfere with interstate commerce.[25]

The seminal case in the Supreme Court's state tax dormant Commerce Clause jurisprudence is *Complete Auto Transit, Inc. v. Brady*.[26] Under *Complete Auto*, "a tax [is] sustained against [a] Commerce Clause challenge when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[27] The *Complete Auto* test appears to be applicable to all forms of state taxation on interstate commerce.[28] The Supreme Court's modern Commerce Clause jurisprudence is clear that interstate commerce is not exempt from state taxes, and instead may be obligated to pay its fair share.[29] This article focuses on the substantial nexus prong of the *Complete Auto* test.

The Supreme Court's current substantial nexus jurisprudence originated ten years prior to *Complete Auto* in *Bellas Hess*. In *Bellas Hess*, the state of Illinois sought to require National Bellas Hess, a mail order business based in Missouri whose only contacts with Illinois were by mail or common carrier, to collect use tax on its sales to customers located in Illinois.[30] The Court upheld National Bellas Hess' Commerce Clause and Due Process Clause challenges to the Illinois tax on the basis that to uphold the tax:

> [W]e would have to repudiate totally the sharp distinction which [our] decisions have drawn between mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business.[31]

Further, the Court indicated that similar tests applied to Due Process and dormant Commerce Clause claims involving state taxation.[32]

Shortly after the Supreme Court's decision in *Complete Auto*, the

24. *See* Gibbons v. Ogden, 22 U.S. 1, 231–32, 239 (1824).

25. S.C. State Highway Dep't v. Barnwell Bros., Inc., 303 U.S. 177, 185–86 (1938).

26. 430 U.S. 274 (1977).

27. *Id*. at 279.

28. *See* D.H. Holmes Co. v. McNamara, 486 U.S. 24, 30 (1988) (discussing the applicability of *Complete Auto* to income taxes, business and occupation taxes, mineral severance taxes, fuel taxes, and sales and use taxes).

29. *See D.H. Holmes*, 486 U.S. at 31; Commonwealth Edison Co. v. Montana, 453 U.S. 609, 623–24 (1981).

30. Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill., 386 U.S. 753, 754–55 (1967).

31. *Id.* at 758.

32. *Id.* at 756.

Court demonstrated the continuing vitality of *Bellas Hess* in *National Geographic Society v. California Board of Equalization*.[33] In *National Geographic Society*, the Court upheld California's attempt to require National Geographic Society to collect use tax from customers on its mail order sales.[34] The Supreme Court concluded that sufficient nexus existed for the imposition of the tax even though National Geographic Society's mail order business' only contact with California was by mail or common carrier because it maintained two small offices in California to solicit advertising for its magazine.[35]

About a decade later, in *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue,*[36] the Supreme Court reached what appears to be its outer limit for one being physically present when dealing with personnel in a state. The Court found that sufficient nexus existed to uphold Washington's application of its business and occupation tax to Tyler Piper because an in-state independent contractor sales representative acted daily on Tyler Pipe's behalf "calling on its customers and soliciting orders."[37] Substantial nexus existed even though the taxpayer maintained no offices, owned no property, and had no employees residing in Washington.[38]

The Supreme Court most recently spoke on substantial nexus in 1992 when it was faced with a case similar to *Bellas Hess* in *Quill Corp. v. North Dakota*. In *Quill*, the state of North Dakota attempted to require Quill to collect use tax on its sales to North Dakota customers.[39] North Dakota statutorily imposed this obligation on "every person who engages in regular or systematic solicitation of a consumer market in th[e] state."[40] It further defined "regular or systematic solicitation" as "three or more advertisements within a 12-month period."[41] Quill operated a mail order office equipment and supplies business that had no property or employees in North Dakota.[42] The North Dakota Supreme Court upheld the tax and "declined to follow *Bellas Hess* because 'the tremendous social, economic, commercial, and legal innovations' of the past quarter-century have rendered its holding 'obsole[te].' "[43]

33. 430 U.S. 551, 559 (1977).
34. *Id.* at 562.
35. *Id.* at 559.
36. 483 U.S. 232 (1987).
37. *Id.* at 249.
38. *Id.* at 249–50.
39. Quill Corp. v. North Dakota, 504 U.S. 298, 302–03 (1992).
40. *Id.* at 302 (citing N.D. CENT. CODE § 57-40.2-01(6) (Supp. 1991)).
41. *Id.* at 303 (citing N.D. ADMIN. CODE 81-04.1-01-03.1 (1988)).
42. *Id.* at 302. The Court disregarded the software that Quill provided its North Dakota customers to place orders and the catalogues that it mailed to customers. *Id.* at 302 n.1.
43. *Id.* at 301 (quoting Heitkamp v. Quill Corp., 470 N.W.2d 203, 208 (N.D. 1991)).

The Supreme Court started out by clarifying that the Commerce Clause and the Due Process Clause are distinct; thus, a tax can satisfy the constitutional requirements of one clause, but not the other.[44] The Court explained that "the 'substantial nexus' requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce."[45] It stated that physical presence is not required under the Due Process Clause for a state to require the collection of use tax and explicitly overturned any of its prior decisions that indicated such a requirement.[46] In reaching that conclusion, the Supreme Court noted that its due process jurisprudence had evolved since its decision in *Bellas Hess*.[47] It then concluded that "Quill has purposefully directed its activities at North Dakota residents, that the magnitude of those contacts is more than sufficient for due process purposes, and that the use tax is related to the benefits Quill receives from access to the State."[48]

The Supreme Court then went on to weakly affirm the physical presence requirement of *Bellas Hess*.[49] It based its decision on stare decisis.[50] The Court further encouraged Congress to resolve the issue.[51] Interestingly, the Court noted that even though it had not explicitly applied to other types of taxes "the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule."[52] It then mentioned, "although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes."[53]

Thus, after *Quill*, it is unclear whether the physical presence requirement applies to other taxes outside of the sales and use tax context.[54] It is also unclear how much physical presence in a state is neces-

44. *See id.* at 312 (explaining the difference between the two clauses).
45. *Id.* at 313.
46. *See id.* at 307–08.
47. *Id.* at 307.
48. *Id.* at 308.
49. *See id.* at 311–19.
50. *Id.* at 317.
51. *Id.* at 318.
52. *Id.* at 314.
53. *Id.* at 317.
54. *See, e.g.*, KFC Corp. v. Iowa Dep't of Revenue, 792 N.W.2d 308, 322 (Iowa 2010), *cert. denied*, 132 S. Ct. 97 (2011); 1 Walter Hellerstein, Exploitation of Intangible Property Rights in the State as a Basis for Jurisdiction to Tax Out-of-State Persons Deriving Income From Such Property, State Taxation ¶ 6.11 (3d ed. 2011).

sary before substantial nexus is satisfied.[55] However, it is clear that nexus under the Commerce Clause requires a greater connection to a state than is required under the Due Process Clause.[56] Further, the Supreme Court has never concluded that substantial nexus under the *Complete Auto* test existed without the taxpayer having a physical presence in the taxing state.[57]

III. Post-*Quill* State Court Developments

Since the Supreme Court decided *Quill*, state appellate courts have wrestled with the meaning of "substantial nexus" on numerous occasions. The equivocal nature of the Court's opinion in *Quill*, combined with states' desire to collect revenue, has resulted in a sixteen-court conflict among state appellate courts.[58] A minority of state appellate courts have concluded that the physical presence requirement applies outside of the sales and use tax context.[59] A growing majority of state courts have concluded that the physical presence requirement is not applicable outside of the sales and use tax context.[60] These state courts have determined that substantial nexus is satisfied when the taxpayer has sufficient economic nexus to the state. Even when dealing with the application of the physical presence test, state appellate courts have decided cases that dealt with the outer limits of physical presence.[61]

55. The presence of one resident independent contractor who regularly conducted business on the out-of-state company's behalf was sufficient in *Tyler Pipe*; however, "a few floppy diskettes" in *Quill* was not substantial enough. Where the line falls between those two is unclear. *See Quill*, 504 U.S. at 315 n.8; Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue, 483 U.S. 232, 248–251 (1987).

56. *See Quill*, 504 U.S. at 312–13.

57. *See* Petition for a Writ of Certiorari at 19, KFC Corp. v. Iowa Dep't of Revenue, 792 N.W. 2d 308 (Iowa 2010) (No. 10-1340), 2011 WL 1633948, at *19; *Am. Online, Inc. v. Johnson*, No. M2001-00927-COA-R3-CV, 2002 WL 1751434, at *2 (Tenn. Ct. App. July 30, 2002).

58. *See* Petition for a Writ of Certiorari, *supra* note 57, at 12–13.

59. *See* Rylander v. Bandag Licensing Corp., 18 S.W.3d 296, 299–300 (Tex. Ct. App. 2000); J.C. Penney Nat'l Bank v. Johnson, 19 S.W.3d 831, 837 (Tenn. Ct. App. 1999); Guardian Indus. Corp. v. Dep't of Treasury, 499 N.W.2d 349, 356 (Mich. Ct. App. 1993).

60. *See* KFC Corp. v. Iowa Dep't of Revenue, 792 N.W.2d 308, 325 (Iowa 2010), *cert. denied*, 132 S. Ct. 97 (2011); Capital One Bank v. Comm'r of Revenue, 899 N.E.2d 76, 84 (Mass. 2009); Geoffrey, Inc. v. Comm'r of Revenue, 899 N.E.2d 87, 92 (Mass. 2009); Lanco, Inc. v. Dir., Div. of Taxation, 908 A.2d 176, 177 (N.J. 2006); Buehner Block Co. v. Wyo. Dep't of Revenue, 139 P.3d 1150, 1158 (Wyo. 2006); Tax Comm'r v. MBNA Am. Bank, N.A., 640 S.E.2d 226, 232 (W. Va. 2006); Geoffrey, Inc. v. S.C. Tax Comm'n, 437 S.E.2d 13, 18 n.4 (S.C. 1993); Bridges v. Geoffrey, Inc., 984 So. 2d 115, 127 (La. Ct. App. 2008); Geoffrey, Inc. v. Okla. Tax Comm'n, 132 P.3d 632, 638 (Okla. Civ. App. 2005); A & F Trademark, Inc. v. Tolson, 605 S.E.2d 187, 196 (N.C. Ct. App. 2004); Kmart Props., Inc. v. Taxation & Revenue Dep't, 131 P.3d 27, 34–35 (N.M. Ct. App. 2001); Gen. Motors Corp. v. City of Seattle, 25 P.3d 1022, 1028 (Wash. Ct. App. 2001); Borden Chems. & Plastics, L.P. v. Zehnder, 726 N.E.2d 73, 80–81 (Ill. App. Ct. 2000).

61. *See* Lamtec Corp. v. Dep't of Revenue, 246 P.3d 788, 793 (Wash. 2011), *cert. denied*,

A. *Minority View: Physical Presence Required*

Appellate courts in Michigan, Tennessee, and Texas have held that the physical presence requirement of *Quill* and *Bellas Hess* applies to state taxes generally, rather than only sales and use taxes.[62] In *J.C. Penney National Bank v. Johnson*,[63] Tennessee sought to impose franchise and excise taxes on a bank that conducted credit card activities involving Tennessee customers.[64] The bank had no offices or agents located in Tennessee, but over ten thousand of its credit cards were present in the state.[65] The court rejected the Commissioner's argument that the bank had substantial nexus to Tennessee because it was "doing business" in the state and that the physical presence requirement only applied to sales and use taxes.[66] The court pointed out that the Commissioner was "unable to provide any authority as to why the analysis should be different for franchise and excise taxes."[67]

The next year, a Texas appellate court stated that it saw "no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause."[68] In *Rylander v. Bandag Licensing Corp.*, the court rejected the Comptroller's attempt to impose franchise taxes on a taxpayer that had no offices, property, or employees in Texas but merely held a certificate of authority that authorized it to conduct business in Texas.[69] The court concluded that substantial nexus does not exist when a taxpayer lacks physical presence in a state.[70]

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132 S. Ct. 95 (2011); Amazon.com, LLC v. N.Y. State Dep't of Taxation and Fin., 81 A.D.3d 183, 195 (N.Y. App. Div. 2010).

62. *See supra* note 59.

63. *J.C. Penney Nat'l Bank*, 19 S.W.3d at 831.

64. *Id.* at 832.

65. *Id.* at 839–40. The court found the presence of the credit cards in the state to be constitutionally insignificant. *Id.* at 840.

66. *Id.* at 839.

67. *Id.* at 839. The Tennessee Court of Appeals revisited the issue in *America Online, Inc. v. Johnson*, No. M2001-00927-COA-R3-CV, 2002 WL 1751434, at *1 (Tenn. Ct. App. July 30, 2002), in which it clarified that it had not concluded that physical presence was required, but rather that no state taxes had been upheld "where no activities had been carried on in the taxing state *on the taxpayer's behalf*." *Id.* at *2.

68. Rylander v. Bandag Licensing Corp., 18 S.W.3d 296, 300 (Tex. Ct. App. 2000).

69. *Id.* at 299–300.

70. *Id.*

B. *Majority View: Economic Nexus Sufficient*

1. Intangibles Holding Companies

The economic nexus line of cases got its start about a year after the Supreme Court's decision in *Quill* in *Geoffrey, Inc. v. South Carolina Tax Commission*.[71] In *Geoffrey*, Toys R Us, a Delaware company, formed Geoffrey, Inc., a wholly owned Delaware intangibles holding company subsidiary to hold several of its trademarks and trade names.[72] Geoffrey then engaged in an "income-stripping"[73] transaction in which it licensed the trademarks and trade names to Toys R Us in return for a royalty payment of one-percent of Toys R Us' net sales. Geoffrey had no physical presence in South Carolina.[74] The South Carolina Supreme Court upheld the tax against Geoffrey's Due Process and Commerce Clause challenges.[75] In its two-paragraph discussion of the Commerce Clause challenge, the court started out by restating the *Complete Auto* test and then noting that the "physical presence requirement had not been extended to other types of taxes."[76] Next, the court stated that physical presence is not required for income to be taxable by a state and that "[t]he presence of intangible property alone is sufficient to establish nexus."[77] Consequently, the court concluded that "by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a 'substantial nexus' with South Carolina."[78] Scholars have criticized the South Carolina Supreme Court's opinion in *Geoffrey* for its cursory and conclusory reasoning.[79]

Many of the other economic nexus cases dealt with similar income-stripping arrangements, in which a company formed an intangibles holding company subsidiary, transferred its intangible property to the subsidiary, and then paid a royalty to the subsidiary for use of the intangible property. Three of the cases involved the same taxpayer, conducting the

71. 437 S.E.2d 13 (S.C. 1993).

72. *Id.* at 15.

73. "Income-stripping" is the conversion of income earned in one jurisdiction to a service fee, interest, or royalties to a related party that are situated in another jurisdiction that has no or low tax.

74. *Geoffrey*, 437 S.E.2d at 15.

75. *Id.* at 19.

76. *Id.* at 18 n.4.

77. *Id.* at 18 (citing Am. Dairy Queen Corp. v. Taxation and Revenue Dep't, 605 P.2d 251, 255 (N.M. 1979) and Int'l Harvester Co. v. Wis. Dep't of Taxation, 322 U.S. 435, 441–42 (1944)).

78. *Geoffrey*, 437 S.E.2d at 18.

79. *See, e.g.,* Hellerstein, *supra* note 54, at ¶6.11[2]; Richard H. Kirk, Note, *Supreme Court Refuses to Re-Examine Whether Physical Presence Is a Prerequisite to State Income Tax Jurisdiction:* Geoffrey, Inc. v. South Carolina Tax Commission, 48 Tax Law. 271, 276 (1994).

same transaction as in *Geoffrey*.[80] Courts in Louisiana,[81] Maryland,[82] Massachusetts,[83] New Jersey,[84] New Mexico,[85] North Carolina,[86] and Oklahoma[87] have all concluded that the intangibles holding company had sufficient nexus to the state because of its economic nexus. They have also concluded that *Quill'*s physical presence requirement does not apply to taxes other than sales and use taxes. The cases primarily relied on *Geoffrey* to support their decisions.

The Court of Appeals of North Carolina provided the most substantial analysis on the issue. In *A & F Trademark v. Tolson* it declined to apply the *Quill* physical presence test because of the Supreme Court's weak endorsement of the test, the Court's emphasis on stare decisis in retaining it, and the "distinctions between sales and use taxes and income and franchise taxes."[88] The court's dislike for the income-stripping transaction was apparent as it concluded its substantial nexus discussion by stating that:

> Given these reasons, we reject 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 we hold that under the 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.[89]

The Court of Appeals of Maryland in *Comptroller of the Treasury v. SYL., Inc.*,[90] added a twist to its support of the economic presence approach. It concluded that the intangibles holding companies at issue lacked substance.[91] The court discussed a Massachusetts Supreme Judicial Court decision that disallowed a parent company's deduction on royalty payments to its wholly-owned intangibles holding company

80. Geoffrey, Inc. v. Comm'r of Revenue, 899 N.E.2d 87 (Mass. 2009); Bridges v. Geoffrey, Inc. 984 So. 2d 115 (La. Ct. App. 2008); Geoffrey, Inc. v. Okla. Tax Comm'n, 132 P.3d 632 (Okla. Civ. App. 2005).

81. *See Geoffrey*, 984 So. 2d at 115; Sec'y, Dep't of Revenue, State of La. v. Gap (Apparel), Inc., 886 So. 2d 459 (La. Ct. App. 2004).

82. Comptroller of the Treasury v. SYL, Inc., 825 A.2d 399 (Md. 2003).

83. *Geoffrey*, 899 N.E.2d 87 (relying on the court's earlier decision in Capital One Bank v. Comm'r of Revenue, 899 N.E.2d 76 (2009)).

84. Lanco, Inc. v. Dir., Div. of Taxation, 908 A.2d 176 (N.J. 2006).

85. Kmart Props., Inc. v. Taxation & Revenue Dep't, 131 P.3d 27 (N.M. Ct. App. 2001).

86. A&F Trademark, Inc. v. Tolson, 605 S.E.2d 187 (N.C. Ct. App. 2004).

87. Geoffrey, Inc. v. Okla. Tax Comm'n, 132 P.3d 632 (Okla. Civ. App. 2005).

88. *A&F Trademark*, 605 S.E.2d at 194.

89. *Id.* at 195.

90. 825 A.2d 399 (Md. 2003).

91. *Id.* at 415.

under the sham transaction doctrine.[92]

2. Financial Institutions

Another strand of the "economic nexus" line of cases involves the taxation of financial institutions that lack a physical presence in the taxing state. These cases involve facts similar to the situation previously discussed in *J.C. Penney National Bank*, *supra* part III-A. Appellate courts in Massachusetts and West Virginia concluded that the banks were subject to tax in the respective state because they had "substantial economic presence" in the state.

In *Tax Commissioner v. MBNA American Bank, N.A.*,[93] the West Virginia Supreme Court concluded that the appropriate test was substantial economic presence rather than physical presence.[94] MBNA issued and serviced Visa and MasterCard credit cards.[95] It had no employees or property in West Virginia.[96] MBNA solicited business in the state by mail and telephone.[97] During the years at issue, it received about $8.4 million and $10.1 million in gross receipts from West Virginia customers.[98] The court acknowledged that the applicability of the physical presence test to income taxes was not answered by *Quill* and that the intangibles holding company cases in other states were inapplicable to *MBNA*.[99]

To rationalize the appropriateness of its new substantial economic presence test the court concluded that physical presence only applied to sales and use taxes because of the Supreme Court's reliance on stare decisis in *Quill*, its emphasis that physical presence had not been applied to other types of taxes, and the administrative burdens of collecting sales and use taxes in every jurisdiction would interfere with interstate commerce.[100] It then went on to state that the physical presence test was no longer sensible because of technological advances evidenced by the growth of electronic commerce, which "now makes it possible for an entity to have a significant economic presence in a state absent any

92. *Id.* at 416 (citing Syms Corp. v. Comm'r of Revenue, 765 N.E.2d 758, 760–63 (Mass. 2002)).

93. Tax Comm'r v. MBNA Am. Bank, N.A., 640 S.E.2d 226 (W. Va. 2006).

94. *Id.* at 234. The court relied on an article by Christina R. Edson, Quill's *Constitutional Jurisprudence and Tax Nexus Standards in an Age of Electronic Commerce*, 49 Tax Law. 893, 943–45 (1996), for its "substantial economic presence" test. *Id.*

95. *MBNA*, 640 S.E.2d at 227.

96. *Id.*

97. *Id.*

98. *Id.* at 227–28.

99. *Id.* at 231.

100. *Id.* at 232–33.

physical presence there."[101]

According to the West Virginia Supreme Court, substantial economic presence combines due process' purposeful direction with an examination of "the quality and quantity of the company's economic presence."[102] The court rejected MBNA's argument that the test was merely an application of the due process approach which would be contrary to the Supreme Court's decision in *Quill* on the grounds that substantial nexus requires a greater level of nexus.[103] The court then concluded that the substantial economic presence test was satisfied in this case because MBNA "continuously and systematically" engaged in promotional and solicitation activities in the state.[104] Additionally, its gross receipts from West Virginia customers exceeded $8 million and $10 million respectively in the years at issue.[105]

The next year, in *Capital One Bank v. Commissioner of Revenue*,[106] which involved facts similar to those in *MBNA*, the Supreme Judicial Court of Massachusetts upheld the imposition of an income-based tax against banks that lacked physical presence in the state.[107] The court relied on the West Virginia Supreme Court's opinion in *MBNA* in reaching its conclusion that *Quill*'s physical presence test was not applicable and that "'substantial nexus' is more elastic than 'physical presence.'"[108] The court concluded that because the banks were engaged in significant business activities involving Massachusetts residents and used the state's banking and credit facilities as well as its court system, the banks had sufficient nexus to Massachusetts.[109]

3. Royalties From Unrelated Parties

The most recent variation to the economic nexus line of cases involved the imposition of state income taxes on an out-of-state company that received royalty payments from unrelated in-state parties. Late in 2010, in *KFC Corp. v. Iowa Department of Revenue*,[110] the Iowa Supreme Court upheld Iowa's imposition of corporate income taxes against KFC.[111] KFC, a Delaware Corporation with headquarters in Kentucky, which owns the trademark and related system for Kentucky

101. *Id.* at 234.
102. *Id.*
103. *Id.* at 235.
104. *Id.*
105. *Id.* at 236.
106. 899 N.E.2d 76 (Mass. 2009).
107. *Id.* at 86.
108. *Id.*
109. *Id.* at 86–87.
110. 792 N.W.2d 308 (Iowa 2010), *cert. denied*, 132 S. Ct. 97 (2011).
111. *Id.* at 328.

Fried Chicken, did not own any restaurants in Iowa.[112] All of its Iowa restaurants were owned by independent franchisees.[113] KFC licensed its intangible property to its independent franchisees, which included all of its Iowa franchisees.[114] The Iowa Department of Revenue assessed income taxes against KFC for its royalty income from Iowa franchisees for 1997, 1998, and 1999.[115]

The Iowa Supreme Court started out by discussing the evolution of the Supreme Court's personal jurisdiction Due Process and dormant Commerce Clause case law.[116] It then surveyed the approaches of state appellate courts that addressed the issue and noted "it might be argued that state supreme courts are inherently more sympathetic to robust taxing powers of states than is the United States Supreme Court."[117] The court then stated that its task was "to determine . . . how the United States Supreme Court would decide this case under its case law and established dormant Commerce Clause doctrine."[118] It concluded that the use of KFC's intangibles by its franchisees within the state was the "functional equivalent of 'physical presence.'"[119] Nowhere in the opinion did the court address the factual distinction between this case and the cases in other states that involved income-stripping transactions. Those cases dealt with royalties from wholly owned intangibles holding companies while this case dealt with royalties from unrelated parties. The court further stated that it doubted that the Supreme Court would apply the physical presence test outside of the sales and use tax context because of the "potential for tax evasion that the test engenders."[120]

C. *The Outer Limits of Physical Presence*

Recently state appellate courts have also tested the outer limits of the physical presence test. The issue was most recently addressed by the Washington Supreme Court in *Lamtec Corp. v. Department of Revenue*.[121] In *Lamtec*, the court upheld the application of Washington's bus-

112. *Id.* at 310.
113. *Id.*
114. *Id.*
115. *Id.*
116. *See id.* at 313–20.
117. *Id.* at 322. Given the sympathetic nature of state courts to not impede their states' attempts to collect revenue, Justice Scalia's observation in a dissenting opinion seems appropriate for this situation, "[t]here is an obvious lesson here for state supreme courts that do not agree with our jurisprudence: ignoring it is worth a try." Kansas v. Crane, 534 U.S. 407, 424 (2002) (Scalia, J., dissenting).
118. *KFC*, 792 N.W.2d at 322.
119. *Id.* at 324.
120. *Id.* at 327.
121. 246 P.3d 788 (Wash. 2011), *cert. denied*, 132 S. Ct. 95 (2011).

iness and occupation tax to a New Jersey manufacturer that lacked property, an office, address, phone number or permanent employees in the state.[122] Lamtec is a manufacturer of insulation and vapor barriers that sold its products to wholesale customers who placed their orders by telephone.[123] During the period at issue, Lamtec sent three sales employees to Washington to visit major customers about two or three times per year.[124] The employees merely answered questions and provided information about the company's products on their trips to Washington.[125] They did not solicit sales directly.[126] The court relied on the Supreme Court's decision in *Tyler Pipe* to conclude that Lamtec's physical presence in Washington was sufficient. The court stated that it did not see a difference between a staff of permanent employees in a state, the use of independent agents to perform activities within a state, or persons traveling to a state temporarily to conduct business.[127] It concluded that physical presence and substantial nexus required that "[t]he activities must be substantial and must be associated with the company's ability to establish and maintain the company's market within the state."[128]

Another recent twist on the outer limits of physical presence came in the form of a challenge to New York's "Amazon Law." The statute that require that an out-of-state seller to collect sales or use taxes on sales of tangible goods if the seller uses an unrelated New York resident to solicit sales through the internet from New York residents.[129] The statute imputes physical presence on an out-of-state seller that contracts with an unrelated New York resident for advertising services. In *Amazon.com, LLC v. New York State Department of Taxation and Finance*,[130] a New York appellate court rejected Amazon's facial Commerce Clause challenge to the statute.[131] The court concluded that the substantial nexus requirement was satisfied because the statute "impose[d] a tax collection obligation on an out-of-state vendor only where the vendor enters into a business-referral agreement with a New

122. *Id.* at 790.

123. *Id.*

124. *Id.* (totaling between 50 and 70 visits during the seven year period at issue).

125. *Id.*

126. *Id.*

127. *Id.* at 795.

128. *Id.*

129. Amazon.com, LLC v. N.Y. State Dep't of Taxation and Fin., 81 A.D.3d 183, 189 (N.Y. App. Div. 2010). The statute that required sellers of tangible goods in the state was amended to apply to large internet businesses in N.Y. Tax Law § 1101(b)(8)(vi). The New York Dep't of Taxation and Finance took the position that when an affiliate is paid based on completed sales, it is a sales representative. *See* Amy Hamilton, *New York Tax Official: Team Flier Resulted in "Amazon" Law*, 62 ST. TAX. NOTES, 139, 139 (2011).

130. *Amazon.com*, 81 A.D.3d at 189.

131. *Id.* at 196.

York State resident, and only when the resident receives a commission based on a sale in New York."[132] Several other states have recently enacted similar statutes that are also designed to target large internet retailers such as Amazon and Overstock.[133] The constitutionality of these statutes is questionable because *Quill* would appear to be applicable since they deal with sales and use taxes of mail order businesses that lack a physical presence in the states.[134] Amazon has responded by terminating its affiliate program in some of those states to avoid being obligated to collect sales or use taxes on its sales.[135]

IV. Physical Presence Should Prevail Over Economic Nexus

The applicability of *Quill*'s physical presence test to business activity taxes is far from outrageous; even though an overwhelming majority of the state appellate courts that have addressed the issue have concluded that *Quill*'s physical presence test does not apply outside of the sales and use tax context. Instead, the Supreme Court's constitutional jurisprudence and the flawed rationale of the state court economic nexus cases demonstrates that the physical presence requirement is more consistent with the Court's decisions. Further, even though both economic presence and physical presence have their strengths and weaknesses, requiring physical presence is the superior approach.

A. *Physical Presence is More Consistent with Supreme Court Jurisprudence*

The Iowa Supreme Court stated in *KFC Corp v. Iowa Department of Revenue*, that its job was not to "improve or clarify Supreme Court doctrine," instead its "function [was] to determine, to the best of [its] ability, how the United States Supreme Court would decide this case under its case law and established dormant Commerce Clause doctrine."[136] Based on its decision, the court concluded that the Supreme Court would endorse economic nexus. Notwithstanding the view of the Iowa Supreme Court, the physical presence requirement is more consis-

132. *Id.*

133. *See* Verne G. Kopytoff, *Amazon Pressured on Sales Tax*, N.Y. Times, March 13, 2011, http://www.nytimes.com/2011/03/14/technology/14amazon.html?pagewanted=all; Billy Hamilton, *The Empire Strikes Back: Amazon Fights Against Online Tax Efforts*, 60 St. Tax Notes 959, 959–60 (2011).

134. *See generally, e.g.*, Edward A. Zelinsky, *Lobbying Congress: Amazon Laws in the Lands of Lincoln and Mt. Rushmore*, 60 St. Tax Notes 557 (2011).

135. *See* John Buhl, *Amazon Cuts Ties With Affiliates*, 60 St. Tax Notes 864, 864 (2011); Hamilton, *supra* note 133; Kopytoff, *supra* note 133; Karen Setze & John Buhl, *California Governor Signs 'Amazon' Law*, 61 St. Tax Notes 7, 7–8 (2011).

136. KFC Corp. v. Iowa Dep't of Revenue, 792 N.W.2d 308, 322 (Iowa 2010) *cert. denied*, 132 S. Ct. 97 (2011).

tent with the Court's prior decisions and would likely be applied by the Supreme Court in this case.

1. The Supreme Court's Case Law

Substantial nexus and physical presence are part of constitutional law. Therefore, it appears unlikely that the Supreme Court would create a narrow, industry specific rule. However, that is exactly what the physical presence requirement becomes when *Quill* is analyzed under the economic nexus approach. Under economic nexus, *Quill* applies to either sales and use taxes generally, or only to sales and use taxes as applied to an out-of-state mail order company. Not surprisingly, two related areas of constitutional law, personal jurisdiction due process and state tax dormant Commerce Clause cases generally, apply the same standard to all cases.

There is little dispute that the minimum contacts and purposeful direction framework apply to all aspects of personal jurisdiction due process. The different rationales for one to attempt to assert jurisdiction provides an appropriate comparison to the diverse forms of state taxation. One can seek jurisdiction either in personam or in rem. Similarly, a state can impose various types of taxes, such as income, property, excise, franchise, and sales and use to name a few. When the Supreme Court was presented with whether *International Shoe*'s minimum contacts standard applied to both in rem and in personam jurisdiction in *Shaffer v. Heitner*, the Court held that it did.[137] Further, the Supreme Court's case law indicates that the same standard applies regardless of the basis of the claim, whether it's based in contract, tort, or something else.[138]

Similarly, the seminal case in state tax dormant Commerce Clause jurisprudence, *Complete Auto*, applies to all forms of state taxation.[139] Interestingly, the tax at issue in *Complete Auto* was a sales tax,[140] yet that has not stopped the *Complete Auto* test from being applied to other types of taxes.[141] Further, the Supreme Court's jurisprudence for the sec-

137. Shaffer v. Heitner, 433 U.S. 186, 212 (1977).

138. *See generally, e.g.,* World-Wide Volkswagon Corp. v. Woodson, 444 U.S. 286, 297–98 (1980); Burger King Corp. v. Rudzewicz, 471 U.S. 462, 476 (1985).

139. *See, e.g.,* Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 183 (1995) (discussing the applicability of the *Complete Auto* test to excise taxes, use taxes, franchise taxes, and severance taxes); D.H. Holmes Co. v. McNamara, 486 U.S. 24, 30 (1988) (discussing the applicability of *Complete Auto* to income taxes, business and occupation taxes, mineral severance taxes, fuel taxes, and sales and use taxes).

140. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 275–76 (1977). "Any person liable for the tax is required to add it to the gross sales price, and insofar as practicable, to collect it at the time the sales price is collected." *Id.* at 276 (internal citations and quotations omitted).

141. *See* cases cited *supra* note 139.

ond prong of the *Complete Auto* test, fair apportionment, has been shaped by cases involving different types of taxes.[142] Still, proponents of economic nexus argue that *Quill* does not apply to other types of taxes when determining whether a state has jurisdiction to impose a tax on an out-of-state company even though nothing in the Court's personal jurisdiction due process or state tax dormant Commerce Clause jurisprudence has such a narrow application.

Supporters of economic nexus have pointed out that the Supreme Court stated that it had not applied the physical presence requirement to taxes other than sales and use taxes.[143] In *Quill,* the Court said: "Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule."[144] It then mentioned that "although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes."[145] Those statements do not clearly indicate that physical presence does not apply to other types of taxes. It merely states that the Court has not explicitly applied it. Interestingly, the Court has never found that substantial nexus existed when a taxpayer lacked a physical presence in the taxing state.[146] Some authors have argued the Court's assertions could just as easily be interpreted as supporting the application of the physical presence requirement to other taxes rather than only applying to sales and use taxes.[147] The argument that the *Quill* physical presence requirement applies to all forms of state taxes is bolstered by two older Supreme Court cases that

142. *See generally, e.g., Jefferson Lines*, 514 U.S. at 185 (sales tax); Goldberg v. Sweet, 488 U.S. 252, 261 (1989) (telephone excise tax); Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 163 (1983) (franchise tax); Moorman Mfg. Co. v. Bair, 437 U.S. 267, 270 (1978) (income tax).

143. *See* KFC Corp. v. Iowa Dep't of Revenue, 792 N.W.2d 308, 319 (Iowa 2010), *cert. denied*, 132 S. Ct. 97 (2011); Tax Comm'r v. MBNA Am. Bank, N.A., 640 S.E.2d 226, 231–32 (West Va. 2006)*;* Geoffrey v. S.C. Tax Comm'n, 437 S.E.2d 13, 18 n.4 (S.C. 1993); *see generally,* Christina R. Edson, Quill's *Constitutional Jurisprudence And Tax Nexus Standards In An Age Of Electronic Commerce*, 49 TAX LAW. 893 (2006); John A. Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343 (2003).

144. Quill Corp. v. North Dakota, 504 U.S. 298, 314 (1992).

145. *Id.* at 317.

146. Petition for a Writ of Certiorari at 19, KFC Corp. v. Iowa Dep't of Revenue, 792 N.W. 2d 308 (Iowa 2010) (No. 10-1340), 2011 WL 1633948, at *19.

147. Megan A. Stombock, *Economic Nexus and Nonresident Corporate Taxpayers: How Far Will it Go?*, 61 TAX LAW. 1225, 1236 (2008) (citing R. Todd Ervin, Comment, *State Taxation of Financial Institutions: Will Physical Presence or Economic Presence Win the Day?*, 19 VA. TAX REV. 515, 539 (2000)).

indicate that the specific type of state tax is irrelevant for purposes of the dormant Commerce Clause.[148]

Further, the Supreme Court clearly stated in *Quill* that substantial nexus under the Commerce Clause is different from due process' purposeful direction.[149] However, the state appellate courts' analysis when concluding that economic nexus is sufficient for a taxpayer to satisfy substantial nexus resembles due process analysis.[150] Even the Supreme Court cases that courts[151] and scholars[152] rely on to justify economic nexus are more easily viewed as due process cases than Commerce Clause cases. Further, *New York ex rel. Whitney v. Graves,*[153] Wisconsin v. J.C. Penney Co.,[154] and *International Harvester Co. v. Wisconsin Department of Taxation*[155] are all pre-*Complete Auto* and are from a time when it was thought that one's necessary connection to a state was the same under both the Due Process and Commerce Clauses. Each case allowed a state to subject an out-of-state taxpayer that lacked a physical presence in the state to tax on the rationale that the state provided the taxpayer with the forum to earn the income.

For example, in *International Harvester*, the Supreme Court concluded that Wisconsin could require that the payor of dividends withhold tax that reflected the portion of the company's earnings within the state on payments to out-of-state shareholders.[156] However, some practitioners have questioned whether *International Harvester* would be constitutional under the Court's modern dormant Commerce Clause jurisprudence.[157] Still, the state action at issue in *International Harvester* is different from the actions of economic nexus states because those states are attempting to assert their taxing authority on companies outside of their jurisdiction, while Wisconsin employed a withholding

148. *See* Spector Motor Serv. v. O'Connor, 340 U.S. 602, 608 (1951), *overruled by* Complete Auto Transit v. Brady, 430 U.S. 274 (1977) (regarding the proposition "that a state tax on the privilege of doing business is per se unconstitutional when it is applied to interstate commerce"); Wisconsin v. J.C. Penney Co., 311 U.S. 435, 443 (1940).

149. *Quill*, 504 U.S. at 312–13.

150. *See* Scott D. Smith & Sharlene Amitay, *Economic Nexus: An Unworkable Standard for Jurisdiction*, 25 ST. TAX NOTES 787, 789 (2002).

151. *See, e.g.* KFC Corp. v. Iowa Dep't of Revenue, 792 N.W.2d 308, 325 (Iowa 2010), *cert. denied*, 132 S. Ct. 97 (2011); Geoffrey, Inc. v. S.C. Tax Comm'n, 437 S.E.2d 13, 18 (S.C. 1993).

152. *See, e.g.* Michael T. Fatale, Geoffrey *Sidesteps* Quill*: Constitutional Nexus, Intangible Property and the State Taxation of Income*, 23 HOFSTRA L. REV. 407, 438–41 (1994); Sheldon H. Laskin, *Only a Name? Trademark Royalties, Nexus, and Taxing That Which Enriches*, 22 AKRON TAX J. 1, 16–21 (2007); John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 362–65 (2003).

153. 299 U.S. 366 (1937).

154. 311 U.S. 435 (1940).

155. 322 U.S. 435 (1944).

156. *Id.* at 442.

157. *See* Friedman, *supra* note 8, at 47.

regime that required a Wisconsin company to withhold Wisconsin taxes. The economic nexus rationale is more consistent with the Supreme Court's due process jurisprudence than its Commerce Clause jurisprudence, however that is what the state courts have relied on when concluding that economic nexus is sufficient under the Commerce Clause.

Interestingly, in *Geoffrey v. South Carolina Tax Commission*, the case that spawned economic nexus, the South Carolina Supreme Court dedicated about three pages to its due process analysis but only two paragraphs to its Commerce Clause discussion even though the Commerce Clause presented the novel issue.[158] The West Virginia Supreme Court attempted to provide a substantial economic presence test in *MBNA*, the first case to apply economic nexus to financial institutions; however, the test, by its own terms, is simply a variation on due process' purposeful direction.[159] The inability of the state courts to get away from due process analysis when rationalizing economic nexus demonstrates that it is not rooted in the Supreme Court's Commerce Clause jurisprudence.

One of the other common arguments in support of economic nexus is that the physical presence requirement is obsolete.[160] However, when the Supreme Court was presented with that argument in *Quill*, it rejected it, even though it acknowledged that the world had changed substantially since it first announced the physical presence requirement in *Bellas Hess*.[161] Proponents of the physical presence standard have argued that technology and society will continue to evolve and it is up to state tax systems to respond without burdening interstate commerce.[162] Further, modern Supreme Court dormant Commerce Clause jurisprudence strongly indicates that the Clause's purpose remains the same even though society advances. In *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, the Court stated:

> The provision thus "reflect[s] a central concern of the Framers that was an immediate reason for calling the Constitutional Convention: the conviction that in order to succeed, the new Union would have to

158. 437 S.E.2d 13, 16–19 (S.C. 1993).

159. *See* Tax Comm'r v. MBNA Am. Bank, N.A., 640 S.E.2d 226, 234 (W. Va. 2006).

160. *See, e.g.* KFC Corp. v. Iowa Dep't of Revenue, 792 N.W.2d 308, 326 (Iowa 2010), *cert. denied*, 132 S. Ct. 97 (2011); *MBNA Am. Bank, N.A.*, 640 S.E.2d at 234; *see generally* John A. Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 319, 343–44 (2003); Julie M. Buechler, Note, *Virtual Reality: Quill's "Physical Presence" Requirement Obsolete When Cogitating Use Tax Collection in Cyberspace*, 74 N.D. L. REV 479 (1998).

161. Quill Corp. v. North Dakota, 504 U.S. 298, 314 (1992).

162. Douglas L. Lindholm, *"Old Economy" Tax Systems on a "New Economy" Stage: The Continuing Vitality of the "Physical Presence" Nexus Requirement*, COUNCIL ON ST. TAX'N, Feb. 27, 2003, at 28.

avoid the tendencies toward economic Balkanization that had plagued relations among the Colonies and later among the States under the Articles of Confederation."[163]

Therefore, even if technological advancements have made the physical presence requirement obsolete, it must be replaced with a standard that either does not impermissibly burden interstate commerce or is blessed by Congress. Economic nexus places an impermissible burden on interstate commerce because interstate businesses will have no idea when they will have achieved sufficient nexus with a state to be subject to tax. Thus, technological advancement does not provide sufficient justification for employing economic nexus.

2. The Roberts Court

The likelihood of the Supreme Court supporting an economic nexus approach over the physical presence requirement becomes even more unfathomable when looking at the Roberts Court's jurisprudence. The Roberts Court has earned a reputation as being extremely friendly to business interests.[164] One Supreme Court scholar went so far as to state that he "believe[d] that the Roberts Court is the most pro-business Court of any since the mid-1930's."[165]

An economic nexus approach is unfavorable for businesses because it subjects them to taxation in more jurisdictions. When a business is subject to tax in additional jurisdictions, it is more likely to incur double taxation and incur greater expense in determining its tax liability. Economic nexus is even more problematic for businesses because there is no standard for when one is economically present in a jurisdiction. The state appellate courts that have found in favor of economic nexus have yet to provide a coherent standard to determine when one has achieved sufficient economic nexus. The decisions have left interstate businesses with nothing more than a random assortment of conclusions based on facts and circumstances. As a result, businesses cannot even attempt to plan strategically to minimize their tax liabilities or even accurately assess where they will be subject to tax.[166]

163. Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 180 (1995) (quoting Wardair Can., Inc. v. Fla. Dep't of Revenue, 477 U.S. 1, 7 (1986)). The Court also cited to The Federalist Nos. 42 (James Madison), 7 (Alexander Hamilton), and 11 (Alexander Hamilton) for the proposition.

164. *See, e.g.*, Erwin Chemerinsky, *The Roberts Court at Age Three*, 54 Wayne L. Rev. 947, 962–72 (2008) (discussing the Court's pro-business decisions); Jeffrey Rose, *Supreme Court Inc.*, N.Y. Times, Mar. 16, 2008, http://www.nytimes.com/2008/03/16/magazine/16supreme-t.html?pagewanted=all; Nick Timiraos, *Hot Topic: Roberts Court Unites on Business*, Wall St. J., June 30, 2007, at A5.

165. Chemerisky, *supra* note 164, at 962.

166. *See* Friedman, *supra* note 8, at 42.

On the other hand, the physical presence requirement is advantageous for businesses. First, it provides a bright-line rule.[167] A clear rule, in and of itself, is favorable to businesses merely because it enables them to plan accordingly. Therefore, businesses will know whether they will be subject to tax in a state. The rule goes even further; it allows businesses to structure their operations in a way to minimize their tax liability. Because one cannot be subject to tax without being physically present, corporations can structure themselves in a way that minimizes their physical presence in high tax jurisdictions and shifts some income to no or low tax jurisdictions. Examples of this are the intangibles holding company cases that got the economic nexus train rolling. Further, a bright-line rule that provides an opportunity to create "nowhere income"[168] is the most business-friendly rule possible.

The Iowa Supreme Court concluded that the United States Supreme Court would support economic nexus and applied it to the *KFC* case, even though based on its jurisprudence, it would appear that the Roberts Court is significantly more likely to explicitly extend the *Quill* physical-presence requirement.

B. *Physical Presence Requirement is Superior*

The physical presence requirement is superior to economic nexus because it provides a clear rule and alleviates double taxation. The most significant arguments against requiring physical presence are that it enables taxpayers to create nowhere income and encourages income-stripping; however, states have other means with which they can combat the creation of nowhere income and income-stripping.

Taxpayers benefit from a clear rule because it allows them to know if they will be subject to tax and then plan accordingly. In many instances, the tax costs that will be imposed on a business factor into a taxpayer's decision-making process when evaluating various options. When a business cannot determine whether it will be subject to tax in a state prior to making a strategic decision, it cannot properly evaluate the actual costs involved in a particular transaction. Businesses will also need to devote greater resources to learning the intricacies of states' tax laws under economic nexus. Additionally, states also benefit from a clear jurisdictional rule because they can save resources by reducing the number of tax controversies with jurisdictional challenges and avoid scaring off potential investment in the state.[169]

167. Quill Corp. v. North Dakota, 504 U.S. 298, 315–16 (1992).

168. "Nowhere income" is income allocated by an apportionment formula to a state that does not have tax jurisdiction.

169. For example, in response to aggressive, and likely unconstitutional, tax positions taken by

In *Quill*, the Supreme Court recognized that even though the bright-line physical presence requirement "appears artificial at its edges," such a rule was beneficial in part because "our law in this area is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensible power of taxation.' "[170] Conversely the economic nexus standard is far from a bright-line rule. It is an amorphous approach that, according to some experts, has potentially unlimited scope.[171] The impossibility of economic nexus having a coherent standard is made evident by the West Virginia Supreme Court's purported substantial economic presence test. One cannot determine in advance if "the frequency, quantity and systematic nature of [his or her] economic contacts with a state"[172] will provide sufficient nexus for a state to subject them to tax. To the contrary, under a physical presence requirement, taxpayers will be able to quickly and inexpensively determine in advance if they will be subject to tax in a state.

A clear rule also reduces compliance costs for both taxpayers and states.[173] With a clear rule, such as physical presence, taxpayers can plan accordingly to comply with their state tax obligations. However, under an economic presence approach to nexus, taxpayers will go to considerable expense to determine if they are subject to tax in a jurisdiction. Realistically, taxpayers could be subject to tax in any jurisdiction in which they have customers. In many of the cases in which state appellate courts concluded that the taxpayer had sufficient economic nexus to the state, the taxpayer was unaware that it was subject to tax in the state and did not even file a tax return.[174] As a result, state tax authorities go to greater expense to determine when a taxpayer is subject to tax in a state because they have to determine if a taxpayer is even subject to tax in the state at all.[175]

Further, the physical presence requirement effectively prevents

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states, Amazon withdrew from its affiliate marketing within those states. *See* Buhl, *supra* note 135, at 864; Hamilton, *supra* note 133, at 960; Setze & Buhl, *supra* note 135, at 7–8. It will also deter taxpayers from conducting business in multiple jurisdictions. *See* Stombock, *supra* note 147, at 1238.

170. *Quill*, 504 U.S. at 315–16 (quoting Nw. States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457–58 (1959).

171. *See* Joseph Henchman, *Why the* Quill *Physical Presence Rule Shouldn't Go the Way of Personal Jurisdiction*, 46 ST. TAX NOTES 387, 396 (2007); Smith & Amitay, *supra* note 150, at 789–91.

172. Tax Comm'r v. MBNA Am. Bank, N.A., 640 S.E.2d 226, 234 (W. Va. 2006).

173. Stombock, *supra* note 147, at 1240–42.

174. *See, e.g.*, Capital One Bank v. Comm'r of Revenue, 899 N.E.2d 76, 80 (Mass. 2009).

175. Stombock, *supra* note 147, at 1240.

multiple taxation of the same income. Taxation of the same income by multiple states is one of the classic instances of states placing impermissible burdens on interstate commerce. The *Complete Auto* test minimizes instances of duplicative taxation by states. The substantial nexus prong works to prevent a state from having jurisdiction to impose a tax when the taxpayer does not have a sufficient connection to the state. Physical presence provides a clear limit to a state subjecting an out-of-state business to tax in the state because geographical limits provide a constraint.

On the other hand, economic nexus has virtually unlimited reach. The same transaction can "occur" in many different places, especially if the transaction involves the internet.[176] This becomes even more problematic when taxpayers face the reality that states will attempt to "tax whatever they can reach."[177] The fair-apportionment prong of *Complete Auto* cannot completely prevent duplicative taxation on its own because states are entitled to have their own apportionment formulas. The only requirement is that the apportionment formulas be internally and externally consistent.[178] The jurisdictional bar of substantial nexus serves an important gatekeeper function towards preventing duplicative taxation because it can prevent a state from having the ability to impose taxes. However, under economic nexus, multiple states could attribute the same revenue to in-state activities even if the taxpayer has no connection to a state. For example, in a situation such as the one in *KFC*, *supra* part III-B-3, under economic nexus nothing would preclude the states of Iowa, Delaware, and Kentucky from all claiming that they are economically entitled to tax all of KFC's royalties from Iowa franchises. Iowa could claim that it is entitled to tax all of the royalties from Iowa franchises because the intangible property is used at KFC restaurants in Iowa. Delaware could claim that it is entitled to tax the same royalties because they are received by a Delaware corporation, which receives the benefits of Delaware's courts and well-established corporate law. Kentucky, the headquarters state, could assert a right to tax the same royalties because the intangible property was developed in the state by virtue of the headquarters being located there. And, none of those states would necessarily be wrong.

The fair-apportionment prong of *Complete Auto* would be unable to resolve this because each state is permitted to have a different apportionment formula. The physical presence requirement would alleviate the multiple taxation of the royalties.[179] Iowa and Kentucky could not sub-

176. *See* Henchman, *supra* note 171, at 396.
177. *See id.* at 395.
178. Goldberg v. Sweet, 488 U.S. 252, 260–61 (1989).
179. As long as states can use differently weighted sales factors, there can still be double

ject KFC to state income tax on the Iowa royalties. Iowa could not tax the royalties because KFC has no physical presence in the state. And Kentucky would be prevented from taxing the royalties because the transaction has no connection to KFC's operations in the state and are not paid to a Kentucky corporation.

The most significant flaw with the physical presence requirement is that it provides an opportunity for taxpayers to create nowhere income. However, an economic nexus approach is not the answer. Instead, states can employ "throwback" and "throwout" rules to deal with the creation of nowhere income. A throwback rule prevents "any part of the tax base from being assigned to states in which the taxpayer is not taxable, and thus . . . escaping taxation by any state."[180] It does so by reassigning sales receipts to the state that the goods were shipped from when the purchaser's state cannot impose income or franchise taxes on the sale because of constitutional restrictions or Public Law 86-272.[181] A throwout rule is an alternative to the throwback rule under which sales receipts are excluded from sales or receipt factors in all states "if a taxpayer is not subject to income tax in the destination state."[182] Consequently, both rules prevent the creation of nowhere income. Additionally, neither rule allows a jurisdiction to impose tax on a taxpayer that does not already know that it is within the jurisdiction's taxing authority. Thus, throwback and throwout rules accomplish the same result as economic nexus without the high level of uncertainty that accompanies an economic nexus approach.

Another argument against the physical presence requirement is that it creates an incentive for taxpayers to engage in income-stripping transactions with related parties, such as those discussed in the intangibles holding company cases, *supra* part III-B-1. However, states can deny deductions on income-stripping transactions involving related parties. Not surprisingly, most states already do this.[183] If a state's tax statutes do not provide its tax authorities with effective tools to combat income-stripping transactions, a state's legislature has the ability to revise its statutes. State courts can also employ judicial doctrines such as substance over form, the business purpose requirement, and the sham trans-

taxation. For example, manufacturing states are likely to more heavily weight physical stuff, while destination states with some physical nexus would more heavily weight sales.

180. *See* 1 WALTER HELLERSTEIN, EXPLOITATION OF INTANGIBLE PROPERTY RIGHTS IN THE STATE AS A BASIS FOR JURISDICTION TO TAX OUT-OF-STATE PERSONS DERIVING INCOME FROM SUCH PROPERTY, STATE TAXATION, STATE TAXATION ¶9.18[1][b] (3d ed. 2011).

181. *See, e.g.*, UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT, § 16(b) (1957).

182. HELLERSTEIN, *supra* note 180, at ¶9.18[1][c]; *see* Whirlpool Props. Inc. v. Dir., Div. of Taxation, 26 A.3d 446, 463–64 (N.J. 2011); Cara Griffith, *Broader Implications of New Jersey's Interpretation of Throwout Opinion*, 62 ST. TAX NOTES 99, 99 (2011).

183. *See* HELLERSTEIN, *supra* note 180, at ¶7.17[3][c][i].

action doctrine. Presumably, states will be in similar economic positions regardless of whether they deny a deduction to an in-state taxpayer or impose tax on that income when it is earned by an out-of-state taxpayer after allowing a deduction to the in-state taxpayer. The physical presence requirement does not stop states from denying deductions to in-state taxpayers. It merely prevents states from subjecting out-of-state taxpayers that lack a physical presence in the state to their taxing authority.

V. Conclusion: How the Supreme Court Should Have Decided *KFC* and *Lamtec*

The Supreme Court should have decided *KFC* and *Lamtec* together to provide much needed clarification on what is sufficient for substantial nexus. First, the Supreme Court should have explicitly stated that the physical presence requirement from *Quill* and *Bellas Hess* applies to all types of taxes, not just sales and use taxes. While doing so the Court should have emphatically rejected the economic nexus approach as unconstitutional because it places impermissible burdens on interstate commerce. As a result, the decision of the Iowa Supreme Court should have been reversed. In its opinion the Court should have stated that there is no such thing as the "functional equivalent of physical presence."[184] Consequently, physical presence cannot be imputed as a result of a transaction between an out-of-state taxpayer and an in-state resident.

After establishing that physical presence is required for an out-of-state taxpayer to have substantial nexus, the Supreme Court should have attempted to clarify the outer limits of substantial nexus by way of *Lamtec*. The Court should have upheld the Washington Supreme Court's determination that Lamtec had sufficient physical presence in the state because it sent employees to Washington 50-70 times over a seven-year period to meet with customers. In doing so, it should have made clear that the use of personnel in a state constitutes sufficient nexus. In the case of personnel, the slightest presence should be sufficient nexus because the physical presence requirement already precludes a state from asserting long-arm taxing authority. In dicta, the Court should have mentioned that when determining if an out-of-state taxpayer has sufficient nexus as a result of having minimal property in the state, more than the slightest presence is necessary. For example, renting even a minimal amount of storage space should be sufficient; however, mailing catalogues or software to potential customers is not constitutionally sufficient.

184. KFC Corp. v. Iowa Dep't of Revenue, 792 N.W.2d 308, 324 (Iowa 2010), *cert. denied*, 132 S. Ct. 97 (2011).

Nevertheless, such opinions will never be issued because the Supreme Court denied certiorari in *KFC* and *Lamtec* in October 2011.[185] As a result, taxpayers and practitioners will need to wait until another case comes along for the Supreme Court to resolve the issue. However, that might be a while because some practitioners do not expect the Supreme Court to grant certiorari on the issue anytime soon.[186] As a result, businesses and their advisors will continue to have difficulty knowing when they will be subject to tax in a jurisdiction. Therefore, businesses will be unable to accurately evaluate the full costs of a transaction in advance. Further, publicly traded companies will need to set up substantial reserves on their financial statements for uncertain state income tax positions. Thus, businesses will continue to lack certainty with regards to their potential tax obligations and be unable to plan accordingly because of the potentially unlimited scope of the amorphous economic nexus standard.

185. *See* Carr, *supra* note 14, at 81.
186. *See* Rosen & Hedstrom, *supra* note 5, at 936.