

ONLY A NAME? TRADEMARK ROYALTIES, NEXUS, AND TAXING THAT WHICH ENRICHES

*Sheldon H. Laskin**

I. INTRODUCTION

*Good name in man and woman, dear my lord,
Is the immediate jewel of their souls:
Who steals my purse steals trash; 'tis something, nothing;
'Twas mine, 'tis his, and has been slave to thousands:
But he that filches from me my good name
Robs me of that which enriches him
And makes me poor indeed.¹*

What Shakespeare's classic villain Iago first said of the value of an individual's good name in the seventeenth century remains equally true for the value of a business name in the twenty-first. Reflecting the fact that the value of a good name is often the greatest asset a business can have, tradenames and trademarks are very big business indeed.² In 2004, Coca-Cola's trademark was valued at more than \$67 billion,

* Adjunct Professor of Law, University of Baltimore Graduate Tax Program; Counsel, Multistate Tax Commission. B.A., J.D., Rutgers University; LL.M in Taxation, University of Baltimore. The author is grateful to the following for their kind review of various drafts of this article and their helpful suggestions: Gar Alperovitz, Professor of Political Economy, University of Maryland; H. Beau Baez III, Assistant Professor, Liberty University School of Law; Michael T. Fatale, Esq., Chief, Rulings and Regulations Bureau, Massachusetts Department of Revenue; Michael Mazerov, Senior Fellow, Center on Budget and Policy Priorities; John A. Swain, Associate Professor, University of Arizona School of Law; and the staff of the Multistate Tax Commission, particularly Elliott Dubin, Greg Matson, and Shirley Sicilian. The views expressed herein are entirely those of the author.

1. WILLIAM SHAKESPEARE, *OTHELLO, THE MOOR OF VENICE* act 3, sc. 3.

2. A tradename is a "name, style, or symbol used to distinguish a company, partnership or business (as opposed to a product or service); [it is] the name under which a business operates." BLACK'S LAW DICTIONARY 1533 (8th ed. 2004). A trademark is a "word, phrase, logo, or other graphic symbol used by a manufacturer or seller to distinguish its product or products from those of others." *Id.* at 1530.

Microsoft's brand was worth \$61 billion, IBM's mark came in at \$54 billion, GE's at \$44 billion, and Intel's at \$34 billion.³

The value of intellectual property—copyrights and patents as well as trademarks and tradenames—reflects the increased importance of intangible assets to the current highly mobile service economy and the corresponding decreased importance of land and other fixed assets that made up the backbone of the old manufacturing economy.⁴

It is not at all surprising that the use of an asset as valuable as a trademark raises significant state taxation issues. For tax purposes, where is a trademark to be located? Does it matter for state tax purposes whether the record title holder of the trademark is an affiliate of the entity that uses the trademark in conducting a retail business? If a state has a sufficient connection with the trademark holder to tax its income, what is the most appropriate method to apportion royalty income received by the trademark holder? And what is the most appropriate constitutional nexus standard to apply to businesses that realize income entirely through the sale of digital goods or services via electronic commerce? This Article explores these and related questions.

A basic tenet of tax law in the American system is that no one has an obligation to maximize his taxes. The classic formulation of this principle is the famous dictum of Judge Learned Hand that, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."⁵

Given the amount of money involved, it is understandable that holders of intellectual property will seek to minimize their state tax responsibilities through various tax planning techniques. But those tax planning techniques can only succeed if done in accordance with all applicable legal principles, including federal constitutional principles that govern when a state has a sufficient nexus, or connection, with a taxpayer to tax its income. This Article contends that the formation of a passive investment company ("PIC")—a common tax planning

3. Diane Brady et al., *Cult Brands; The BusinessWeek/Interbrand Annual Ranking of the World's Most Valuable Brands Shows the Power of Passionate Consumers*, BUS. WK., Aug. 2, 2004, at 64, 68 (ranking 100 most valuable worldwide trademarks). Rounding out *Business Week's* list of the 10 most valuable brands in 2004 were Disney at more than \$27 billion, McDonald's (\$25 billion), Nokia (\$24 billion), Toyota (\$23 billion) and Marlboro (\$22 billion). *Id.*

4. See DAVID BRUNORI, STATE TAX POLICY: A POLITICAL PERSPECTIVE 34 (2d ed. 2005) ("The service industry relies far more on human capital and intangible property . . . than does the traditional manufacturing industry. . . . Plants, equipment and land—the inputs that are most difficult to move—are relatively minor components of today's booming electronic commerce.").

5. *Comm'r v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

technique to shield royalty income derived from the use of intellectual property from state taxation—should be an ineffective tax planning technique because it does not sever the nexus between the PIC and the taxing state.

This Article asserts that the correct constitutional nexus standard for state taxation of royalty income derived from the use of trademarks and tradenames is the well-established business situs rule for taxing intangibles. Pursuant to the business situs rule, a state may, consistent with federal constitutional requirements, levy an appropriately apportioned tax on the trademark royalty income of a business that has purposefully availed itself of the benefits and opportunities of doing business in that state. That is, intellectual property is presumed to have a taxing situs at any location where it is used to realize income. A state may therefore assert income tax nexus with a business located in another state if the business derives trademark royalty income in the taxing state; the creation of a PIC in a state that does not tax the royalty income (hereinafter, “tax haven state”) is ineffective in shielding the trademark-holding company from income tax nexus in its affiliate’s market states.

Part II briefly discusses the general differences between combined and separate entity income tax reporting, the primary methods by which a multi-state business reports its income to the states in which it operates.

Part III describes how separate entity reporting encourages the formation of PICs so as to avoid income tax on operating income earned in the separate entity states. Part III also explores state responses to this tax avoidance technique. Part III then analyzes the physical presence use tax collection nexus rule and examines the state case law that has addressed the issue of whether the physical presence nexus rule should also apply to the corporate income tax.

Part IV presents an historical overview of the business situs rule for taxing income derived from intangibles. Part IV also explains why the Supreme Court’s use tax collection nexus jurisprudence does not preclude application of the business situs rule in taxing trademark royalty income.

Part V discusses several ramifications of the business situs rule as applied to PICs, including implications for the taxation of an author’s royalty income and the appropriate apportionment formula for taxing trademark royalty income.

Part VI is a critique of recent proposed federal legislation that would create a physical presence income tax nexus standard.

Part VII provides a broad analytical framework for approaching

income tax nexus as applied to electronic commerce.

This Article concludes that a physical presence nexus rule for taxing the income derived from intangibles is inconsistent with well-established and soundly reasoned Supreme Court jurisprudence and would be totally incongruous in our modern, service-based economy. Instead, the business situs rule for taxing intangibles remains the appropriate nexus rule for taxing the income of a PIC. Finally, this Article proposes that nexus should be determined through the use of uniform, easily verifiable economic thresholds that would apply irrespective of the form in which the business provides its services or products.

II. THE CORPORATE INCOME TAX: COMBINED AND SEPARATE ENTITY REPORTING

Forty-five states and the District of Columbia currently impose an income-based tax on corporations.⁶ Of those states, approximately half require or allow each affiliate of a related corporate group that does business within the state to file separate tax returns for that affiliate; not surprisingly, these states are called “separate entity” states.⁷ The remaining states require all members of a corporate unitary business to file a “combined report.”⁸

Separate entity states calculate the taxable income and apportionment percentage of each corporate affiliate doing business

6. 1 JOHN C. HEALY & MICHAEL S. SCHADEWALD, 2007 MULTISTATE CORPORATE TAX GUIDE I-3 (2007).

7. *See id.* at I-495 to -498. Of the forty-five states, plus the District of Columbia, that are listed as imposing a corporate income tax, twenty states are listed as either mandating a combined return in all circumstances or allowing the state to require a combined return if certain conditions are met. *Id.* This leaves twenty-six states where combined reporting is either not allowed or is available entirely at the election of the taxpayer. The term “separate entity states” as used in this article, refers to those twenty-six states. John Mackay Metzger, *Unitary Taxation in New Jersey*, 28 SETON HALL L. REV. 162, 167 (1997) (describing a “separate entity state” as a state “where each subject corporate legal entity is required to file its own corporation tax return”).

8. 1 HEALY & SCHADEWALD, *supra* note 6, at I-495 to -498. A combined report is not a consolidated return, in that each affiliate of a unitary business must ordinarily file a separate return. 2 RICHARD D. POMP & OLIVER OLDMAN, STATE & LOCAL TAXATION 10-38 (5th ed. 2005). A combined report simply requires all affiliates of a unitary business to include the factors and income of those affiliates on the report. *Id.* A corporate enterprise is said to be “unitary” if there are significant flows of value between the affiliates as measured by the following factors: functional integration, centralization of management, and economies of scale. *See* Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 166 (1983) (discussing the unitary business concept and citing cases that furthered the concept). In most combined reporting states, membership in a combined unitary group generally requires more than a 50% ownership interest. 1 HEALY & SCHADEWALD, *supra* note 6, at I-444.

within the state as if those affiliates were unrelated strangers.⁹ As a result, the income (or loss) of one affiliate has no effect on the calculation of income or loss for any other affiliate, and the apportionment factors of each affiliate are calculated separately.

Conversely, combined reporting states calculate business income for unitary affiliates as if they were divisions of the same entity.¹⁰

Inter-corporate transactions between them would be eliminated and the income reported . . . [by] the subsidiary would be added to the income reported . . . [by] the parent Similarly, the apportionment percentage would be calculated by taking into account the factors of both the parent and the subsidiary.¹¹

III. THE PASSIVE INVESTMENT COMPANY (“PIC”)

A. *The PIC and Separate Entity Reporting*

As a general rule, a combined report does not systematically lead to a higher or lower tax than would separate reporting.¹² However, separate entity reporting does present opportunities for tax avoidance that are not available in a combined reporting state. One particularly widespread tax avoidance technique is the creation in a tax haven state of a holding company that owns the intellectual property of affiliates doing business in the separate entity states.¹³ These holding companies have been historically referred to as Delaware holding companies.¹⁴ Currently, they are commonly referred to as passive investment companies (PICs).

Perhaps the first thing to say about a Delaware holding company is that it need not be based in Delaware; the technique works equally well

9. 2 POMP & OLDMAN, *supra* note 8, at 10-37. For a discussion of the apportionment of corporate income for tax purposes, *see infra* Part V.B.

10. 2 POMP & OLDMAN, *supra* note 8, at 10-37.

11. *Id.*

12. *Id.*

13. Although this article focuses on the use of a passive investment company to shelter trademark royalty income, separate entity reporting provides opportunities for additional forms of tax avoidance through the formation of holding companies in tax shelter states. For example, the formation of a holding company in Delaware to own stock and bonds of its parent corporation that would otherwise result in apportionable business income results in tax-free dividends and interest to the holding company. 2 POMP & OLDMAN, *supra* note 8, at 10-41.

14. An early use of the term “Delaware holding company” appears in Wesley Yang, *Utilization of Delaware Holding Companies to Save State Income Taxes*, 34 TAX EXECUTIVE 169 (1982).

if the holding company is located in any state that does not tax passive investment income, or has no income tax at all.¹⁵

Another strategy is to create a holding company in a state where the taxpayer is already filing a combined return.¹⁶ Doing so does not increase the combined state tax liability for the unitary business, as intra-corporate transactions within the unitary business are ignored in a combined report.¹⁷

A leading authority in state taxation has described how a PIC¹⁸ is used to shelter royalty income derived from the use of trademarks and tradenames from taxation in the separate entity states.

One typical use of a [PIC] is for a corporation to transfer valuable trademarks and trade names to a holding company. The holding company executes a license agreement allowing its parent to use the transferred property. In return, the parent pays its subsidiaries a royalty, which it deducts in calculating the taxable income it apportions to the states where it does business. . . .

The licensing of a trademark is only one way of using a [PIC] in an attempt to generate a deduction to the payor without any tax to the payee. Another way would involve loans made by the [PIC] to related corporations.¹⁹ The objective would be for the payor to deduct the payment of interest in calculating its apportionable taxable income and for the payee to be exempt from taxation by [the tax shelter state] (and by any other state) on the receipt of the interest.²⁰

The amount of income sheltered from taxation as a result of the creation of a PIC is huge. In one case, nine wholly-owned subsidiary

15. A Delaware-based corporation whose activities in Delaware are limited to maintaining and managing intangible assets that generate income, such as capital gains, dividends, interest and royalties, is exempt from Delaware income tax. DEL. CODE ANN. tit. 30, § 1902(b)(8) (2006). Similarly, royalty income is not subject to Michigan's Single Business Tax. MICH. COMP. LAWS § 208.9(7)(c) (2006). Nevada, South Dakota, and Wyoming do not impose a corporate income tax. 1 HEALY & SCHADEWALD, *supra* note 6, at I-497 to -498. Washington also does not impose a corporate income tax. *Id.* at I-462. But the Washington business and occupation tax would include gross receipts from royalties received by a Washington-based holding company in the tax base. *Id.* at I-206 to -207.

16. 2 POMP & OLDMAN, *supra* note 8, at 10-41.

17. *Id.* at 10-37.

18. Because the term Delaware holding company falsely implies that the company must be located in Delaware, this article instead uses the terms "passive investment company" or "PIC."

19. The two techniques are often combined. A PIC receiving trademark royalties from its affiliates often loans the royalty income back to those affiliates, who then deduct the interest on the loans from their taxable income in the states in which they operate. *See, e.g.,* A&F Trademark, Inc. v. Tolson, 605 S.E.2d 187 (N.C. Ct. App. 2004).

20. 2 POMP & OLDMAN, *supra* note 8, at 10-41.

PICs of the Limited, Inc. received royalty payments and interest from their affiliates in the amount of \$423,098,963 in one year.²¹ Furthermore, these PICs often demonstrate little, if any, economic substance. The nine Limited PICs had no employees, and shared office space, equipment, and supplies.²² The primary office space used by the nine PICs was also the primary office address for more than 650 other companies, none of which was related to either the Limited or any of its wholly-owned subsidiaries.²³

B. State Responses to the PIC

States have sought to address the use of PICs to avoid income taxation in a variety of ways. A number of states have sought to deny the deductions taken by the affiliates on a case-by-case basis, asserting that the formation of the PIC lacked business purpose or economic substance.²⁴ A number of states have enacted statutes that require a company to add back deductions taken for payments made to an affiliated PIC.²⁵ In addition, the Multistate Tax Commission (MTC) has proposed a Model Statute Requiring the Addback of Certain Intangible and Interest Expenses.²⁶

21. *A&F Trademark*, 605 S.E.2d at 189.

22. *Id.*

23. *Id.* at 189-90.

24. These cases often turn on subtle factual distinctions, and the states that have gone this route have met with mixed results. *Compare* *Syms Corp. v. Comm'r of Revenue*, 765 N.E.2d 758 (Mass. 2002) (denying deductions and finding no valid business purpose for or economic substance to PIC) *with* *Sherwin-Williams Co v. Comm'r of Revenue*, 778 N.E.2d 504 (Mass. 2002) (allowing deductions and finding that the formation of PIC had economic substance and that it was irrelevant that motive for forming PIC was tax planning). *But see* *Sherwin-Williams Co. v. Tax Appeals Tribunal*, 784 N.Y.S.2d 178 (App. Div. 2004), *appeal denied*, 4 N.Y.3d 709 (2005) (requiring taxpayer, on same facts as Massachusetts' *Sherwin-Williams Co., v. Commissioner of Revenue*, to file combined return in New York because formation of PIC lacked business purpose or economic substance).

25. *See, e.g.*, ALA. CODE § 40-18-35(b)(1) (2005); IND. CODE § 6-3-2-20 (2006); KY. REV. STAT. ANN. § 141.205 (West 2006). As of 2006, eighteen states, and the District of Columbia, have adopted statutes or regulations that disallow related party expenditures between a PIC and its operating affiliates under a variety of circumstances. Tammy Hunter, Presentation at the Georgetown University 29th Annual Advanced State and Local Tax Institute: Current Developments in Multistate Taxation, at 15 (May 18, 2006) (on file with author). These provisions generally provide an exemption from disallowance in several contexts, including when the formation of the PIC had a business purpose or there is economic substance to the PIC. Philip M. Plant, *The Addback Statute Wars – The Taxpayers' Case*, 37 ST. TAX NOTES 585 (2005).

26. MODEL STATUTE REQUIRING THE ADD-BACK OF CERTAIN INTANGIBLE AND INTEREST EXPENSES (Multistate Tax Comm'n, Proposed Official Draft 2006), *available at* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Add-Back%20-%20FINAL%20version.pdf. The Multistate Tax Commission (MTC) was

Other states have addressed the issue by allowing the in-state affiliate to take deductions for the payments made to the PIC, while asserting jurisdiction to tax the out-of-state PIC on the income received from the affiliates.²⁷ Invariably, the PIC in these cases has asserted that there is an insufficient connection, or “nexus,” between the state and the PIC for the state to assert its taxing authority under the Due Process Clause²⁸ and the Commerce Clause²⁹ of the United States Constitution. In support of their argument, the PICs rely on nexus principles developed, not in the context of the corporate income tax, but in the very different context of use tax collection. It is therefore necessary to discuss briefly the Supreme Court’s use tax collection nexus jurisprudence.

C. The Physical Presence Use Tax Nexus Rule

In 1967, the Supreme Court first addressed the issue of whether a state can constitutionally require an out-of-state seller whose only connections with its customers in the taxing state are by common carrier or U.S. mail to collect use tax on its sales to those customers.³⁰

created in 1967 as the administrative agency of the Multistate Tax Compact. *U.S. Steel Corp. v. Multistate Tax Comm’n*, 434 U.S. 452, 454-57 (1978). Among its functions, the Commission is charged by Article VI, Section 3 of the Compact to study state and local tax systems and to develop and recommend proposals for an increase in uniformity and compatibility of state and local tax laws in order to encourage simplicity and improvement in state and local tax law and administration. *Id.* at 456. Pursuant to Article VI, Section 3, the Commission adopted the Model Addback Statute at its annual meeting in Topeka, KS on August 17, 2006. See MODEL STATUTE REQUIRING THE ADDBACK OF CERTAIN INTANGIBLE AND INTEREST EXPENSES.

27. *Geoffrey, Inc. v. S.C. Tax Comm’n*, 437 S.E.2d 13 (S.C. 1993) (finding that physical presence is not required for state to tax royalty income received by out-of-state trademark holding company from in-state affiliate); *Kmart Props., Inc. v. Taxation & Revenue Dep’t*, 2006-NMCA-26, 139 N.M. 177, 131 P.3d 27 (2001) (same); *Comptroller of the Treasury v. SYL, Inc.*, 825 A.2d 399 (Md. 2003) (same); *A&F Trademark*, 605 S.E.2d 187 (same); *Geoffrey, Inc. v. Okla. Tax Comm’n*, 2006 OK CIV APP 27, 132 P.3d 632 (same); *Lanco, Inc. v. Dir., Div. of Taxation*, 908 A.2d 176, 177 (N.J. 2006) (“[W]e do not believe that the Supreme Court intended to create a universal physical-presence requirement for state taxation under the Commerce Clause.”).

28. U.S. CONST. amend. XIV, § 1.

29. U.S. CONST. art. I, § 8, cl. 3.

30. *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill.*, 386 U.S. 753 (1967). Prior to *Bellas Hess*, the Court had sustained a state’s constitutional authority to require a remote seller to collect use tax in a variety of contexts. *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U.S. 62 (1939) (in-state agents); *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359 (1941) (catalog sales when seller also maintains stores in state); *Nelson v. Montgomery Ward & Co.*, 312 U.S. 373 (1941) (same); *General Trading Co. v. State Tax Comm’n of Iowa*, 322 U.S. 335 (1944) (employees soliciting orders in state, which are accepted and filled from out of state); *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960) (independent contractors soliciting orders in state, which are accepted and filled from out of state).

In *National Bellas Hess, Inc. v. Department of Revenue*, the Court ruled that a state was barred by both the Due Process Clause and the Commerce Clause from requiring an out-of-state mail order company to collect use tax on its sales to customers in the taxing state, if the company's connections to those customers were limited to the solicitation of orders by advertisements mailed to the customers, with any resulting orders filled by U.S. mail or common carrier.³¹

The Court in *Bellas Hess* created a safe harbor from use tax collection for sellers whose only connection with the taxing state is by U.S. mail or common carrier—a safe harbor which mirrored the existing practices of the states that then imposed a use tax.

In order to uphold the power of Illinois to impose use tax burdens on National in this case, we would have to repudiate totally the sharp distinction . . . 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. But this basic distinction, *which until now has been generally recognized by the state taxing authorities*, is a valid one, and we decline to obliterate it.³²

The Court noted that, as of 1965, eleven states besides Illinois required mail order sellers to collect use tax.³³ However, none of the tax administrators in those states considered in-state advertising alone to be sufficient to create nexus.³⁴ Read in this light, the *Bellas Hess* decision can be viewed as a judicial rebuke to the one outlier state that had exceeded the limit of state use tax jurisdiction universally applied by every other relevant state.

In contrast, at least thirty states take the position that licensing a trademark or tradename creates corporate income or franchise tax nexus.³⁵ To the extent that the *Bellas Hess* nexus rule merely mirrored state practice, the Court's rationale supports a contrary income tax nexus rule as applied to income received by a PIC from its affiliates.

The Court further explained its holding in *Bellas Hess* by stating:

[I]f the power of Illinois to impose use tax burdens upon National were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote. For if

31. *Bellas Hess*, 386 U.S. at 758. The Court did not analyze the case separately under the Due Process and the Commerce Clauses.

32. *Id.* (internal footnote omitted) (emphasis added).

33. *Id.* at n.11.

34. *Id.*

35. 1 HEALY & SCHADEWALD, *supra* note 6, at I-72 to -74.

Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes.³⁶

It is important to note that the Court specifically spoke of *use tax burdens*, not the general burden of paying taxes and filing returns. Under the Court's Commerce Clause jurisprudence, "with certain restrictions, interstate commerce may be required to pay its fair share of state taxes."³⁷ The Court has long made clear that "[i]t was not the purpose of the Commerce Clause to relieve those engaged in interstate commerce from their just share of [the] state tax burden even though it increases the cost of doing the business."³⁸

The Court was very clear in *Bellas Hess* precisely which use tax burdens informed its holding: "The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government.'"³⁹

Finally, the Court noted that the prevailing system of use tax collection required a remote seller to administer rules that varied from one state to another and which required the remote seller in each taxing jurisdiction to interpret facts that were often too remote and uncertain for the level of accuracy mandated by the system.⁴⁰ These concerns are generally inapplicable to a corporate income or franchise tax.⁴¹

In 1992, the Supreme Court revisited its holding in *Bellas Hess*. In *Quill Corp. v. North Dakota*,⁴² the Supreme Court once again addressed the question of whether a state can require an out-of-state mail order company to collect use tax when the company's only connections with the taxing state are by U.S. mail or common carrier.

36. *Bellas Hess*, 386 U.S. at 759. The Court noted that in 1965, over 2,300 localities imposed local sales taxes and that in most states, the local sales tax was complemented by a use tax. *Id.* at n.12.

37. *D.H. Holmes Co. v. McNamara*, 486 U.S. 24, 30-31 (1988). *Accord* *Quill Corp. v. North Dakota*, 504 U.S. 298, 310 n.5 (1992).

38. *W. Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938). *Accord* *Colonial Pipeline Co. v. Traigle*, 421 U.S. 100, 108 (1975); *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 623-24 (1981); *Quill*, 504 U.S. at 310, n.5.

39. *Bellas Hess*, 386 U.S. at 759-60 (internal footnotes omitted). As of 1965, there were eight different rates of sales and use tax in the United States. *Id.* at 759 n.13.

40. *Id.* at 760 n.14.

41. *See* discussion *infra* beginning at note 52 and Part III.D.

42. 504 U.S. 298.

The Court first recognized that the evolution of its due process jurisprudence since 1967 allowed a state, consistently with the Due Process Clause, to require a mail order company that purposefully avails itself of the market in that state to collect its use tax notwithstanding that the company's only contacts with the state are by U.S. mail or common carrier.⁴³

However, the Court declined the invitation to overrule *Bellas Hess* under the Commerce Clause.⁴⁴ The Court so declined on two grounds.

First, the Court felt that the existence of a use tax collection bright-line rule "furthers the ends of the dormant Commerce Clause . . . by the demarcation of a discrete realm of commercial activity that is free from interstate taxation."⁴⁵ The Court viewed such a use tax collection safe harbor as establishing "the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduc[ing] litigation concerning those taxes."⁴⁶

Second, the Court noted that "a bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment by businesses and individuals."⁴⁷ In this context, the Court speculated that "the mail-order industry's dramatic growth over the [previous] quarter century is due in part to the bright-line exemption

43. *Id.* at 306-08.

44. *Id.* at 309-19.

45. *Id.* at 314-15. Although the text of the Commerce Clause contains only an affirmative grant of authority to Congress to regulate interstate commerce, the Court has long interpreted it to include an implied, or "dormant," limitation on the power of the states to burden interstate commerce. *S.C. State Highway Dep't v. Barnwell Bros., Inc.*, 303 U.S. 177, 184-85, 185 n.2 (1938); *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 236 (1824) (Johnson, J., concurring).

46. *Quill*, 504 U.S. at 315. The Court's bright line rationale is highly dubious in view of the volume of post-*Quill* litigation over the nature and extent of physical presence necessary to establish Commerce Clause use tax collection nexus. *Compare Orvis Co., Inc. v. Tax Appeals Tribunal*, 654 N.E.2d 954 (N.Y. 1995) (finding that visits to nineteen wholesale customers four times per year or forty-one visits to customers during three-year audit period are each sufficient to establish substantial nexus as there is demonstrably more than a slightest presence in state), *and* *Ariz. Dep't of Revenue v. O'Connor*, 963 P.2d 279 (Ariz. Ct. App. 1997) (finding that four deliveries and installation services provided to one customer over a two month period, four repair visits by employees or local representatives over three-year warranty period, and seventeen custom furnishing transactions over four years were sufficient to establish nexus as activities are significantly associated with the taxpayer's ability to establish and maintain a market for the sales), *with* *Fla. Dep't of Revenue v. Share Int'l, Inc.*, 667 So. 2d 226 (Fla. Dist. Ct. App. 1995), *aff'd*, 676 So.2d 1362 (Fla. 1996) (determining that once the *Bellas Hess/Quill* "bright-line" is satisfied, it must then be determined whether the seller's activities within the state establish a substantial nexus; four annual three-day in-state appearances at seminars or conventions insufficient to establish substantial nexus), *and* *In re Intercard, Inc.*, 14 P.3d 1111 (Kan. 2000) (finding eleven in-state installation visits to company's largest customer in Kansas over three month period too isolated, sporadic and insufficient to establish substantial nexus).

47. *Quill*, 504 U.S. at 316.

from state taxation created in *Bellas Hess*.⁴⁸ Therefore, the Court viewed the “interest in stability and orderly development of the law that undergirds the doctrine of *stare decisis*” as counseling in favor of affirming *Bellas Hess*.⁴⁹

None of the concerns that motivated the Court in *Quill* are applicable in the income tax context. First, the Court twice noted that it had never imposed a physical presence requirement for any tax other than for use tax collection.⁵⁰ Indeed, as the cases in Part IV, *infra*, demonstrate, the Court has consistently upheld the constitutionality of the business situs rule for the taxation of intangibles or the income derived from the licensing of intangibles—a rule that by its very terms rejects physical presence as a jurisdictional requirement for taxation.

For the same reason, there is no settled expectation of a physical presence rule as applied to the income taxation of intangibles. Neither in *Quill*, nor in any previous or subsequent case, has the Court even hinted that intangibles are entitled to the same safe harbor from nexus that *Bellas Hess* created for use tax collection. In contrast, the grudging nature of the Court’s affirmance of *Bellas Hess*⁵¹ should caution against relying on *Quill* as authority for a physical presence safe harbor for intangibles.

Lastly, running through the Court’s opinion is a concern for the same unique burdens of use tax collection that informed the Court’s decision in *Bellas Hess*. The Court noted that North Dakota required any seller who advertised in the state three times per year to collect use

48. *Id.*

49. *Id.* at 317 (internal quotation omitted).

50. *Id.* at 314, 317. It is worth noting that a corporation, being a legal fiction, can never be said to be “physically present” anywhere. See *Int’l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945) (determining that when used with reference to a corporation “the terms ‘present’ or ‘presence’ are used merely to symbolize those activities of the [corporation] within the state . . .”). In all cases a corporation can only be said to be present in a state to the extent it has representatives or engages in economic activities in that state. The Court’s “physical presence” rule in *Quill* cannot therefore be interpreted literally. It can only be understood to be a shorthand term for the result of the case; that an out-of-state seller whose only connections with the taxing state are advertising and delivery via common carrier lacks the requisite nexus with the state to require it to collect use tax. See Michael T. Fatale, *State Tax Jurisdiction and the Mythical “Physical Presence” Constitutional Standard*, 54 *TAX LAW.* 105 (2000), for an excellent discussion of these principles.

51. “While contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today, *Bellas Hess* is not inconsistent with *Complete Auto* and our recent cases.” *Quill*, 504 U.S. at 311. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), established the modern four-part test for determining whether a state tax on interstate commerce is consistent with the Commerce Clause. The four requirements are: the tax must be applied to an activity with a substantial nexus with the taxing state, must be fairly apportioned, must not discriminate against interstate commerce, and must be fairly related to services provided by the state. *Id.*

tax and that similar obligations might be imposed by any of the more than 6,000 taxing jurisdictions that imposed a use tax as of 1992.⁵² These concerns are simply irrelevant in the income tax context. Only 45 states and the District of Columbia impose a corporate income tax.⁵³ In addition to the District of Columbia, only one other locality—New York City—imposes a general corporate income tax.⁵⁴

The burdens of filing annual income tax returns reporting one's own income to no more than 47 taxing authorities are simply not of the nature or magnitude of reporting use tax collected from hundreds of thousands, if not millions, of purchasers in thousands of taxing jurisdictions, on a quarterly or even monthly basis. Therefore, the burdens of use tax collection that provided the primary foundation for *Quill* simply do not apply to the corporate income tax.⁵⁵

D. State Caselaw Supports Economic Presence as the Correct Nexus Standard for the Income Taxation of a PIC

The issue of whether the Commerce Clause requires a PIC to have physical presence within a state before the state may tax income received by the company from its licensing of intangibles to its affiliates has generated considerable academic controversy.⁵⁶ However, the issue

52. *Quill*, 504 U.S. at 313 n.6.

53. 1 HEALY & SCHADEWALD, *supra* note 6, at I-3.

54. 4 U.S. CENSUS BUREAU, U.S. DEP'T OF COMMERCE, 2002 CONSENSUS OF GOVERNMENTS: COMPENDIUM OF GOVERNMENT FINANCES, tbl.45, 92, 101, 125 (2005). Ernst & Young estimate that 728 local jurisdictions in the United States impose business income taxes and 1,185 local jurisdictions impose gross receipts taxes on general businesses. *State and Local Jurisdictions Imposing Income, Franchise, and Gross Receipts Taxes on Business*, QUANTITATIVE ECONOMICS AND STATISTICS (Ernst & Young), Mar. 7, 2007, available at [http://www.ey.com/Global/download.nsf/US/Imposing_Taxes_on_Businesses/\\$file/Imposing_Taxes_on_Businesses.pdf](http://www.ey.com/Global/download.nsf/US/Imposing_Taxes_on_Businesses/$file/Imposing_Taxes_on_Businesses.pdf). It is impossible to evaluate the extent of any constitutionally significant burdens imposed on interstate commerce as a result of applying an economic nexus test to these taxes because the report does not define the scope of any applicable tax base. For example, if the term "gross receipts taxes" includes a sales tax imposed solely on the gross receipts of the vendor, nexus for such a tax is determined by the *Quill* physical presence test. See, e.g., *Kmart Props., Inc., v. Taxation & Revenue Dep't*, 2006-NMCA-26, ¶¶ 25-42, 139 N.M. 177, 186-90, 131 P.3d 27, 36-40 (2001). Consequently, including these taxes in any assessment of the burdens imposed by an economic nexus test would be inappropriate. In terms of the burdens issue, it is far more telling that only two localities impose a general tax on net income derived from sources within the locality.

55. See, e.g., *Tax Comm'r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 233-34 (W.Va. 2006).

56. Compare Tun-Jen Chiang, *State Income Taxation of Out-of-State Trademark Holding Companies*, 70 U. CHI. L. REV. 1533 (2003) (stating that physical presence is required), and Plant, *supra* note 25 (same), with Michael T. Fatale, *Geoffrey Sidesteps Quill: Constitutional Nexus, Intangible Property and the State Taxation of Income*, 23 HOFSTRA L. REV. 407 (1994) (stating that physical presence not required), and Cory D. Olson, Comment, *Follow the Giraffe's Lead – Lanco, Inc. v. Director, Division of Taxation Gets Lost in the Quagmire that is State Taxation*, 6 MINN. J.

has proven to be far less controversial in the state appellate courts. As of this writing, every state appellate court that has squarely addressed the issue has ruled that physical presence is not required for a state to have Commerce Clause income tax nexus with a PIC.⁵⁷

In ruling that the *Quill* physical presence requirement is inapplicable to an income tax, state courts have noted that the Supreme

L. SCI. & TECH. 789 (2005) (same).

57. See cases cited *supra* note 27.

In other contexts, state appellate courts have also held that the Commerce Clause does not require physical presence for a state to impose a tax other than use tax collection. *See, e.g.,* Couchot v. State Lottery Commission, 74 Ohio St. 3d 417, 1996-Ohio-262, 659 N.E.2d 1225 (allowing state to tax lottery proceeds received by nonresident where there is no physical presence); Borden Chems. & Plastics, L.P. v. Zehnder, 726 N.E.2d 73 (Ill. App. Ct. 2000) (allowing state to tax income received by nonresident partners of a partnership doing business in Illinois where there is no physical presence). *But see* Lanzi v. Ala. Dep't of Revenue, No. 2040298, 2006 Ala. Civ. App. LEXIS 406 (Ala. Civ. App. June 30, 2006) (finding that a nonresident limited partner in an Alabama limited partnership lacked sufficient due process minimum contacts with state as his ownership interest in the partnership, without more, did not establish either a commercial domicile or business situs in Alabama).

One appellate court has ruled that physical presence is required to establish Commerce Clause franchise tax nexus. *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000). In *Bandag Licensing*, Texas sought to impose franchise tax on an Iowa corporation solely because it possessed a license to do business in Texas. *Id.* at 298. Bandag received patent royalty payments from a Texas affiliate. *Id.* However, Texas was precluded by state law from imposing its franchise tax as a result of the royalty income. *See id.* Therefore, *Bandag Licensing* did not involve a state's assertion of nexus due to the receipt of income derived from intangibles. In a subsequent case, the Court clarified that the physical presence test is met if the taxpayer maintains "retail outlets, solicitors, or property within the state." *INOVA Diagnostics, Inc. v. Strayhorn*, 166 S.W.3d 394, 402 (Tex. App. 2005). The use of a trademark or other intellectual property within the state should satisfy the constitutional test albeit Texas would be precluded from taxing royalty income by state law.

In Tennessee, the Court of Appeals applied a physical presence income tax nexus standard in a case involving a national credit card issuer, without deciding whether the Commerce Clause compelled such a standard. *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 839 (Tenn. Ct. App. 1999) (declining to rule that physical presence is not required; the state had failed to articulate a reason to distinguish the case from the use tax collection obligation at issue in *Quill*). The court later clarified that it was not its purpose to decide in *J.C. Penney* whether physical presence was required to establish Commerce Clause income or franchise tax nexus. *America Online, Inc. v. Johnson*, No. M2001-00927-COA-R3-CV, 2002 Tenn. App. LEXIS 555, at *5 (Tenn. Ct. App. July 30, 2002). Whether the Commerce Clause requires a physical presence nexus standard for income and franchise tax therefore remains an open question in Tennessee. On the same facts as in *J.C. Penney*, the West Virginia Supreme Court held that significant economic presence is the appropriate Commerce Clause nexus standard for taxes other than sales and use tax collection. *MBNA*, 640 S.E.2d 226. The court held that, in addition to the "purposeful [availing]" required by the Due Process Clause, the Commerce Clause requires an additional examination of "the frequency, quantity and systematic nature of a taxpayer's economic contacts with a state." *Id.* at 234. The Court found that MBNA had a significant economic presence in West Virginia, based on its continuous and systematic direct mail and telephone solicitation and promotion of its national credit card services, as well as MBNA's significant gross receipts from West Virginia consumers of those services. *Id.* at 235-36.

Court explicitly limited its Commerce Clause ruling in *Quill* to use tax collection.⁵⁸ Next, the courts have recognized that the Supreme Court in *Quill* was heavily motivated by stare decisis concerns to preserve the bright-line, physical presence rule for use tax collection originally declared in *Bellas Hess* twenty-five years previously.⁵⁹ No such stare decisis concerns inform the issue of income tax nexus, because the Court has never previously required physical presence for a state to impose a tax on income derived from intangibles.⁶⁰

Some commentators have asserted that it would be incongruous to allow an economic presence nexus test for income tax since physical presence is required for use tax collection.⁶¹ However, as recognized by the state courts that have decided the issue, both the distinctions between the nature of the two taxes and the differing burdens imposed on taxpayers by those taxes justify a different nexus standard.

As the New Mexico Court of Appeals stated:

[A] sales and use tax can impose a special burden on interstate commerce beyond just the payment of money.[⁶²] Unlike an income tax, a sales and use tax can make the taxpayer an agent of the state, obligated to collect the tax from the consumer at the point of sale and then pay it over to the taxing entity. Whereas, a state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate,

58. *Kmart Props., Inc., v. Taxation & Revenue Dep't*, 2006-NMCA-26, ¶ 21, 139 N.M. 177, 185, 131 P.3d 27, 35 (2001); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194 (N.C. Ct. App. 2004); *Geoffrey, Inc. v. Okla. Tax Comm'n*, 2006 OK CIV APP 27, ¶ 10, 132 P.3d 632, 635; *MBNA America Bank*, 2006 W. Va. LEXIS, *20.

59. *Kmart Props.*, 2006-NMCA-26, ¶ 21, 139 N.M. at 185, 131 P.3d at 35; *A&F Trademark*, 605 S.E.2d at 194; *Geoffrey*, 2006 OK CIV APP 27, ¶ 16, 132 P.3d at 638; *MBNA*, 640 S.E.2d at 232.

60. See *infra* note 68 and accompanying text.

61. “[T]here is but one Commerce Clause and it applies regardless of the type of tax involved.” Paul H. Frankel et al., *Lanco – It Isn’t Over Yet*, 40 ST. TAX NOTES 227, 228 (2006). See also Xuan-Thao N. Nguyen, *Holding Intellectual Property*, 39 GA. L. REV. 1155, 1173, 1173 n.93 (2005). *Cerro Copper Products*, the administrative decision upon which Professor Nguyen relies, has been overruled. *Cerro Copper Products, Inc. v. Ala. Dep’t Rev.*, 1995 WL 800114 (Dec. 11, 1995), *overruled by* *Lanzi*, Ala. Dep’t of Revenue, 2003 Ala. Tax LEXIS 75 (Sept. 26, 2003). In overruling *Cerro Copper Products*, the administrative law judge (“ALJ”) in *Lanzi* remarked, “After studying the issue further, I am no longer convinced that the Supreme Court intended the *Quill* physical presence test to apply beyond sales and use tax. . . . [T]he Supreme Court’s statements in *Quill* that it has never applied a physical presence test to other type taxes [sic] must be taken at face value.” *Id.* at *9-11.

Both *Cerro Copper Products* and *Lanzi* were decided by Chief ALJ Bill Thompson of the Alabama Department of Revenue, Administrative Law Division. Telephone interview with Michael E. Mason, Director of Tax Policy, Alabama Department of Revenue (January 24, 2006).

62. The Supreme Court has repeatedly ruled that the routine burdens of paying a state tax and filing a return do not raise any issues under the Commerce Clause. See *supra* notes 37-38, and accompanying text.

a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates. . . . Thus, collecting and paying a sales and use tax can impose additional burdens on commerce that the Supreme Court has repeatedly identified in prior opinions.⁶³

In addition, use tax collection is based on the nature and extent of the seller's activities in the state, whereas income and franchise taxes imposed on income derived from intangibles is based on the use of the intangible property in the state, irrespective of whether the owner of the intangible is engaged in activities in the state.⁶⁴ These differences make it inappropriate to require physical presence before a state can tax income received as a result of use within the state of an intangible which, by definition, has no physical presence anywhere.⁶⁵

In the final analysis, the economic presence income tax nexus test for taxing income received by a PIC is neither new nor remarkable. It is nothing more than the business situs rule for taxing intangibles, dressed up for the modern economy. For more than a century, the Supreme Court has recognized the constitutional authority of the states to apply the business situs rule for the taxation of intangibles. It is to those cases that we now turn.

IV. THE BUSINESS SITUS RULE FOR TAXING INTANGIBLES

A. Historical Development of the Business Situs Rule

In *Quill*, the Supreme Court reaffirmed the Commerce Clause physical presence use tax collection nexus standard it had previously established in *Bellas Hess*.⁶⁶ The Court made clear that it had never applied the physical presence standard to any tax other than use tax collection.⁶⁷ The Court did not make this declaration in a jurisprudential vacuum. Rather, the Court's dicta regarding other taxes is an implicit recognition that the Court has consistently ruled that the business situs rule satisfies federal constitutional requirements for state taxation of intangibles or income derived from intangibles, precisely because

63. *Kmart Props.*, 2006-NMCA-26, ¶ 22, 139 N.M. at 185, 131 P.3d at 35. *Accord A&F Trademark*, 605 S.E. 2d at 195; *Geoffrey*, 2006 OK CIV APP 27, ¶ 15, 132 P.3d at 637; *MBNA*, 640 S.E.2d at 233.

64. *A&F Trademark*, 605 S.E. 2d at 194-95.

65. *Id.*

66. *Quill Corp. v. North Dakota*, 504 U.S. 298, 317-18 (1992).

67. *Id.* at 314, 317.

intangibles cannot be said to have a physical presence anywhere.⁶⁸

In *Louisville & Jeffersonville Ferry Company v. Kentucky*,⁶⁹ the Supreme Court held that a franchise tax levied by Kentucky on a Kentucky corporation for the operation of a ferry across the Ohio River from Kentucky to Indiana violated the Due Process Clause to the extent the state included, within the assessed value of the Kentucky franchise, the value of a separate franchise granted by Indiana to operate a ferry across the Ohio from Indiana to Kentucky.

The Louisville & Jeffersonville Ferry Company was a Kentucky corporation.⁷⁰ It was a successor in interest to the original licensees of a franchise granted by the Indiana Territory to operate a ferry across the Ohio River from Indiana to Kentucky.⁷¹ The company also was the licensee of a franchise granted by the City of Louisville to operate a ferry across the Ohio River from Kentucky to Indiana.⁷²

Kentucky levied a franchise tax on the company's Louisville ferry franchise from Kentucky to Indiana, the value of which included the value of the Indiana franchise from Indiana to Kentucky.⁷³ The Court ruled that Kentucky violated the Due Process Clause in including the value of the Indiana franchise in the assessed value of the Kentucky franchise.⁷⁴ In doing so, the Court noted that "beyond all question, the ferry franchise derived from Indiana is an incorporeal hereditament derived from and having its legal situs in that state. It is not within the jurisdiction of Kentucky."⁷⁵

68. *Louisville & Jeffersonville Ferry Co. v. Kentucky*, 188 U.S. 385 (1903) (holding that the Due Process Clause barred Kentucky from imposing franchise tax on the value of a license granted by Indiana to Kentucky corporation to operate a ferry over the Ohio River from Indiana to Kentucky as Indiana was the business situs of the license); *Wheeling Steel Corp. v. Fox*, 298 U.S. 193 (1936) (finding West Virginia ad valorem property tax on accounts receivable and bank deposits of Delaware corporation did not violate Due Process Clause as West Virginia was the business situs of the intangibles); *New York ex rel. Whitney v. Graves*, 299 U.S. 366 (1937) (upholding the New York tax on income derived from sale by non-resident of membership in New York Stock Exchange as New York was the business situs of the license); *First Bank Stock Corp. v. Minnesota*, 301 U.S. 234 (1937) (Delaware corporation properly subject to Minnesota ad valorem property tax on value of stock in banks chartered in Montana and North Dakota as Minnesota was the business situs of the stock); *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940) (Wisconsin Privilege Dividend Tax properly applied to dividends declared and paid outside of state by foreign corporation doing business in Wisconsin); *Int'l Harvester Co. v. Wisc. Dep't of Taxation*, 322 U.S. 435 (1944) (same).

69. 188 U.S. 385.

70. *Id.* at 391.

71. *Id.*

72. *Id.*

73. *Id.* at 392.

74. *Id.* at 398.

75. *Id.*

In *Wheeling Steel Corp. v. Fox*,⁷⁶ the Court held that West Virginia's ad valorem property tax did not violate the Due Process Clause when applied to a foreign corporation's accounts receivable and bank deposits having a business situs in West Virginia.

The Court began its analysis of the constitutionality of the West Virginia ad valorem property tax as applied to Wheeling Steel's bank deposits and receivables by observing: "When we deal with intangible property, such as credits and choses in action generally, we encounter the difficulty that by reason of the absence of physical characteristics they have no situs in the physical sense, but have the situs attributable to them in legal conception."⁷⁷

The Court then acknowledged that a state could properly apply the rule *mobilia sequuntur personam* and treat intangibles as located at the owner's domicile for tax purposes.⁷⁸

Having stated the general rule of sourcing intangibles for tax purposes, the Court nevertheless acknowledged that in modern times, intangibles, as well as tangible personal property, are often used in the conduct of business in locations other than at the commercial domicile of the business.⁷⁹ The Court surveyed its prior caselaw and concluded that those cases "recognize the principle that choses in action may acquire a situs for taxation other than at the domicile of their owner, if they have become integral parts of some local business."⁸⁰

The Court found that Wheeling Steel had established a commercial domicile in West Virginia and that the state could therefore, consistently with the Due Process Clause, levy its tax on the entire value of the corporation's bank deposits and receivables, without apportioning any portion of the value of the intangibles to other states.⁸¹

In *New York ex rel. Whitney v. Graves*,⁸² the Court sustained the constitutionality of New York's tax on the income realized by a Massachusetts resident as the result of his sale of a seat on the New York Stock Exchange ("NYSE" or "Exchange"). Mr. Whitney had always been domiciled in Massachusetts and never had an office or home in New York.⁸³ He never carried on any business in New York, executed no trades on the floor of the Exchange, and did not buy and sell

76. 298 U.S. 193 (1936).

77. *Id.* at 209.

78. *Id.*

79. *Id.* at 209-10.

80. *Id.* at 210 (citation omitted).

81. *Id.* at 213-14.

82. 299 U.S. 366 (1937).

83. *Id.* at 371.

securities on the Exchange for his firm account.⁸⁴

Whitney accepted orders from customers at his Boston office for execution on the NYSE, which orders were executed on the Exchange by members of the Exchange with New York offices, acting in their own names as correspondents.⁸⁵

Whitney asserted that New York was without authority to tax his profit on the sale of his seat on the Exchange, because he lacked a business situs in New York, transacting all his business in Massachusetts.⁸⁶

The Court rejected Whitney's argument, noting that intangible rights "may be identified with a particular place because the exercise of the right is fixed exclusively or dominantly at that place. In [that] case the localization for the purpose of transacting business may constitute a business situs quite as clearly as the conduct of the business itself."⁸⁷ As to the right to execute trades on the floor of the NYSE, the Court observed that "[i]ts very nature localizes it at the Exchange. It is a privilege which can be exercised nowhere else."⁸⁸

In *First Bank Stock Corp. v. Minnesota*,⁸⁹ the Supreme Court ruled that the Due Process Clause did not prevent Minnesota from imposing its ad valorem property tax on a Delaware corporation based on the value of stock the corporation owned in state banks chartered in Montana and North Dakota, as Minnesota was the business situs of the stock.

The Court found that First Bank Stock maintained within Minnesota "an integrated business of protecting its investments in bank shares, and enhancing their value, by the active exercise of its power of control through stock ownership of its subsidiary banks."⁹⁰ The Court therefore ruled that the corporation had established a commercial domicile in Minnesota for its intangibles, including the stock it held in the controlled out-of-state banks.⁹¹

In holding that Minnesota's business situs rule for the ad valorem property taxation of stock is consistent with the Due Process Clause, the Court observed that, "[t]he rule that property is subject to taxation at its situs, within the territorial jurisdiction of the taxing state, readily

84. *Id.*

85. *Id.*

86. *Id.* at 372.

87. *Id.*

88. *Id.* at 373.

89. 301 U.S. 234 (1937).

90. *Id.* at 237.

91. *Id.* at 237-38.

understood and applied with respect to tangibles, is in itself meaningless when applied to intangibles which, since they are without physical characteristics, can have no location in space.”⁹²

Finally, the Court rejected the taxpayer’s argument that Minnesota’s imposition of the tax violated the Due Process Clause because the stock was properly subject to tax in the bank domiciliary states of Montana and North Dakota.⁹³ The Court noted that both the domiciliary state and the business situs state provide legal protection to the corporation and are equally entitled under the Due Process Clause to be reimbursed their share of the cost of providing governmental services.

The economic advantages realized through the protection, at the place of domicile [sic], of the ownership of rights in intangibles, the value of which is made the measure of the tax, bear a direct relationship to the distribution of burdens which the tax effects. . . . Like considerations support their taxation at their business situs, for it is there that the owner in every practical sense invokes and enjoys the protection of the laws, and in consequence realizes the economic advantages of his ownership.⁹⁴

In *Wisconsin v. J.C. Penney Co.*,⁹⁵ the Supreme Court ruled that the Wisconsin Privilege Dividend Tax did not violate the Due Process Clause as applied to dividends declared and paid by a Delaware corporation doing business in Wisconsin.

Wisconsin imposed a tax on corporations doing business in the state for the privilege of declaring and receiving dividends.⁹⁶ The tax was applied to dividends declared and paid out of the apportioned share of the company’s corporate income attributable to business transacted in Wisconsin.⁹⁷ The company challenged the tax as violating the Due Process Clause to the extent it was applied to a foreign corporation that declared and paid its dividends outside of Wisconsin.⁹⁸

In sustaining the constitutionality of the tax, the Supreme Court rejected the contention that there was no nexus between the dividends and Wisconsin, because the dividends were declared and paid outside

92. *Id.* at 240.

93. *Id.* at 239-41.

94. *Id.* at 241. *Cf.*, *Curry v. McCanless*, 307 U.S. 357 (1939) (determining that the Due Process Clause permits both Alabama and Tennessee to “impose death taxes upon the transfer of an interest in intangibles held in trust by an Alabama trustee but passing under the will of a beneficiary decedent domiciled in Tennessee”).

95. 311 U.S. 435 (1940).

96. *Id.* at 441.

97. *Id.* at 441-42.

98. *Id.* at 443.

the state:

The substantial privilege of carrying on business in Wisconsin . . . clearly supports the tax, and the state has not given the less merely because it has conditioned the demand of the exaction upon happenings outside its own borders. The fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction.⁹⁹

*International Harvester Co. v. Wisconsin Department of Taxation*¹⁰⁰ was a later iteration of *J.C. Penney*. Following the Supreme Court's decision in *J.C. Penney*, the Wisconsin Supreme Court ruled that the legal incidence of the Wisconsin Privilege Dividend Tax fell on the stockholders receiving the dividends, not upon the corporation declaring them.¹⁰¹

The Supreme Court once again ruled that the tax did not violate the Due Process Clause, notwithstanding that the burden of the tax fell on out-of-state stockholders.¹⁰² In so doing, the Court declared the stockholders' lack of physical presence in Wisconsin to be immaterial:

Personal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them. A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers.¹⁰³

B. Quill Does Not Establish a Physical Presence Income Tax Nexus Rule

The thesis of this Article is that the business situs rule for taxing income received from intangibles satisfies the Commerce Clause nexus requirement as applied to royalties and other income received by a trademark licensor from its affiliated licensees.¹⁰⁴ A corollary of this

99. *Id.* at 444-45.

100. 322 U.S. 435 (1944).

101. *Id.* at 439.

102. *Id.* at 441-42.

103. *Id.*

104. The business situs of a trademark is wherever the trademark is used. The value of a trademark "is tied to the underlying business that generates the goodwill associated with the

thesis is that the business situs rule as so applied is fully consistent with the Supreme Court's decision in *Quill*. There are at least four arguments to support this thesis.

First, nothing in *Quill* can fairly be read as overruling the Court's business situs jurisprudence for the taxation of intangibles. Indeed, the opinion never mentions this jurisprudence at all. It is hornbook law that the Supreme Court does not normally overturn earlier authority sub silentio.¹⁰⁵ That business situs taxation of intangibles satisfies the Due Process Clause is beyond dispute.

Second, notwithstanding that a number of the Supreme Court's business situs cases involved taxpayers who had real estate and/or tangible property in the taxing state, the Court has explicitly declared that the presence of real estate and/or tangible property is of no constitutional significance: "Nor are we able to perceive any sound reason for holding that the owner must have real estate or tangible property within the state in order to subject its intangible property within the state to taxation."¹⁰⁶

Third, although the Supreme Court's business situs jurisprudence is grounded in the Due Process Clause, it is noteworthy that the Supreme Court located its comments regarding the lack of a physical presence requirement for taxes other than use tax collection in the Commerce Clause portion of the *Quill* opinion.¹⁰⁷ Consequently, the Court's Commerce Clause physical presence nexus rule for use tax collection was consciously informed—and limited—by its reference to a contrary rule for other taxes, including the business situs rule for taxing intangibles.

Fourth, there is nothing in *Quill* that requires, or even suggests, that the Commerce Clause nexus test must be identical for all taxes.¹⁰⁸ One

trademarks Goodwill is bound to the business with which it is associated [T]rademark rights in the United States . . . are wholly dependent upon actual use." *Kmart Props., Inc., v. Taxation & Revenue Dep't*, 2006-NMCA-26, ¶ 27, 139 N.M. 177, 187, 131 P.3d 27, 37 (2001) (internal citations omitted).

105. *Shalala v. Ill. Council on Long Term Care, Inc.*, 529 U.S. 1, 18 (2000). *Accord San Remo Hotel L.P. v. San Francisco*, 364 F.3d 1088, 1095 n.2 (9th Cir. 2004).

106. *Virginia v. Imperial Coal Sales Co.*, 293 U.S. 15, 20 (1934), *quoted in* *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 213 (1936).

107. *Quill Corp. v. North Dakota*, 504 U.S. 298, 314, 317 (1992). The discussion of the Commerce Clause begins at page 309 of the opinion.

108. Notwithstanding the argument that "there is but one Commerce Clause" and that therefore the nexus test should be the same for all taxes, *see supra* note 61, there is nothing remarkable about applying the same constitutional provision differently in varying contexts. For example, under the Supreme Court's Equal Protection Clause jurisprudence, the Court will analyze most state statutes under a rational basis standard of review and the statute will be sustained if there is any set of facts

commentator has noted that the *Quill* Commerce Clause nexus test is neither higher nor lower than the Due Process test; it is merely different because the two tests reflect different constitutional values and concerns.¹⁰⁹ Similarly, the Commerce Clause nexus test itself should not be identical for all taxes, because a “one size fits all” physical presence test does not reflect material differences in the nature of each tax and the characteristics of the asset or income being taxed. Such differences render a physical presence Commerce Clause nexus test entirely unworkable as applied to the taxation of intangibles or the income derived therefrom.

Arguably, the unique burdens of use tax collection justify a restricted physical presence Commerce Clause nexus test for use tax collection.¹¹⁰ Those burdens are simply inapplicable to a tax imposed directly on the income derived from intangible property. In contrast, the unique nature of intangibles—that they have no physical presence anywhere—demonstrates that a physical presence test for taxing income from intangibles would be entirely inappropriate. Indeed, such a test would be oxymoronic.

The Supreme Court has declared, in the context of defining appropriate due process standards for personal jurisdiction over an out-of-state litigant, that “it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted.”¹¹¹ In

that rationally furthers the legislative objective. *Allied Stores of Ohio, Inc. v. Bowers*, 358 U.S. 522, 527-29 (1959). But if the statute trenches on a fundamental right, such as interstate travel, or discriminates on the basis of a suspect classification, such as race, the statutory scheme will be subject to a heightened, or strict, standard of review. Such statutes will be sustained only if the state can demonstrate a compelling interest that justifies the discrimination. *Johnson v. California*, 543 U.S. 499, 505 (2005) (race); *Shapiro v. Thompson*, 394 U.S. 618, 638 (1969) (interstate travel). Viewed in this light, the *Quill* nexus test can be viewed as a form of strict Commerce Clause scrutiny that is justified because of the unique burdens of use tax collection—burdens that are inapplicable to a direct tax on one’s own income.

109. John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 372 (2003).

110. The physical presence test is not without its critics, even as applied to use tax collection. Justice White was of the view that nexus is properly analyzed exclusively under the Due Process Clause, and that any consideration of burdens should be separately addressed under the Commerce Clause. *Quill*, 504 U.S. at 325-27 (White, J., dissenting). Taking Justice White’s position a step further, one commentator has urged that, in lieu of a physical presence nexus test, the Court should adopt a balancing test similar to that used in Commerce Clause regulatory cases—whether the nature and extent of the burdens imposed on interstate commerce outweighs the state interests furthered by requiring out-of-state sellers to collect the use tax. Robert D. Plattner, *Quill: 10 Years After*, 25 ST. TAX NOTES 1017, 1020 (2002).

111. *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985).

ruling that an individual who “purposefully avails” himself of a forum state’s markets thereby subjects himself to suit in that state arising out of those activities, the Court recognized that “courts must not be blind to what all others can see and understand.”¹¹²

In affirming the constitutionality of the business situs rule for the taxation of intangibles, the Supreme Court was not “blind to what all others can see and understand.”¹¹³ Indeed, in acknowledging that a taxpayer need not have any real and/or tangible property in a state and still be liable for tax on account of the intangibles used by his business in that state,¹¹⁴ the Court has explicitly seen and understood the unique nature of intangibles that justify economic presence as the appropriate Commerce Clause nexus standard—intangibles have no physical presence upon which to base nexus.¹¹⁵ The business situs rule for the taxation of income from intangibles therefore satisfies the Commerce Clause nexus test as applied to the income received by a trademark licensor from its affiliates.

V. RAMIFICATIONS OF THE BUSINESS SITUS RULE AS APPLIED TO PICs

A. *The Taxation of an Author’s Royalty Income*

The business situs rule as applied to PICs has been criticized on the grounds that the application of the rule in that context would subject authors of copyrighted books to state income tax in every state where the author’s books are sold.¹¹⁶ In making this argument, such critics ignore

112. *Id.* at 486 (citation omitted). A number of state courts, in ruling that economic presence establishes income or franchise tax nexus, have also acknowledged the realities of modern commercial life in rejecting a physical presence nexus standard. “[W]e believe that the *Bellas Hess* physical-presence test . . . makes little sense in today’s world. . . . The development and proliferation of communication technology exhibited . . . by the growth of electronic commerce now makes it possible for an entity to have a significant economic presence in a state absent any physical presence there.” Tax Comm’r v. MBNA Am. Bank, N.A., 640 S.E.2d 226, 234 (W. Va. 2006).

113. *See supra* note 112.

114. *See* cases cited *supra* note 106.

115. Although the focus of this article is on trademark holding companies, the principles enunciated herein have equal force when applied to income derived from other forms of intellectual property, such as copyrights or patents. *Cf.* *General Motors Corp. v. Ariz. Dep’t of Revenue*, 938 P.2d 481 (Ariz. Ct. App. 1996) (“[I]ntangibles like patents and copyrights have no physical location. . . . Accordingly, we are not persuaded that a patent necessarily has a single discrete situs that the patent income can follow . . .”).

116. Nguyen, *supra* note 61, at 1180-84 (stating that to apply the business situs rule to royalty income derived from licensing trademarks would cause John Grisham to be subjected to income tax in every state where his books are sold). *See also*, *Kmart Props., Inc., v. Taxation & Revenue Dep’t*, 2006-NMCA-26, ¶ 36, 139 N.M. 177, 188-89, 131 P.3d 27, 38-39 (2001) (“KPI counters

the essential difference between a licensor of intellectual property and the author of a book.

The licensor of intellectual property has at least a contractual, and often a legal, relationship with the licensee using the intellectual property in the taxing state.¹¹⁷ On the other hand, the author of a book typically has neither a legal nor a contractual relationship with the retailers who sell the books. Instead, “[b]ook authors usually contract with book publishers for the publication of their works, the publisher taking title to all rights in the work subject to the provisions of the contract.”¹¹⁸ For example, the books of noted legal thriller author John Grisham are published by Random House.¹¹⁹ Random House, not John Grisham, has the contractual relationship with each retailer for the sale of Grisham’s books. As such, Random House is properly subject to an appropriately apportioned income tax on the income it derives from sales of the books in each state in which the books are sold.¹²⁰ Random House would apportion its receipts from the book sales on the basis of a formula, the numerator of which is its total receipts in the taxing state during the tax period, and the denominator of which is the publisher’s total receipts everywhere during the tax period.¹²¹

Unlike the publisher, John Grisham derives no income from the sale of his books merely because of their association with his copyrights.¹²² While the measure of his compensation is undoubtedly

that, if we attribute physical presence for Commerce Clause purposes, based solely on the tangible manifestation of KPI’s marks in New Mexico, then the State’s taxing jurisdiction would become boundless. KPI poses a hypothetical dilemma that any out-of-state third-party, such as a national book author . . . would have to pay gross receipts tax to New Mexico simply for allowing its trademark to appear on products held for sale on Kmart’s shelves.”).

117. A PIC of course has both a legal and a contractual relationship with its affiliated operating companies and trademark licensees. See discussion *supra* Part III.A.

118. *Mills Music, Inc. v. Snyder*, 469 U.S. 153, 175 n.43 (1985) (citation omitted).

119. Biographical information on John Grisham contained in this article is taken from John Grisham: The Official Site, <http://www.randomhouse.com/features/grisham/main.php> (last visited March 11, 2007).

120. See generally, JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION ch. 8C, § 1 (8th ed. 2005) (discussing federal constitutional limitations on formulary apportionment of corporate income).

121. UNIF. DIVISION OF INCOME FOR TAX PURPOSES ACT §15 (2005) “Approximately half of the states with a corporate income tax have adopted the essential features of UDITPA and most of the others have statutes that are consistent with UDITPA’s basic approach, although some variations are common.” 2 POMP & OLDMAN, *supra* note 8, at 10-1.

122. Grisham’s copyrights are in fact held by Belfry Holdings, Inc., a private holding company in Tupelo, Mississippi, of which he is President and his wife, Renee Grisham, is Vice President. See JOHN GRISHAM, INNOCENT MAN: MURDER AND INJUSTICE IN A SMALL TOWN (2006); KnowX.com, Corporate Records, <http://www.knowx.com/corp/detail.jsp?db=MS-CORP&docid=103079423935&query=na> (last visited Mar. 9, 2007). The author assumes that Belfry Holdings is in all likelihood, a

based on the total volume or price of books sold,¹²³ the fact remains that he is neither the seller of the books nor in any way affiliated with or contractually linked to the seller. Grisham is entitled to royalty compensation solely under his contract with Random House.¹²⁴ Therefore, his liability for state income tax on his royalty income is determined without regard to where the books are sold.¹²⁵

Finally, at least one critic of the business situs rule argues that it would be incongruous for the states to assert income tax nexus over Grisham as the result of remote sales via telephone of a few autographed copies of his books, because *Quill* forbids the states from imposing the obligation to collect use tax under these facts.¹²⁶ This argument is grounded in a mistaken premise. The states are precluded from imposing an income tax under these circumstances by Public Law 86-272, 15 U.S.C. §§ 381-84.¹²⁷ Public Law 86-272 forbids a state from

small business corporation for which an election under § 1362(a) of the Internal Revenue Code, I.R.C. § 1362(a) (2006), is in effect. The discussion in the text therefore assumes that the federal income tax attributes of a Subchapter S corporation pass through to Grisham. Specifically, the discussion assumes that Belfry Holdings is not subject to federal income tax under § 1363(a) of the Code and that Grisham, as a shareholder of Belfry Holdings, is liable for a pro rata share of federal income tax on the corporation's income under § 1366(a)(1). Mississippi follows the federal treatment of S corporations for residents. ALL STATES TAX GUIDE (RIA) § 222-C (2007) (chart), available at www.checkpoint.riag.com (last visited Mar. 9, 2007).

123. *Mills Music*, 469 U.S. at 175 n.43.

124. *See id.* at 166-68 (owner of copyrighted song after reversion of copyright has neither a statutory nor contractual right to royalty payments from pre-existing licensees of derivative work; licensees are solely contractually obligated to publisher/licensor of song, who in turn is liable to copyright owner for his share of royalties).

125. Some commentators have suggested that promotional book tours by authors such as Grisham could subject him to state income tax on his royalty income, if the states can tax the royalty income of out-of-state intellectual property licensors. *See, e.g.*, Nguyen, *supra* note 61, at 1181. As explained in the text, Grisham is neither the seller of the books nor is he legally or contractually affiliated with the booksellers. Therefore, any book tours in which he participates do not change the analysis of the income tax consequences of his receipt of royalty income. He would of course be subject to state income tax for any compensation he receives for the promotional tours, on an appropriately apportioned basis. *See, e.g.*, *Newman v. Franchise Tax Bd.*, 256 Cal. Rptr. 503 (Cal. Ct. App. 1989) (finding that a nonresident actor's income from filming of the movie *The Sting* apportioned to California on the basis of a formula, the numerator of which was total working days within California and the denominator of which was total working days everywhere).

126. Nguyen, *supra* note 61, at 1184.

127. 15 U.S.C. § 381 provides, in relevant part:

a) Minimum standards

No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived 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

imposing a tax on or measured by net income if the only activity in the taxing state consists of the solicitation of orders 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. Public Law 86-272 would preclude a state from imposing a net income tax on Grisham if his activities within the state were limited to remote sales via telephone of a few autographed copies of his books, irrespective of the appropriate limits of Commerce Clause income tax nexus.¹²⁸

B. Single Sales Factor Apportionment and PICs: Fairly Dividing the Pie

As asserted *supra*, the physical presence Commerce Clause nexus rule is inappropriate as applied to the state taxation of income received by a PIC from its affiliates. Rather, the business situs rule is the appropriate Commerce Clause nexus test, as it is for the taxation of all income from the licensing of intangibles. Consequently, a PIC that receives income from an affiliate has Commerce Clause nexus with all states in which the affiliate uses the intangible property in its business operations.

Having said that, the question remains—what is the correct apportionment formula to apply to the income of PICs? This is a critical question, because an inappropriate apportionment rule will encourage precisely the same tax avoidance techniques as does an inappropriate physical presence nexus rule.

The business income of a multistate business is apportioned for state tax purposes among all the states in which it operates.¹²⁹

Business income is defined in Uniform Division of Income for Tax Purposes Act (“UDIPTA”) as: “[I]ncome arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of

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).

Act of Sept. 14, 1959, Pub. L. No. 86-272 (codified as amended as 15 U.S.C. § 381 (2006)).

128. As discussed *supra* at Part IV.B, an individual who purposefully avails himself of the taxing state’s market has satisfied the Commerce Clause income tax nexus test.

129. UNIF. DIVISION OF INCOME FOR TAX PURPOSES ACT § 9 (2005).

the taxpayer's regular trade or business operations."¹³⁰

Clearly, the income received by a PIC from its affiliates constitutes business income within the meaning of UDIPTA.¹³¹

The UDITPA rule for the apportionment of the business income of a multistate business is to multiply the business income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.¹³²

The property, payroll, and sales factors are each a fraction, the numerator of which is each factor in the taxing state during the relevant period and the denominator of which is the total factor everywhere.¹³³

The problem with applying the typical equally-weighted three-factor apportionment formula to the income of a PIC is that doing so would not reflect the extent of the PIC's business activity in the state, thereby perpetuating the very tax avoidance planning that the creation of the holding company was designed to foster in the first place. An illustration will explain.

Assume that Retail Corp. creates a wholly-owned affiliate, Hold Co., located in the State of Michigan, which does not tax royalty income.¹³⁴ Retail Corp. assigns its trademarks, its Michigan real and personal property and its Michigan employees to Hold Co., in return for Hold Co.'s stock.¹³⁵ After the transaction, Hold Co. owns property valued at \$10,000,000 and has total payroll of \$7,000,000, all located in the State of Michigan. Hold Co. owns and operates Retail's Michigan stores and owns all of Retail's trademarks.¹³⁶

Assume further that Hold Co. receives a total of \$20,000,000 in

130. *Id.* § 1(a).

131. *Cf.* *Mont. Dep't of Revenue v. Am. Smelting & Refining Co.*, 567 P.2d 901, 907 (Mont. 1977), *appeal dismissed*, 434 U.S. 1042 (1978) (holding that royalties derived from patents and copyrights developed by a mining company's research department constituted apportionable business income); *Xerox Corp. v. Comptroller of Treasury*, 428 A.2d 1208 (Md. 1981) (holding that royalties received from out-of-state licensees for use of patents, trademarks, and copyrights properly apportionable under non-UDIPTA statute, because of close relationship of these royalties to Xerox's in-state copier-related operations).

132. UNIF. DIVISION OF INCOME FOR TAX PURPOSES ACT § 9.

133. UNIF. DIVISION OF INCOME FOR TAX PURPOSES ACT §§ 10, 13, 15.

134. MICH. COMP. LAWS § 208.9(7)(c) (2006).

135. The transfer of property to a corporation solely in exchange for the corporation's stock is a tax-free exchange under § 351 of the Internal Revenue Code, I.R.C. § 351 (2006).

136. That Hold Co. actually operates Retail's Michigan stores, plus its ownership of substantial property in Michigan, makes it highly unlikely that a state could disallow the deductions taken by the affiliates on the ground that Hold Co. lacks economic substance or business purpose. Similarly, the addback statutes generally do not require addback when the formation of the PIC had a substantial business purpose and economic substance. *See, e.g.*, ALA. CODE § 40-18-35(b)(3) (2005). Those facts are irrelevant to the determination of whether a state has nexus with Hold Co.

income in Year 1, \$1,000,000 of which consists of royalties paid by the affiliate in State X for use of the trademarks. The amount of royalties paid is equal to 4% of the net retail sales made by the affiliate. Under an equally-weighted three-factor apportionment formula, the amount of royalty income apportioned to State X is \$333,332, notwithstanding that the actual royalty income from the State X affiliate is \$1,000,000.¹³⁷

The disparity is created by the fact that Hold Co. has no property or payroll in State X to be included in the property and payroll factors. Using a three-factor apportionment formula in this context allows Hold Co. to shift 67% of its State X-sourced royalty income to Michigan, which does not tax it. Similar income shifting would result in every separate entity state in which Retail paid royalties to Hold Co. for the use of the trademarks.

Hold Co.'s business activity in State X would more fairly be represented by use of a single sales factor apportionment formula.¹³⁸ Section 18(b) of UDIPTA allows a state tax administrator to require the exclusion of any one or more of the factors if the standard apportionment formula does not fairly represent the extent of the taxpayer's business activity in the state.¹³⁹

Professor William J. Pierce, the drafter of UDIPTA, explained the purpose of Section 18:

[Section 18] gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity,

137. $(0/\$10,000,000 + 0/\$7,000,000 + \$1,000,000/\$20,000,000)/3 \times \$20,000,000 = \$333,332$.

138. The term "sales" in UDITPA means all gross receipts of the taxpayer not allocated to a single state under the statute. UNIF. DIVISION OF INCOME FOR TAX PURPOSES ACT § 1(g) (2005). It is appropriate to source an apportioned share of Hold Co.'s gross receipts from royalty income derived from trademark licensing fees to State X, without regard to Hold Co.'s costs of performance, because the income-producing activity—the licensing of trademarks to Hold Co.'s affiliate for use within State X—takes place wholly in that state *Id.* § 17(a); M.T.C. Reg. § IV.17(1) (proposed Nov. 2006) available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/OBO%20HO%20Report.pdf.

139. UDIPTA § 18 provides:

If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (a) separate accounting;
- (b) the exclusion of any one or more of the factors;
- (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

UNIF. DIVISION OF INCOME FOR TAX PURPOSES ACT § 18.

some more equitable method of allocation and apportionment could be achieved. Of course, departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle . . . the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.¹⁴⁰

Under UDIPTA, a departure from the standard apportionment formula requires the presence of two elements.¹⁴¹ First, the statutory formula as a whole must be shown to not fairly represent the extent of the taxpayer's business in the state; it is insufficient to show that only one factor fails to meet this standard in order to invoke Section 18.¹⁴² Second, the alternative apportionment method must be reasonable.¹⁴³

Clearly, the standard three-factor formula as a whole does not fairly represent the extent of Hold Co.'s business activity in State X. Although Hold Co. derives substantial royalty income from State X, only a fraction of that income is reported to State X, because Hold Co.'s property and payroll factors in State X are "de minimis compared to the sales factor in both amount and significance in terms of [its] business activity" in the state.¹⁴⁴

In addition, it is reasonable for a state tax administrator to require the holding company to use a single sales factor apportionment formula in order to avoid the distortion of income that would result by allowing the company to apportion its income on the basis of the standard three-factor formula.¹⁴⁵ Reasonableness, in the context of UDITPA, has at

140. William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 781 (1957). Professor Pierce also notes that the standard three-factor apportionment formula was designed for manufacturing and mercantile businesses. *Id.* at 749.

141. *Twentieth Century-Fox Film Corp. v. Dep't of Revenue*, 700 P.2d 1035, 1042 (Or. 1985). *Accord* *Kmart Props., Inc., v. Taxation & Revenue Dep't*, 2006-NMCA-26, ¶ 51, 139 N.M. 177, 191, 131 P.3d 27, 41 (2001); *Toys "R" Us, Inc. v. Franchise Tax Bd.*, 41 Cal. Rptr. 3d 285 (Ct. App. 2006), *as modified upon denial of reh'g*, No. C045386, 2006 Cal. App. LEXIS 660, at *1-2 (Ct. App. May 4, 2006).

142. *Twentieth Century-Fox*, 700 P.2d at 1042.

143. *Id.* at 1043.

144. *Kmart Props.*, 2006-NMCA-26, ¶ 49, 139 N.M. at 191, 131 P.3d at 41.

145. The constitutionality of single sales factor apportionment was upheld in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978). A number of states have adopted the single sales factor formula as the standard apportionment formula. This practice has been severely criticized as poor tax policy, because when it is used in conjunction with the provisions of PL 86-272, it encourages businesses that sell tangible personal property to locate in tax haven states while substantially reducing the tax base in the market states. This issue is beyond the scope of this article. For an excellent analysis of the issue, see MICHAEL MAZEROV, CTR. ON BUDGET & POLICY PRIORITIES, THE "SINGLE SALES FACTOR" FORMULA FOR STATE CORPORATE TAXES: A BOOM TO

least three components.¹⁴⁶

“(1) [T]he division of income fairly represents business activity and if applied uniformly would result in taxation of no more *or* no less than 100 percent of taxpayer’s income.”¹⁴⁷

Use of a single sales factor apportionment formula in the above hypothetical would result in precisely 100% of the State X-source royalty payments being apportioned to State X.¹⁴⁸ The same would be true in every separate entity state in which Retail paid Hold Co. royalties for the use of the trademarks.

“(2) [T]he division of income does not create or foster lack of uniformity among UDIPTA jurisdictions.”¹⁴⁹

It is in the interest of all the separate entity states in which Retail has retail stores to use a single sales factor apportionment formula to apportion Hold Co.’s royalty income. Conversely, Michigan is indifferent to the issue, because it does not tax the royalty income. Use of the single sales factor apportionment formula therefore does not create or foster lack of uniformity.

“(3) [T]he division of income reflects the economic reality of the business activity engaged in by the taxpayer in [State X].”¹⁵⁰

Hold Co.’s business activity in State X is limited to the receipt of royalty income for the use of its trademarks. It has neither employees nor property in the state. The single sales factor apportionment formula perfectly reflects the economic reality of its business activity in State X.

Use of the single sales factor apportionment formula therefore results in apportioning 100% of a PIC’s royalty income received from an affiliate in a given state to that state, rather than to a tax haven state that had nothing to do with the retail sales that produced the royalty income. Use of the single sales factor apportionment formula is the appropriate formula to fully effectuate the business situs Commerce Clause nexus rule for PICs.¹⁵¹

ECONOMIC DEVELOPMENT OR A COSTLY GIVEAWAY? (2005), available at <http://www.cbpp.org/3-27-01sfp.pdf>.

146. *Twentieth Century-Fox*, 700 P. 2d at 1043.

147. *Id.*

148. $\$1,000,000/\$20,000,000 \times \$20 \text{ Million}/1 = \$1,000,000$.

149. *Twentieth Century-Fox*, 700 P. 2d at 1043.

150. *Id.*

151. The New Mexico Court of Appeals sustained the use of a single sales factor apportionment formula as applied to trademark royalty income in *Kmart Properties, Inc., v. Taxation & Revenue Department*, 2006-NMCA-26, ¶¶ 46-52, 139 N.M. 177, 190-92, 131 P.3d 27, 40-42 (2001). The Oklahoma ALJ also approved the use of single sale factor apportionment to apportion the royalty income at issue in *Geoffrey, Inc. v. Oklahoma Tax Commission*, 2006 OK CIV APP 27, ¶ 23, 132 P.3d 632, 640 n.12.

VI. PROPOSED FEDERAL LEGISLATION

Notwithstanding the conceptual incongruity of a physical presence nexus rule for the taxation of intangibles, in recent years bills have been introduced in Congress that, if enacted, would impose such a requirement on a wide range of taxes in addition to use tax collection.¹⁵²

The principal features of the physical presence nexus bills are as follow.¹⁵³ First, the Senate's version of the Business Activity Tax Simplification Act ("the Act") would impose a physical presence nexus standard for other business activity taxes ("BAT"), in addition to net income taxes.¹⁵⁴ The term "other business activity tax" is defined broadly to include:

- (i) a tax imposed on or measured by gross receipts, gross income, or gross profits;
- (ii) a business and occupation tax;
- (iii) a franchise tax;
- (iv) a single business tax or a capital stock tax; or
- (v) any other tax imposed by a State on a business measured by the amount of, or economic results of, business or related activity conducted in the State.¹⁵⁵

In addition, the Act would extend the protection of Public Law 86-272 to income derived from services and intangibles.¹⁵⁶

Finally, the Act contains a number of "carve outs" that would allow a business to maintain substantial physical presence in a state and still be

152. Business Activity Tax Simplification Act of 2003, H.R. 3220, 108th Cong. (2003); Business Activity Tax Simplification Act of 2005, H.R. 1956, 109th Cong. (2005); Innovative and Competitiveness Act, H.R. 4845, tit. I, subtit. A, 109th Cong. (2006).

153. The discussion in the text focuses on the Senate version of the Business Activity Tax Simplification Act of 2006, S. 2721, 109th Cong. (2006). The Business Activity Tax Simplification Act was introduced in the Senate on May 4, 2006 and referred to the Senate Finance Committee. On June 28, 2006, the House Judiciary Committee approved by voice vote an amendment in the nature of a substitute to House Bill 1956, the effect of which is to match the language in Senate Bill 2721. House Bill 1956 was scheduled for a vote by the full House on July 25, 2006 but the bill was withdrawn from the calendar prior to vote.

154. S. 2721 § 2(b).

155. *Id.* § 4(2)(A). The Act excludes from the definition of "other business activity tax" a sales tax, a use tax, or a similar tax, imposed as the result of the sale or acquisition of goods or services, whether or not denominated a tax imposed on the privilege of doing business. *Id.* § 4(2)(B).

156. *Id.* § 2(a).

immune from business activity tax in that state.¹⁵⁷

The fiscal impact of the Act on the states would be substantial. The National Governors Association (“NGA”) estimates that the Act would reduce business activity tax revenues by an average of 10.4%, costing states and localities \$6.6 billion annually.¹⁵⁸

As the NGA points out, the Act “represents a blatant and unnecessary intrusion into the states’ authority to govern. . . . [T]he authority to structure one’s own tax system [is] a core element of state sovereignty.”¹⁵⁹ Furthermore,

this change would shrink state tax bases by relieving out-of-state businesses of BAT liability while allowing larger in-state companies to circumvent tax laws by legalizing questionable tax avoidance schemes. These outcomes would effectively constitute a federal corporate tax cut using state tax dollars—a decision that, fundamentally, should be left to state elected officials.¹⁶⁰

In its analysis of the Act, the Congressional Research Service (“CRS”) concluded that it would lead to more “nowhere income.”¹⁶¹

157. For example, a corporation could engage in business activities within a state for up to twenty-one days in a taxable year without creating business activity tax nexus. *Id.* § 3(b). The corporation can exceed the twenty-one day rule if it uses an agent (other than an employee) to establish and maintain a market in the state, as long as that agent performs business services in the state for any other person during the taxable year. *Id.* § 3(b)(2). There is no requirement that the “other person” be unaffiliated with the corporation. Furthermore, section 3(b)(1)(C) allows a corporation to gather information within the state in excess of twenty-one days per year if the information is needed in order to perform services outside the state. *Id.*

158. NAT’L GOVERNORS ASS’N, IMPACT OF H.R. 1956, BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2005, ON STATES 1 (2005). The NGA also notes that the Act would overrule well-established business activity tax nexus jurisprudence in a number of states, upsetting long-standing precedent in such industries as publishing, interstate trucking, general and customized manufacturing, the sale of distributorships, intellectual property licensing, and the leasing of computer hardware and software. *Id.* at 8-15.

159. Letter from National Governors Association to The Honorable Charles E. Grassley, Chair, and the Honorable Max S. Baucus, Ranking Member, U.S. Senate Finance Committee (June 1, 2006), available at <http://www.nga.org> search for “Grassley,” select “Letters,” and select “June 1, 2006 letter - BAT.” In reflecting why it is that Congress has so seldom used its Commerce Clause powers to intervene in the area of state taxation, two noted authorities on state taxation opine that congressional restraint in this area is predicated on fundamental principles of federalism. Charles E. McLure, Jr. and Walter Hellerstein, *Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals*, 31 ST. TAX NOTES 721, 722 (2004). “The states’ sovereign power of taxation has always been regarded as essential to their independent existence and thus to the federal scheme that the Framers created.” *Id.*

160. Letter, *supra* note 159.

161. STEVEN MAGUIRE, CONGRESSIONAL RESEARCH SERVICE, STATE CORPORATE INCOME TAXES: A DESCRIPTION AND ANALYSIS 15-16 (2006). “Nowhere income” arises because states use different apportionment formulas and nexus rules. This creates opportunities for a multistate business to avoid state income tax through tax planning. *Id.* at 5.

CRS reports that if the Act is enacted, exceptions to its physical presence standard, notably the 21-day rule and the expansion of Public Law 86-272 to services and intangibles, “would . . . expand[] the opportunities for tax planning and thus tax avoidance and possibly evasion.”¹⁶²

There is little doubt that Congress has the power under the Commerce Clause to enact a physical presence business activity tax nexus standard.¹⁶³ But the wisdom of imposing such a standard in the modern economy is highly questionable. As one commentator has noted regarding the current physical presence nexus standard for sellers of tangible personal property imposed by Public Law 86-272:

Current rules for determining income tax nexus fail miserably. P.L. 86-272 has ben [sic] justified as needed to limit extra-territorial taxation and interference with interstate commerce, but it has no conceptual foundation. Instead it reflects the exercise of raw political power and prevents the assertion of nexus by states that should be able to collect income tax from corporations deriving income from within their boundaries.¹⁶⁴

Proponents of the Act often assert that it is inequitable for a state to tax an out-of-state business in the absence of physical presence, because such a business derives no benefit from governmental services provided

162. *Id.* at 15-16.

163. “The Congress shall have power . . . to regulate commerce . . . among the several States . . .” U.S. CONST. art. I, § 8, cl. 3. In recent years, the Supreme Court has ruled that Congress exceeded its Commerce Clause authority in enacting statutes that regulate purely local, non-economic activity. *United States v. Lopez*, 514 U.S. 549 (1995) (Gun-Free School Zones Act of 1990); *United States v. Morrison*, 529 U.S. 598 (2000) (Section 13981 of the Violence Against Women Act of 1994). *But see* *Gonzales v. Raich*, 545 U.S. 1 (2005) (holding that Congress’s Commerce Clause authority includes the power to prohibit the local cultivation and use of marijuana in compliance with state law). Whatever the limits of the *Lopez/Morrison* line of cases, state income taxation of a multistate business clearly implicates interstate commerce.

164. Charles E. McClure, Jr., *Implementing State Corporate Income Taxes in the Digital Age*, 53 NAT’L TAX J. 1287, 1297 (2000). Professor McClure’s observation that Public Law 86-272 reflects “the exercise of raw political power” is borne out by the NGA’s criticism of current proposed BAT legislation as “a federal corporate tax cut using state tax dollars.” *Id.* See *supra* text accompanying note 157. The Congressional Budget Office (CBO) estimates that, if H.R. 1956 were enacted, federal revenues would increase by \$106 million in 2007, by \$1.2 billion over the 2007-2011 period, and by \$3.1 billion over the 2007-2016 period, as a result of reduced federal corporate income tax deductions for state and local taxes. CONGRESSIONAL BUDGET OFFICE, COST ESTIMATE: H.R. 1956 2 (2006). Conversely, the CBO estimates that state and local governments would lose more than \$1 billion in the first year after H.R. 1956 was enacted. *Id.* at 3. This amount would rise to about \$3 billion annually by 2011. *Id.* While the CBO’s estimated revenue losses are less than the NGA’s, they still “far exceed the threshold established in UMRA” (the Unfunded Mandates Reform Act). *Id.* The CBO estimates that about 70% of the estimated revenue losses would come from ten states: California, Florida, Illinois, Michigan, New Jersey, New York, Pennsylvania, Tennessee, Texas, and Washington. *Id.* at 4.

by its market states.¹⁶⁵ This argument is both conceptually unsound and demonstrably false.

The “no benefit” argument is conceptually unsound because it is merely another way of asserting that it is fundamentally unfair for the market states to require the corporation to pay tax in the absence of government services. As such, the argument is grounded in the Due Process Clause and not the Commerce Clause.

Due process centrally concerns the fundamental fairness of governmental activity. . . . [T]he due process nexus analysis requires that we ask whether an individual’s connections with a State are substantial enough to legitimate the State’s exercise of power over him. . . . In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy. . . . [The Commerce Clause] bars state regulations that unduly burden interstate commerce.¹⁶⁶

Whether or not it is “fair” to an individual taxpayer to require it to pay tax to its market states if those states provide it no governmental services is wholly immaterial to whether or not interstate commerce has been unduly burdened.¹⁶⁷ Indeed, even if—as is clearly the case—the market states do provide governmental services to an out-of-state business, the provision of those services, while clearly establishing the

165. “The underlying principle of this legislation is that states and localities that provide benefits and protections to a business, like education, roads, fire and police protection, water, sewer, etc., should be the ones who receive the benefit of that business['] taxes, rather than a remote state that provides no services to the business. By imposing a physical presence standard for business activity taxes, House Bill 3220 ensures that state tax impositions are appropriately borne only by those businesses that receive such benefits and protection from the taxing state.” *Business Activity Tax Simplification Act: Hearing on H.R. 3220 Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 108th Cong. (2004) (statement of Arthur Rosen, Member, International Law Firm) 2004 WL 1090199. See also Frankel et al., *supra* note 61, at 229.

166. *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992).

167. This is not to say that the fairness of a particular state income tax system is wholly irrelevant under the Commerce Clause. “[A] State must . . . apply a formula apportioning the income of [a] business within and without the State. Such an apportionment formula must, under both the Due Process and Commerce Clauses, be fair.” *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983). While fairness is therefore an essential Commerce Clause attribute in determining the appropriate *amount* of income that a state can properly tax, considerations of fairness do not enter into the Commerce Clause nexus inquiry in determining whether a state has a sufficient connection to the taxpayer to tax its income in the first instance. Whether it is fair for the state to exercise its taxing power *at all* implicates only the Due Process Clause. *Quill*, 504 U.S. at 312; H. Beau Baez III, *The Rush to the Goblin Market: The Blurring of Quill’s Two Nexus Tests*, 29 SEATTLE U. L. REV 581, 600 (2006) (“Fairness considerations play no part in the *Quill* Commerce Clause test.”).

fairness of taxing that business, does not reduce the compliance burden imposed on interstate commerce one iota. The “no benefits” argument is merely another way of saying that the state has not given anything for which it can ask return: a classic due process argument.¹⁶⁸ And, after *Quill*, there can be no doubt that a taxpayer has due process nexus with a state if it has purposefully availed itself of an economic market in that state; physical presence is not required.¹⁶⁹

The “no benefits” argument is demonstrably false because it is clear that the market states do provide governmental services to remote business. Proponents of the “no benefits” argument assert that any public benefit to remote business is at best indirect, the direct beneficiaries being instate businesses and citizens.¹⁷⁰ In the context of a state’s authority to tax a multistate business, any distinction between direct and indirect benefit is of dubious relevance.¹⁷¹ Be that as it may, the “indirect benefits” argument is predicated on the manifestly false assumption that public benefits are a zero sum game—if residents directly benefit, then non-residents can at most be indirectly benefited.

Remote businesses clearly directly benefit from the public services provided in their market states, as do the residents of those states. Among the services provided to a remote business are a functioning judicial system, a system of publicly built and maintained roads, police and fire protection, and public schools and universities.

First, the existence of a functioning court system directly allows a remote business to enforce its contracts and protect itself from unlawful

168. *Nat’l Bellas Hess, Inc. v. Dep’t of Revenue of Ill.*, 386 U.S. 753, 756 (1967).

169. *Quill*, 504 U.S. at 307, 308.

170. Frankel et al., *supra* note 61, at 229.

171. As the Supreme Court has stated:

Nothing is more familiar in taxation than the imposition of a tax upon a class or upon individuals who enjoy no direct benefit from its expenditure, and who are not responsible for the condition to be remedied. A tax is not an assessment of benefits. It is . . . a means of distributing the burden of the cost of government. The only benefit to which the taxpayer is constitutionally entitled is that derived from his enjoyment of the privileges of living in an organized society, established and safeguarded by the devotion of taxes to public purposes. Any other view would preclude the levying of taxes except as they are used to compensate for the burden on those who pay them, and would involve the abandonment of the most fundamental principle of government—that it exists primarily to provide for the common good. A corporation cannot object to the use of the taxes which it pays for the maintenance of schools because it has no children.

Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 521-23 (1937) (internal citations and footnote omitted). Furthermore, the Court has made clear that “[t]here is no reason to suppose that this latitude afforded the States [in *Carmichael*] under the Due Process Clause is somehow divested by the Commerce Clause merely because the taxed activity has some connection to interstate commerce; particularly when the tax is levied on an activity conducted within the State.” *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 623 (1981).

competition in its market states. Indeed, in the absence of a functioning court system in the market states, any judgment obtained by the remote business in its home state would often be unenforceable.¹⁷² In the digital age, it is highly likely that an intellectual property owner will be obliged to resort to litigation in its market states in order to enforce its rights against numerous unauthorized electronic users of its products.¹⁷³

Second, a functioning system of roads directly allows a remote business to deliver goods to its customers and to send representatives into the state to provide services to those customers. The critical benefits of those roads to the financial wellbeing of remote business was dramatically illustrated on September 11, 2001, when all commercial air traffic in the United States was halted following the terrorist attacks in New York and Washington. As highway historian Dan McNichol noted, “when every airplane was grounded, we were able to move goods and people on the interstate [highway] system and keep the economy moving.”¹⁷⁴

As is true of public roads, the existence of public police and fire services benefit a remote business by protecting its property, employees and representatives while they are in a market state in the course of business. That these services directly benefit residents do not make them any the less of a direct benefit to remote business. Yet the Act

172. Forty-six states, the District of Columbia and the Virgin Islands have adopted the Uniform Enforcement of Foreign Judgments Act, 13 U.L.A. 155-56 (2006), which requires states and territories which have adopted the Act to give effect to the judgments of other states and territories, if an exemplified copy of the foreign judgment is registered with the clerk of a court of competent jurisdiction. In the remaining four states, the Full Faith and Credit Clause of the Constitution, Article IV, Section 1, requires a state to enforce a domesticated judgment entered by a court of a sister state, as it would a judgment entered by its own courts. In either case, a remote business has a right to enforce its judgments in the courts of its market states. Unlike most local government services, the opportunity to enforce foreign judgments largely benefits nonresidents.

173. See, e.g., *RIAA Leaning on Kids' Parents*, WIRED NEWS, July 24, 2003, <http://www.wired.com/news/digiwood/1,59756-0.html> (last visited August 21, 2006) (reporting that Recording Industry of America issues at least 911 federal subpoenas to Internet providers, seeking names and addresses of users of Napster file-sharing program in preparation of copyright infringement lawsuits against users for illegally downloading copyrighted music).

174. T. R. Reid, *The Superhighway to Everywhere*, WASH. POST, June 28, 2006, at A1. The federal government reimbursed the states 90% of the original cost of building the interstate highway system; the states absorbed the remaining ten percent. *Id.* While the highways continue to receive substantial federal funding for operations and improvements, the highways are owned, built and operated by the state in which they are located, with the only exception being the federally-owned Woodrow Wilson Bridge on the Capital Beltway (I-95/I-495). Wikipedia, Interstate Highway System, http://en.wikipedia.org/wiki/Interstate_highway (last visited Sept. 25, 2006). Finally, portions of the interstate highways were originally constructed as, and remain, state roads. See, e.g., New Jersey Turnpike, Historic Overview, <http://www.nycroads.com/roads/nj-turnpike/> (last visited Sept. 25, 2006) (“The New Jersey Turnpike is designated I-95 from EXIT 6 (Pennsylvania Turnpike Extension) to the George Washington Bridge toll plaza.”).

would allow remote business to utilize state police and fire services tax free, as long as the business was not in the state in excess of 21 days per year, or even longer if its activities were entirely within the statutory safe harbors.

Finally, remote business is continually benefited by the existence of a public educational system, including the state university system. The public educational system provides the business with well-educated customers who can afford to purchase the goods or services of the remote business. This directly benefits remote business by providing a market for those goods or services that in turn creates profit for the shareholders. Again, the fact that the customers and employees are also directly benefited by the public educational system in no way detracts from the benefits directly received by remote business through the existence of that system—the public educational system serves both the graduate by making him more employable and business by meeting its need to sell its goods or services.

In discussing global competition, particularly in the areas of biology, medicine and computer technology, Microsoft founder Bill Gates constantly emphasizes the importance of the United States maintaining a first rate educational system.¹⁷⁵ He notes that job creation and success in these fields have overwhelmingly been where there is a great university and that, of the more than 25 of the top universities in the world located in the United States, almost half are state universities.¹⁷⁶ Furthermore, Mr. Gates acknowledges that the state system produces more world-class graduates than the private system.¹⁷⁷ Finally, Mr. Gates recognizes that it is necessary to have top-notch elementary and secondary schools in order to produce “the great students to go into these universities and do these incredible things.”¹⁷⁸

As recognized by Mr. Gates, the stunning success of the modern American economy is directly related to the strength of the American public educational system. As he has noted, global competition for skilled workers, particularly in China and India, requires the United States to maintain a first class educational system so that the American economy can continue to grow.¹⁷⁹ In the final analysis, all business—local and remote—benefits from the world-class education provided by

175. See, e.g., Bill Gates, Interview at the National Conference of State Legislatures (August 17, 2005) available at <http://www.microsoft.com/events/executives/billgates.msp>.

176. *Id.*

177. *Id.*

178. *Id.*

179. *Id.*

our nation's public schools and state universities.¹⁸⁰

VII. INCOME TAX NEXUS AND ELECTRONIC COMMERCE: SETTING SOME PARAMETERS

In some respects, the PIC cases discussed in Part III D, *supra*, present a relatively straightforward nexus scenario. In each case, the trademarks were being used at a store, a paradigmatic physical location. Once it is determined that a PIC has nexus as a result of an affiliate's use of the marks, it is an easy enough matter to determine where that use takes place. But how is nexus to be determined in the case of a business that realizes income entirely through electronic commerce? Where, for example, does a licensor of customized software that is downloaded over the Internet in digital form have nexus?¹⁸¹

Several non-tax due process cases suggest a framework for analysis of the issue. The cases fall broadly into one of three factual scenarios. At one extreme are the cases involving a purely passive website. At the other extreme are those cases involving a specifically identifiable contract. Somewhere in between the two are cases involving an interactive website that solicits users to purchase an intangible or a service electronically. Examples of each follow.¹⁸²

A. *Passive Websites*

In *Bensusan Restaurant Corp. v. King*,¹⁸³ the court held that placing an Internet advertisement on a computer server located in Missouri was insufficient to create personal jurisdiction in New York. The plaintiff in *Bensusan* owned a chain of jazz restaurants in the United States and

180. The current role of the state universities in meeting the educational requirements of the modern economy reflects the history of public education in this country. The establishment of the original Land-Grant colleges pursuant to the first Morrill Act (1862) reflected a growing demand for agricultural and technical education in the United States. While a number of institutions had begun to expand upon the traditional classical curriculum, higher education was still unavailable to many agricultural and industrial workers. The Morrill Act was intended to provide a broad segment of the American population with a practical education that had direct relevance to their daily lives. NAT'L ASS'N OF STATE UNIVERSITIES & LAND-GRANT COLLEGES, *THE LAND-GRANT TRADITION* (1995).

181. Customized software, as used here, means and includes programming which results when a user purchases the services of a person to create software which is specialized to meet the user's particular needs.

182. The analytical tripartite "sliding scale" suggested in the text has been utilized by a number of courts in determining whether personal jurisdiction exists in Internet domain name disputes. *See, e.g., Zippo Mfg. Co. v. Zippo Dot Com, Inc.*, 952 F. Supp. 1119, 1124 (W.D. Pa. 1997); *Alitalia-Linee Aeree Italiane S.p.A. v. Casinotalia.com*, 128 F. Supp. 2d 340, 349 (E.D. Va. 2001).

183. 937 F. Supp. 295 (S.D.N.Y. 1996), *aff'd*, 126 F.3d 25 (2d Cir. 1997).

elsewhere named “The Blue Note” and the defendant owned a jazz restaurant in Missouri, also named “The Blue Note.”¹⁸⁴ The Missouri Blue Note advertised its club via an ad on the Internet.¹⁸⁵ The ad consisted of a calendar of scheduled entertainment, and a menu.¹⁸⁶ It was not possible to make reservations or to order or pay for tickets electronically on the defendant’s website.¹⁸⁷

The New York-based Blue Note chain filed a trademark infringement action in the Southern District of New York and the defendant moved to dismiss for lack of personal jurisdiction.¹⁸⁸ The court held that merely creating a website, including a hyperlink to the plaintiff’s website, that was viewable in New York was insufficient under the Due Process Clause to subject the Missouri defendant to jurisdiction in New York.¹⁸⁹ In ruling that there was no allegation that the defendant had directed his activities specifically to New Yorkers, and that therefore the plaintiff had failed to show that the defendant conducted any business in New York, the court stated, “Creating a site, like placing a product into the stream of commerce, may be felt nationwide—or even world wide—but, without more, it is not an act purposefully directed toward the forum state.”¹⁹⁰

B. Specifically Identifiable Contract

*CompuServe, Inc. v. Patterson*¹⁹¹ was a trademark infringement case. Patterson, a Texas software entrepreneur, entered into a written agreement with CompuServe to sell software over CompuServe’s network.¹⁹² During a three-year period, Patterson sent 32 files of software to the network and made twelve sales in Ohio, totaling \$650.¹⁹³ Eventually, Patterson accused CompuServe of infringing on his trademark. CompuServe filed a preemptive lawsuit in Ohio, its home state, seeking a declaratory judgment that it had not infringed Patterson’s trademark.¹⁹⁴

Patterson moved to dismiss the case for lack of personal jurisdiction

184. *Id.* at 297.

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.*

189. *Id.* at 301

190. *Id.*

191. 89 F.3d 1257 (6th Cir. 1996).

192. *Id.* at 1260.

193. *Id.* at 1261.

194. *Id.*

in Ohio.¹⁹⁵ The court denied the motion, finding in personam jurisdiction under the Due Process Clause based on Patterson's signed agreement with an Ohio company and an ongoing commercial relationship with that company through the transmission of software over the CompuServe network.¹⁹⁶ The court noted that the contacts between the parties were deliberate and repeated even though they yielded little revenue; the quality of the contacts rather than their number satisfied Due Process fairness concerns.¹⁹⁷

C. Interactive Website

In *Thompson v. Handa-Lopez, Inc.*,¹⁹⁸ the court ruled that it had personal jurisdiction over a diversity action between a Texas resident and a California corporation that maintained an interactive gambling website. The website invited users to pay a fee to play online poker and other games.¹⁹⁹ Thompson did so and won, but the corporation failed to pay him.²⁰⁰ He filed suit in Texas alleging breach of contract, fraud and violation of Texas consumer protection laws.²⁰¹ The court found specific jurisdiction based upon a contract formed on the defendant's interactive website that the defendant knowingly maintained to attract paying customers to gamble online, irrespective of the customer's location.²⁰²

D. Nexus Implications

The foregoing three cases suggest analytic parameters for determining income tax nexus for electronic commerce. If the business simply advertises its services or products on a passive website, and offers no opportunities for a customer to contract or pay for those services or products online, nexus would not be created merely as a result of the creation or existence of the website. At the other extreme, nexus would clearly be created if the business entered into a specific contract with a readily identifiable customer to provide its services or products online. In the case of a licensor of customized software, nexus would exist wherever the contract authorized or allowed the customer to

195. *Id.*

196. *Id.* at 1263-67.

197. *Id.*

198. 998 F. Supp. 738 (W.D. Tex. 1998).

199. *Id.* at 741.

200. *Id.*

201. *Id.*

202. *Id.* at 742-46.

use the software. Finally, an interactive website that allows the general public to pay online for specific digital services or products would create income tax nexus where the customer uses the service or product.²⁰³ This would include most, if not all, digital sales of canned software, such as virus or spyware protection programs.²⁰⁴

Objections might be raised that a nexus rule based upon the foregoing analysis unfairly penalizes providers of canned digital products or services, because a seller of the identical products in tangible form would be within the safe harbor of Public Law 86-272 if it limited its activities to the online solicitation of sales. The proper solution to that problem is to establish uniform minimum nexus standards that would apply to all businesses, irrespective of the form in which they provide their products or services.²⁰⁵

A leading scholar advocates an income tax nexus standard based on whether the taxpayer conducts significant amounts of the economic

203. It is of course possible to use a digital product while traveling. As one commentator has observed in the related context of electronic commerce and sales and use taxation:

[T]his difficulty must largely be ignored as a result of practical necessity. The knowledge of the service provider as to the location of origination/termination and of the billing/service address will govern. However the provider records the event for its normal business records undoubtedly will become the default for reporting the transaction even though this reporting may not correspond to the actual facts.

Paull Mines, *Conversing with Professor Hellerstein: Electronic Commerce and Nexus Propel Sales and Use Tax Reform*, 52 TAX L. REV. 581, 602 n.117 (1997). Income tax nexus would exist, both for digital products or services purchased under a specific contract or through an interactive website, wherever the provider's normal business records indicate the customer will use the product or service.

204. Canned software, as used here, means and includes programming that has general applicability and/or has not been prepared at the special request of the purchaser to meet his particular needs. It is sometimes known and/or described as "pre-written programming."

205. An economic presence nexus standard does not necessarily result in sourcing receipts from the sale of intangibles or services to the market states. Sales other than sales of tangible personal property are sourced to the state where the income-producing activity was performed. UNIF. DIVISION OF INCOME FOR TAX PURPOSES ACT § 17 (2005). If the income-producing activity is performed in more than one state, the sales are sourced to the state where the greater proportion of the income-producing activity is performed than in any other state, based on costs of performance. *Id.* This is an "all or nothing" determination, resulting in 100% of the sales being sourced to the state with the greater costs of performance. The greater cost of performance rule is clearly anachronistic in the digital age. As a result, a number of states include receipts from services in the sales factor numerator based either on the percentage of total cost of performance incurred in the state or on the ratio of time spent performing the service in the state to the total time spent on performing the service. 1 HEALY & SCHADEWALD, *supra* note 6, at I-729 to -733. Furthermore, Georgia, Iowa, Maryland, Minnesota, Ohio, and Wisconsin have moved away from the greater cost of performance rule for the provision of services, replacing it with a market-based approach that sources the sale to the location of the recipients of the services. *Id.* at I-724. Similarly, a number of states have adopted a market-based approach for sourcing royalty receipts from the licensing of intangibles. *Id.* at I-658.

activities that are factors in the state's apportionment formula.²⁰⁶ The Multistate Tax Commission ("MTC") has adopted Professor McClure's reasoning in promulgating its Factor Presence Nexus Standard for Business Activity Taxes.²⁰⁷ The MTC's Factor Presence Nexus Standard establishes uniform, objective de minimis nexus standards of \$50,000 in property or payroll, \$500,000 of sales or 25% of total property, payroll or sales before a state can impose a business activity tax.²⁰⁸

There is nothing sacred about the specific thresholds suggested by the MTC's Factor Presence Nexus Standard. Furthermore, whatever amounts are initially used to establish nexus can and should be updated regularly for inflation. In the digital age, however, it makes eminent sense to base income tax nexus on exceeding an easily verifiable, uniform economic activity threshold rather than an anachronistic physical presence requirement that is unsuited to the current economy.

VIII. CONCLUSION

The Supreme Court got it right in promulgating the business situs rule for taxing intangibles; a state's authority to tax intangibles cannot be limited by considerations of the intangible's non-existent physical location. The business situs rule remains the appropriate nexus standard for taxing income from intangibles, including trademark royalty income. As *Quill* is limited to use tax collection, the state court decisions that uphold the business situs rule for taxing income from intangibles were correctly decided. Although Congress has the power to impose a physical presence nexus rule on the state taxation of income from intangibles, such a rule would be completely incongruous in the modern economy. Instead, nexus should be determined by the application of uniform, easily verifiable economic thresholds that would apply irrespective of the form in which the business provides its services or products. Such a rule is the appropriate measure of a state's authority to tax the income of remote businesses that benefit from the public services provided by their market state governments.

206. McClure, *supra* note 164, at 1296.

207. MULTISTATE TAX COMM'N, FACTOR PRESENCE NEXUS STANDARD FOR BUSINESS ACTIVITY TAXES (2003), available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessAct_Taxes.pdf.

208. *Id.*