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Economic Nexus: Legislative Presumption or Legitimate Proposition?

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ECONOMIC NEXUS: LEGISLATIVE PRESUMPTION OR LEGITIMATE PROPOSITION?

by

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I. INTRODUCTION

"The determination of the parameters of a state's authority to impose taxes on out-of-state companies has become an increasingly contentious battlefield between the states and multistate enterprises."[1] This statement leads to two important questions. First, where do states derive their authority to tax out-of-state entities? Second, what is causing such increased contention?

A. *Concept of Nexus*

State taxation of nonresident corporations is bound by the nexus requirements of two clauses in the U.S. Constitution: the Due Process Clause and the Commerce Clause. While the purpose and meaning of these two clauses are not identical, each of them requires that a nonresident have sufficient contacts, or nexus, with the state before it can be subject to tax in that state. This means that, even if a company is earning income from sales to customers within a state, the company is not subject to tax if it does not have nexus with that state. Traditionally, these nexus requirements have been considered to mandate a physical contact between the state and the nonresident corporation.[2] The physical presence

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[1] Frieden, Karl A. and Michael E. Porter, *The Taxation of Cyberspace: State Tax Issues Related to the Internet and Electronic Commerce,* STATE TAX NOTES, November 11, 1996.

[2] Lieberman, Richard L. and Stewart Lipeles, *The Geoffrey Case: A Failed Attempt to Provide Content to the Economic Nexus Principle*, STATE TAX NOTES, March 7,1994.

of such items as the taxpayer's tangible property, employees, or agents has been considered sufficient to meet the nexus requirements of both clauses.[3]

B. Theory of Economic Nexus

However, there has been a recent development in the world of state taxation that has challenged this traditional concept of nexus, and, in doing so, has caused the increased contention between states and taxpayers which was spoken of at the beginning of this article. This development is the theory of economic nexus, under which an out-of-state company can establish nexus with a state without establishing a physical presence in the state. There are several different ways in which this theory has been applied, including the presence of intangible property or affiliates, or, in some cases, simply the derivation of economic benefit from the state's residents. Nevertheless, the tie that binds all applications of economic nexus together is the lack of a physical presence. The result of this theory has been tremendous division, not only between taxpayers and taxing authorities, but also between the taxing authorities of different states.

C. Why is Economic Nexus Such an Issue at Present?

In a recent nationwide survey, over one-third of financial and tax executives cited the uncertainty surrounding nexus as their foremost state tax concern.[4] Why is nexus such an issue? There are several reasons for the current prominence of nexus concerns, including the growing revenue stream, possible erosion of the tax base, and additional issues related to out-of-state vendors.

1. Growing revenue stream

The growth of the service sector in the U.S., and, in particular, of electronic commerce, is a sufficient attraction to allure state taxing authorities to devise some means of taxing these industries. As one author has said, "Many states and municipalities are cash strapped, and to them, the Net represents fast money."[5] A recent Neilsen Survey indicated that over 40 million Americans currently have access to the Internet. The survey also estimated that 300 million people worldwide will have access to the Internet by the year 2000.[6] With Web sites increasing at a

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[3] *Id.*

[4] Frieden, *supra* note 1.

[5] Simons, John, *Shaking Down the Net: Local Governments Seek to Tax Internet Sales and Services*, U.S. NEWS AND WORLD REPORT, June 10, 1996; at 60-61.

[6] Frieden, *supra* note 1.

rate of 1,000 per minute, those who utilize the Internet have almost unlimited opportunities to conduct purchases and other business electronically.[7] At present, 36 percent of American families own home computers.[8] However, recent initiatives taken to allow Internet access via television sets have opened the possibility of the Internet reaching an even greater portion of Americans, since over 98 percent of American households own at least one television.[9] A prediction of the International Data Corporation anticipates Internet-related revenues of greater than $150 billion in the year 2000,[10] and retail sales via the Internet, which were $108 million during 1995, are predicted to reach $125 billion in the year 2000.[11] Without a doubt, this represents a revenue source that state taxing authorities would love to tap. Just as electronic commerce is expanding, so are the range of telecommunications services and financial services, adding still more to the attractiveness of the revenue stream that, in many cases, can only be reached by economic nexus.

2. Possibility of erosion of the tax base

The possibility of tax base erosion is closely related to the growth of electronic commerce and other intangible services discussed above. As these services grow, the portion of business conducted by the traditional, tangible methods will diminish. Thus, the tax base allowed states by the physical presence standard of nexus will diminish unless states can find a way to tax these new methods of conducting business.

3. Issues related to out-of-state vendors

A third and final motivation for states' pursuit of economic nexus involves the relationship between in-state and out-of-state vendors that is caused by electronic commerce and similar services. If out-of-state vendors service in-state customers through the Internet, and their revenues are not subject to tax, they possess a significant advantage over in-state vendors who are required to pay taxes on their revenues. Thus, aside from increasing revenues and protecting the tax base from erosion, states have a further motivation in the form of the need to resolve such inequities between in-state and out-of-state vendors. It is these three factors which are causing states to have such a present interest in pursuing the theory of economic nexus.

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[7] *See id.*
[8] *See id.*
[9] *See id.*
[10] *See id.*
[11] Simons, *supra* note 5.

This article discusses the theory of economic nexus, the present nexus conditions in various states, and the constitutional issues surrounding nexus. These constitutional issues will then be applied to the theory of economic nexus in order to draw conclusions concerning the constitutionality and feasibility of this theory.

II. ECONOMIC NEXUS

As previously stated, the theory of economic nexus holds that a nonresident company can have sufficient nexus with a state, disregarding the question of physical presence. The theory of economic nexus, if fully put into practice, could substantially broaden the states' taxing authority. At present, there has been no conclusive Supreme Court guidance on the question. The most notable case in which the Supreme Court considered the theory was *Quill Corp. v. North Dakota.*[12] In this case, the court held that, for use tax purposes, a company does not satisfy the nexus requirements of the Commerce Clause unless there are physical contacts between the company and the state.[13] However, the Court left open the question of whether physical contacts are necessary for other types of tax.[14] The first case in which a state took advantage of this opening left by the Supreme Court was *Geoffrey, Inc. v. South Carolina Tax Commission*,[15] decided by the South Carolina Supreme Court. This case was the first occasion of a state supreme court upholding a net income-based tax against a nonresident company that had no physical contacts in the state.[16]

A. Geoffrey, Inc. v. South Carolina Tax Commission

Geoffrey, Inc., a Delaware corporation, was established by Toys 'R' Us, Inc. as a wholly-owned subsidiary. Geoffrey served as a holding company for certain of the intellectual property, such as trademarks and trade names, belonging to Toys 'R' Us. The two parties then formed a licensing agreement under which Toys 'R' Us was allowed to use the intellectual property in all but a few states. Furthermore, Geoffrey was entitled to receive a one percent royalty on the net sales Toys 'R' Us made using the property covered by the licensing agreement.

Following the incorporation of Geoffrey and the formation of the licensing

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[12] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
[13] *Id.* at 316.
[14] *Id.*
[15] *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), *cert. denied* 114 S.Ct. 550 (1993).
[16] *Id.* at 19.

agreement, Toys 'R' Us began doing business in South Carolina. On its South Carolina returns, Toys 'R' Us deducted the royalty payments made to Geoffrey from its South Carolina taxable income. Originally, the South Carolina Tax Commission disallowed the royalty expense deductions. However, the Commission later reversed its ruling on the issue and allowed the deductions, while, at the same time, holding Geoffrey subject to tax on the royalty income. Geoffrey challenged the imposition of the tax, arguing, among other things, that its indirect contacts with South Carolina were not sufficient to allow the imposition of a net income-based tax. The case was ultimately appealed to the South Carolina Supreme Court, which upheld the lower court's decision against Geoffrey.[17] The court held that Geoffrey was "aware of, consented to, and benefited from Toys 'R' Us's use of Geoffrey's intangibles in South Carolina"[18] The court also held that Geoffrey's intangible property in South Carolina, consisting of an "account receivable" and a "franchise," was sufficient to create an economic nexus and allow the state to impose the tax.[19] Based on these two facts, the court concluded that the imposition of the tax violated neither the Due Process Clause nor the Commerce Clause.[20] Despite the controversiality of the decision, the U.S. Supreme Court denied writ of certiorari on the case.[21]

B. Agency and Affiliate Nexus

As will be seen later, a significant number of states have adopted the economic nexus doctrine espoused by the *Geoffrey* decision. In the process, several adaptations of the theory have emerged. Two of these deserving note are agency nexus and affiliate nexus. Under both of theses theories a corporation, otherwise lacking nexus in a state, can have nexus through the attribution of the nexus of another entity.

Under agency nexus, a nonresident corporation is subject to tax in a state based on the nexus of its agents. Agents can include such parties as representatives and independent contractors. Several U.S. Supreme Court decisions have supported this concept. In *Scripto, Inc. v. Carson*, the Court held that a nonresident corporation was responsible for use tax related to orders solicited in-state by independent contractors.[22] Likewise, in *Tyler Pipe Industries Inc. v. Washington*

[17] *Id.*
[18] *Id.* at 16.
[19] *See id.*
[20] *Id.* at 19.
[21] *See* 114 S.Ct. 550.
[22] *Scripto, Inc. v. Carson*, 362 U.S. 207, 211-12 (1960).

Department of Revenue, the Court held that actions by an in-state independent contractor on behalf of an out-of-state corporation can create income tax nexus.[23] Also notable is Multistate Tax Commission (MTC) Bulletin 95-1, which "takes the position that contracting with a third party to provide in-state warranty repair services creates sales and use and income nexus for the remote seller for both corporate income and sales or use tax purposes."[24] While this MTC Bulletin only refers to warranty repair services, it does not take a stretch of the imagination to envision the same logic being applied to other services.

Closely related to agency nexus is the concept of affiliate nexus. Under this theory, a nonresident corporation is subject to tax in a state based on the nexus of affiliated entities. Affiliated entities can include a parent, subsidiary, or other affiliate. While there have been cases which have upheld this approach, the theory has been unsuccessful in more recent cases. For example, in *CIT Financial Services Consumer Discount Company v. Director, Division of Taxation*,[25] the New Jersey Supreme Court upheld the taxation of a nonresident corporation which, alone, did not have a nexus with New Jersey, by attributing to it the nexus which its affiliates had established with New Jersey.[26] However, in *SFA Folio Collections Inc. v. Tracy*,[27] the Ohio Supreme Court noted the legal distinction between affiliated entities and refused to subject a nonresident corporation with no physical presence in Ohio to use tax based solely on the nexus of a sister corporation.[28] Similarly, the Connecticut Supreme Court, in *SFA Folio Collections Inc. v. Bannon*,[29] took the position that "affiliate nexus would be appropriate in 'exceptional circumstances,' for example where the in-state corporation was a mere shell or an alter ego."[30]

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[23] *Tyler Pipe Industries Inc. v. Washington Department of Revenue,* 483 U.S. 232, 251 (1987).
[24] Multistate Tax Commission Bulletin 95-1 (December 1995). For the full text of the Bulletin 95-1, *see* STATE TAX NOTES, January 1, 1996.
[25] *CIT Financial Services Consumer Discount Company v. Director, Division of Taxation,* 4 N.J. Tax 578 (1982).
[26] *Id.*
[27] *SFA Folio Collections Inc. v. Tracy*, 652 N.E.2d 693 (Ohio 1995).
[28] *Id.* at 697.
[29] *SFA Folio Collections Inc. v. Bannon*, 585 A.2d 666, (Conn. 1991).
[30] *Id.* at 672.

C. Areas of Taxation Affected

The theory of economic nexus has been applied to situations involving both corporate income tax and sales and use tax.

1. Corporate income tax

There are several corporate income tax issues that are relevant to the theory of economic nexus. For the most part, these issues revolve around the different ways in which the types of activities affected by economic nexus can be classified by a state. The options states have in this area are tangible personal property, intangible property, or services. First of all, the classification chosen by the state affects the method of sourcing the income derived from the activity. Income derived from sales of tangible personal property is usually sourced to the state where the customer is located. However, there is some variation among states concerning how sales from intangible property and services are sourced. Most states source this type of income to the state in which the vendor is located, or, in other words, the state in which the income-producing activity is performed.[31] A smaller number of states source this income to the state in which the customer is located, or the state in which the benefit of the service or property is received.[32] The difference in these two approaches is important. For example, if a vendor is located in a state that sources such income to the state where the income-producing activity occurred, and that vendor makes sales to a state that sources such income to the state where the benefit is received, the vendor could possibly be taxed twice on the same income.

A second corporate income tax issue involves the throwback sales rules. Under these rules, if a vendor makes a sale of tangible personal property to a customer in a state in which the vendor is not subject to tax, the vendor will often be required to "throwback" the income to the vendor's state of domicile. However, sales of intangible personal property and services are not subject to these rules.

Finally, there is another significant difference which can occur due to the classification of the business activity involved. This difference is caused by Public

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[31] A few of the states that source this income to the state in which the income-producing activity is performed include: California, Massachusetts, Connecticut, Texas, New York. *See e.g.*, CAL. REV. & T. CODE §25136 (1998); M.G.L.A. 63 §38(f) (1998); C.G.S.A. §12-218(c) (1998); 34 TAC §3.557(e)(33) (1998); N.Y. Reg. §4-4.3(a) (1998).

[32] The states that source this income to the state in which the benefit is received include Iowa and Minnesota. *See e.g.*, Iowa Dept. Rev. Fin. Rul.701-54.6; M.S.A. §290.191(5)(j-i).

Law 86-272.[33] This law protects solicitations by sales representatives relating to sales of tangible personal property. Such solicitations do not create income tax nexus for the vendor in jurisdictions in which it does not otherwise have nexus. The protection of this law does not apply to sales of intangible property and services.

2. Sales and use tax

Unlike the corporate income tax, nexus for sales and use tax means a collection responsibility on the part of the vendor. The first difficulty encountered in the sales and use tax arena is the determination of whether a transaction is taxable in a certain state. Significant differences exist among the states in definitions of taxable activities. Some states subject only tangible personal property and a few selected services to sales or use tax.[34] On the other hand, some states impose sales or use tax on a broad range of services in addition to tangible personal property.[35] Either way, the sales and use taxation of services is very complicated. The demarcation lines between such activities as 'information services' and 'computer services' are often arbitrarily drawn, and yet, they can have a tremendous effect on the taxable or nontaxable status of a transaction. For example, in Connecticut, transactions conducted via electronic channels are separated into computer services, which are taxable, and information services, which are not taxable. In fact, interpretation of these demarcation lines as they relate to electronic commerce can be so complicated that, "some states may tax electronic services while other states exempt them from taxation even though the states are relying on nearly identical statutory language."[36]

A second sales and use tax issue involves the question of where the sale occurs. The majority of states site sales according to where the consumer is located while a few states site sales according to where the vendor is located. The confusion here arises due to the fact that, with many of the activities affected by economic nexus, the vendor may not be aware of the consumer's location. For example, wireless telephones and laptop computers allow the consumer to have mobility in the use of the service. In such cases, while the vendor may have information concerning the consumer's billing address, he may have no information

[33] P.L. 86-272 is codified at 15 U.S.C. §§381-384 (1959).

[34] States that tax tangible personal property and only a few enumerated services include Indiana, Illinois, and Kansas. *See* 35 ILCS 630/2(c) (1998); IND. CODE §6-2.5-4-6 (1998); K.S.A. §79-3603(b)(1) (1998).

[35] South Carolina is one state that taxes a broad range of services. (See S.C. Rev. Rul. No. 89-114).

[36] Frieden, *supra* note 1.

concerning where the actual use of the service takes place. Also, when a transaction deals with two states, with one state siting sales to where the customer is located and the other siting sales to where the vendor is located, there is potential for double taxation.

Finally, the application of exemptions is an important sales and use tax issue. Each state has a different list of exemptions under which certain transactions that otherwise would be taxable can avoid sales or use taxation. However, a problem arises when one tries to apply these exemptions to sales of services. This problem arises because "exemptions were typically developed with reference to sales of tangible personal property, not services."[37] The area of electronic commerce once again provides the best way to illustrate this problem. For instance, consider that a sale of tangible personal property by the traditional methods could apply for an exemption and, thereby, avoid taxation, while a sale of the same property electronically would be ineligible for the exemption and subject to the tax.

D. Industries Affected by Economic Nexus

There are three industries which are particularly vulnerable to the application of economic nexus. These industries are the financial services industry, telecommunications industry, and electronic commerce.

1. Financial institutions

The vulnerability of financial institutions to theories of economic nexus arises from the growing diversification of such institutions. While, at one time, the norm in this industry was the small local bank concentrating on an individual town or region, the current trend of multistate and multi-service expansion has pushed those small banks into the background. The industry is now dominated by larger financial institutions (expansion has rendered the term "bank" inadequate) which offer an ever-increasing variety of non-traditional services. Such services include credit card, mortgage, trust, brokerage, and investment planning services. Citibank, Nations Bank, and First Tennessee Bank are examples of diversified financial institutions. Along with this expansion of services comes increased multistate activity. Indeed, "it is quite common for financial institutions to generate income from transactions with residents of a state in which they have no physical presence."[38] It is, therefore, not surprising that some states are looking to the theory

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[37] *Id.*

[38] Simons, *supra* note 5.

of economic nexus for a basis on which to tax such activities by financial institutions.

Most states that are applying economic nexus concepts to financial institutions measure economic presence by so-called "bright-line" tests involving such factors as "number of customers in the state, value of assets or deposits in the state, and receipts attributable to sources in the state."[39] In general, a financial institution is presumed to be conducting business in a state (and, therefore, has income or franchise tax nexus) if it meets the state's bright-line test. Among the states that have adopted economic presence standards for financial institutions are Massachusetts, Connecticut, Kentucky, West Virginia, Indiana, Minnesota, and Tennessee. Under Massachusetts and Connecticut regulations, a financial institution has economic presence in the state if it conducts business with 100 in-state customers during the year, has assets of $10 million attributed to the state, or has receipts greater than $500,000 attributed to the state. An institution is subject to tax in Kentucky or West Virginia if it obtains or solicits business with 20 in-state customers during the year or has receipts of $100,000 attributed to the state. In Indiana and Minnesota, an institution is subject to tax if it engages in business activities with 20 in-state customers or if the sum of its assets and deposits attributed to the state equals $5 million or more. Tennessee subjects an institution to tax if the sum of its assets and deposits attributed to Tennessee equal $5 million. These bright-line tests are, of course, in addition to the traditional physical presence standards of nexus. Additionally, in some states, financial institutions could be subjected to tax in a state based on the application of agency or affiliate theories of nexus.

Furthermore, the *Geoffrey* decision holds tremendous potential impact for financial institutions. As was discussed earlier, the South Carolina Supreme Court in *Geoffrey* held that a nonresident company had income tax nexus with the state based on its intangible property in the state. Thus, in South Carolina and in the other states that have adopted the *Geoffrey* doctrine, a financial institution could be taxed based simply on any intangible property owned within the state. This means that institutions could be taxed "in any state in which its borrowers reside or any state in which its credit card customers do business."[40] Not only could this doctrine dramatically increase the state tax liability of multistate financial institutions, it could also expose them to multiple taxation of income from intangible property.

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[39] *Id.*
[40] *Id.*

2. Telecommunications providers

As discussed *supra*, states tend to impose sales and use taxes on sales of tangible personal property and on certain specified services. Telecommunication services have traditionally been one of the types of services which is taxed in most states. "Approximately two-fifths of the states impose a sales or use tax on interstate telecommunications. Approximately four-fifths of the states tax intrastate telecommunications."[41] However, this industry deserves mention due to its close connection with electronic commerce. The difference between the two areas is that taxation of telecommunications involves taxation of the transmission of information, whereas taxation of electronic commerce involves taxation of the information content itself. Current complications with taxation in this industry arise from such innovative, "enhanced" telecommunications services as e-mail, facsimile services, and Internet access charges. The issue with these services is how to determine what portion is transmission and what portion is content. Stated differently, how does one separate the medium from the message? States tend to either tax a narrow range or a broad range of telecommunications services. Those states that tax a narrow range do not include enhanced services as taxable telecommunications services. These states tax only basic telecommunications services, such as local and cellular phone calls, and are, therefore, able to avoid making the difficult distinction between medium and message. The states which have to deal with this distinction are those states that tax a broader range of telecommunications services, including both basic and some enhanced telecommunications services. Thus, when dealing with sales and use taxation in various states, the vendor can have difficulty in determining which transactions are taxable and where.

Another issue arises for those states that tax only intrastate telecommunications. In this day and age, with items such as cellular telephones and prepaid long-distance phone cards, it is difficult to determine whether a transaction is purely intrastate or includes interstate use.

Taxation of telecommunications services also involves differences among states dealing with how a sale is sited: to the location of the consumer or to the location of the vendor. This can mean potential for double taxation when a transaction involves two states that treat sales differently. Also, when the consumer and the vendor reside in different states, these differences can mean that neither party has a nexus for the transaction, and, therefore, the transaction cannot be taxed at all.

[41] Frieden, *supra* note 1.

3. Electronic commerce

Taxation of electronic commerce is very difficult, even without considering nexus issues. Inherently, electronic transactions cannot be observed, which means that state taxing authorities can have difficulty in obtaining needed information about such transactions. Furthermore, the regulations of most states are inadequately prepared to deal with the unique taxing issues which have arisen with the growth of electronic commerce. In most cases, states are simply trying to apply old laws to a new industry, and the result is often confusion and disagreement.

It is helpful to look first at the activities which comprise the electronic commerce industry. Aside from the tangible equipment involved, electronic commerce involves three types of activities:[42] transmission and linkage, content, and electronic marketing. Transmission and linkage involve the channels established and serviced by telecommunications and Internet service providers. Content refers to goods and services sold and delivered completely over the Internet or other electronic medium. Electronic marketing refers to goods and services which are advertised and ordered over the Internet, but are delivered by tangible methods. Transmission issues typically fall under a discussion of telecommunications services. Both content and electronic marketing activities can result in unique taxation and nexus issues.

For instance, some states would tax a good in an electronic marketing transaction, but would not tax the same good in a content transaction, due to the difference between the use of a tangible versus an intangible delivery method. As society grows more and more accustomed to the instantaneous exchange of information, any purchases of goods and services which can be conducted via the Internet or other electronic means will become structured to take advantage of the ease of electronic commerce. Some of the goods and services which have potential for electronic exchange include: software, financial services, books, newspapers, magazines, and informational databases.[43] As the electronic exchange of such goods and services becomes increasingly prevalent, the nexus issues relating to these exchanges will become increasingly important.

"Electronic commerce holds the potential to drastically increase the penetration of markets by out-of-state vendors with little or no physical presence in market states."[44] When this fact is combined with the tremendous potential for

[42] *Id.*
[43] *Id.*
[44] *Id.*

revenues from electronic commerce, the possibility of economic nexus theories being applied to electronic transactions becomes very evident. Companies involved in electronic commerce can establish a nexus based on any of several concepts, including physical presence, intangible presence, agency presence, or economic presence. Under these categories, where applicable, there will be included a description of the activities which the MTC has included in its discussion drafts of possible nexus guidelines for sales and use tax purposes.

There has been some discussion of how Web sites should be treated for tax purposes. The most natural classification of Web sites would seem to be intangible property. However, some states have suggested "that those sites that are located on a third-party computer server in the state and for which a monthly or annual fee is paid constitute leases of tangible personal property."[45] If this logic is used to classify Web sites as tangible personal property, it could result in a company having a physical presence in a state. Nexus could then be asserted by the state in which the computer server is located based simply on the traditional nexus rules. In addition, activities included in the MTC discussion drafts of possible nexus guidelines concerning minimal physical presence are the "ownership, lease, use, or maintenance of computer terminals available for access in the taxing jurisdiction," and the "licensing of proprietary software in the taxing jurisdiction that facilitates use of the online services."[46]

However, it is much more likely that goods and services exchanged via electronic commerce will be classified as intangible property. Both Web sites and the exchange of such products as computer software could create an intangible property presence in a state. Thus, in those states adopting the *Geoffrey* doctrine, many sales and services conducted via the Internet would fall under the nexus guidelines. It is also worthwhile to again mention Public Law 86-272, which protects solicitations on behalf of sellers of tangible personal property. When a vendor solicits orders electronically, or, in other words, through intangible means, those solicitations are no longer protected by P.L. 86-272 and could, therefore, establish a nexus for the vendor.

Another theory of nexus which could have far-reaching implications for the electronic commerce industry is agency nexus. A recent article provided two striking examples of how this theory could be applied to electronic transactions.

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[45] *Id.*
[46] *Id.*

> Nexus arguably could be created in taxing jurisdictions for a company that has various commercial links to a third-party online service that may provide such services as credit verification, the generation of purchase orders, billing, and promotional activities for the company. In such a case taxing authorities might argue that a company has nexus in all the states where the third party has nexus under the theory of attributional nexus.[47]

The second example involves the relationship between a telecommunications provider and an Internet service provider. "A telecommunications provider that provides local dial access service to a customer to enable the customer to access information service providers such as America Online or Compuserve could be deemed to be creating nexus for these information service providers in the states where the telecommunications provider has nexus."[48]

Yet another question posed by the theory of agency nexus is whether an information service provider such as America Online should be considered to be an agent capable of creating a nexus for an electronic marketer of goods. All three of these situations could create adverse consequences for the taxpayer engaged in electronic commerce if a state implements economic nexus theories. Included in the MTC discussion drafts of possible nexus guidelines are the "[u]tilization of a 'cybermall' with a computer server in the taxing jurisdiction that performs various administrative and financial functions on behalf of the remote seller," and "[m]aintaining a telecommunication linkage by private contract in the taxing jurisdiction that permits the online service to establish and maintain a market in the taxing jurisdiction."[49]

Finally, consideration must be given to the theories of nexus based on economic presence, which several states are applying to financial institutions. While economic presence standards have thus far been applied only to financial institutions, the possibility of states attempting to extend these or similar standards to other services, including those offered by Internet service providers, is imaginable. In addition, a theory which is quite similar to economic presence nexus, called "transactional" nexus, has recently emerged. "Under this theory, a vendor would have nexus with a taxing jurisdiction if the 'taxable event' - e.g., the rendering of an electronic service - occurred in a state, even if the vendor had no

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47 Frieden, *supra* note 1.
48 *Id.*
49 *Id.*

physical presence in the market state."[50] However, the only support for this theory is derived from cases whose circumstances had little in common with the issues presented by electronic commerce, and in which the nexus of the vendor was not in question. For these reasons, actual implementation of transactional nexus does not appear to be imminent. However, the MTC has included the following activity in its list of possible nexus guidelines: "performing or rendering electronic services in the taxing jurisdiction."[51]

III. PRESENT CONDITIONS

The *Geoffrey* decision has had tremendous, though varying, impact on many states. There has been no true uniformity in the states' reactions to this decision. Some states have adopted the *Geoffrey* doctrine by changing statutes and regulations to include this concept of economic nexus. Other states have been enforcing the doctrine, but have been doing so without changing statutes or regulations to give them specific legislative authority. Yet other states have expressed firm disagreement with the *Geoffrey* doctrine, and have been equally firm in their refusal to implement it. In order to give a picture of the seriousness of the impact this decision has had on state policy, it is necessary to examine several states' current position on the *Geoffrey* doctrine.

A. States Adopting the Geoffrey Doctrine

Massachusetts has been among the most aggressive of the states adopting this doctrine. The Massachusetts Department of Revenue has issued Directive 96-2, which explains the situations in which an out-of-state corporation will be subject to excise tax based on the ownership and use of intangible property within the state. According to this directive, an out-of-state corporation has a nexus based on its ownership and use of intangible property in Massachusetts when, through a purposeful activity, the property generates gross receipts within the state, and the corporation's presence based upon that property and activity is more than a de minimis presence.

Under Arkansas Regulation 1996-3, "a corporation that owns, licenses, or manages intangible property has nexus with Arkansas for the purposes of filing a corporate income tax return if the corporation seeks the benefit of economic contact with Arkansas by directing its economic activity at the state through the licensing

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[50] *Id.*
[51] *Id.*

of intangibles."[52]

Similarly, in Iowa, a corporation has a nexus based on intangible property if that property represents "an integral part of some business activity occurring regularly in Iowa."[53]

Included in the North Carolina definition of business activities which create a nexus in the state are the "owning, renting, or operating of business or income-producing property such as trademarks, trade names, franchise rights, computer programs, copyrights, patented processes, and licenses in North Carolina."[54]

Likewise, the sale or license of intangible property for use in Florida creates nexus for income tax purposes. Both Florida and New Jersey specifically cite trademarks and trade names as intangible property which can create nexus. In total, ten states have formally adopted a *Geoffrey* approach to nexus.[55]

B. States Enforcing the Doctrine Without Legislative Authority

Of the nine states which fall in this category,[56] Colorado has issued perhaps the clearest indication of its intentions. The Colorado Department of Revenue has stated that it intends to enforce the *Geoffrey* doctrine "as long as there is case law in this area and there are no other factors to prohibit the state from asserting nexus."[57]

The Mississippi legislature has adopted a *Geoffrey* approach which will expire without action.[58]

In Tennessee, there has been no actual adoption of the doctrine, but it is supposedly being pursued at the administrative level. In February of this year, there

[52] John J. Cronin & Maryann B. Gall. *Economic Nexus: A Case Study,* STATE TAX NOTES Feb. 16, 1998. *See* Arkansas Regulation 1996-3, entitled "Apportionment of Business Income Arising From Intragroup Intangible Licensing Transactions."
[53] IOWA CODE §422.32.
[54] Cronin, *supra* note 52. See N.C. Reg. §17:05C.0102.
[55] The ten states which have adopted the *Geoffrey* approach are: Arkansas, Florida, Hawaii, Iowa, Maine, Massachusetts, New Jersey, North Carolina, South Carolina, and Wisconsin. *See* Cronin, *supra* note 52.
[56] The nine states which are enforcing the *Geoffrey* doctrine without specific legislative authority are: Colorado, Georgia, Maryland, Missouri, Mississippi, New Hampshire, New Mexico, Rhode Island, and Tennessee. *See* Cronin, *supra* note 52.
[57] *See* Cronin, *supra* note 52.
[58] *Id.*

were two cases pending which involved the *Geoffrey* doctrine.[59]

The Georgia Department of Revenue has litigated one case involving the establishment of nexus based on intangible property, as was asserted in *Geoffrey*. Although the Department lost this case, it has indicated that it still intends to pursue such issues should another good candidate for litigation arise.

Finally, Maryland, Missouri, and New Hampshire are all "reportedly asserting *Geoffrey* in audits."[60]

C. States Rejecting the Geoffrey Doctrine

Seven states have indicated a reluctance to enforce this doctrine,[61] some more forcefully than others. First, in Alabama, the Department of Revenue's assertion that "an account receivable arising from a sale within Alabama created nexus"[62] was refuted by the Administrative Law Judge, who took the position that the physical presence standard as established by the U.S. Supreme Court in *Quill* should apply, and that "accounts receivable do not, by themselves, create substantial nexus."[63] The Department of Revenue has also indicated that it will not enforce two regulations which established franchise and income tax nexus based on the *Geoffrey* doctrine.

Similarly, while the Michigan Department of Revenue has not officially taken any position regarding the *Geoffrey* doctrine, the doctrine has been rejected by the Michigan Appeals Court. The Court has rendered a decision which includes the following statement: "after Quill, it is abundantly clear that a corporation must show a physical presence within a target state to establish a substantial nexus to it."[64]

The positions taken by Ohio and Texas are also of interest. Ohio has stated that it "will wait until other states have established a 'track record' and will then

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[59] *Id.*
[60] *Id.*
[61] The seven states which have indicated reluctance to apply the *Geoffrey* doctrine are: Alabama, Connecticut, Michigan, New York, Ohio, Pennsylvania, and Texas. *See* Cronin, *supra* note 52.
[62] *See* Cronin, *supra* note 52.
[63] *Id.*
[64] Guardian Indus. Corp. v. Department of Treasury, 499 N.W. 2d 349, 356 (Mich. Ct. App. 1993).

proceed accordingly."[65] Texas is also holding off on enforcement of the doctrine, but for different reasons. In 1993, the state issued a proposed regulation that would have officially adopted the doctrine, but taxpayer opposition was so great that "adoption efforts have been put on indefinite hold."[66]

IV. CONSTITUTIONAL ISSUES

With the *Geoffrey* decision affecting so many states, it is interesting that the U. S. Supreme Court has declined to review the decision, especially in light of the fact that the decision involves important constitutional concerns. These concerns involve proper interpretation of the nexus requirements of the Due Process Clause and the Commerce Clause of the Constitution, which, as was mentioned earlier, give the states the authority to tax interstate commerce. This section will explore the implications of each of these clauses.

A. Due Process Clause

The Due Process Clause declares that no state shall "deprive any person of life, liberty or property, without due process of law."[67] As it applies to nexus concerns, the clause provides two tests to determine if a state's taxation of an out-of-state corporation complies with the clause. First, the corporation must have certain minimum contacts with the taxing state. Second, those contacts must be sufficient to allow the imposition of the tax without violating the principles of "fair play and substantial justice."[68] Since these two tests are rather abstract, the Supreme Court has issued various decisions interpreting their requirements. Moreover, the Court's interpretation of the clause has not remained static, but has evolved over time.

B. Evolution of Supreme Court Interpretations

The first significant case in which the Court considered the nexus implications of the Due Process Clause was *International Shoe*.[69] This was the first decision in which the Court broke from its opinion that a strict physical presence in the state was necessary in order for a state to have jurisdiction over a non-

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[65] Cronin, *supra* note 52.
[66] *Id.*
[67] U.S. CONST. amend. XVI, §1.
[68] International Shoe, 326 U.S. at 316.
[69] *Id.*

resident corporation.[70] The relevant facts of the case were as follows. International Shoe was incorporated in Delaware and headquartered in St. Louis. It did not maintain offices in Washington. However, International Shoe did employ between 11 and 13 salesmen in Washington, who solicited business using a line of samples provided by International Shoe. The state of Washington imposed an employment tax on International Shoe, based on the activities of its salesmen located within the state. International Shoe argued that its lack of offices within the state of Washington meant that it did not have sufficient presence to create a nexus with the state, and, accordingly, the state could not assess the tax. In deciding the case, the Supreme Court held that it was necessary to consider the qualitative aspects of the corporation's activities in the state.[71] Concerning these aspects, the Court declared that the activities were "neither casual nor irregular,"[72] but, instead, were "systematic and continuous throughout the years in question."[73] Based on these facts, the Court's decision established the two limitations of the Due Process Clause on a state's authority over an out-of-state corporation that were discussed *supra.*

The next case having impact on the Court's interpretation of the Due Process Clause was *McGee v. International Life Insurance Co.*[74] In this case, the Court stated that "a trend is clearly discernible toward expanding the permissible scope of state jurisdiction over foreign corporations and other nonresidents. In part this is attributable to the fundamental transformation of our national economy over the years. Today, many commercial transactions touch two or more states . . . ."[75] Another outcome of this decision was the addition of a new basis on which to judge a state's assertion of nexus: "whether the purported contact amounts to a 'substantial connection' with the forum state."[76]

Following *McGee*, the next decision offering significant implications for the issue of nexus under the Due Process Clause was in the case of *Shaffer v. Heitner.*[77] In this case, the Court considered the concept of a state's exercise of jurisdiction over a nonresident corporation based on the presence of property in the state.[78] The Court concluded that "although the presence of the defendant's property

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[70] *Id.*
[71] *Id.*
[72] Lieberman, *supra* note 2.
[73] International Shoe, 326 U.S. at 320.
[74] McGee v. International Life Insurance Co., 355 U.S. 220 (1957).
[75] *Id.*
[76] Lieberman, *supra* note 2.
[77] *Shaffer v. Heitner*, 433 U.S. 186 (1977).
[78] *Id.* at 186.

in a state might suggest the existence of other ties among the defendant [and] the state, . . . the presence of the property alone would not support the state's jurisdiction."[79]

Also of interest is a statement which the Court made in its decision in *World-Wide Volkswagen Corp. v. Woodson.*[80] In its opinion, the Court said that a foreign corporation which "purposefully avails itself of the privilege of conducting activities within the forum state"[81] can come under the jurisdiction of the forum state. Likewise, in its opinion in *Burger King Corp. v. Rudzewicz,*[82] the Court observed the following: "So long as a commercial actor's efforts are 'purposefully directed' toward residents of another state, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there."[83]

This position was once again affirmed in *Quill Corp. v. North Dakota,*[84] in which a nonresident corporation lacking physical presence was held to have a use tax nexus with the state.[85] Here, the Court again disregarded the question of physical presence, instead basing its decision on the fact that the foreign corporation had purposefully directed its activities at customers in North Dakota.[86] Thus, it appears as though, for purposes of the Due Process Clause, a physical presence is not required in order for a foreign corporation to establish a nexus with a state.

C. Commerce Clause

The Commerce Clause asserts that "Congress shall have power . . . [to] regulate commerce with foreign nations, and among the several states, and with the Indian tribes."[87] The Supreme Court has established a four-prong test for determining whether a state has the authority to impose a tax under the constraints of the Commerce Clause. According to this test, a state tax is valid if it "(1) is applied to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly

[79] *Id.* at 209.
[80] *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286 (1980).
[81] *Id.* at 297, *quoting* Hanson v. Denkla, 357 U.S. 235, 253 (1958).
[82] *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985).
[83] *Id.* at 476.
[84] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
[85] *Id.* at 308.
[86] *Id.*
[87] U.S. CONST. art. I, §8, cl. 3.

related to the services provided by the state."[88] As with the Court's interpretations of the Due Process Clause, interpretations of the Commerce Clause have evolved over time.

D. Evolution of Supreme Court Interpretations

The initial interpretation of the nexus requirements of the Commerce Clause came from *National Bellas Hess, Inc. v. Department of Revenue of Illinois*.[89] The Court held that the requirements of the Due Process Clause and the Commerce Clause were deemed substantially similar.[90] Following this decision, there was little distinguishable difference between the two clauses. Then, several years later, in *Complete Auto Transit, Inc. v. Brady*,[91] the Court set forth the four-prong test of the Commerce Clause.[92]

However, in 1992, with the *Quill* decision, the Court reconsidered the view it had taken in *National Bellas Hess*.[93] In *Quill*, it established that the two clauses held two different limitations on the states' taxing authority. The Court stated that "a [corporation] may have the 'minimum contacts' with a taxing state as required by the Due Process Clause, and yet lack the 'substantial nexus' with that state as required by the Commerce Clause."[94] Thus, the Commerce Clause requires a higher degree of contacts than does the Due Process Clause. In other words, "[i]t is now clear that substantial nexus equals minimum due process nexus plus something."[95] Therefore, in considering questions of nexus, states should examine the interplay between the two clauses. For instance, in a case where the contacts of the nonresident corporation distinctly satisfy the nexus requirements of the Due Process Clause, it is reasonable to conclude that the contacts also satisfy the requirements of the Commerce Clause. However, in cases where there is some ambiguity concerning whether the contacts are sufficient to satisfy the Due Process Clause, it is doubtful whether they can reasonably be regarded as also satisfying the Commerce Clause.

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[88] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 278 (1977).
[89] National Bellas Hess, Inc. v. Department of Revenue of Illinois, 386 U.S. 753 (1957), *overruled by* Quill Corp. v. North Dakota, 504 U.S. 298 (1992).
[90] *Id.* at 756.
[91] Complete Auto Transit, 430 U.S. at 298.
[92] *Id.*
[93] Quill Corp, 504 U.S. at 301.
[94] Quill Corp, 504 U.S. at 298.
[95] Lieberman, *supra* note 2.

V. THE DUE PROCESS CLAUSE AND ECONOMIC NEXUS

Through an analysis of the Supreme Court's interpretation of the Due Process Clause, it becomes apparent that this clause does not hold significant threats for the theory of economic nexus. The Court stated in the case of *Burger King Corp. v. Rudzewicz* that "[s]o long as a commercial actor's efforts are 'purposefully directed' toward residents of another state, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there."[96] Since the essence of economic nexus is nexus without physical presence, this statement leaves little room for constitutional questions of the theory under the Due Process Clause. The Supreme Court has explicitly stated that physical presence is not necessary to satisfy the nexus requirements of the Due Process Clause.

However, as has been seen, all theories of economic nexus are not created equal. There is one application of the theory for which the Due Process Clause does hold constitutional questions. That application is the one espoused by the *Geoffrey* decision; specifically, the use of intangible property presence to create a nexus. Here, a statement of the Supreme Court in *Shaffer v. Heitner* is relevant. The Court stated that, "[a]lthough the presence of the defendant's property in a state might suggest the existence of other ties among the defendant [and] the state, . . . the presence of the property alone would not support the state's jurisdiction."[97] This statement explicitly refutes the South Carolina Supreme Court's position that the presence of intangible property alone "provided an independent basis for the court's jurisdiction."[98] Thus, while *Geoffrey* could not have had Due Process nexus with South Carolina based on its intangible property, it could still have had Due Process nexus based on its purposeful direction of business activities at residents of South Carolina. However, Geoffrey did argue that it did not purposefully direct any activities at South Carolina, since, when it formed the licensing agreement with Toys 'R' Us, the company was not yet operating in South Carolina. Despite this argument, it does appear reasonable that the court could have concluded that Geoffrey's actions were purposefully directed toward South Carolina. Regardless of the court's decision on this issue, it is clear that Geoffrey's intangible property in South Carolina did not create Due Process nexus with South Carolina.

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[96] *Burger King*, 471 U.S. at 476.
[97] Shaffer, 433 U.S. at 209.
[98] Lieberman, *supra* note 2.

VI. THE COMMERCE CLAUSE AND ECONOMIC NEXUS

As they relate to economic nexus, the requirements of the Commerce Clause are more difficult to interpret than are those in the Due Process Clause. The only definition of substantial nexus that the Supreme Court offered in *Quill* was that Commerce Clause nexus requires greater contacts than does Due Process nexus. Indeed, the Court's decision in *Quill* left open more questions than it answered. While *Quill* required physical presence for use tax nexus, there is no guidance as to whether that same standard should apply to income and sales tax nexus as well. Thus, no true conclusion concerning the constitutionality of economic nexus can be reached.

The *Geoffrey* decision, however, once again deserves notice. It has already been seen that there was some ambiguity concerning whether Geoffrey had Due Process nexus. Since Commerce Clause nexus requires something greater than Due Process nexus, it is, therefore, questionable whether Geoffrey's contacts could have satisfied the requirements of the Commerce Clause. Indeed, a similar application of the Due Process Clause and the Commerce Clause to the *Geoffrey* decision led one commentator to conclude that "the decision in *Geoffrey* offers little guidance to other states and taxpayers, and its effect should be limited to South Carolina."[99]

VII. CONCLUSIONS

Based on the above discussion, it does appear that the theory of economic nexus, as it is now being applied, might not be able to stand against an attack on its constitutionality. It is also apparent that the primary threats to its constitutionality come from the nexus requirements of the Commerce Clause. Particularly troubling in light of these constitutional threats is the number of states adopting the *Geoffrey* doctrine. While the *Geoffrey* doctrine is the most widely applied theory of economic nexus, it is also the most questionable in terms of constitutionality. Essentially, this issue will need further Supreme Court clarification in order for the constitutional limits of the theory to be understood. Until such clarification occurs, however, it is likely that the states will continue in their attempts to test those limits.

In addition to its constitutionality, the administrative feasibility of economic nexus should be considered. There are several issues which add to the administrative burden of economic nexus tax systems. First, "all taxes consume resources in administration and compliance, with costs generally higher for recently

[99] *Id.*

reformed systems and newly implemented taxes."[100] Due to the novelty of many of the issues presented by financial, telecommunications, and electronic commerce services, businesses and tax administrators alike are inexperienced in dealing with the taxation of these areas. Thus, the compliance burden imposed by economic nexus is likely to be high, as businesses and states scramble to understand the issues involved.

Second, in order to apply economic nexus to a corporation, a state must bear the burden of discovery. In general, the transactions which are potential candidates for economic nexus cannot be observed. This means that the states will have to invest time and resources into identifying the corporations that have an economic nexus with the state.

Massachusetts provides an example of the actions a state must make to be able to apply economic nexus. The Massachusetts Department of Revenue has formed new task force known as the Financial Institution Audit Unit. The mission of this task force is to research and find financial institutions that, according to the state's new regulations for financial institutions, have a nexus with Massachusetts based on the economic presence standards. The institutions found through this research will then be compared with financial institutions which are currently filing in Massachusetts, in order to identify those institutions that have a nexus but are not in compliance with the new regulations. It is not difficult to see that such a program will consume many, many man-hours. Many states may not have the resources to invest in such enforcement activities.

VIII. RECOMMENDATIONS

Despite the constitutional questions surrounding the theory of economic nexus, it appears very likely that states will continue the pursuit. States are not going to be content to allow service industries such as financial services and electronic commerce to experience such intense growth tax-free. Therefore, the most helpful course of action would be to clarify the issues involved, and to strive to devise a system of economic nexus which is administratively workable. Questions such as what activities are taxable, what constitutes nexus, and how activities are sourced are definitional questions to which only the states have the answers. If states clarified the answers to these questions, it would give businesses some of the knowledge they need to be able to comply. Also, with so many novel issues involved, a structured communication between taxing authorities and

[100] Matthew N. Murray, *Telecommunication Services and Electronic Commerce: Will Technology Break the Back of the Sales Tax?*, STATE TAX NOTES, Jan. 27, 1997.

businesses could help to devise the most understandable and workable regulations.

However, there is no perfect solution to this dilemma, largely due to the existence of what one commentator has called " 'healthy tension' between the states' legitimate quest for revenue and taxpayers' legitimate quest to pay the minimum amount of taxes."[101] In conclusion, until the Supreme Court or Congress takes some definitive action concerning the applicable limits on a state's jurisdiction over nonresident corporations, economic nexus is really an issue which must be dealt with on an operating basis rather than on a theoretical basis.

[101] Scot R. Grierson, *California Conference Topics: Interest Offset Rule, Sales Factor, the Test For Unity*, STATE TAX NOTES, Nov. 25, 1996.