"THE NEXUS WARS: EPISODE TWO"

Starring Frank Katz, Deputy General Counsel, Multistate Tax Commission (a/k/a Obi-Wan Kenobi) and Michael D. Sontag, Esq., Member, Bass, Berry & Sims, PLC, Nashville, Tennessee (a/k/a Darth Vader).

INTRODUCTION

It has now been 10 years since the United States Supreme Court rendered its decision in Quill Corp. v. North Carolina, 504 U.S. 298 (1992). While the Quill decision brought some level of clarity to the nexus issue in the context of sales and use taxes, the Supreme Court's unwillingness[1] to provide the same level of clarity in the context of corporate income and franchise taxes has left tax administrators and taxpayers alike to search for their answers through protracted state court litigation and, more recently, through legislative initiatives targeted at purported tax "loopholes."

In the context of this continued controversy, the better question might be what should be the nexus standard for corporate income and net worth (or other similar business) taxes. Should Quill's physical presence be the standard, or rather, should some level of "economic presence", without more, be sufficient? Before discussing this issue, a review of the current state of the law will illustrate the perplexing mess that now exists, with states who are already facing budget shortfalls attempting to stretch their jurisdictional boundaries to tax as far as they possibly can.

Until recently, the judicial controversies regarding the proper constitutional nexus standard for income, net worth and other business taxes were rare. Since Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (1997), cert. denied 510 U.S. 992 (1993), only a few courts have squarely held that Quill's physical presence test was inapplicable to income taxes (See, e.g., Kmart Properties, Inc. v. Revenue Department of New Mexico, No. 21,140, (New Mexico Court of Appeals, November 28, 2001), cert. granted, N.M., No. 27,269, 1/9/02 (taxation of royalty payments to trademark/tradename holding company); Camelot v. State Lottery Commission, 659 N.E.2d 1225 (Ohio 1996) (taxation of lottery winnings of nonresident with no physical presence in the state) and Borden Chemicals and Plastics, L.P. v. Zehnder, 726 N.E.2d 73 (Ill. App. Ct. 2000) (limited partner was "physically present" in state by virtue of its ownership of a limited partnership)); while several courts have reached the opposite conclusion. See J.C. Penney National Bank v. Johnson, 19 S.W.3d 831 (Tenn. Ct. App. 1999), cert. denied 121 S.Ct. 305 (200); American On-Line Inc. v. Johnson, No. 97-3786-III (Tenn. Chan. Ct. 2000); Rylander v. Bandag Licensing Corp., 18 S.W.3d 296 (Tax. Ct. App. 2000); Dial Bank, 1998 Ala. Tax LEXIS 196 (Docket No. INC-95-289, F-95-308, August 10, 1998) and Cerro Copper Products, Inc. v. State of Alabama (No. F. 94-444, Admin. Law Div. 12/11/95). More recently, however, this issue has gained significantly more attention from the courts and from the state legislatures in the context of a widespread state tax reduction planning device, the so-called Delaware trademark/tradename holding company. Once again, courts from the various states

---

[1] The United States Supreme Court denied certioreri in Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (19983) cert. Denied 510 U.S. 992 (1993) and in J.C. Penney National Bank v. Johnson , 19 S.W.3d (Jenn. ed. App. 1999), cert. Denied 121 S.Ct. 305 (2000), where two state appellate courts reached contrary decisions on the question of whether the Quill bright-line the physical presence standard for nexus should apply in the context of the corporate income and net with taxes.

that have heard these controversies have failed to see eye-to-eye on the issue, with cases involving precisely the same facts and litigants reaching completely divergent results. A detailed review of these cases follows:

RECENT STATE DEVELOPMENTS REGARDING INTANGIBLE HOLDING COMPANIES

Gore Enterprise Holdings Inc. v. Director of Revenue, No. 99-2856 (Administrative Hearing Commission, State of Missouri, January 3, 2002).

Factual Background. W.L. Gore ("Gore") owned certain patents on a unique polymer used to manufacture various products. Gore formed Holdings as a holding company for its patents, transferred those patents to Holdings in exchange for all of Holdings' stock and then Holdings licensed the patents back to Gore under a licensing agreement. Holdings manages the patent portfolio, collects royalties for the use of the patents, invests the royalty proceeds in various investment vehicles, pays patent fees to various governmental authorities and retains patent counsel as necessary.

Commission's Conclusions. The Commission concluded that Holdings was "doing business in" Missouri because it generated royalty income from Missouri sales. The Commission reasoned that without the Missouri sales, there would be no royalty payments. The Commission rejected the taxpayer's argument that it was not doing business in Missouri because the manufacture of the products, not the sale of such products, generated the obligation to make royalty payments.

Due process was satisfied because the taxpayer "purposefully availed itself of the benefits of Missouri's economic market" by licensing its patents to generate royalty income there. Interstate commerce was not unduly burdened for the same reason. The Commission noted that the Quill Court did not extend the physical presence test to other taxes. Income taxes are different than sales/use taxes because intangibles may earn income in the taxing state even though their owner has no physical presence in the state; accordingly, the Quill physical presence test does not apply to income taxes.

While noting that patents are different than trademarks (which are not separate property rights but integral and inseparable elements of the good will of the business to which they pertain) the Commission found those differences immaterial because they both "produce income in the state where the product is sold." In both situations, without the sales, there would be no royalty income. The Commission proceeded to quote extensively from the trademark cases, *Kmart Properties, Inc*. and *Geoffrey* to further support its conclusions pertaining to the taxpayer's patents.

While not relying on this reasoning, the Commission noted that it "could easily rule" that Gore's business activity in Missouri may be attributed to the taxpayer simply because the two companies were part of a unitary business and were functionally integrated. Thus, Gore's physical presence (it's unclear from the facts just what its presence was other than simply "doing business" there) is attributable to the taxpayer.

Lastly, the Commission concluded that the three-factor apportionment formula did not fairly represent the extent of the taxpayer's business activity in the state so it approved the use of a two factor apportionment formula: sales and payroll.

Acme Royalty Company v. Director of Revenue, No. 99-2839 (Missouri Administrative Hearing Commission, January 3, 2002).

Factual Background. As part of a reorganization, the taxpayer was formed to hold, manage, protect and market the trademarks and trade names of Acme Brick Company ("Acme"). Acme had a sales force and sales offices in Missouri. The taxpayer collected royalties from Acme Brick, and did all the accounting and filing for the related group of companies. Subsequently, the taxpayer formed a limited partnership (the "Partnership") and exchanged all of its trademarks and trade names for 99% of the limited partnership interests in the Partnership. Acme formed a separate corporate subsidiary to serve as the general partner of the Partnership.

Commission's Conclusion. The taxpayer was subject to Missouri income taxes because it earned income in Missouri by licensing its intangible assets for use in Missouri and earning royalty income from the use of the trademarks in Missouri.

Due Process was satisfied where the taxpayer had the power to control the license agreements and thus where the trademarks would be used. By allowing Acme to use the taxpayer's trademark in Missouri to promote sales of Acme's products, the taxpayer was able to generate royalty income the taxation of which would not "offend notions of substantial justice."

The Supreme Court did not explicitly extend the physical presence test to taxes other than sales and use taxes in Quill. Income taxes are different than sales/use taxes because intangibles, such as the trademarks at issue here, may earn income in the taxing state even though the owner has no physical presence in that state. Corporations are mere legal constructs that are not in fact present anywhere; the Commission does "not countenance the use of a mere legal construct to shelter income from taxation in the state from whose revenue stream the income was derived." The Commission thus equated Missouri's "revenue stream" to the Vermont revenue stream that the Supreme Court had allowed Vermont to tax in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 100 S. Ct. 1223 (1980) (holding that a corporate taxpayer conducting no business itself in Vermont was subject to Vermont tax on dividend income the taxpayer received from a unitary subsidiary actually doing business in Vermont).

The Commission quoted extensively from *Kmart Properties Inc.* and *Geoffrey* to support its Due Process and Commerce Clause conclusions. Similar to *Gore,* the Commission noted that it "could easily rule that [Acme's] business activity conducted in Missouri may be attributed to [the taxpayer] and that physical presence is established" solely because Acme and the taxpayer were part of the same unitary business and were functionally integrated.

The Commission concluded that the standard three-factor apportionment formula did not fairly represent the extent of the taxpayer's activities in Missouri because the taxpayer had *de minimis* payroll and property. Thus, those factors were eliminated from the formula.

Kmart Properties, Inc. v. Revenue Department of New Mexico, No. 21,140, (New Mexico Court of Appeals, November 28, 2001).

Factual Background. The taxpayer was a wholly owned subsidiary of Kmart Corp ("Kmart"). The taxpayer owns and manages trademarks previously developed by Kmart. In 1991, Kmart transferred ownership of the marks to the taxpayer, and the two corporations entered into a licensing agreement whereby the taxpayer granted Kmart the exclusive right to use the marks in the U.S. In exchange for this exclusive right, Kmart made royalty payments to the taxpayer based on a percentage of Kmart's gross sales throughout the U.S. The licensing agreement was negotiated, drafted and signed by the parties in Michigan at a time when Kmart owned over twenty stores in New Mexico.

Taxpayer's Position. The taxpayer argued that its corporate business was conducted solely within Michigan and that it lacked any connection to New Mexico.

Court's Conclusions. The court found that imposing an income tax on the taxpayer would satisfy Due Process because the licensing agreement ties the taxpayer to New Mexico and to other states outside of Michigan where Kmart has stores. By allowing its marks to be used throughout the United States, including New Mexico, to generate income, the taxpayer "purposefully availed itself of the benefits" of New Mexico's economic market. The taxpayer took no action to prevent the use of its trademarks in New Mexico, even though it knew the marks were being used there at the time the licensing agreement was executed.

The court further concluded that imposing the gross receipts tax (which the court determined was the functional equivalent to sales and use taxes under Quill) on the taxpayer would not offend the Commerce Clause. The court relied on trademark law to conclude that, unlike patents or copyrights, trademarks are inseparable from the underlying goodwill it represents. When Kmart contractually separated the trademark from the underlying business, the court concluded that Kmart and the taxpayer became inextricably bound to each other. Relying on *Tyler Pipe Industries* and *Scripto*, the court concluded that the Kmart licensees were the representatives of the taxpayer that maintained an extensive apparatus of signs, stores and employees physically present in New Mexico to work on behalf of the taxpayer's goodwill and associated interests. The use of the taxpayer's marks in this fashion has allowed Kmart to personify the goodwill owned by the taxpayer to facilitate merchandise sales in New Mexico.

Lastly, the court held that the Quill physical presence test does not apply to New Mexico's corporate income tax. The court concluded that an income tax was much less burdensome on a taxpayer than a sales and use tax, which can make the taxpayer an agent of the state by obligating it to collect the tax from the consumer at the point of sale. In contrast, an income tax is usually paid once a year to one taxing jurisdiction and at one rate. Thus, these additional burdens on commerce were what the Supreme Court found offensive in Quill, and these burdens simply do not exist in the case of a state income tax.

North Carolina Tax Review Board, Dkt No. 97-990 (May 7, 2002).

Background. Taxpayers, A&F Trademark, Inc., Caciqueco, Inc., Expressco, Inc., Lanco, Inc., Lemco, Inc., Limco, Inc., Limtoo, Inc., Structureco, Inc. and V. Secret Stores, Inc., all wholly-owned subsidiaries of The Limited Stores, Inc. (the "Parent"), own and license trademarks, tradenames, service marks and goodwill associated with those marks to their Parent company and its related retail companies, nine of which are located in North Carolina and operate over 130 retail stores there. The marks owned by the taxpayers were all previously owned by either the Parent or its retail subsidiaries.

Court's Conclusions. On September 19, 2000, the administrative hearing officer concluded that applying the North Carolina income tax against the taxpayers would not violate due process because the taxpayers purposefully directed their business activities toward the North Carolina market and derived an economic benefit from those activities. The officer agreed with the Department that the taxpayers controlled the decision whether, to whom and where they would license their marks.

The officer further concluded that the tax did not violate the Commerce Clause because the taxpayers extensively use their intangible property in the state through licensing agreements with their related retail companies, the related retail companies perform activities in the state on the taxpayers' behalf that are attributed to and inure to the benefit of the taxpayers, and the taxpayers exercise actual control in fact over the use of the marks by the related retail companies in the state. The officer cited *Tyler Pipe Industries* to support its conclusion that the activities of the retail stores' employees should be attributed to the taxpayers because these activities are necessary to preserve the existence of the taxpayers' marks and the activities were performed to fulfill taxpayers' obligation under trademark law. The officer also found that the trademarks, as intangible property, has also acquired a business situs in North Carolina under *Wheeling Steel Corp. v. Fox,* 298 U.S. 193 (1936) because they were used there. The officer also expressed the opinion that the Quill physical presence test does not extend to state income taxes.

The officer relied heavily on trademark law to support these conclusions. The officer noted that under trademark law principles, unless the taxpayers exercised actual control over the use of trademarks by its licensees in North Carolina, the taxpayer would have been deemed to abandon its trademarks. If the taxpayers exercised sufficient control "in fact" over the licensees, however, the use of the marks would not have been abandoned. Because the taxpayers had no employees, they had to rely on their licensee's to control the use of the trademarks. Furthermore, under trademark law, the taxpayers' property cannot exist apart from an established business in which it is used.

In its appeal before the Tax Review Board, the taxpayer first argued that the North Carolina legislature's enactment of anti-PIC legislation in 2001 (Session Law 2001) indicated that the legislature did not intend to subject those types of companies to tax before 2001. The Board rejected this argument stating that it "finds no merit in Taxpayer's argument that until the enactment of recent legislation, the statute did not authorize the taxation of the Taxpayers." With respect to the taxpayers argument that the constitution required physical presence in the state to subject the taxpayers to an income tax, the Tax Review noted that, as an administrative body, it lacked jurisdiction to rule on constitutional issues. The Board then affirmed the hearing officer's opinion in its entirety.

The Sherwin-Williams Company: *In re the Petition of The Sherwin-Williams Company*, N.Y. Div. Tax App., Admin. Law Judge Unit, DTA No. 816712 (June 7, 2001); *Sherwin Williams Co. v. Commissioner of Revenue*, Mass. App. Tax Bd., No. F233560 (July 19, 2000).

Background. Taxpayer intangible holding companies ("IHC") own and license trademarks, tradenames, service marks and goodwill associated with those marks to their parent company, The Sherwin-Williams Company ("SW"), and its related retail companies. Both New York and Massachusetts were presented with almost identical facts but interpreted those facts in vastly different manners.

New York Decision. The Department sought to force the IHC to file a combined return with SW. Because there were substantial intercorporate transactions between SW and IHC, there was a presumption that filing separate returns distorted the parties' New York taxable income, unless the parties could establish that all transactions among them were at arm's length. In finding that SW had rebutted the presumption that IHC and SW should file a combined return, the ALJ determined that (1) all royalties were paid at arms length prices, (2) all interest charges were at arm's length rates, and (3) all rates charged for trademark services were at arm's length. The ALJ concluded that the taxpayers were free to structure their business affairs as they choose, including the use of any legal corporate structure to minimize state taxes. Key to the decision was the ALJ's determination that IHC carried out substantial business in their own names, including actively managing and protecting the trademarks and pursuing trademark violations.

The ALJ determined that an overlap of only 2 of 4 directors between SW and IHC was sufficient to ensure SW and IHC were independent. The ALJ concluded that an independent board member who served on many boards of intangible holding companies provided expertise. The ALJ determined the expert testimony provided to appraise the trademarks and to establish the royalty rates was reliable and accurate. The ALJ determined that IHC's attempts to operate separately from SW by having, *inter alia*, separate board and shareholder meetings in Delaware, separate administrative staffs and independent financial responsibility for federal income taxes (through a tax sharing agreement) indicated that IHC was not a sham corporation and established the operational independence necessary for the transactions among them to have been conducted at arm's length.

Massachusetts Decision. The Commissioner of Revenue attacked the intangible holding company structure by disallowing royalty payment deductions based upon the sham transaction theory, the substance over form doctrine and Massachusetts' section 482 type statute. The Board concluded that SW's transfer of the trademarks to IHC had no economic substance other than tax avoidance because it was no more than a "paper shuffle" with canned business reasons designed to prop up the paramount business reason of tax avoidance. The Board also determined that the substance of the transactions was as if no transaction had actually occurred and SW had always remained the owner of the intangibles. Lastly, the Board allowed the Commissioner to exercise her 482-type powers because the purpose of such powers was to prevent a foreign corporation from artificially reducing its Massachusetts taxable income by entering into non-arm's length transactions with affiliated corporations. The Board concluded that the transactions were not arm's length because if IHC were truly an independent company, it would have licensed the marks to the highest bidder without regard to SW.

The Board determined that an overlap of 2 of 4 directors between SW and IHC indicated that there was too much overlap to establish the independence of IHC from SW. The Board concluded that an independent board member who served on many boards of intangible holding companies was a failed attempt to inject "independence" where none existed. The Board determined the expert testimony provided to appraise the trademarks and to establish the royalty rates was based upon the faulty assumption that IHC was an independent operating company and was thus unreliable and inaccurate. The Board concluded that the operational activities were failed attempts to breathe life into a structure that was dead from the outset.

Syms Corp. v. Commissioner, Dkt. No. SJC-08513 (Mass. April 10, 2002); ***Syl, Inc. v. Comptroller of the Treasury***, 1999 Md. Tax LEXIS 2 (Md. Tax Ct, April 26, 1999), *aff'd* Md. Circ. Ct., Case No. 24-C-99-002389 (Md. Cir. Ct. for Baltimore City, Mar. 17, 2000)

Background. Syms, Inc. was a New Jersey based clothing store with two stores in Massachusetts. Syms formed a Delaware holding company ("IHC") to hold title to Syms' trademarks. Syms paid royalties to IHC of four percent of net sales of products covered by the trademarks. Syms set this structure up pursuant to the advice and guidance of a financial advisor, to which Syms paid a percentage of the corporate tax savings each year.

Massachusetts Conclusions. The Board concluded that the arrangement was a sham and devoid of economic substance. The Board concluded that the business operations of Syms did not change after the transfer of the trademarks to IHC and that the costs of maintaining the trademarks were borne by Syms as before the formation of IHC (Syms, not the IHC, continued to pay its trademark lawyers). The Commissioner submitted expert opinions that there was no need for Syms to pay a royalty to a related subsidiary for the use of a trademark that it had developed and continued to protect and control. The Board concluded that neither trademark protection nor enhanced management of the trademarks was achieved by the arrangement. Furthermore, the transaction did not create any risk of a loss of control to the taxpayer. The Board observed that Syms could refuse to pay royalties and IHC could no nothing because the two shared officers and directors. Lastly, the Board relied on trademark law that regarded Syms and IHC as the same entity, which is necessary to prevent the transfer from being considered a naked assignment.

Maryland Conclusions. The Maryland Tax Court refused to allow Maryland to tax IHC. The Maryland Tax Court concluded that because IHC was not a "phantom" corporation, it had to be respected for tax purposes. The court focussed its nexus inquiry on the taxpayer itself and not any other member of the unitary group of which the taxpayer was a part. The court stated that the comptroller could not simply ignore the taxpayer's existence to impute its income to its in-state parent or to deny deductions to the parent for expenses it paid to the taxpayer. Focusing solely on the taxpayer, the court concluded that it had no offices, employees, agents or property in Maryland. Thus, its lack of in-state activity precluded the imposition of the tax.

The court specifically disagreed with the *Geoffrey* court's conclusion that the use of the taxpayer's intangible property by an in-state affiliate of the taxpayer constituted "substantial" nexus under the Commerce Clause. First, the court noted that *Geoffrey* dealt with South Carolina law and its application and therefore is not precedent for its application of Maryland law. Second, the court stated that *Geoffrey* analysis was inconsistent with the court's previous holding that the activities, as opposed to the activities of the taxpayer's in-state affiliates, determined whether the taxpayer had established nexus with Maryland. The activities of the

taxpayer's affiliate in the taxing state, even where those activities included the use of the taxpayer's property within the taxing state, were simply irrelevant to determining whether the taxpayer itself had substantial nexus with the taxing state. Specifically, the court stated, "*Geoffrey* focused on the use of the marks by the in-state affiliate of the unitary group in order to determine the nexus of the foreign corporation. We disagree that that activity constitutes 'substantial nexus.'"

LEGISLATIVE INITIATIVES AIMED AT CLOSING THE "LOOPHOLE"

More recently, the battle between tax administrators and taxpayers regarding this issue has moved to the state legislatures. Often passed under the guise of corporate "loophole" closers, these legislative initiatives have been fueled on by the widespread budgetary woes being suffered by the states and the constant search for new revenue sources. In fact, in a recent article appearing in *State Tax Notes*, "Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States" 2002 STT 82-1 (April 11, 2002) Michael Mazerov of the Center on Budget and Policy Priorities, suggests that all states should "enact laws to nullify a corporate tax avoidance strategy based on the use of passive investment companies." As stated by Mazenov:

> Such laws prevent corporations from using payments of royalties and interests to PIC subsidiaries to siphon taxable income out of the states in which the income is actually earned and into tax haven states like Delaware and Nevada.

Thus far, five states have created statutes specifically aimed at passive investment companies.[2] Ohio was the first state to pass such legislation and contains the following language which is fairly common to all of these legislative efforts, as follows:

> The key language of the Ohio anti-PIC statute is as follows: "For purposes of computing its net income . . . [a] corporation shall add [back] interest expenses and costs and intangible expenses and costs directly or indirectly paid [to] . . . Any related member who activities, in any one state, are primarily limited to the maintenance and management of intangible investments . . . 'intangible investments' includes, without limitation, investments in stocks, bonds, notes, and other debt obligations . . . interests in partnerships, patents, patent applications, trademarks, trade names, and similar types of intangible assets." Section 5733.042, Ohio statutes.

The Connecticut statute is almost identical to the Ohio statute and both statutes similarly provide for two exemptions as follows:

> The taxpayer establishes by clear and convincing evidence that the addition is unreasonable.

[2] Section 5733.042, Ohio statutes; Alabama, 2001 Special Session, HB2; North Carolina, HB 1157, enacted 2001; Connecticut SB 416, adopted 1998, Section 20; Mississippi, HB 1695, enacted 2001. (For the full text of Alabama Special Session HB 2, see Doc 2002-379 (40 original pages) or 2002 STT 10-2. For the full text of Connecticut SB 416, see Doc 98-17023 (56 pages) or 98 STN 108-13. For the full text of North Carolina HB 1157, see doc 2001-22294 (6 original pages) or 2001 STT 165-26.)

> The taxpayer and the Secretary of Revenue agree in writing to the application or use of an alternative method of apportionment. Nothing in this subdivision shall be construed to limit or negate the commissioner's authority to otherwise enter into agreements and compromises otherwise allowed by law.

The more recently enacted legislative proposals in Mississippi, Alabama and North Carolina have been much more direct in their attack on the passive investment company, with Alabama Governor Dan Siegelman referring to the Delaware trademark/tradename holding company as "legal money laundering." The following is a brief description of these legislative measures:

Alabama

HB2 – requires add-back of otherwise deductible interest expenses and costs and intangible expenses and costs that are paid to related members.

The Senate amended the bill to include two safe-harbors not found in the original house bill (1) where the corporation submits a statement with the return showing that it was "subject to a tax on the related member's net income in Alabama or any other state of the U.S. or foreign nation," or (2) "the corporation can establish that the transaction giving rise to the expense did not have as a principal purpose the avoidance of any Alabama tax and the related member is not primarily engaged in the acquisition licensing, maintenance or management, ownership, sale, exchange or any other disposition of intangible property or in the financing of related entities."

For purposes of this section, "subject to tax based on or measured by the related member's net income" means that the receipt of the payment by the recipient related member is reported and included in income for purposes of a tax on net income, and not offset or eliminated in a combined or consolidated return that includes the payor.

North Carolina

The North Carolina law provides for a choice on the part of a North Carolina taxpayer who pays royalties to a related party not otherwise doing business in North Carolina. Either the North Carolina taxpayer can add back the royalty payments in determining its taxable income or the related party can file returns in North Carolina and report the royalty income. Section 105-130.7A(a) states as follows regarding the purpose of the election:

> (a) Purpose. – Royalty payments received for the use of trademarks in this State are income derived from doing business in this State. This section provides taxpayers with an option concerning the method by which these royalties can be reported for taxation when the recipient and the payer are related members. As provided in this section, these royalty payments can be either (i) deducted by the payer and included in the income of the recipient, or (ii) added back to the income of the payer and excluded from the income of the recipient.

Subsection (c) of the North Carolina statute then provides as follows:

> (c) Election. – For the purpose of computing its State net income a taxpayer must add royalty payments made to, or in connection with transactions with, a related member during the taxable year. This addition is not required for an amount of royalty payments that meets either of the following conditions:
>
> (1) The related member includes the amount as income on a return filed under this Part for the same taxable year that the amount is deducted by the taxpayer, and the related member does not elect to deduct the amount pursuant to G.S. 105-130.5(b)(20).
>
> (2) The taxpayer can establish that the related member during the same taxable year directly or indirectly paid, accrued, or incurred the amount to a person who is not a related member.

Mississippi

The Mississippi legislation (HB 1695) denies a deduction for expenses, losses and costs relating to intangibles if paid to a related entity and requires taxpayers to add back such payments to its income unless the taxpayer can establish one of the following:

> The related member directly or indirectly paid, accrued or incurred such portion to a person during the same income year who is not a related member; or
>
> The transaction giving rise to the interest expenses and costs or intangible expenses and costs between the taxpayer and related member was done primarily for a valid business purpose other than the avoidance of taxes, and the related member is not primarily engaged in the acquisition, use, maintenance or management, ownership, sale, exchange or any other disposition of intangible property.

Other State's Efforts

Recently, Tennessee proposed legislation to this same effect, except that, as currently drafted, Tennessee would deny all deductions for related party expenses. SB 3913/HB 2937 provides as follows:

> **SECTION 25.** Tennessee Code Annotated, Section 67-4-2006(b)(1), is amended by adding the following as a new subitems (K), (L), and (M):
>
> (K) Any intangible expense and any interest expense related to or in connection with a transaction with one or more related members, whether direct or indirect. Nothing in this subitem shall be construed to limit or negate the provisions of Sections 67-4-2014 or 67-4-2112 where deemed appropriate by the commissioner. For purposes of this subitem and subitem (L) below:

(i) "Intangible expense" means:

(a) expenses related to, or in connection with, directly or indirectly, the acquisition, use, maintenance or management, ownership, sale, exchange or any other disposition of intangible property to the extent such amounts are allowed as deductions or costs in determining federal taxable income for purposes of subsection (a) above;

(b) losses related to or in connection with, directly or indirectly, factoring transactions or discounting transactions; and

(c) other similar expenses and costs.

(ii) "Interest expense" means amounts allowed as deductions under Section 163 of the Internal Revenue Code for purposes of determining federal taxable income, to the extent such expense is related to, or in connection with, directly or indirectly, the acquisition, maintenance, management, ownership, sale, exchange or disposition of intangible property.

(iii) "Intangible property" means patents, patent applications, trade names, trademarks, service marks, franchise rights, copyrights, research, management, consulting or technical expertise, formulas, designs, patterns, processes, formats, accounts or notes receivable, and similar types of intangible assets.

(iv) "Related member" means an individual or entity that, with respect to the taxpayer during all or any portion of the taxable year, is a related entity, as defined in this subitem, a component member as defined in Section 1563(b) of the Internal Revenue Code, or is an individual or entity to or from whom there is attribution of stock ownership in accordance with Section 1563(e) of the Internal Revenue Code.

(v) "Related entity" means:

(a) a stockholder who is an individual, or member of the stockholder's family enumerated in Section 318 of the Internal Revenue Code, if the stockholder and members of the stockholder's family own, directly, indirectly, beneficially or constructively, in the aggregate, at least fifty percent (50%) of the value of the taxpayer's outstanding stock;

(b) a stockholder, or a stockholder's partnerships, limited liability companies, estates, trust and corporations own directly, indirectly, beneficially or constructively, in the aggregate, at least fifty percent (50%) of the value of the taxpayer's outstanding stock; or

(c) a corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution

rules of Section 318 of the Internal Revenue Code, if the taxpayer owns, directly, indirectly, beneficially or constructively, at least fifty percent (50%) of the value of the corporation's outstanding stock. The attribution rules on Section 318 of the Internal Revenue Code shall apply for purposes of determining whether the ownership requirements described herein have been met.

(L) Notwithstanding the provisions of subitem (K) above, a taxpayer shall be permitted to deduct an intangible expense or interest expense item to the extent that the corresponding income item of the recipient related member or related entity is subject to a tax based upon or measured by such member's or entity's net income in this state, any other state of the United States, or any other country. For purposes of this subitem, "subject to a tax based upon or measured by such member's or entity's net income" means that the related member or related entity recipient of the payment has included it in the computation of its net earnings subject to a state income tax, or tax measured by income in a country other than the United States. In the event that the related member or related entity apportions its net earnings subject to a state income tax, then the taxpayer may deduct only the portion of the intangible expense payment or interest expense payment upon which the recipient is subject to a state tax based on or measured by income, or a tax measured by income in a country other than the United States. In such a case, the amount of intangible expense payment or interest expense payment deductible by the taxpayer for Tennessee excise tax purposes shall be determined by multiplying the expense payment by the recipient's apportionment ratio in the taxing state or foreign country. The amount to be added back to federal taxable income in determining the taxpayer's excise tax bases shall be the difference between the entire expense payment and the amount deductible by the taxpayer as an expense for Tennessee excise tax purposes.

(M) Notwithstanding the provisions of subitem (K) above, a taxpayer shall be permitted to deduct an intangible expense or interest expense item to the extent that such expense was incurred for a valid business purpose other than the avoidance of taxes, and the related member is not solely engaged in the acquisition, use, maintenance or management, ownership, sale, exchange, or any other disposition of intangible property..

Thus, the proposed Tennessee statute is much broader in its scope and, unlike the North Carolina statute, provides for no elections on the part of the taxpayer.

Many have argued against such legislative proposals as unfairly discriminating against similarly situated taxpayers by providing a "safe-haven" for business expenses paid to related parties doing business in the taxing state. In a series of letters written by COST in response to the North Carolina initiative, it is stated as follows:

SB 1005 requires taxpayers to add royalty payments made to a related member to net income unless the payment was made to a related member that includes the amount as income on a separate North Carolina tax return. Thus, the add-back is required if the expense is paid to a company doing business in another state but is

> not required if the expense is paid to a company doing business in North Carolina. This is unconstitutional under the Commerce Clause of the United States Constitution because it facially discriminates between transactions with in-state and out-of-state entities.
>
> [T]he Department of Revenue apparently throws up its hands on the issue of HB 1157's constitutionally and asserts that taxpayers will always challenge the validity of a statute. Although there are many gray areas in the law, the validity of discriminating against interstate commerce is not one of them. The Supreme Court has ruled time and time again that a state cannot treat taxpayers in the state differently than taxpayers outside of the state. (In fact, in the not too distant past, North Carolina ran afoul of this prohibition with its former intangible tax). HB 1157 turns the taxability of the royalty expense on whether it is paid to a company paying tax in the state. This is classic discrimination and will be disallowed by the courts – no question. The issue of HB 1157's constitutionally is very different from the issue in Geoffrey referenced by the LDO. Geoffrey dealt with the constitutional presence necessary before a state could tax an out-of-state company; HB 1157 deals with a statute that on its face discriminates between in-state and out-of-state companies.

SEARCHING FOR THE PROPER STANDARD – PHYSICAL PRESENCE OR ECONOMIC PRESENCE

With this background, the better question at this point is what should be the nexus standard for corporate income, net worth, and other similar business taxes. Should it be the bright-line, physical presence standard adopted by the Supreme Court in Quill or, rather, should some defined level of economic presence be sufficient?

AN ARGUMENT IN FAVOR OF THE PHYSICAL PRESENCE STANDARD

While we are all free to debate the proper standard for nexus for purposes of applying franchise (net worth), excise (net income) and other similar taxes, it is beyond dispute that in Quill the United States Supreme Court held that a taxpayer's "physical presence" was required in the taxing state in order for a state to be able to impose a use tax collection responsibility on an out-of-state taxpayer. Given the Quill court's adoption of a strict physical presence standard for sales and use taxes, the question then becomes, it would seem, whether any principled reason exists to impose a lower constitutional threshold for corporate income, net worth and similar business taxes.

Those who favor the adoption of a lower constitutional threshold for business taxes attempt to distinguish sales and use taxes from other state taxes on the basis that the duty to pay corporate income net worth and similar business taxes on entities would not be unduly burdensome in comparison to the compliance burdens of the sales and use tax laws. In the first place, this argument ignores the fact that the franchise and excise tax constitutes, in all instances, a direct economic burden on the taxpayer, whereas the sales and use tax is, by its very nature, a tax which is supposed to be passed on to the ultimate consumer.

If anything, the constitutional hurdle of the Commerce Clause should be higher for the franchise and excise tax because, as the United States Supreme Court has previously recognized, "a vice in a tax on gross receipts of a corporation doing an interstate business is the risk of multiple taxation. A concern not present when only imposition of use-tax-collection duty is involved." National Geographic Company, supra, 430 U.S. at 557 (citing Standard Pressed Steel Co. v. Washington Rev. Dept., 419 U.S. 560, 563 (1975)). Thus, the Supreme Court has indicated that corporate income or gross receipts taxes deserve a higher level of scrutiny due to the risks of multiple taxation. Accordingly, the constitutional requirements of the Commerce Clause certainly can be no less stringent in the corporate income and net worth tax arena than those standards in the use tax collection arena. Simply stated, not a single policy exists that would support such a distinction. The argument that the use tax collection obligation is more burdensome ignores economic reality. Clearly, the impact of taxes, whether income, net worth, sales, use or other types of taxes, must be figured into any pricing model. To the extent that a business underestimates its true tax liability with respect to any of these taxes, it no longer has the ability to incorporate those costs into their profit structure and achieve the returns that it expected.

Instead of addressing this clearly significant difference in the economic burden associated with the franchise and excise tax compared to the sales and use tax, the state's favoring such a distinction point to the relative administrative burden associated with each tax. For this purpose, the departments of revenue rely primarily on the difference in the number of filing jurisdictions for sales and use taxes.[3] The collective departments of revenue, however, have ignored the myriad of other compliance burdens that face multi-state businesses in preparing and filing corporate income and net worth tax returns and paying the taxes shown thereon. Instead, the state's argue that the process of filing a state corporate income tax return is simply a matter of applying a tax rate to the number shown as federal taxable income on the federal corporate income tax return. This characterization, however, grossly understates the compliance burdens imposed by state income and net worth taxes.[4]

First, there is a threshold issue of identifying the taxpaying unit. Affiliated groups filing consolidated income tax returns for federal purposes must determine, with respect to each state, which of their various member corporations are subject to tax in each state. Not only may the affiliates with direct jurisdictional nexus vary from state to state, but so also may the legal standards for determining both nexus as well as which members of the groups are engaged in a unitary business.[5] Once the precise taxpaying unit is identified, taxpayers must then determine

---

[3] The collective departments of revenue ignore the fact that, although there may be filing requirements in 6,000-plus jurisdictions imposing sales and use taxes, the sales and use tax rules are generally uniform among the various filing jurisdictions in a given state. Thus, businesses must only contend with about 50 sets of rules for and exemptions to the use tax – approximately the same number of sets of rules for determining net worth and income taxes owed to the various states.

[4] To judge the accuracy of this statement, one need only review one of the leading treaties on state taxation, Hellerstein & Hellerstein, State Taxation (3d ed. 1998), which devotes approximately 800 pages to a discussion of the general principles and compliance issues that are involved in state corporate income taxes.

[5] See generally, Hellerstein, at 8-57 to 8-211. If a corporation is part of a "unitary business" with its affiliates, many states will include its income in the apportionable tax base for the unitary group. Consider, for example, the convoluted analysis that every multi-state business would have to undergo to determine whether the "economic presence" of the business within the state are sufficient to subject it to a state's taxing jurisdiction. Even if the legal

the potential tax base that is within each state's reach. States follow different income apportionment formulas – in some cases, for example, giving extra weight to the sales factor to a variety of degrees. Even where the formulas are ostensibly the same, their precise meaning may differ.

Lastly, income tax compliance involves applying the rules for determining taxable income once the potential tax base is known. Contrary to the argument posited by most states, it is in the sales and use tax area where determination of the tax is simply a matter of multiplying gross receipts by the sales tax rate. States' rules for computing taxable income, however, vary from the federal rules and from each other in a number of significant respects.

As the foregoing discussion amply demonstrates, the compliance burdens of filing franchise and income tax returns in all the varying jurisdictions in the United States is not a trivial exercise.[6] In Quill and National Bellas Hess, the U.S. Supreme Court found that similar costs associated with sales and use tax compliance unduly burdened interstate commerce where the putative taxpayer had no physical presence in the taxing state. It would seem then that the costs associated with franchise and income tax compliance similarly burdens interstate commerce. Given the relative compliance burdens associated with sales and use taxes, on the one hand, and, corporate business taxes on the other hand, the proper standard for each such tax should be the same. Simply stated, the Commerce Clause prohibits such an undue burden where Congress has not expressly allowed it.

If a taxpayer does not have substantial nexus with Tennessee for sales and use tax collection purposes, which it clearly does not have under Quill, then it is incongruous that a taxpayer would somehow have "substantial nexus" to be subject to franchise and excise taxes or similar business taxes. This situation would propel form over substance in this constitutional inquiry by establishing a formal distinction among these two forms of state taxation without any principled basis for the inconsistent treatment. Such a formal distinction between a use tax collection duty and an income tax hearkens back to the days before Complete Auto where such formalism allowed the validity of statutes to hinge on "legal terminology" and "draftsmanship and phraseology." See Complete Auto Transit, 430 U.S. at 281 (rejecting the distinction between "direct" and "indirect" taxes and directing courts to look behind the formal language of a taxing statute to determine its effect on interstate commerce). It would be a strange constitutional doctrine indeed that would impose a more stringent physical presence nexus standard before allowing states to require retailers to merely collect and pass on use taxes owed by others, and yet impose a more relaxed economic presence nexus standard in allowing states to impose a much heavier economic burden or financial institutions by subjecting out-of-state banks to a direct tax on the bank's net income. It is, after all, "a constitution we are expounding."

---

issues are clear, tax record keeping by the overall group may be complicated by the varying sets of in-state taxpayers. Moreover, if some affiliates are deemed outside the state's taxing jurisdiction, transactions between the inside and outside affiliates are subject to review under statutory provisions giving the revenue administrator the power to reallocate income among affiliated taxpayers if the administrator determines that the taxpayer is inappropriately shifting income to other states. See T.C.A. § 67-4-804(c).

[6] As further proof of the complexity of franchise and excise tax, one need only compare the Tennessee sale and use tax return, which consists of two pages, with the Tennessee franchise and excise ("F&E") tax return, which consists of 10 pages. Furthermore, financial institutions and their unitary affiliates must file a special Tennessee F&E Tax Return that similarly consists of ten pages. See Exhibit A attached hereto.

McCulloch v. Maryland, 14 U.S. (4 Wheat) 316, 407 (1819).

Such a doctrine would mean that while the Commerce Clause prohibits a state from placing merely an administrative duty to collect a tax on a company without a physical presence in the taxing state, it would permit that state to, nonetheless, impose a direct tax on the same company's net income. The Supreme Court has never acknowledged a distinction between the constitutional standards to be applied to use tax collection statutes and income tax statutes. Moreover, it is difficult to imagine any rational basis on which to distinguish the use tax struck down by Quill and the franchise and excise tax would explain why a physical presence is necessary to establish "substantial nexus" for the use tax but not for the franchise and excise tax. See Guardian Industries Corporation v. Michigan, 499 N.W.2d 349 (Mich. Ct. App. 1993) in which the Michigan Court of Appeals, in construing Michigan's single business tax (which is certainly not a sales tax), declared that "after Quill it is abundantly clear that [a corporation] must show a physical presence within the taxing state to establish a substantial nexus to it."

The Supreme Court has noted on several occasions that "our law in this area is something of a 'quagmire' and its 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the states in the exercise of their indispensable power of taxation." Quill, 504 U.S. at 315-16 (citing Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. at 450, 457-458 (1959). Indeed, Quill concluded that, despite some "artificial[ity] at its edges," the "bright-line [physical presence] rule . . . furthers the ends of the dormant Commerce Clause" by "firmly establish[ing] the boundaries of state authority" to tax and "reduc[ing] litigation concerning those taxes." 504 U.S. at 314-15. The benefits of certainty and predictability in the administration of state taxing statutes, and the resulting reduction in litigation, are as worthy of protection in the context of state franchise and excise taxes as in the context of state sales and use taxes. As further noted in Quill, this consistency "encourages settled expectations, and in doing so, fosters investment by businesses" that are confronted with a plethora of state taxing schemes. See Quill, 504 U.S. at 316.

By contrast, an economic presence test for state income and net worth taxes would result in different tests for the same "substantial nexus" standard—one applicable to sales and use taxes, another for state income and net worth taxes. The creation of another and markedly different nexus standard would only further confuse this area of the law. The adoption of a murky "I know nexus when I see it" standard would introduce significant uncertainty—and protracted litigation—into this otherwise, I would submit, well-settled area.

AN ARGUMENT IN FAVOR OF AN ECONOMIC PRESENCE STANDARD

Without a Market There is No Income

Current law reflects a sensible nexus standard by tying the imposition of income taxes to where income is earned, to where the taxpayer "'avails itself of the "substantial privilege of carrying on business" within the State.'" Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 220 (1980). Several factors contribute to doing business and earning income. First, the seller has to create or obtain something to sell. He uses capital and labor—property and payroll—to create or obtain the items for sale. But no income is earned from goods sitting in a warehouse or information sitting on a computer. The sine qua non of earning income in our

vaunted market economy is the market, buyers and sellers, supply and demand. Without a sale, there is no income. Those who claim that market states do not contribute to earning income would not for one moment permit those market states to bar entry into their markets. Didn't an Internet seller famously explain when faced with quarter after quarter of losses that the first step in its business plan was to develop the customer base? What to sell them and the profits from those sales would follow. And it has.

What does the market state provide the seller? It provides the roads over which the products are delivered to the customer. It provides the police and firefighters who protect the property from highwaymen and catastrophe on its way there. It provides a judicial system that gives the customers the confidence of redress if the seller does not deliver, and gives the seller a remedy of the buyer does not pay. It regulates the electric utility industry to ensure that the consumer has the power to connect to the Internet (remember California's summer of 2000). And most important, the market state educates its citizens, the remote seller's customers. An illiterate citizenry does not make good online customers.

For over sixty years, the U.S. Supreme Court has recognized the contribution that property, payroll and sales make to earning income by repeatedly affirming the validity of the three-factor formula for apportioning income for income tax purposes. Butler Bros. v. McColgan, 315 U.S. 501, 506 (1942) (We read the statute [California's three factor apportionment formula] as calling for a method of allocation which is 'fairly calculated' to assign to California that portion of the net income 'reasonably attributable' to the business done there"); Trinova Corp. v. Michigan Dept. Of Treasury, 498 U.S. 358 (1991). If anything, taxpayers have lately pushed for greater representation of sales in the formula. How can they reconcile this full acceptance of the sales factor for formulary apportionment with the argument that the market state contributes nothing?

Thus, as a matter of sound tax policy, Charles E. McLure of the Stanford University Hoover Institute has suggested that using the factors of property, payroll and sales mark the most sensible measure for nexus. Those factors reflect, after all, how the income of a multistate taxpayer is earned, and therefore how it will be apportioned if subject to tax. It makes sense that those same factors should also determine where a taxpayer is subject to tax.

Multistate Tax Commission's Proposed Factor Presence Nexus Standard

The Multistate Tax Commission (MTC) has for the last six months been working out the details of just such a factor presence nexus standard. The proposal is the essence of simplicity, convenience and certainty. A multistate taxpayer is presumed to have nexus with a state when in any tax period the taxpayer has property, payroll or sales in the state measured by the apportionment factors as they are defined in paragraph two in an amount in excess of the thresholds set forth in paragraph three. By using a mathematical standard based on numbers already tracked by multistate taxpayers, such a standard has the advantage of being constitutional, simple, certain and fair.

- It is **constitutional** because the U.S. Supreme Court has long accepted the three-factor formula as representing where a company does business and derives its income. By setting substantial thresholds, the standard would actually mark a significant draw-back from the outer limits of the States' constitutional authority. The Supreme Court has long

found nexus for imposition of income tax on income earned in a state in several cases even where the taxpayer has no physical presence in the state. In New York ex rel. Whitney v. Graves, 299 U.S. 366 (1937), the Court upheld New York's imposition of income tax on a nonresident devoid of physical presence for income earned from selling an intangible—rights to a seat on the NYSE. The Court recognized in Curry v. McCandles, 307 U.S. 357 (1939), that transactions involving intangibles reflects a relationship between the two parties that require the protections and benefits of the states of both parties, entitling both states to impose tax. In International Harvester v. Wisconsin, 322 U.S. 425 (1944), the Court upheld imposition of Wisconsin's tax on nonresident shareholders' right to receive a dividend from profits earned in Wisconsin by their intangible—shares of stock in the Int'l Harvester Corp.—explicitly stating that the shareholders' physical presence was not necessary.

_ It is **simple** because it relies on concepts already used and financial determinations already made by every multistate corporation. It depends on straightforward numbers, not strained relationships or a laundry list of nexus-giving or nexus-depriving activities. It also eliminates reporting obligations for business that don't have a substantial presence in the taxing State, and therefore would not owe substantial tax.

_ It is **certain** because a business either meets a property, payroll, or sales threshold or it doesn't. No interpretation is needed concerning whether some in-state representative, contractor or affiliate is performing essential market creation and support work for the taxpayer. The customers are either in the State or they are not.

_ It is **fair** because it finds nexus where companies actually do business, matching the taxation of income to the place where it is earned. It treats both in-state and out-of-state business equitably. Local businesses get to play on a level playing field. It helps minimize the kinds of manipulations of the corporate form we have seen in the trademark holding company cases in an effort to avoid paying taxes where a company really does business and earns its income.

The proposal is still in the development stage. The Commission has directed that public hearings be held on the technical aspects of the proposal during June and July, and on the philosophical, legal and constitutional aspects at the MTC annual meeting at the end of July. We would appreciate input from everybody.

Neither Law Nor Policy Justifies Imposing a Physical Presence Requirement for Income Tax Nexus

Those proposing a physical presence standard for income tax nexus argue that Quill Corp. v. North Dakota should be extended to income taxes. Their argument fails to acknowledge that the reasoned bases for the Quill decision do not apply to income tax. It also fails to recognize that Court in Quill only reluctantly delayed the full adoption of the Court's modern commerce clause doctrine requiring that interstate commerce pay its fair share of tax for doing business in multiple states. (Of course, interstate commerce cannot be discriminated against and any tax must be fairly apportioned.) The delay was appropriate because of the undue burden that the disparate state sales and use tax schemes impose on interstate commerce. But the states have

recognized that problem and are hard at work developing a streamlined sales tax system that will remove that undue burden.

The Court in Quill accepted that it was fair to impose the compliance burden on the remote seller under due process standard—the market state gave something for which it could ask a return. But because of two problems the Court found insufficient nexus under the commerce clause. Neither problem applies to income tax. First was the substantial reliance by remote sellers on the physical presence nexus standard for use tax announced in the National Bellas Hess decision. As noted above, the legal standard for income tax nexus has always been different so there is no reliance interest to protect. Second, the difficulty of complying with the laws of the some 7500 diverse sales and use tax jurisdictions, with different tax bases, different deductions, different exemptions, different tax rates and a monthly filing obligation imposed an undue burden on interstate commerce. The compliance burden for the annual state income taxes—all starting from variations on the theme of federal taxable income, and all using a similar apportionment system—is vastly simpler. It imposes no such undue burden. Indeed, contrary to the assertion Mike Sontag makes above, the Supreme Court in Barclays Bank v. Franchise Tax Board, 512 U.S. 298 (1994), explicitly rejected the argument that the cost of compliance with California's corporate income tax imposed an undue burden on interstate commerce.

Mr. Sontag argues that the nexus standard should be stricter for income tax because the taxpayer bears the economic burden, not just a compliance burden. But the Court in Quill recognized under due process standards that it is fair for the market state to impose a tax burden on businesses that intentionally sell products to customers in the state. There is no authority for a different "higher" nexus standard where the taxpayer bears the economic burden. Nor does the risk of multiple taxation implicate nexus decisions. Fair apportionment of an income tax will ensure that it passes commerce clause muster on that account.

The constitutional standard must be the same for all kinds of taxes. That standard under commerce clause strictures is that states cannot impose a tax that will unduly burden interstate commerce. The crucial distinction is that different taxes impose a different level of compliance burden. Ultimately, the Supreme Court was probably correct in Quill that the effort required to file monthly sales and use tax returns potentially in over 7000 jurisdictions with diverse tax bases, rates, exemptions and deductions is an undue burden. The same is not true for income tax.

Nevertheless, Mr. Sontag argues that the compliance burden in the income tax is really hard and it would be unfair to make multistate taxpayer bear that burden. We believe he is wrong. Income taxes went through their streamlining in the mid-1960s in face of threats of congressional preemption. Many states adopted the Uniform Division of Income for Tax Purposes Act (UDITPA). Others adopted similar apportionment formulae. Nearly half the states adopted and joined the Multistate Tax Compact with the primary purpose of furthering uniformity in the taxes imposed on multistate businesses, primarily corporate income taxes. To be sure, states have fallen away from complete uniformity. But one example cited by Mr. Sontag serves to distinguish the relative uniformity and simplicity of the income tax from the complexity of the current sales tax regimes. A number of states have changed the apportionment formula from an evenly weighted three-factor formula to extra weighting the sales factor, or even to a single sales factor. A double weighted sales factor merely requires the taxpayer to multiply the sales factor by two. This is neither complex nor difficult. A single sales factor makes the determination even easier. As to the complexity inhering in identifying the taxpaying unit, who

created all those interlocking subsidiaries? Mr. Sontag would have us reward the Enrons of the world for establishing over 900 entities to evade taxes because it is too complex for them to figure out the proper taxpaying unit. I don't think this is a problem created by the states.

Finally, there are additional policy reasons for using economic presence standard in the 21st century.

We are moving from an economy where the seller and the buyer must meet physically to exchange goods for money to an economy where the seller can meet the buyer in cyberspace and make the sale there, without ever touching ground anywhere. Many of the very large companies advocating a physical presence standard are new economy companies that need virtually no physical presence to operate. They can locate in the Cayman Islands and pretend that no market state provides them anything when it provides them customers. All the while, many of the old economy and Main Street companies in states cannot get out of their fair share of state income taxes. A greater and greater portion of the tax burden is shifted to them. This is simply not fair.

Along the course of this transformation from real to virtual companies, there have been an infinite variety of relationships developed as the seller tries to pretend he has no presence in a state and claim, therefore, that he doesn't have nexus. Thus the computer warranty issue and the argument over affiliate nexus, representational nexus and the like. The reality is that in many instances, customers are not comfortable with remote and inaccessible sellers. They want someone to show up if the computer does not work. For his part, the seller may want to hire a lawyer to sue those buyers who fail to pay. Thus, in a variety of ways, the seller needs to have a presence in the market state. And yet when a market state points out the fact that the seller using these various arrangements is doing business there, Industry accuses the state of being aggressive in pushing nexus.

For many of these reasons, we believe that a mathematical factor presence nexus standard represents a much clearer and more definite standard, reflecting the reality of the business relationship between sellers and buyers, and falling well within current constitutional "doing business" standards.