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THE EVOLUTION AND FUTURE OF SUBSTANTIAL NEXUS IN STATE TAXATION OF CORPORATE INCOME

Abstract: The proper nexus standard for state taxation of out-of-state corporations has been a contentious issue since the U.S. Supreme Court decided *Quill Corp. v. North Dakota* in 1992. In that case, the Court upheld a physical presence standard, but numerous state courts have since affirmed economic presence standards, holding that the state can tax corporations with no physical presence within its borders. This Note examines the evolution of state taxation of out-of-state corporations, including some of the most recent state tax court decisions on the topic, and analyzes whether there are any overarching principles that may be gleaned from the various decisions. The Note then considers possible consequences of the proliferation of the economic presence standard and whether there is any limit to its application.

INTRODUCTION

The debate over the proper nexus requirement for state taxation of corporations has been ongoing since the U.S. Supreme Court decided *Quill Corp. v. North Dakota* in 1992.¹ In *Quill*, the Court reaffirmed its 1967 decision in *National Bellas Hess v. Department of Revenue*, where it held that a state cannot collect a use tax from a vendor that limited its contacts with a state to communications effected solely by mail and common carrier.²

The debate over the proper nexus requirement is important because the reach of the states' jurisdiction to tax net corporate income greatly affects both multistate corporations and the states in which they

¹ 504 U.S. 298, 319 (1992). See generally Doug Sheppard et al., *Shining a Blue Light on Nexus: Katz and Rosen Debate the Kmart Decision*, 23 ST. TAX NOTES 847 (2002) (debating the New Mexico Court of Appeals' decision in *Kmart Properties Inc. v. Taxation and Revenue Department*, 131 P.3d 27 (N.M. Ct. App. 2001), and the appropriate substantial nexus standard for imposing a corporate income tax on a corporation that is not physically present within a state); John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 321 (2003) (concluding that a corporation need not be physically present within a state to have an income tax nexus with that state).

² See *Quill*, 504 U.S. at 311; Nat'l Bellas Hess v. Dep't of Revenue, 386 U.S. 753, 758 (1967); Michael T. Fatale, *State Tax Jurisdiction and the Mythical "Physical Presence" Constitutional Standard*, 54 TAX LAW. 105, 106 (2000) (arguing that there is no physical presence requirement for corporate income taxes or any other type of taxes).

do business.³ As the national economy becomes more integrated, corporations frequently do business in multiple states.⁴ For their part, states would like to reach the coffers of these corporations to fill their own depleted treasuries.⁵ The problem arises because many of these corporations do not have even a minimal physical presence in the states that wish to tax them, and the U.S. Supreme Court has been unclear about the jurisdiction requirements that would allow the states to tax these corporations.⁶

There are two basic viewpoints regarding what amount of contact with a state is sufficient to permit the state to tax the income of the corporation.⁷ One view mandates the physical presence of the corporation in the state for the state to be able to assert its taxation power over the corporation.⁸ The other view holds that a corporation's traditional physical presence is unnecessary and that the corporation's economic presence in a state is alone sufficient to permit taxation of the corporation by that state.⁹ Economic presence refers to the situation where a corporation does business in a state and derives revenue from those activities, without having an actual physical presence within the state.¹⁰

The Supreme Court has unequivocally held that economic presence is sufficient for a plaintiff to hale an out-of-state corporation into

³ See Swain, *supra* note 1, at 321.

⁴ See *id.*

⁵ See *id.* at 321 n.1.

⁶ See *id.* at 321.

⁷ See *id.* at 323. John Swain explains the difference between a nexus with the taxpayer and a nexus with the income, transaction, or property sought to be taxed. *Id.* at 328–29. As in Swain's article, this Note will focus on the former. See *id.* These two types of nexus are related but the former is a jurisdictional issue while the latter is more of a fair apportionment issue. See *id.*

⁸ See Swain, *supra* note 1, at 323. See generally *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999).

⁹ See Swain, *supra* note 1, at 322. See generally *Geoffrey, Inc. v. S.C. Tax Comm'n (Geoffrey I)*, 437 S.E.2d 13 (S.C. 1993).

¹⁰ See R. Todd Ervin, *State Taxation of Financial Institutions: Will Physical Presence or Economic Presence Win the Day?*, 19 VA. TAX REV. 515, 531–32 (2000) (explaining that the basic premise of economic nexus is that economic realities, such as the benefits and opportunities provided by the taxing state, should determine whether a corporation has a substantial nexus with a state, instead of relying solely on whether the corporation has a physical presence within the taxing state); Swain, *supra* note 1, at 321. The line between physical presence and economic presence is not cut and dry, such that depending on the circumstances, it may be unclear whether a corporation has a physical presence in a state. See Michael T. Fatale, *Federalism and State Business Activity Tax Nexus: Revisiting Public Law 86-272*, 21 VA. TAX REV. 435, 502 n.358 (2002). A typical example of a company that has an economic presence in a state, but not a traditional physical presence, is a mail-order company that makes sales in a state where it has no offices or personnel. See *Quill*, 504 U.S. at 303.

court under the Due Process Clause of the U.S. Constitution.¹¹ The Court's state tax jurisprudence, however, has resulted in a two-prong approach, focusing on both the Due Process Clause and the Dormant Commerce Clause.¹² Under the Due Process Clause prong, economic presence is sufficient because doing business in a state gives enough notice to the corporation that they may be subject to the laws and taxing authority of that state.¹³

The Supreme Court explained the test for whether a state tax passes muster under the Dormant Commerce Clause in *Complete Auto Transit, Inc. v. Brady* in 1977.¹⁴ A state tax is constitutional under the Dormant Commerce Clause if it is assessed against a taxpayer with whom the state has a substantial nexus, is fairly apportioned, is nondiscriminatory, and is fairly related to the services provided by the state.¹⁵ Under this test, a nonresident taxpayer must have established a substantial nexus with a state in order to be subject to that state's taxing jurisdiction.¹⁶ States traditionally relied on physical presence within the state to prove the existence of a substantial nexus, but more recently, states are asserting jurisdiction based on economic presence.¹⁷

In the past few years, a number of states have taxed corporations that did not have a traditional physical presence in the taxing state.¹⁸ Many of those corporations brought suit challenging the state's jurisdiction over them.¹⁹ Those cases are all at the state level, and so far, the Supreme Court has denied certiorari to all such cases, leaving unresolved the issue of whether states can tax the net income of nonresident corporations.²⁰

¹¹ See *Quill*, 504 U.S. at 308; Swain, *supra* note 1, at 322.

¹² See *Quill*, 504 U.S. at 305; *Geoffrey I*, 437 S.E.2d at 16; Swain, *supra* note 1, at 322.

¹³ See *Quill*, 504 U.S. at 312; Swain, *supra* note 1, at 334.

¹⁴ 430 U.S. 274, 279 (1977).

¹⁵ See *id.* at 279; Swain, *supra* note 1, at 328.

¹⁶ See Ervin, *supra* note 10, at 516.

¹⁷ See *id.*

¹⁸ See, e.g., *Lanco, Inc. v. Dir., Div. of Taxation (Lanco II)*, 908 A.2d 176, 177 (N.J. 2006), *cert. denied*, 127 S. Ct. 2973 (2007); *Kmart Props., Inc. v. Taxation and Revenue Dep't*, 131 P.3d 27, 36 (N.M. Ct. App. 2001), *cert. granted*, 40 P.3d 1008 (N.M. 2002), *cert. quashed*, 131 P.3d 22 (N.M. 2005); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004); *Geoffrey, Inc. v. Okla. Tax Comm'n (Geoffrey II)*, 132 P.3d 632, 638 (Okla. Civ. App. 2006); *Tax Comm'r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 234 (W. Va. 2006), *cert. denied*, 127 S. Ct. 2997 (2007).

¹⁹ See, e.g., *Lanco II*, 908 A.2d at 176; *Kmart Props.*, 131 P.3d at 30; *A & F Trademark*, 605 S.E.2d at 189; *Geoffrey II*, 132 P.3d at 633; *MBNA*, 640 S.E.2d at 227.

²⁰ See, e.g., *A & F Trademark*, 605 S.E.2d 187, *cert. denied*, 546 U.S. 821 (2005); *Geoffrey I*, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993). Although *Lanco* and *MBNA* had filed petitions for certiorari in March 2007, the Supreme Court refused to take up the cases. Patrice

Congress, however, may exercise its plenary power under the Commerce Clause to determine the appropriate nexus standard.²¹ In 1959 Congress passed Public Law 86-272 ("P.L. 86-272"), which created a safe harbor for sellers of tangible personal property whose activities within a state were limited to solicitation.²² P.L. 86-272, however, does not mention anything about services or intangibles, because those sectors of the economy were not widely present in 1959.²³ On April 28, 2005, a bill was introduced in the House of Representatives that aimed to include both intangibles and services in the safe harbor provision of P.L. 86-272.²⁴ Additionally, the bill sought to codify a physical presence standard for net income and other business activity taxes.²⁵ Hearings on this bill, known as the Business Activity Tax Simplification Act, were held in the Subcommittee on Commercial and Administrative Law on September 27, 2005.²⁶ The bill was reported to the House in July 2006, and a related bill was introduced in the Senate on May 4, 2006.²⁷ Although a House floor vote on the bill was postponed in the summer of 2006,²⁸ a new Senate bill entitled the Business Activity Tax Simplifica-

Gay, *U.S. Supreme Court Will Not Hear Business Tax Nexus Cases*, 44 ST. TAX NOTES 925, 925 (2007); see *Lanco II*, 908 A.2d 176 (N.J. 2006), cert. denied, 127 S. Ct. 2973 (2007); *MBNA*, 640 S.E.2d 226 (W. Va. 2006), cert. denied, 127 S. Ct. 2997 (2007).

²¹ See *Quill*, 504 U.S. at 318; Swain, *supra* note 1, at 323-24.

²² Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified at 15 U.S.C. § 381 (2000)). As noted by Swain, although the law has been incorporated into the U.S. Code, state and local tax professionals still refer to it as P.L. 86-272 and this Note will also. See Swain *supra* note 1, at 324-25. Congress enacted P.L. 86-272 in response to *Northwestern States Portland Cement Co. v. Minnesota*, where the Supreme Court held that Minnesota could tax the apportioned income of the taxpayer even though its business in Minnesota consisted solely of soliciting orders for the sale of its product. 358 U.S. 450, 452 (1959); see Swain, *supra* note 1, at 352-53. The taxpayer had a leased sales office and several salespeople in Minnesota, granting it a physical presence in the state, but Congress and some commentators believed that the natural consequence of the decision would be taxation by states where there was no physical presence at all. See Swain, *supra* note 1, at 352-53. P.L. 86-272 created a safe harbor for sellers of tangible personal property whose only activity in a state is the solicitation of orders, provided that the orders are forwarded out-of-state for acceptance and the goods are shipped from an out-of-state location. See 15 U.S.C. § 381; Swain, *supra* note 1, at 352-53.

²³ See Swain, *supra* note 1, at 325.

²⁴ Business Activity Tax Simplification Act of 2005, H.R. 1956, 108th Cong. (2005).

²⁵ *Id.*

²⁶ See generally *Business Activity Tax Simplification Act of 2005: Hearing on H.R. 1956 Before the Subcomm. on Commercial and Administrative Law*, 109th Cong. (2006) [hereinafter *Business Tax Hearing*].

²⁷ Business Activity Tax Simplification Act of 2006, S. 2721, 109th Cong. (2006); H.R. 1956.

²⁸ See E-mail from Branden Ritchie, Legislative Director and Counsel, Office of Congressman Bob Goodlatte (Nov. 20, 2006, 12:08 EST) (on file with author).

tion Act of 2007 was introduced by Senator Charles Schumer on June 28, 2007.²⁹

Neither Congress nor the Supreme Court has addressed the jurisdictional issue, either in favor of the states or in favor of the taxpayers.³⁰ In the meantime, this area of law is fraught with uncertainty both for taxpayers and states.³¹ One of the most uncertain areas concerns the definition of the "substantial nexus," which is required under the first prong of the *Complete Auto Transit* test.³² This Note addresses the evolution and future of substantial nexus from its first articulation in *Complete Auto Transit*. Part I discusses the historical development of substantial nexus.³³ Part II analyzes the recent state court decisions addressing substantial nexus in the corporate income tax scenario and their justifications for moving towards an economic presence standard.³⁴ Part III then applies the concept of substantial nexus to different industries likely to be affected by an expansion of the economic presence standard in the future.³⁵

I. THE HISTORY OF SUBSTANTIAL NEXUS

A. *The Development of the Concept of Substantial Nexus*

The first major case in the line of decisions leading up to the current debate on the state taxation jurisdiction was *National Bellas Hess, Inc. v. Department of Revenue*, decided by the U.S. Supreme Court in 1967.³⁶ In that case, the appellant, National Bellas Hess ("Bellas Hess"), was a mail order company with its principal place of business in North Kansas City, Missouri.³⁷ Bellas Hess was licensed to do business only in

²⁹ Business Activity Tax Simplification Act of 2007, S. 1726, 110th Cong. 1 (2007).

³⁰ See generally Kirk J. Stark, *State Tax Shelters and U.S. Fiscal Federalism*, 42 ST. TAX NOTES 773 (2006); Swain, *supra* note 1, at 323, 325.

³¹ See Swain, *supra* note 1, at 323; see, e.g., *Lanco II*, 908 A.2d at 177; *Kmart Props.*, 131 P.3d at 36; *A & F Trademark*, 605 S.E.2d at 195; *Geoffrey II*, 132 P.3d at 638; *J.C. Penney*, 19 S.W.3d at 842; *MBNA*, 640 S.E.2d at 234.

³² See 430 U.S. at 279; *Geoffrey I*, 437 S.E.2d at 18; *J.C. Penney*, 19 S.W.3d at 842.

³³ See *infra* notes 36–198 and accompanying text.

³⁴ See *infra* notes 199–264 and accompanying text.

³⁵ See *infra* notes 265–294 and accompanying text. This Note will not address whether an economic presence or physical presence standard is the ideal standard. Many commentators have made excellent arguments regarding which standard should be adopted. See generally, Ervin, *supra* note 10; Swain, *supra* note 1. A normative analysis of the standards is beyond the scope of this Note.

³⁶ See 386 U.S. 753, 753 (1967); Swain, *supra* note 1, at 322.

³⁷ *Bellas Hess*, 386 U.S. at 753–54.

Missouri and Delaware, where it was incorporated.³⁸ The Illinois Department of Revenue obtained a judgment from the Illinois Supreme Court requiring Bellas Hess to collect and remit use taxes to the State of Illinois, even though the company had no physical presence in Illinois.³⁹ Bellas Hess argued before the U.S. Supreme Court that its taxation by the state of Illinois was in violation of the company's rights under the Due Process Clause of the Fourteenth Amendment and the Dormant Commerce Clause.⁴⁰

The Court concluded that Bellas Hess's constitutional objections were closely related and that the test for whether a state tax on interstate commerce is allowable is similar to the test for a state's compliance with due process.⁴¹ In terms of the Due Process Clause, the Court affirmed that the test is "whether the state has given anything for which it can ask return."⁴² Similarly, in terms of taxation of interstate commerce, the Court explained that taxation of companies with no physical presence in the state is allowable to the extent that the tax causes the company bear a fair share of the cost of the state whose protection it enjoys.⁴³ In prior cases, the Court had examined use taxes and upheld the power of a state to impose liability on an out-of-state seller in a variety of circumstances.⁴⁴ Specifically, the Court had held that a state may impose a use tax liability on an out-of-state seller where the sales were arranged by local agents in the taxing state and where the out-of-state seller maintained local retail stores.⁴⁵ As justification for those decisions, the Court explained that in those situations, the out-of-state seller was "plainly accorded the protection and services of the taxing state."⁴⁶

The Court explained that it had never held that a state may impose a use tax collection duty on a seller whose only connection to the taxing state was by common carrier or U.S. mail.⁴⁷ Thus, the Court in

³⁸ *Id.* at 754.

³⁹ *Id.*; see also *Ervin*, *supra* note 10, at 532 n.72 (explaining that both sales and use taxes require the retailer to act as a collection agent for the tax and that a sales tax is imposed on sales occurring within the taxing state, whereas a use tax is imposed on goods purchased outside the state but then brought into the state for use or consumption).

⁴⁰ *Bellas Hess*, 386 U.S. at 756.

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.* at 757; see also *Gen. Trading Co. v. State Tax Comm'n*, 322 U.S. 335, 337 (1943); *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359, 364 (1940); *Nelson v. Montgomery Ward & Co.*, 312 U.S. 373, 375 (1940); *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U.S. 62, 66 (1938).

⁴⁵ *Bellas Hess*, 386 U.S. at 757.

⁴⁶ *Id.*

⁴⁷ *Id.* at 758.

National Bellas Hess endorsed a physical presence nexus and rejected the economic presence argument advanced by the Illinois Department of Revenue.⁴⁸ It held that the mail order transactions at issue in the case were exclusively interstate, and if Illinois's power to tax *Bellas Hess* was upheld, the burdens on interstate commerce would be tremendous.⁴⁹ The Court therefore found that the Illinois use tax as applied to *Bellas Hess* was unconstitutional under the Commerce Clause.⁵⁰ It stated that "[t]he very purpose of the Commerce Clause [is] to ensure a national economy free from such unjustifiable local entanglements."⁵¹

The next important decision in the line of cases leading up to the current debate on physical versus economic nexus occurred in *Complete Auto Transit, Inc. v. Brady*, decided by the U.S. Supreme Court in 1977.⁵² The tax at issue in *Complete Auto Transit* was a privilege tax, where Mississippi taxed *Complete Auto* for the privilege of doing business in the state.⁵³ The issue was whether the privilege tax was unconstitutional under the Dormant Commerce Clause.⁵⁴ The Court announced the rule that a tax may be sustained against a Dormant Commerce Clause challenge if it is (1) 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 related to the services provided by the state.⁵⁵ Subsequent cases have referred to this standard as the *Complete Auto Transit* test, and have applied it when evaluating the constitutionality of a tax under the Dormant Commerce Clause.⁵⁶

⁴⁸ See *id.*

⁴⁹ See *id.* at 759 (explaining that "if 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").

⁵⁰ See *Bellas Hess*, 386 U.S. at 760.

⁵¹ *Id.*

⁵² See 430 U.S. 274, 274 (1977).

⁵³ *Id.* at 274.

⁵⁴ See *id.*

⁵⁵ *Id.* at 279; see also *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1992) (describing the four-part test and pointing out that *Bellas Hess* concerned the first prong—substantial nexus—of the test).

⁵⁶ See *Quill*, 504 U.S. at 310; *Kmart Props., Inc. v. Taxation and Revenue Dep't*, 131 P.3d 27, 34 (N.M. Ct. App. 2001), cert. granted, 40 P.3d 1008 (N.M. 2002), cert. quashed, 131 P.3d 22 (N.M. 2005); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 193 (N.C. Ct. App. 2004); *Geoffrey, Inc. v. Okla. Tax Comm'n (Geoffrey II)*, 132 P.3d 632, 635 (Okla. Civ. App. 2006); *Geoffrey, Inc. v. S.C. Tax Comm'n (Geoffrey I)*, 437 S.E.2d 13, 18 (S.C. 1993); *Am. Online, Inc. v. Johnson*, No. M2001-00927-COA-R3-CV, 2002 WL 1751434, at *2 (Tenn. Ct. App. July 30, 2002); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.2d 831, 838 (Tenn. Ct. App. 1999); see also Christina M. Lyons, *The Constitutionality of the Worldwide Combined Reporting Method of Taxation of Multinational Corporations: Barclays Bank v. Franchise Tax Board*, 37 B.C. L. Rev. 183, 192 (1995).

After *Complete Auto Transit* was decided in 1977, no other major cases addressed the issue of states imposing taxes on out-of-state companies until *Quill Corp. v. North Dakota* was decided by the Supreme Court in 1991.⁵⁷ *Quill* involved North Dakota's attempt to require an out-of-state, mail-order house that had neither outlets nor sales representatives in North Dakota to collect and pay a use tax on goods purchased for use within the state.⁵⁸ The Court analyzed the North Dakota tax under the *Complete Auto Transit* test and observed that the substantial nexus prong and the fairly related prong of the test limit the reach of the state's taxing authority to ensure that state taxation does not unduly burden interstate commerce.⁵⁹ The fairly apportioned prong and the no discrimination against interstate commerce prong prohibit taxes that pass an unfair share of the tax burden onto interstate commerce.⁶⁰

In *Quill*, the Court began its analysis by noting that although the taxpayer's claims of unconstitutionality under the Due Process Clause and the Commerce Clause were closely related, they posed different limits on the taxing powers of the states.⁶¹ The Court acknowledged that although in the past it had not always been precise in distinguishing between the analyses under the two clauses, the Due Process Clause and the Commerce Clause are analytically distinct and reflect different constitutional concerns.⁶² The Due Process Clause concerns the fundamental fairness of governmental activity, and as such, notice or fair warning is the key to a due process analysis.⁶³ The focus of the Commerce Clause and its substantial nexus requirement is not on fairness for the individual defendant, but concerns the effects of state regulation on the national economy.⁶⁴ The Court in *Quill* explained that under the Articles of Confederation, state taxes and duties "hindered and suppressed interstate commerce; the Framers intended the Commerce Clause as a cure for these structural ills."⁶⁵ Therefore, in *Quill*, the Court reiterated that the Commerce Clause prohibits dis-

⁵⁷ See *Quill*, 504 U.S. at 301; Swain, *supra* note 1, at 329.

⁵⁸ *Quill*, 504 U.S. at 301.

⁵⁹ See *id.* at 313.

⁶⁰ *Id.*

⁶¹ *Id.* at 305.

⁶² *Id.*

⁶³ *Quill*, 504 U.S. at 312.

⁶⁴ *Id.*

⁶⁵ *Id.*

crimination against interstate commerce and bars state regulations that unduly burden interstate commerce.⁶⁶

The Due Process Clause requires at least some connection between a state and a taxpayer the state is seeking to tax.⁶⁷ The Court in *Quill* pointed out that due process jurisprudence had evolved substantially since *Bellas Hess* was decided.⁶⁸ Most of the change in the due process jurisprudence was sparked by the Court's 1945 decision in *International Shoe v. Washington*.⁶⁹ *International Shoe* held that, in the context of personal jurisdiction, the relevant inquiry is whether a defendant has minimum contacts with the jurisdiction such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice.⁷⁰ In accordance with the decision in *International Shoe*, the Court in *Quill* abandoned the formalistic tests that focused on a defendant's presence within a state in favor of a more flexible inquiry into whether a defendant's contacts with the forum make it reasonable to require the defendant to defend the suit in that state.⁷¹ In decisions following *International Shoe*, the Court held that if an out-of-state corporation purposefully availed itself of the benefits of an economic market in the forum state, it possibly subjects itself to the state's *in personam* jurisdiction even where there is no physical presence in the state.⁷² The Court applied these previous due process decisions to the issue in *Quill* and held that the imposition of the use tax on a mail-order house that is engaged in continuous and widespread solicitation of business within a state is justified.⁷³ A corporation with continuous and widespread contacts with a state has fair warning that its activity may subject it to the jurisdiction of that state.⁷⁴ As the Court in *Quill* noted, "[i]t matters little that such solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: the requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State."⁷⁵ The Court concluded that

⁶⁶ *Id.*

⁶⁷ *See id.* at 306 (citing *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-45 (1954)).

⁶⁸ *Quill*, 504 U.S. at 307.

⁶⁹ *Id.* *See generally* *Int'l Shoe v. Washington*, 326 U.S. 310 (1945).

⁷⁰ *Quill*, 504 U.S. at 307; *Int'l Shoe*, 326 U.S. at 316.

⁷¹ *Quill*, 504 U.S. at 307.

⁷² *Id.* *In personam* jurisdiction is defined as a "court's power to bring a person into its adjudicative process; jurisdiction over a defendant's personal rights, rather than merely over property interests." BLACK'S LAW DICTIONARY 870 (8th ed. 2004).

⁷³ *See Quill*, 504 U.S. at 308; *see also* *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985); *Shaffer v. Heitner*, 433 U.S. 186, 212 (1977).

⁷⁴ *Quill*, 504 U.S. at 308 (citing *Shaffer*, 433 U.S. at 218 (Stevens, J., concurring)).

⁷⁵ *Id.*

physical presence is therefore not necessary to satisfy the inquiry under the Due Process Clause, and that Quill purposefully directed its activities at North Dakota residents.⁷⁶ Thus, in *Quill* the Due Process Clause did not bar enforcement of North Dakota's use tax.⁷⁷

The Court in *Quill* also discussed the validity of the use tax under the Dormant Commerce Clause.⁷⁸ It applied the four-part test elucidated in *Complete Auto Transit* to Quill's contacts with North Dakota.⁷⁹ It stated that a taxpayer engaged in interstate commerce can be made to pay its fair share of state taxes so long as it satisfies the four prongs of the *Complete Auto Transit* test.⁸⁰ The Court went on to note that had *Bellas Hess* been decided at this time, contemporary Commerce Clause jurisprudence might have dictated a different outcome, but the Court also asserted that *Bellas Hess* is not inconsistent with *Complete Auto Transit*.⁸¹ The *Complete Auto Transit* test in part reflects the Court's concern about unduly burdensome state regulations.⁸² Therefore, the Court found that the substantial nexus requirement of the *Complete Auto Transit* test is not, like due process's minimum contacts requirement, "a proxy for notice, but rather a means for limiting state burdens on interstate commerce."⁸³ Because the two clauses address different concerns, it is possible for a corporation to have the minimum contacts necessary as required by the Due Process Clause and still lack the substantial nexus with the state as required by the Commerce Clause.⁸⁴ Substantial nexus, therefore, requires something more than minimum contacts.⁸⁵

The Court indicated that Quill's situation was one in which the corporation had sufficient minimum contacts to justify the tax under the Due Process Clause, yet lacked the substantial nexus necessary to satisfy the Commerce Clause.⁸⁶ Therefore, it disagreed with North Dakota, and did not conclude that *Bellas Hess* should be overturned, despite its holding that physical presence within a state is necessary for a

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *See id.* at 309.

⁷⁹ *See Quill*, 504 U.S. at 310.

⁸⁰ *See id.* at 310 n.5.

⁸¹ *Id.* at 311.

⁸² *See id.* at 313.

⁸³ *Id.*

⁸⁴ *Quill*, 504 U.S. at 313.

⁸⁵ Ervin, *supra* note 10, at 537; *see Quill*, 504 U.S. at 313.

⁸⁶ *See Quill*, 504 U.S. at 313.

tax on interstate commerce to be valid.⁸⁷ The Court concluded that although its Commerce Clause jurisprudence now favors a more flexible balancing approach, there are benefits to maintaining a bright-line physical presence rule described in cases such as *Bellas Hess*.⁸⁸ The bright-line rule of *Bellas Hess* advances the ends of the Dormant Commerce Clause by preventing undue burdens on interstate commerce.⁸⁹ The Court explained that undue burdens on interstate commerce may be avoided both by a case-by-case analysis of the burden imposed by a certain tax, but also by exempting a discrete realm of commercial activity from interstate taxation.⁹⁰ The justification for maintaining a bright-line rule is its clarity for both the states and corporations, encouraging settled expectations, and fostering investment by businesses and individuals.⁹¹

In *Quill*, the Court stated that the fact that a few of Quill's floppy disks were located in North Dakota did not allow North Dakota to meet the substantial nexus requirement of the Commerce Clause test because the contact between Quill and North Dakota was de minimus.⁹² Due to the lack of direct physical connection between Quill and North Dakota, the Court concluded that North Dakota's imposition of the use tax on Quill was unconstitutional under the Dormant Commerce Clause.⁹³ The Court, however, was ambiguous about whether the physical presence requirement extends to taxes other than sales and use taxes.⁹⁴ Since *Quill*, the Court has declined to grant certiorari to any state tax case petitions on this issue.⁹⁵

Whether *Quill*'s holding extended to other types of taxes was tested soon afterwards in *Geoffrey, Inc. v. South Carolina Tax Commission* (*Geoffrey I*), decided by the Supreme Court of South Carolina in 1993.⁹⁶ *Geoffrey* was a wholly-owned, second-tier subsidiary of Toys "R" Us, Inc., incorporated and headquartered in Delaware.⁹⁷ *Geoffrey* did not

⁸⁷ See *id.* at 314.

⁸⁸ *Id.*

⁸⁹ *Id.* at 314–15.

⁹⁰ See *id.*

⁹¹ *Quill*, 504 U.S. at 315–16.

⁹² *Id.* at 315 n.8.

⁹³ See *id.* at 319.

⁹⁴ See *id.* at 314, 317; *Geoffrey I*, 437 S.E.2d at 18 n.4; Swain, *supra* note 1, at 337.

⁹⁵ See generally *Lanco, Inc. v. Dir., Div. of Taxation (Lanco II)*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S. Ct. 2973 (2007); *A & F Trademark*, 605 S.E.2d 187, *cert. denied*, 126 S. Ct. 353 (2005); *Geoffrey I*, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993); *Tax Comm'r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006), *cert. denied*, 127 S. Ct. 2997 (2007).

⁹⁶ See 437 S.E.2d at 18.

⁹⁷ *Geoffrey I*, 437 S.E.2d at 15.

have any employees or offices in South Carolina.⁹⁸ In 1984 Geoffrey became the owner of several valuable trademarks and trade names of Toys "R" Us, including the name, "Toys 'R' Us."⁹⁹ In an arrangement typical of such intangible holding companies, Geoffrey licensed the use of the trademarks and trade names to Toys "R" Us in exchange for a percentage royalty of Toys "R" Us's net sales.¹⁰⁰ This arrangement created what has been dubbed "nowhere income," because the royalty income paid to Geoffrey is never taxed due to Delaware's lack of an income tax imposition on royalties.¹⁰¹ The agreement also benefited Toys "R" Us because they were able to lower their taxable income through royalty payments to Geoffrey.¹⁰² The effectiveness of the strategy was undeniable: in 1990, Geoffrey, without any full-time employees, had an income of approximately \$55 million and paid no income taxes anywhere.¹⁰³ The South Carolina Tax Commission ultimately concluded that Geoffrey was required to pay income taxes on its royalty income.¹⁰⁴

The South Carolina Supreme Court assessed the validity of the income tax by examining it under the Due Process and Commerce Clause rubrics set out by the U.S. Supreme Court in *Quill*.¹⁰⁵ The state court held that the nexus requirement of the Due Process Clause can be satisfied where a corporation has no physical presence in the taxing state so long as the corporation has purposefully directed its activity at the state's economy.¹⁰⁶ Thus, by choosing to license its trademarks and trade names for use by Toys "R" Us in numerous states, the South Carolina Supreme Court found that Geoffrey "contemplated and purposefully sought the benefit of economic contact with those states."¹⁰⁷

Geoffrey also satisfied the due process requirement because its intangibles were located in South Carolina.¹⁰⁸ Geoffrey argued that the intangibles were situated at its corporate headquarters in Delaware, but the South Carolina Supreme Court rejected that argument, following instead the view of the U.S. Supreme Court in *Mobil Oil Corp. v. Commissioner of Taxes*, which found that intangibles do not need to be allocated

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *See id.* at 15 n.1.

¹⁰² *See Geoffrey I*, 437 S.E.2d at 15.

¹⁰³ *Id.* at 15 n.1.

¹⁰⁴ *Id.* at 15.

¹⁰⁵ *See id.* at 16-18.

¹⁰⁶ *Id.* at 16.

¹⁰⁷ *Geoffrey I*, 437 S.E.2d at 16.

¹⁰⁸ *Id.*

to a single situs.¹⁰⁹ Geoffrey further argued that South Carolina did not confer any benefits on the corporation to which the income tax could be rationally related.¹¹⁰ The court disagreed.¹¹¹ It held that the real source of Geoffrey's income in South Carolina was the state's Toys "R" Us customers, and that by providing an orderly society in which Toys "R" Us conducts business, South Carolina made it possible for Geoffrey to earn income pursuant to the royalty agreement.¹¹² The fact that Geoffrey earned income in South Carolina was evidence of the protection, benefits, and opportunities granted to it by South Carolina, and because the state seeks only to tax that portion of Geoffrey's income generated within the state, the tax is rationally related to the advantages of doing business in the state.¹¹³ The combination of purposeful direction, possession of intangibles in South Carolina, and a rational relationship between the company's activities and the tax levied on it, led the South Carolina Supreme Court to hold that the Due Process Clause test had been satisfied.¹¹⁴

In addition to disputing the constitutionality of the income tax under the Due Process Clause, Geoffrey advanced a Commerce Clause argument under the *Complete Auto Transit* test, which requires a substantial nexus with the taxing state.¹¹⁵ In its argument, Geoffrey relied on *Quill*, stating that it did not have a substantial nexus with South Carolina because it was not physically present in the state.¹¹⁶ The court disagreed with Geoffrey, distinguishing *Bellas Hess* from the case at issue because that case only applied to sales and use taxes, and not to income taxes.¹¹⁷ Therefore, the court held that by licensing intangibles for use in South Carolina and deriving income from their use there, Geoffrey had a substantial nexus with South Carolina, and the income tax was constitutional.¹¹⁸ An economic presence was sufficient for a finding of substantial nexus.¹¹⁹

¹⁰⁹ *Id.* at 17; see *Mobil Oil Corp. v. Comm'n of Taxes*, 445 U.S. 425, 445 (1980) (holding that a corporation organized under the laws of New York, but doing business in many states, including Vermont, may have its intangible property located in more than one state).

¹¹⁰ See *Geoffrey I*, 437 S.E.2d at 17.

¹¹¹ See *id.* at 18.

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.* at 17-18.

¹¹⁵ See *Geoffrey I*, 437 S.E.2d at 18.

¹¹⁶ See *id.*

¹¹⁷ See *id.* at 18 & n.4.

¹¹⁸ *Id.* at 18.

¹¹⁹ See *id.*

B. *Recent Applications of Substantial Nexus*

A number of recent state tax cases have held in favor of the states' power to tax the income of out-of-state corporations based on the corporation's economic presence in the state.¹²⁰ In *America Online, Inc. v. Johnson*, decided by the Appeals Court of Tennessee in 2002, Tennessee sought to tax America Online even though it did not own or lease any real property in Tennessee and did not have any regular employees in the state.¹²¹ The America Online service, however, was provided to Tennessee residents through modems and other component parts located in Tennessee.¹²² The Appeals Court of Tennessee decided that this case had entirely to do with the first prong of the *Complete Auto Transit* test, which requires a substantial nexus between the taxpayer corporation and the taxing state.¹²³ The Tennessee court interpreted prior U.S. Supreme Court decisions as rejecting state taxes on interstate commerce "where no activities had been carried on in the taxing state on the taxpayer's behalf."¹²⁴ Furthermore, the Tennessee court held that the activity being taxed must itself have a substantial nexus with the state.¹²⁵ The court found that there were a substantial number of businesses operating in Tennessee helping to make America Online available to Tennessee customers, and therefore the activities conducted on America Online's behalf could be more than de minimus.¹²⁶ The court, however, concluded that the record developed by the Chancery Court was incomplete and as a result, the question of whether America Online's nexus with the state satisfied the substantial nexus prong of the *Complete Auto Transit* test was still unresolved, and the case was remanded for resolution of that question.¹²⁷

In *Kmart Properties, Inc. v. Taxation and Revenue Department*, decided by the Appeals Court of New Mexico in 2001, Kmart Properties, Inc. ("KPI"), a wholly-owned Michigan subsidiary of Kmart Corporation, challenged New Mexico's assessment of a corporate income tax upon

¹²⁰ See generally *Lanco II*, 908 A.2d 176; *Kmart Corp. v. Taxation & Revenue Dep't*, 131 P.3d 22 (N.M. 2005); *A & F Trademark*, 605 S.E.2d 187; *Geoffrey II*, 132 P.3d 632; *MBNA*, 640 S.E.2d 226.

¹²¹ 2002 WL 1751434, at *1.

¹²² *Id.* at *1-2.

¹²³ *Id.* at *2.

¹²⁴ *Id.*

¹²⁵ *Id.* at *3.

¹²⁶ See *Am. Online*, 2002 WL 1751434, at *3.

¹²⁷ *Id.* at *4.

royalties paid by Kmart Corporation to KPI.¹²⁸ KPI and Kmart Corporation had a royalty and licensing arrangement similar to the one at issue in *Geoffrey I.*¹²⁹ Kmart Corporation created KPI for the purpose of holding title to and managing the trademarks, tradè names, and service marks originally developed and used by Kmart Corporation.¹³⁰

KPI was a typical passive investment company ("PIC").¹³¹ A passive investment company is a tax-planning device whereby a corporation sets up a holding company and transfers all of the corporation's valuable intangible property to the holding company in a tax-free transaction.¹³² The holding company is known as a passive investment company, or PIC, and is usually incorporated in a state where it will not be subject to income taxation.¹³³ The PIC then licenses the intangible property back to the corporation in exchange for royalty payments, and the corporation may then use the intangible property wherever it sees fit.¹³⁴ Kmart Corporation transferred all the intellectual property to KPI, and then licensed it back for use in exchange for a royalty payment to KPI.¹³⁵

New Mexico's income tax laws allowed Kmart Corporation to take a business deduction for royalty payments made to KPI, which reduced, and in some years, altogether eliminated Kmart Corporation's income tax liability in New Mexico.¹³⁶ Meanwhile, because KPI paid state taxes only in Michigan, which does not tax income from royalty payments, the New Mexico Department of Taxation and Revenue calculated that during the tax assessment period at issue in *Kmart Properties, Inc.*, KPI earned royalty income in excess of \$2 million per year from conducting business in New Mexico, and that revenue was never taxed anywhere.¹³⁷

¹²⁸ 131 P.3d at 30 (N.M. Ct. App. 2001), *cert. granted*, 40 P.3d 1008 (N.M. 2002), *cert. quashed*, 131 P.3d 22 (N.M. 2005) (quashing certiorari on the corporate income tax issues and ordering the Appeals Court decision to be filed concurrently with the filing of the Supreme Court decision).

¹²⁹ *See id.*

¹³⁰ *Id.*

¹³¹ *See id.*

¹³² *See Fatale supra* note 2, at 135 (describing the general PIC transaction); 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. L. SCI. & TECH. 789, 800–01 (2005) (detailing the formation of a PIC).

¹³³ *See Fatale, supra* note 2, at 135; Olson, *supra* note 132, at 800–01.

¹³⁴ *See Fatale, supra* note 2, at 135; Olson, *supra* note 132, at 800–01.

¹³⁵ *See Kmart Props.*, 131 P.3d at 30–31.

¹³⁶ *Id.* at 31.

¹³⁷ *Id.*

The court held that KPI established and maintained sufficient minimum contacts with New Mexico to satisfy the requirements of the Due Process Clause.¹³⁸ As for the Commerce Clause analysis, the court acknowledged that the standard it imposes is more demanding than the standard under the Due Process Clause.¹³⁹ After an examination of the *Quill* and *Bellas Hess* decisions, the court in *Kmart* decided not to extend the *Quill* and *Bellas Hess* analyses to income taxes, because it concluded that income taxes are not sufficiently similar to the sales and use taxes discussed in *Quill* and *Bellas Hess*, and therefore, a physical presence standard should not apply to them.¹⁴⁰ Although the court did not attempt to differentiate the substantial nexus requirements from the minimum contacts requirements, it concluded that the use of KPI's marks in New Mexico, for the purpose of generating income for KPI, established a sufficient nexus between the income and the state to justify the imposition of an income tax.¹⁴¹ After initially granting certiorari, the Supreme Court of New Mexico quashed certiorari for all issues relating to the corporate income tax, and ordered that the Appeals Court decision be filed concurrently with its decision on the other issues.¹⁴²

In 2004 in *A & F Trademark, Inc. v. Tolson*, the Court of Appeals of North Carolina reaffirmed the economic presence standard for the Commerce Clause analysis.¹⁴³ A & F Trademark, a wholly-owned subsidiary corporation of The Limited, Inc., appealed the assessment of corporate income taxes imposed on it by North Carolina.¹⁴⁴ The Limited was engaged in the retail sale of clothing and accessories through separate operating subsidiaries, nine of which were operating in North Carolina.¹⁴⁵ A & F Trademark had a royalty and licensing agreement with The Limited, much like the one between Geoffrey and Toys "R" Us in *Geoffrey I*.¹⁴⁶ In a typical PIC transaction, the taxpayer, A & F Trademark, was incorporated in Delaware and The Limited transferred cer-

¹³⁸ *Id.* at 34.

¹³⁹ *Id.*

¹⁴⁰ See *Kmart Props.*, 131 P.3d at 35-36.

¹⁴¹ *Id.* at 36.

¹⁴² *Kmart Corp.*, 131 P.3d at 23.

¹⁴³ See 605 S.E.2d at 195.

¹⁴⁴ *Id.* at 189.

¹⁴⁵ *Id.* The nine retail companies were The Limited Stores, Inc., Cacique, Inc., Express, Inc., Lane Bryant, Inc., Lerner, Inc., Limited Too, Inc., Structure, Inc., Victoria's Secret, Inc., and Abercrombie & Fitch. *Id.* at 189 n.1.

¹⁴⁶ See *id.* at 189.

tain trademarks to the taxpayer.¹⁴⁷ North Carolina sought to levy a tax on the income earned by A & F Trademark and the other taxpayers through the use of their intellectual property in the state.¹⁴⁸

A & F Trademark argued that the presence of its intangible property in North Carolina was irrelevant in light of its lack of physical presence in the state.¹⁴⁹ The court rejected A & F Trademark's arguments, holding that the physical presence standard expounded by the U. S. Supreme Court in *Bellas Hess* and *Quill* did not apply to income taxes because the two types of taxes are not analogous in either substance or result to the corporate income taxes at issue in *A & F Trademark*.¹⁵⁰ The court held that in this situation, where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the state sufficient to satisfy the Commerce Clause.¹⁵¹ Therefore, the court upheld the income tax on the basis of A & F Trademark's economic presence in North Carolina.¹⁵²

Economic presence was also upheld in *Geoffrey, Inc. v. Oklahoma Tax Commission* ("*Geoffrey II*"), decided by the Civil Appeals Court of Oklahoma in 2006, where Geoffrey once again appealed an income tax, this time in Oklahoma.¹⁵³ The income tax in this case was imposed on Geoffrey's royalties received from the licensing of its intangible property in the state.¹⁵⁴ Geoffrey was a Delaware corporation and had no physical presence in Oklahoma.¹⁵⁵ Geoffrey argued once again for a physical presence standard, but the Court of Civil Appeals of Oklahoma disagreed and held that the physical presence standard did not apply to income taxes.¹⁵⁶ Furthermore, the court agreed with the South Carolina court's decision in *Geoffrey I* that by licensing intangibles for use in the state and deriving income from their use there, Geoffrey had a substantial nexus with the state.¹⁵⁷ The court went on to explain that taxation based on the presence of intangibles in the state did not unduly burden interstate commerce because the

¹⁴⁷ See *id.*

¹⁴⁸ See *A & F Trademark*, 605 S.E.2d at 190.

¹⁴⁹ *Id.* at 193.

¹⁵⁰ See *id.* at 194-95.

¹⁵¹ *Id.* at 195.

¹⁵² See *id.*

¹⁵³ See 132 P.3d at 633.

¹⁵⁴ *Id.*

¹⁵⁵ *Id.* at 634.

¹⁵⁶ See *id.* at 637.

¹⁵⁷ See *id.*

benefits, protections, and opportunities that the state provided Geoffrey justified the imposition on it.¹⁵⁸ Therefore, the income tax against Geoffrey's royalty income was upheld.¹⁵⁹

In *Lanco, Inc. v. Director, Division of Taxation*, decided by the Supreme Court of New Jersey in 2006, New Jersey joined the ranks of states endorsing the economic presence standard.¹⁶⁰ The issue in that case was whether New Jersey could constitutionally subject an out-of-state corporation to the state's "Corporation Business Tax" when that corporation lacked physical presence in New Jersey but derived income through a licensing agreement with a company conducting retail operations in New Jersey.¹⁶¹ In *Lanco*, a Delaware corporation with no real property or offices in New Jersey, held and licensed trademarks and trade names to Lane Bryant, a clothing retailer with stores in New Jersey.¹⁶² The New Jersey Supreme Court affirmed the lower court's decision holding that the U. S. Supreme Court did not intend to create a universal physical presence standard for state taxation under the Commerce Clause.¹⁶³ The court explained that the requirement for a substantial nexus is not the same as the physical presence requirement set out in *Bellas Hess*.¹⁶⁴ Thus, the court upheld the Corporation Business Tax as applied to *Lanco*.¹⁶⁵

West Virginia was added to the list of states endorsing the economic presence standard when in 2006, the Supreme Court of Appeals affirmed a lower court ruling against MBNA America Bank in *Tax Commissioner v. MBNA America Bank, N.A.*¹⁶⁶ MBNA was an out-of-state corporation, which had its principal place of business and commercial domicile in Delaware.¹⁶⁷ During 1998 and 1999, the two tax years in question, MBNA had no real or tangible personal property and no employees located in West Virginia.¹⁶⁸ The principal business of MBNA is issuing and servicing Visa and MasterCard credit cards, including the extension of unsecured credit to customers who used those credit

¹⁵⁸ See *Geoffrey II*, 132 P.3d at 638-39.

¹⁵⁹ *Id.*

¹⁶⁰ See *Lanco II*, 908 A.2d at 177.

¹⁶¹ *Id.* at 176. The New Jersey Corporate Business Tax is a franchise tax for the privilege of doing business in New Jersey. Olson, *supra* note 132, at 810 n.142.

¹⁶² *Lanco, Inc. v. Dir., Div. of Taxation (Lanco I)*, 879 A.2d 1234, 1236 (N.J. 2005).

¹⁶³ *Lanco II*, 908 A.2d at 177.

¹⁶⁴ See *id.*; see also *Bellas Hess*, 386 U.S. at 758.

¹⁶⁵ *Lanco II*, 908 A.2d at 177.

¹⁶⁶ See *MBNA*, 640 S.E.2d at 236; *Steager v. MBNA Am. Bank*, No. 04-AA-157, slip op. at 11 (W. Va. Cir. Ct. June 27, 2005).

¹⁶⁷ *MBNA*, 640 S.E.2d at 227.

¹⁶⁸ *Id.*

cards.¹⁶⁹ MBNA promoted its business in West Virginia via mail and telephone solicitation.¹⁷⁰

The sole issue before the court in *MBNA America Bank* was whether the application of West Virginia's business franchise and income taxes to MBNA, a business with no physical presence in the taxing state, violated the Commerce Clause.¹⁷¹ The court concluded that *Quill's* physical presence requirement for substantial nexus applies only to sales and use taxes and not to business franchise and corporate net income taxes.¹⁷² The court explained that when *Bellas Hess* was decided, it was generally necessary that an entity have some sort of physical presence in a state in order to do business in that state, but that this was no longer the case.¹⁷³ The growth and ubiquity of electronic commerce in the current economy made it possible for a corporation to have a significant economic presence in a state without having any physical presence there.¹⁷⁴ Therefore, a strict application of a physical presence standard was a poor indicator of a corporation's nexus with a particular state.¹⁷⁵

The court in *MBNA America Bank* went on to suggest a significant economic presence test for substantial nexus in lieu of a physical presence standard.¹⁷⁶ The Commerce Clause analysis under this test would require an examination of the frequency, quantity, and systematic nature of a taxpayer's economic contacts with a state.¹⁷⁷ Under the Commerce Clause analysis, a taxpayer's exploitation of the state's markets must be greater in degree than under the Due Process standard so that its economic presence can be characterized as significant or substantial.¹⁷⁸

Looking at the facts of the case, the court in *MBNA America Bank* found that MBNA continuously and systematically engaged in direct mail and telephone solicitation in West Virginia.¹⁷⁹ Additionally, in the tax years at issue, MBNA had significant gross receipts attributable to West

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 229.

¹⁷² *MBNA*, 640 S.E.2d at 232.

¹⁷³ *Id.* at 234.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *MBNA*, 640 S.E.2d at 234.

¹⁷⁸ *Id.* at 235; see *Quill*, 504 U.S. at 313.

¹⁷⁹ 640 S.E.2d at 235.

Virginia customers in the amounts of \$8,419,431 and \$10,163,788.¹⁸⁰ The court concluded that MBNA America Bank's systematic and continuous business activity in the state produced significant income attributable to its West Virginia customers, and therefore, MBNA America had an economic presence sufficient for a finding of substantial nexus.¹⁸¹

Although the majority of state cases have found that an economic presence is sufficient to support a state franchise and excise tax against a nondomiciliary corporation, the Court of Appeals of Tennessee came to the opposite conclusion in *J.C. Penney National Bank v. Johnson* in 1999.¹⁸² J.C. Penney National Bank ("JCPNB") was a federally chartered national banking association incorporated in Delaware, with its principal place of business in Delaware.¹⁸³ Through its Delaware offices, JCPNB offered consumer banking services such as deposit accounts, home mortgage lending, general consumer loans, and ATM services.¹⁸⁴ In addition, JCPNB engaged in credit card lending through the issuance of Visa and MasterCard credit cards.¹⁸⁵ JCPNB contracted with its parent company, the J.C. Penney Company, to perform various marketing and processing services that were necessary to create and maintain JCPNB's credit card business, and the J.C. Penney Company in turn contracted with other companies to provide many of those services.¹⁸⁶ One of the contractors provided data processing, while another engaged in marketing activities such as sending out credit card account solicitations through the mail to potential customers throughout the United States, including in Tennessee.¹⁸⁷ Other than the solicitations that were mailed to Tennessee residents, none of the company's other activities occurred in Tennessee.¹⁸⁸ Furthermore, all the entities involved in JCPNB's credit card operation were located outside of Ten-

¹⁸⁰ *Id.* at 236. In 1998 these revenues resulted in a West Virginia Business Franchise Tax of \$32,010 and a West Virginia Corporation Net Income Tax of \$168,034. For 1999, MBNA paid a Business Franchise Tax of \$42,339 and a Corporation Net Income Tax of \$220,897. *Id.* at 228.

¹⁸¹ *Id.* at 236.

¹⁸² See 19 S.W.3d at 842. *But see Lanco II*, 908 A.2d at 177; *Kmart Props.*, 131 P.3d at 36; *A & F Trademark*, 605 S.E.2d at 195; *Geoffrey II*, 132 P.3d at 638; *MBNA*, 640 S.E.2d at 234.

¹⁸³ *J.C. Penney*, 19 S.W.3d at 832.

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *Id.* at 833.

¹⁸⁷ *Id.*

¹⁸⁸ *J.C. Penney*, 19 S.W.3d at 833. There was no solicitation that specifically targeted Tennessee residents. *Id.* at 833 n.4.

nessee and JCPNB did not maintain any offices or employees in the state.¹⁸⁹

JCPNB's sole question to the court was whether its relationship with Tennessee satisfied the substantial nexus requirement of the Commerce Clause.¹⁹⁰ JCPNB contended that its contacts with Tennessee did not provide a sufficient nexus under the Commerce Clause to sustain the franchise and excise taxes that the Commissioner of Revenue imposed upon it for doing business in the state.¹⁹¹ The court noted that the substantial nexus requirement is a means for limiting state burdens on interstate commerce, but that there is not a specific point at which substantial nexus exists.¹⁹² The court, however, explained that to satisfy the substantial nexus requirement the company's level of presence in a state must be more than merely doing business in the state.¹⁹³ The court rejected the Commissioner's argument that the physical presence of the JCPNB credit cards in Tennessee constituted a basis for finding a substantial nexus, because it noted that although a credit card is tangible, its presence is not constitutionally significant in that it simply represents the customer's right to charge goods and services and is not actually necessary to the transaction.¹⁹⁴ Additionally, the court rejected the Commissioner's argument that the presence of J.C. Penney retail stores in Tennessee created a substantial nexus, because it found that the retail stores were not affiliated with JCPNB's Visa and MasterCard credit card operations.¹⁹⁵ The court also stated that the activities that allowed JCPNB to conduct its credit card operation did not occur in Tennessee.¹⁹⁶ The court noted that the solicitation of accounts was the most important activity for the maintenance of JCPNB's business and held that because the solicitation of accounts took place through the mail, the solicitation was protected under *Quill* and was not enough for a finding of substantial nexus.¹⁹⁷ Overall, the court failed to find that substantial nexus requirement necessary to sustain the tax under the Commerce Clause, thereby endorsing a physical presence standard.¹⁹⁸

¹⁸⁹ *Id.* at 833.

¹⁹⁰ *Id.* at 835.

¹⁹¹ *Id.* The total amount of taxes assessed against JCPNB was \$178,314. *Id.* at 834.

¹⁹² *Id.* at 838.

¹⁹³ See *J.C. Penney*, 19 S.W.3d at 839.

¹⁹⁴ *Id.* at 840.

¹⁹⁵ See *id.* at 841.

¹⁹⁶ *Id.* at 841-42.

¹⁹⁷ *Id.* at 841.

¹⁹⁸ See *J.C. Penney*, 19 S.W.3d at 842. Three years later, the Court of Appeals of Tennessee clarified its position in *J.C. Penney in America Online*. See *Am. Online*, 2002 WL 1751434,

II. A POSITIVE ANALYSIS OF SUBSTANTIAL NEXUS

A few overarching principles may be gleaned from the substantial nexus decisions discussed so far.¹⁹⁹ One such principle is that a tax on an interstate activity may be sustained against a Commerce Clause challenge if it fulfills the four requirements set out by the U.S. Supreme Court in *Complete Auto Transit v. Brady* in 1977.²⁰⁰ The first prong of the test requires that the taxed activity have a substantial nexus with the taxing state.²⁰¹ In *Quill Corp. v. North Dakota*, decided in 1991, the Supreme Court held that substantial nexus requires something more than just minimum contacts.²⁰² The vast majority of state courts that have confronted the issue of substantial nexus have essentially decided in favor of an economic presence standard, but their reasoning has not always been consistent.²⁰³

A. *The Presence of Intangibles as a Justification for Substantial Nexus*

A few state courts have relied on the presence of a corporation's intangible property within the state as a basis for levying corporate income taxes.²⁰⁴ These courts have held that a traditional physical presence, as evidenced by the presence of offices, facilities, employees, or real property, is not necessary when intangible property, such as trademarks or trade names, are being used in the state.²⁰⁵ This reasoning has been used in cases where a corporation contesting the tax is a PIC.²⁰⁶ The presence and use of the intangible property within a

at *2. The court stated that it was "not [its] purpose to decide whether 'physical presence' [was] required under the Commerce Clause," and that the ultimate standard was substantial nexus. *See id.*

¹⁹⁹ *See* *Geoffrey, Inc. v. S.C. Tax Comm'n (Geoffrey I)*, 437 S.E.2d 13, 18 (S.C. 1993); *Am. Online, Inc. v. Johnson*, No. M2001-00927-COA-R3-CV, 2002 WL 1751434, at *3 (Tenn. Ct. App. July 30, 2002); *Tax Comm'r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 234 (W. Va. 2006), *cert. denied*, 127 S. Ct. 2997 (2007).

²⁰⁰ *See* *Quill Corp. v. North Dakota*, 504 U.S. 298, 311 (1991); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); *Geoffrey I*, 437 S.E.2d at 18.

²⁰¹ *Quill*, 504 U.S. at 311; *Complete Auto Transit*, 430 U.S. at 279; *Geoffrey I*, 437 S.E.2d at 18.

²⁰² *Quill*, 504 U.S. at 313; *see* *Geoffrey, Inc. v. Okla. Tax Comm'n (Geoffrey II)*, 132 P.3d 632, 636 (Okla. Civ. App. 2006); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 838 (Tenn. Ct. App. 1999).

²⁰³ *See* *Geoffrey I*, 437 S.E.2d at 18; *Am. Online*, 2002 WL 1751434, at *3; *MBNA*, 640 S.E.2d at 234.

²⁰⁴ *See* *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004); *Geoffrey I*, 437 S.E.2d at 18.

²⁰⁵ *See* *A & F Trademark*, 605 S.E.2d at 195; *Geoffrey I*, 437 S.E.2d at 18.

²⁰⁶ *See* *A & F Trademark*, 605 S.E.2d at 195; *Geoffrey I*, 437 S.E.2d at 18.

state has formed the basis for subjecting the PIC to corporate income taxation in certain cases.²⁰⁷

The presence of intangibles in the state was the justification for the Supreme Court of South Carolina's 1993 decision in *Geoffrey, Inc. v. South Carolina Tax Commission*.²⁰⁸ In that case, Geoffrey was a wholly-owned subsidiary of Toys "R" Us, incorporated and with its principal offices in Delaware.²⁰⁹ In 1984 Toys "R" Us transferred several valuable trademarks and trade names, including "Toys 'R' Us," to Geoffrey and then licensed the use of those marks back to Toys "R" Us for a royalty on the net sales by Toys "R" Us.²¹⁰ This licensing arrangement was very lucrative, because through it Geoffrey earned millions of dollars in income but paid income taxes to no state.²¹¹

Geoffrey relied on *Quill* and contended that it did not have a substantial nexus with South Carolina because it was not physically present in that state.²¹² The court disagreed with Geoffrey, stating that the U.S. Supreme Court in *Quill* had not extended the physical presence standard to taxes other than sales and use taxes.²¹³ The court then stated unequivocally that the presence of intangible property alone is sufficient to establish a nexus.²¹⁴ Therefore, the court held that by licensing intangibles, such as trademarks and trade names, in South Carolina, and deriving income from their use there, Geoffrey had a substantial nexus with South Carolina.²¹⁵

The Court of Appeals of North Carolina used similar reasoning in *A & F Trademark, Inc. v. Tolson* in 2004.²¹⁶ In a typical PIC transac-

²⁰⁷ See *A & F Trademark*, 605 S.E.2d at 195; *Geoffrey I*, 437 S.E.2d at 18.

²⁰⁸ 437 S.E.2d at 18.

²⁰⁹ *Id.* at 15.

²¹⁰ *Id.*

²¹¹ See *id.* at 15 n.1.

²¹² See *Quill*, 504 U.S. at 317; *Geoffrey I*, 437 S.E.2d at 18.

²¹³ See *Geoffrey I*, 437 S.E.2d at 18 n.4.

²¹⁴ *Id.* at 18. Note that there is a difference between a state having jurisdiction over the income generated in that state and jurisdiction over the taxpayer that generates income that state. See 1 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION* 6-54 to -55 (3d ed. Supp. 2006). The situation is analogous to specific versus general jurisdiction in personal jurisdiction jurisprudence. See *id.* If a taxpayer derives income from the use of intangible property in a state, that state may tax the income and enforce the tax by imposing a withholding obligation on the in-state licensees of the intangible property. See *id.* However, the state does not necessarily have general jurisdiction over the taxpayer such that the state can force the taxpayer to pay a direct tax to the state. See *id.* The controversy surrounding substantial nexus centers on the amount of contact a taxpayer must have with a state before the state can force the taxpayer to pay taxes directly to the state. See *id.*

²¹⁵ *Geoffrey I*, 437 S.E.2d at 18.

²¹⁶ 605 S.E.2d at 195.

tion, the taxpayer was incorporated in Delaware, and the parent company, The Limited, transferred certain trademarks to the taxpayer.²¹⁷ North Carolina sought to levy a tax on the income The Limited earned by its use of A & F Trademark and the other taxpayers' intellectual property in the state.²¹⁸

Once again, the taxpayers contended that they did not have a substantial nexus with North Carolina because they had no physical presence in that state.²¹⁹ Therefore, the presence of the taxpayers' intangible property in the state was irrelevant in light of the lack of a physical presence.²²⁰ The court disagreed with the taxpayers, however, and held that where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the state.²²¹ That is, the use of the intangibles in the state creates a substantial nexus.²²²

Although South Carolina and North Carolina have both upheld corporate income taxes based on the presence of intangibles within the state, their reasoning is somewhat suspect because it is based on a theory of *in rem* jurisdiction.²²³ The U.S. Supreme Court disclaimed strict *in rem* jurisdiction in *Shaffer v. Heitner* in 1977, but it did suggest that where the property is the subject of the litigation, such jurisdiction may be appropriate.²²⁴ The Court, however, was concerned with due process and notice in *Shaffer*, and not with substantial nexus.²²⁵ The Court in

²¹⁷ See *id.* at 189.

²¹⁸ See *id.*

²¹⁹ *Id.* at 193.

²²⁰ *Id.*

²²¹ *A & F Trademark*, 605 S.E.2d at 195.

²²² See *id.*

²²³ See HELLERSTEIN & HELLERSTEIN, *supra* note 214, at 6-54 to -55. Jerome and Walter Hellerstein point out that the South Carolina court's suggestion that the mere presence of the intangible property in South Carolina is sufficient to find a substantial nexus is dubious because it is based on a theory of *in rem* jurisdiction, a type of jurisdiction that was repudiated by the U.S. Supreme Court in *Shaffer v. Heitner*. See *id.* at 6-58. Despite the dubious reasoning, however, the Hellersteins do not conclude that the case was wrongly decided, based on the differences between sales and use taxes and income taxes, and based on South Carolina's jurisdiction over Geoffrey's income earned in South Carolina. *Id.* at 6-59. *In rem* jurisdiction is defined as a "court's power to adjudicate the rights to a given piece of property, including the power to seize and hold it." BLACK'S LAW DICTIONARY 869 (8th ed. 2004).

²²⁴ See *Shaffer v. Heitner*, 433 U.S. 186, 207, 209 (1977) (holding that jurisdiction may not be asserted based solely on the presence of the defendant's property in the state where that property is not the subject of the litigation).

²²⁵ See *id.* at 207. The Due Process Clause requires sufficient notice and the Court implicitly held that where a defendant's property in a state is the subject matter of the litiga-

Quill observed that substantial nexus required something more than due process, so perhaps a theory of corporate income taxation based solely on the presence of intangibles within the state will not suffice.²²⁶ The presence of intangibles must be supplemented with something more in order to satisfy the requirements set out in *Quill*.²²⁷

B. Generation of Income as a Justification for Substantial Nexus

Other state courts have provided this “something more” by relying not on any kind of presence in the state, but on the generation of corporate revenue attributable to that state.²²⁸ These courts have held that when the corporation derives income from the use of its intangible property in the state, there exists a substantial nexus sufficient to subject the corporation to income taxes.²²⁹

In 2006 in *Lanco, Inc. v. Director, Division of Taxation* the Supreme Court of New Jersey decided the most recent case regarding the imposition of income taxes on out-of-state PICs.²³⁰ In *Lanco*, the Superior Court Appellate Division noted that the corporation had no physical presence in the state and derived income from a New Jersey source only pursuant to a license agreement with another corporation that conducted a retail business in New Jersey.²³¹ The New Jersey Supreme Court upheld the decision of the Superior Court Appellate Division, finding that physical presence is not a requirement for imposing a corporation business tax.²³²

Neither the lower court nor the Supreme Court discussed the amount of income that *Lanco* derived from its license agreement.²³³ The absence of such discussion implies that any amount of income is

tion, the property provides sufficient contacts with that state to sustain jurisdiction over the defendant. *See id.*

²²⁶ *See Quill*, 504 U.S. at 313.

²²⁷ *See id.*

²²⁸ *See Lanco, Inc. v. Dir., Div. of Taxation*, 908 A.2d 176, 176 (N.J. 2006) (*Lanco II*) (affirming the New Jersey Court of Appeals' decision), *cert. denied*, 127 S. Ct. 2973 (2007); *Kmart Props., Inc. v. Taxation and Revenue Dep't*, 131 P.3d 27, 36 (N.M. Ct. App. 2001), *cert. granted*, 40 P.3d 1008 (N.M. 2002), *cert. quashed*, 131 P.3d 22 (N.M. 2005); *Geoffrey II*, 132 P.3d at 634 (affirming the Oklahoma Tax Commission's finding); *MBNA*, 640 S.E.2d at 236.

²²⁹ *See Lanco II*, 908 A.2d at 176; *Kmart Props.*, 131 P.3d at 36; *Geoffrey II*, 132 P.3d at 634.

²³⁰ 908 A.2d at 177.

²³¹ *Lanco, Inc. v. Dir., Div. of Taxation (Lanco I)*, 879 A.2d 1234, 1235 (N.J. 2005).

²³² *Lanco II*, 908 A.2d at 177; *see Lanco I*, 879 A.2d at 1238.

²³³ *See Lanco II*, 908 A.2d at 176–77; *Lanco I*, 879 A.2d at 1238.

sufficient to create a substantial nexus between the corporation and the taxing state.²³⁴

Other states, however, have required that the income generated in a state be significant or substantial.²³⁵ In 2006 the Civil Appeals Court of Oklahoma in *Geoffrey, Inc. v. Oklahoma Tax Commission (Geoffrey II)* reviewed the very same PIC transaction that was at issue in *Geoffrey, Inc. v. South Carolina Tax Commission (Geoffrey I)*.²³⁶ The facts in both cases were essentially the same.²³⁷ In *Geoffrey II*, the court implicitly affirmed the finding by the Oklahoma Tax Commission that the licensing of Geoffrey intangible property for use within the Oklahoma market establishes substantial nexus.²³⁸ The court explained that taxation based on the royalties earned in the state did not unduly burden interstate commerce.²³⁹ The benefits, protections, and opportunities the state provided Geoffrey justified the imposition on interstate commerce, so long as the income generated by the corporation within the state was substantial.²⁴⁰

The Appeals Court of New Mexico came to a similar conclusion in *Kmart Properties, Inc. v. Taxation and Revenue Department* in 2001.²⁴¹ In that case, KPI was a wholly-owned Michigan subsidiary of Kmart Corporation, and as a PIC it owned and managed intellectual property previously developed by Kmart Corporation.²⁴² Kmart Corporation created KPI for the purpose of holding title to and managing Kmart's trademarks, trade names, and service marks.²⁴³

The court held that the use of KPI's marks by Kmart Corporation within New Mexico's economic market, for the purpose of generating substantial income for KPI, established a sufficient nexus between that income and the legitimate interests of the state and justified the imposition of a state income tax.²⁴⁴ Therefore, the court upheld the imposition of New Mexico's state income tax on KPI's earnings.²⁴⁵ The court

²³⁴ See *Lanco II*, 908 A.2d at 176-17; *Lanco I*, 879 A.2d at 1238.

²³⁵ See *Kmart Props.*, 131 P.3d at 36; *Geoffrey II*, 132 P.3d at 634; *MBNA*, 640 S.E.2d at 236.

²³⁶ See *Geoffrey II*, 132 P.3d at 634; *Geoffrey I*, 437 S.E.2d at 15. Both cases involved Geoffrey, Inc., a PIC established by Toys "R" Us for the purpose of holding Toys "R" Us's intangible property. See *Geoffrey II*, 132 P.3d at 634; *Geoffrey I*, 437 S.E.2d at 15.

²³⁷ See *Geoffrey II*, 132 P.3d at 634; *Geoffrey I*, 437 S.E.2d at 15.

²³⁸ See *Geoffrey II*, 132 P.3d at 634.

²³⁹ See *id.* at 640.

²⁴⁰ See *id.* at 634, 638.

²⁴¹ See *Kmart Props.*, 131 P.3d at 36.

²⁴² *Id.* at 30.

²⁴³ *Id.*

²⁴⁴ *Id.* at 36.

²⁴⁵ *Id.*

distinguished income taxes from the sales and use taxes addressed in *Quill* based on the burdens that each place on interstate commerce and as a result, held that the assessment of state income tax on KPI's royalty revenues was not an undue burden on interstate commerce.²⁴⁶ Once again, the court stated that the amount of income generated in the state by the corporation must be substantial for the taxpayer corporation to have a sufficient nexus with the taxing state.²⁴⁷

In 2006 in *Tax Commissioner v. MBNA America Bank, N.A.*, the Supreme Court of Appeals of West Virginia indicated that a corporation's activity in a state must generate significant income in order for it to be subject to taxation in that state.²⁴⁸ The principal business of MBNA America Bank was issuing and servicing Visa and MasterCard credit cards, including the extension of unsecured credit to customers who used those credit cards.²⁴⁹ MBNA promoted its business in West Virginia via mail and telephone solicitation.²⁵⁰

Instead of using the physical presence standard as the basis for the substantial nexus analysis, the court in *MBNA America Bank* suggested using a significant economic presence test.²⁵¹ The significant economic presence test would require an examination of the frequency, quantity, and systematic nature of a taxpayer's economic contacts with a state.²⁵² For its economic presence to be characterized as significant or substantial under the Commerce Clause, a taxpayer's exploitation of the state's markets must be greater in degree than under the Due Process analysis.²⁵³

Looking at the facts of the case, the court observed that MBNA continuously and systematically engaged in direct mail and telephone solicitation in West Virginia.²⁵⁴ Additionally, in the tax years at issue, MBNA had significant gross receipts attributable to West Virginia cus-

²⁴⁶ See *Kmart Props.*, 191 P.3d at 35, 36. The court distinguished the two types of taxes by explaining that, "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." *Id.* at 35. Additionally, "a state income tax is usually paid only once a year, to one taxing jurisdiction at one rate," whereas "a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates." *Id.*

²⁴⁷ See *id.* at 36.

²⁴⁸ See *MBNA*, 640 S.E.2d at 236.

²⁴⁹ *Id.* at 227.

²⁵⁰ *Id.*

²⁵¹ *Id.* at 234.

²⁵² *Id.*

²⁵³ *MBNA*, 640 S.E.2d at 235; see *Quill*, 504 U.S. at 313.

²⁵⁴ *MBNA*, 640 S.E.2d at 235.

tomers in the amounts of \$8,419,431 and \$10,163,788.²⁵⁵ The court concluded that MBNA America Bank's systematic and continuous business activity in the state produced significant income attributable to its West Virginia customers, which indicated a significant economic presence sufficient for a substantial nexus.²⁵⁶

In *America Online, Inc. v. Johnson*, decided in 2002 by the Appeals Court of Tennessee, the court provided an interesting twist in the substantial nexus debate.²⁵⁷ America Online is an Internet Service Provider and consequently did not have any regular employees in the state, nor did they own or lease any real property there.²⁵⁸ Instead of focusing on the economic or physical presence of America Online in Tennessee, the court in *America Online* observed that substantial nexus exists when activities are being conducted in the taxing state on behalf of the corporation.²⁵⁹ Although the court ultimately remanded the case without ruling on whether America Online had a substantial nexus with Tennessee, the court endorsed a very broad notion of substantial nexus, for very few, if any, businesses can claim that they do not have any businesses in the taxing state helping to make their services available in that state.²⁶⁰

The state courts that have addressed the issue of substantial nexus have relied on several different justifications for finding nexus when a corporation does not have a traditional physical presence in the taxing state.²⁶¹ A finding of a substantial nexus based solely on the presence of intangible property in a state seems too narrow to encompass all the possible types of businesses that may be solely economically present in a state.²⁶² On the other hand, a finding of nexus based on activities being conducted in the state on behalf of the corporation seems too broad as it would encompass almost any conceivable business.²⁶³ If the U.S. Supreme Court were ever to take up this issue again, it would most likely agree with a standard that is in be-

²⁵⁵ *Id.* at 236.

²⁵⁶ *Id.* But see *J.C. Penney*, 19 S.W.3d at 842 (holding, in a very similar fact pattern involving a credit card company, that there was no substantial nexus with the state that would justify the imposition of corporate income taxes, thereby endorsing a physical presence standard).

²⁵⁷ See *Am. Online*, 2002 WL 1751434, at *3.

²⁵⁸ See *id.* at *1.

²⁵⁹ See *id.* at *3.

²⁶⁰ See *id.* at *4.

²⁶¹ See *Lanco II*, 908 A.2d at 176; *Geoffrey I*, 437 S.E.2d at 18; *Am. Online*, 2002 WL 1751434, at *3; *MBNA*, 640 S.E.2d at 236.

²⁶² See *A & F Trademark*, 605 S.E.2d at 195; *Geoffrey I*, 437 S.E.2d at 18.

²⁶³ See *Am. Online*, 2002 WL 1751434, at *3.

tween these two extremes—economic presence based on a significant amount of revenue attributable to the taxing state.²⁶⁴

III. FUTURE APPLICATIONS OF ECONOMIC PRESENCE SUBSTANTIAL NEXUS

Recent state cases addressing substantial nexus for corporate income tax all adopt an economic presence standard instead of a traditional physical presence standard.²⁶⁵ As the economic presence standard is adopted by court after court, the next question becomes whether there is a limit to the economic presence standard and what that limit is? Some of the state court decisions held that a substantial nexus existed based on the presence of a company's intangible property in the taxing state.²⁶⁶ More frequently, however, courts held that a substantial nexus existed when a corporation could attribute a significant amount of income to the taxing state.²⁶⁷ Those decisions pave the way for a number of different types of industries to be taxed by states in which they have an economic presence, but no traditional physical presence.²⁶⁸ Some areas that are likely to be affected by the expansion of this doctrine are the film industry, online retailers of services or intangible property, utilities companies, software companies, and franchising companies.²⁶⁹

²⁶⁴ See *Kmart Props.*, 131 P.3d at 36; *MBNA*, 640 S.E.2d at 236. Although a number of interested parties filed amicus briefs to force the Supreme Court to take notice of the issue, the Court recently denied certiorari to both Lanco and MBNA, who filed certiorari petitions in March 2007, challenging the rulings in New Jersey and West Virginia, respectively. See generally *Lanco II*, 908 A.2d 176, cert. denied, 127 S. Ct. 2973 (2007); *MBNA*, 640 S.E.2d 226, cert. denied, 127 S. Ct. 2997 (2007); John Buhl, *Lanco, MBNA to Petition Supreme Court for Review of Nexus Cases*, 114 TAX NOTES 646 (2007).

²⁶⁵ See, e.g., *Lanco, Inc. v. Dir., Div. of Taxation (Lanco II)*, 908 A.2d 176, 177 (N.J. 2006), cert. denied, 127 S. Ct. 2973 (2007); *Kmart Props., Inc. v. Taxation and Revenue Dep't*, 131 P.3d 27, 36 (N.M. Ct. App. 2001), cert. granted, 40 P.3d 1008 (N.M. 2002), cert. quashed, 131 P.3d 22 (N.M. 2005); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004); *Geoffrey, Inc. v. Okla. Tax Comm'n (Geoffrey II)*, 132 P.3d 632, 634 (Okla. Civ. App. 2006); *Tax Comm'n v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 234 (W. Va. 2006), cert. denied, 127 S. Ct. 2997 (2007).

²⁶⁶ See *A & F Trademark*, 605 S.E.2d at 195; *Geoffrey, Inc. v. S.C. Tax Comm'n (Geoffrey I)*, 437 S.E.2d 13, 18 (S.C. 1993).

²⁶⁷ See *Kmart Props.*, 131 P.3d at 36; *MBNA*, 640 S.E.2d at 236.

²⁶⁸ See *MBNA*, 640 S.E.2d at 234; *Business Tax Hearing*, supra note 26, at 1; Craig J. Langstraat & Emily S. Lemmon, *Economic Nexus: Legislative Presumption or Legitimate Proposition?*, 14 AKRON TAX J. 1, 9 (1999).

²⁶⁹ See *MBNA*, 640 S.E.2d at 234; *Business Tax Hearing*, supra note 26, at 144–46; Langstraat & Lemmon, supra note 268, at 9.

A motion picture company could be taxed in all states where its films or television shows are viewed if the economic presence nexus standard continues to apply.²⁷⁰ For example, if the motion picture company is incorporated in Delaware and distributes its feature films throughout the country for viewing in movie theatres, it is earning income in each of those states, and therefore has an economic presence in those states.²⁷¹ The same is true of direct distributors of movies, such as Netflix, the online entertainment subscription service, which sends rented DVDs to its customers throughout the country by mail.²⁷² Through online rental of films, the company is generating significant income and therefore has a substantial nexus with those states where its customers live.²⁷³ This situation is analogous to some of the PIC cases because there is some property located in the various states in the form of the films themselves, and the significant income generated from the use of those films creates an economic presence in those states.²⁷⁴

Software companies are in a similar situation.²⁷⁵ Computer software is a product that can be distributed using a variety of techniques.²⁷⁶ Copies of computer software can be delivered electronically using the Internet.²⁷⁷ Companies delivering computer software over the Internet are licensing intangible property into all the states in which they do business.²⁷⁸ Therefore, a company could be economically present in all the states where income is generated from the license and use of their intangible property.²⁷⁹ As in some of the PIC cases, the li-

²⁷⁰ See *MBNA*, 640 S.E.2d at 234; *Business Tax Hearing*, *supra* note 26, at 157.

²⁷¹ See *MBNA*, 640 S.E.2d at 234; Viacom, Inc., Annual Report (Form 10-K), at I-14 (Mar. 16, 2006).

²⁷² See *Kmart Props.*, 131 P.3d at 36; *Geoffrey II*, 132 P.3d at 634; Netflix Corporate Factsheet, <http://files.shareholder.com/downloads/NFLX/115849138x0x24776/1F1055CB-DCBB-475A-87CD-03F6091D4901/factsheet.pdf> (last visited Sept. 7, 2007).

²⁷³ See *Kmart Props.*, 131 P.3d at 36; *MBNA*, 640 S.E.2d at 236; Netflix Corporate Factsheet, <http://files.shareholder.com/downloads/NFLX/115849138x0x24776/1F1055CB-DCBB-475A-87CD-03F6091D4901/factsheet.pdf> (last visited Sept. 7, 2007).

²⁷⁴ See *Kmart Props.*, 131 P.3d at 36; *Geoffrey II*, 132 P.3d at 634.

²⁷⁵ See *Business Tax Hearing*, *supra* note 26, at 2; Langstraat & Lemmon, *supra* note 268, at 14.

²⁷⁶ *Business Tax Hearing*, *supra* note 26, at 209.

²⁷⁷ *Id.*

²⁷⁸ See Langstraat & Lemmon, *supra* note 268, at 9. For a variety of legal and business reasons, software companies generally do not "sell" copies of their products to their customers. *Business Tax Hearing*, *supra* note 26, at 209. Instead, they distribute copies of their products subject to a license agreement. *Id.* Therefore, the software company will retain an ownership interest in every one of those copies no matter where the customer chooses to use them. See *id.*

²⁷⁹ See *Kmart Props.*, 131 P.3d at 36; *Geoffrey II*, 132 P.3d at 634; *Business Tax Hearing*, *supra* note 26, at 211.

cense and use of the intangible property in the state, and the generation of significant income from that licensing, could create a substantial nexus with the state.²⁸⁰

Another industry that could be affected by a validation of the economic presence standard is online retailers of services or intangible property.²⁸¹ Any company with a website through which it sells a service or intangible property would have an economic presence in all the states in which it does business, and for many companies, that could be all fifty states.²⁸² It is likely that a court would find that an online retailer of services or intangibles has a substantial nexus with the states in which it does a significant amount of business.²⁸³

Similarly, utility companies could be open to taxation by states in which they simply have an economic presence.²⁸⁴ Since the restructuring of the electric industry, consumers have been able to buy electricity from providers outside of their state.²⁸⁵ These utilities can sell electricity to citizens of a state without having any physical presence in that state.²⁸⁶ The utilities, however, do have an economic presence in the states where they sell electricity based on the income generated from those sales.²⁸⁷ The economic presence of the utility would create

²⁸⁰ See *Kmart Props.*, 131 P.3d at 36; *Geoffrey II*, 132 P.3d at 634.

²⁸¹ See 15 U.S.C. § 381 (2000) (providing a safe harbor from income taxation for online sellers of tangible property, but not for sellers of intangible property or services); *Business Tax Hearing*, *supra* note 26, at 2; Langstraat & Lemmon, *supra* note 268, at 14. An example of an online service retailer is Expedia, Inc., which allows customers to research, plan, and book travel through their online website. Expedia, Inc., Annual Report (Form 10-K), at 2 (Mar. 31, 2006). An example of an online retailer of intangible property is Apple, Inc.'s iTunes Music Store, which is a service that allows customers to find, purchase, and download third-party digital music, audio books, music videos, short films, television shows, movies, and iPod games. Apple, Inc., Annual Report (Form 10-K), at 11 (Dec. 12, 2006).

²⁸² See *Business Tax Hearing*, *supra* note 26, at 2; Langstraat & Lemmon, *supra* note 268, at 14.

²⁸³ See *Kmart Props.*, 131 P.3d at 36; *MBNA*, 640 S.E.2d at 236.

²⁸⁴ See generally MATTHEW H. BROWN & KELLY HILL, *FRANCHISE TAXES AND CORPORATE NET INCOME TAXES IN THE CHANGING ELECTRIC INDUSTRY* (1997), <http://www.ncsl.org/programs/energy/frantaxe.htm>.

²⁸⁵ See *id.* The restructuring provided that consumers in about a dozen states could choose their electricity provider instead of having to rely on the local utility company. See *id.*

²⁸⁶ See *id.* P.L. 86-272 shelters a taxpayer from income taxes if its only interaction with a state is solicitation for the sale of tangible property. See *id.* States are divided on the nature of electricity as tangible personal property. See *id.* If it is tangible personal property, then it is protected under P.L. 86-272, but intangible property or a service is not protected by this law. See *id.*

²⁸⁷ See *id.*

a sufficient nexus for income taxation, provided that the company generates a significant amount of income from the taxing state.²⁸⁸

Franchising companies could also be affected by the adoption of the economic presence standard.²⁸⁹ In the franchise industry, the business relationship between a franchisor and a franchisee is centered on a shared trade identity that is established and maintained by the franchisor's license of its trademarks and other intellectual property to its franchisees.²⁹⁰ These licensing relationships may cross state lines, although the franchisor might not have any physical presence in the states where the franchisees operate.²⁹¹ This relationship is similar to the relationships in the PIC cases because the use of the franchisor's intellectual property in the states where its franchisees are located generates income for the franchisor through royalty payments.²⁹² A significant amount of income is the basis for the franchisor's economic presence in those states where it has franchisees, and therefore creates a substantial nexus with the state.²⁹³ Therefore, those states where a franchisee is located may impose income taxes on the franchisor.²⁹⁴

CONCLUSION

The Commerce Clause requirement of a substantial nexus can be met through an economic presence standard, as state courts have recently held. The economic presence standard seeks to tax those corporations that are deriving income from a state, even if that corporation has no physical presence in the state. In the years since *Complete Auto Transit, Inc. v. Brady* first articulated the concept of substantial nexus, the concept has greatly evolved. Recent state cases have relied on different justifications for imposing taxes on corporations that do not have a traditional physical presence within the state. Although some states have based a finding of a substantial nexus on the presence of intangibles in the state, and other states have relied simply on the fact that the corporation was doing business in the state, the U.S. Supreme Court is likely to find a standard somewhere in between the

²⁸⁸ See *MBNA*, 640 S.E.2d at 236.

²⁸⁹ See *Business Tax Hearing*, *supra* note 26, at 148.

²⁹⁰ *Id.* at 149.

²⁹¹ See *id.*

²⁹² See *id.*; see also *Kmart Props.*, 131 P.3d at 36; *Geoffrey II*, 132 P.3d at 634.

²⁹³ See *Kmart Props.*, 131 P.3d at 36; *Geoffrey II*, 132 P.3d at 634; *MBNA*, 640 S.E.2d at 236; *Business Tax Hearing*, *supra* note 26, at 149.

²⁹⁴ See *Kmart Props.*, 131 P.3d at 36; *Geoffrey II*, 132 P.3d at 634; *MBNA*, 640 S.E.2d at 236; *Business Tax Hearing*, *supra* note 26, at 149.

two if it decides to take up the issue. A standard for a substantial nexus based on a significant amount of income attributable to the state is the likely result, ultimately doing away with any traditional physical presence standard.

An economic presence standard opens the door for state taxation of many types of industries that were previously untouchable. The film industry, software industry, online retailers of services and intangibles, utilities, and franchisors will all be affected by such an expansion of substantial nexus.

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