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Beyond BATSA: Getting Serious About State Corporate Tax Reform†

Quinn T. Ryan*

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I. Introduction

The state corporate income tax system is broken, and only Congress can fix it. The current state of affairs is problematic for states,[1] burdensome for multistate corporations,[2] and unfair to smaller, local businesses.[3] States are unable to resolve these problems themselves; federal intervention is the only solution.

Two major defects plague the current system. The first is the lack of a clear national standard for state income tax jurisdiction.[4] The second is the lack of a uniform method for apportioning the income of multistate businesses for tax purposes.[5] These defects combine to create a number of serious problems. Multistate businesses are subjected to onerous compliance burdens and significant tax uncertainty,[6] as well as the risk of taxation on more than 100% of their income.[7] States suffer as substantial amounts of income fall through jurisdictional cracks, resulting in "nowhere income" that is untaxed by any state.[8] Moreover, the tax revenue that is collected is not distributed equitably among the states in which the income

1. *Infra* Part II.
2. *Infra* note 261 and accompanying text.
3. *Infra* Part VI.A.
4. *Infra* Part IV.
5. *Infra* Parts III.A, V.B.
6. *Infra* note 261 and accompanying text.
7. *Infra* Part III.A.
8. *Infra* Part II.

is generated.[9] Tax planning opportunities abound,[10] diverting resources away from efficient economic activity and into elaborate tax avoidance schemes.[11] Such tax shelters are often not available to smaller local businesses, which places them at a competitive disadvantage with their larger national competitors.[12] Additionally, continual litigation over state tax jurisdiction imposes unnecessary costs on both states and businesses alike.[13]

Congress has recently considered legislation to address some of these problems. The Business Activity Tax Simplification Act (BATSA) would establish a nationwide *physical presence* standard for state income tax jurisdiction; it has been introduced several times, but never enacted.[14] This Note proposes, as an alternative to BATSA, a two-pronged approach: The establishment of a nationwide standard for income tax nexus based on *economic presence*, coupled with the imposition of a uniform method of income apportionment.[15] This approach would alleviate many of the aforementioned problems that arise under the current system. That is to say, in tax policy parlance, it would greatly increase the equity, efficiency, and simplicity of state business activity taxation.[16]

Part II of this Note documents the substantial erosion of the state corporate income tax base and identifies the increased use of tax planning opportunities by multistate businesses as the primary culprit. Part III explains how state corporate income taxes are levied on multistate businesses; it includes a discussion of constitutional and statutory limitations on state tax authority as well as methods states may employ unilaterally to close certain corporate tax loopholes. Part IV identifies an open question under current law—whether a state may assert income tax jurisdiction over a non-physically present business based on its economic presence—and explores through case law the policy implications of answering this question affirmatively or negatively. Part V proposes the establishment of a nationwide standard for income tax jurisdiction based on economic presence, coupled with the imposition of a uniform method of

9. *See, e.g., infra* Part III.B.3 (discussing Public Law 86-272); *infra* Part III.C (describing state efforts to remedy jurisdictional problems under the current system).

10. *Infra* Part IV.

11. *Infra* Part VI.B.

12. *Infra* Part VI.A.

13. *Infra* note 261 and accompanying text.

14. *Infra* Part VII.A.

15. *Infra* Part V.

16. *Infra* Part VI.

income apportionment. Part VI analyzes this proposal in light of three core tax principles: equity, efficiency, and simplicity. Finally, Part VII contrasts this Note's proposal with BATSA's physical presence standard for income tax jurisdiction, which is analyzed under the same criteria.

II. The Disappearing State Corporate Income Tax[17]

Business activity taxes[18]—and corporate income taxes in particular—are an important source of revenue for state governments.[19] Such taxes account for approximately 10% of all state tax revenue, or $75 billion per year.[20] States rely on business activity taxes to fund anywhere from 4% to 20% of their budgets.[21] State revenue departments and commentators have expressed concern, however, that the increasingly aggressive use of certain tax shelters has significantly eroded the state tax base.[22] Moreover, many of these tax planning opportunities are effectively available only to larger, multistate businesses.[23] The result is an

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17. *See* Gary Cornia et al., *The Disappearing State Corporate Income Tax*, 58 NAT'L TAX J. 115 (2005) (describing state corporate income taxes as "disappearing").

18. The term "business activity taxes" refers not only to corporate income taxes but also to franchise taxes, gross receipts taxes, and value added taxes. *See* MULTISTATE TAX COMMISSION, FEDERALISM AT RISK 19 (2003) [hereinafter MULTISTATE TAX COMM'N], *available at* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Resources/Studies_and_Reports/Federalism_at_Risk/FedatRisk--FINALREPORT.pdf (describing various business activity taxes).

19. *Id.*

20. U.S. CENSUS BUREAU, STATE GOVERNMENT TAX COLLECTIONS (2007), http://www.census.gov/govs/statetax/0700usstax.html (last visited Feb. 23, 2010) (on file with the Washington and Lee Law Review). Total state business activity tax revenue calculated by including corporate income tax revenue ($53.4 billion), corporate license tax revenue ($8.3 billion), and occupation and business tax revenue ($13.4 billion). *Id.*

21. STEVEN MAGUIRE, CONGRESSIONAL RESEARCH SERVICE, STATE CORPORATE INCOME TAXES: A DESCRIPTION AND ANALYSIS 1–2 (2006) [hereinafter CONGRESSIONAL RESEARCH SERVICE], *available at* http://digital.library.unt.edu/govdocs/crs/permalink/meta-crs-9311:1.

22. *See, e.g.*, *How Much Should Borders Matter? Tax Jurisdiction in the New Economy: Hearing on S. 2721 Before the Subcomm. on International Trade of the S. Comm. on Finance*, 109th Cong. 2–3 (2006) [hereinafter Bucks] (Statement of Dan R. Bucks, Director, Montana Department of Revenue) ("An appropriately structured operation can avoid business activity tax liability and still exploit the marketplace in any given state . . . [and the] state tax base is seriously eroded [as a result]."); MICHAEL MAZEROV, CTR. ON BUDGET & POLICY PRIORITIES, PROPOSED "BUSINESS ACTIVITY TAX NEXUS" LEGISLATION WOULD SERIOUSLY UNDERMINE STATE TAXES ON CORPORATE PROFITS AND HARM THE ECONOMY 5 (2008), *available at* http://www.cbpp.org/6-24-08sfp.pdf (describing states' efforts to "shut down [what is] perhaps the most abusive state corporate tax shelter in widespread use").

23. *See* Bucks, *supra* note 22, at 3 (describing how one of the most pervasive state tax

uneven distribution of the state tax burden across similar types of firms—with smaller, local businesses shouldering a disproportionately greater share.[24]

One way to measure the erosion of the state tax base is to look at the average *effective* state tax rate on corporate income. This is the amount of tax corporations *actually pay* to states as a percentage of their profits, after taking advantage of any available loopholes as well as explicit policy choices by states to lower corporate tax burdens through decreased nominal tax rates or increased deductions, credits, and other incentives for economic development.[25] The average effective tax rate has decreased by one-third since the 1980s—from approximately 9% percent throughout the 1980s to roughly 6% in 2001.[26] Evidence suggests that much of this reduction is the result of increased utilization of tax planning opportunities by multistate corporations, as opposed to explicit policy choices by states.[27] In 2001, domestic tax sheltering cost states an estimated $5 billion in lost tax revenue[28]—nearly 16% of all state corporate income taxes collected.[29]

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shelters, the out-of-state holding company, favors "large businesses at the expense of small ones," resulting in uneven tax burdens among competing firms).

24. *See id.* at 4 (describing the inequity of the current state corporate income tax system). As Montana's Director of Revenue explained:

> The result of such sheltering is obvious: (a) An appropriately structured operation can avoid business activity tax liability and still exploit the marketplace in any given state; (b) In-state entities subject to state taxes face an unfair competitive disadvantage; (c) The state tax base is seriously eroded; (d) Business income and operations are not subjected to tax where the income is earned; and (e) The state business activity tax falls unevenly across similar types of businesses, depending solely on whether they have taken advantage of the sheltering opportunities . . . .

Id.

25. *See* BLACK'S LAW DICTIONARY 1619 (9th ed. 2009) (defining effective tax rate as "a taxpayer's tax liability divided by the amount of taxable income"); MULTISTATE TAX COMMISSION, CORPORATE TAX SHELTERING AND THE IMPACT ON STATE CORPORATE INCOME TAX REVENUE COLLECTIONS 6 (2003) [hereinafter CORPORATE TAX SHELTERING], *available at* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Resources/Studies_and_Reports/Corporate_Tax_Sheltering/Tax%20Shelter%20Report.pdf (describing some of the explicit policy choices that states have made to reduce corporate tax burdens).

26. CORPORATE TAX SHELTERING, *supra* note 25, at 5–6.

27. *See id.* at 6 (finding that only 25% of the "decline in the effective rates of state corporate taxes is attributable to state legislative changes . . . ."); Cornia et al., *supra* note 17, at 136 (stating that "evidence . . . suggests [that] corporate tax planning is an important factor in explaining the decline in [state corporate income tax revenue]").

28. CORPORATE TAX SHELTERING, *supra* note 25, at 3, 5–6. An additional $5 billion in lost state corporate income tax revenue was tied to international income tax sheltering, an issue beyond the scope of this Note. *Id.* at 3, 4–5.

29. State corporate income tax revenue totaled approximately $31.7 billion in 2001. U.S. CENSUS BUREAU, STATE GOVERNMENT TAX COLLECTIONS: 2001, http://www.census.gov/govs/statetax/0100usstax.html (last visited Feb. 23, 2010) (on file with the

The erosion of the state corporate income tax base is especially problematic given the precarious fiscal health of the states. Many states will be grappling with severe budget shortfalls for years to come and can ill afford the continued loss of tax revenue.[30] In fiscal year 2009, forty-five states faced deficits that averaged 15% of their total budgets—nearly $110 billion in total deficits.[31] In fiscal year 2010, forty-eight states faced budget gaps totaling over $192 billion, or an average deficit of 28% of their total budgets.[32] Similar deficits are projected for fiscal year 2011.[33]

III. The Basic Mechanics of State Corporate Income Taxation

A. Formulary Apportionment

The basic mechanics of state corporate income taxation are illustrated by the following hypothetical. Suppose that Company *X* makes widgets. It is domiciled and headquartered in State *A*. It owns a $12 million manufacturing plant in State *A*, maintains a $6 million payroll in State *A*, and generates $100 million per year from sales to customers in State *A*. Company *X* also sells to customers in State *B*, where it owns a $4 million warehouse and maintains a $2 million payroll. These operations generate $50 million in sales. Finally, Company *X* also sells to customers in State *C*. It has no property or payroll in State *C*, but solicits orders there via mail, telephone, and internet. The orders are then shipped directly from the plant in State *A*, or from the warehouse in State *B*. This activity generates an additional $50 million in sales.

Now suppose that all three states impose a corporate income tax, and that Company *X* realizes a total profit of $10 million. How will this income be taxed by each state? State *A* would seem to have the strongest claim to taxing authority. It is the state of incorporation, where all goods

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Washington and Lee Law Review).

30. *See* ELIZABETH MCNICHOL & NICHOLAS JOHNSON, CTR. ON BUDGET & POLICY PRIORITIES, RECESSION CONTINUES TO BATTER STATE BUDGETS; STATE RESPONSES COULD SLOW RECOVERY 1 (2009), *available at* http://www.cbpp.org/files/9-8-08sfp.pdf ("States are facing a great fiscal crisis. At least 45 states faced or are facing shortfalls in their budgets for this and/or next year, and severe fiscal problems are highly likely to continue into the following year as well.").

31. *Id.* at 10.

32. *Id.* at 5.

33. *Id.* at 4 (projecting aggregate budget deficits of $180 billion for fiscal year 2011).

are manufactured and where the most goods are sold. But States *B* and *C* also have compelling justifications for taxation. State *B* provides all of the government services necessary for Company *X*'s warehousing operations—such as police and fire protection, infrastructure, and a public school system that supplies a competent local workforce. Furthermore, both states *B and C* provide all of the government services necessary to furnish the markets exploited by Company *X*,[34] as well as court systems that Company *X* may use to enforce the legal obligations of its customers and business partners in the area. Thus, allocating Company *X*'s entire taxable income to any one state is an unsatisfactory solution.[35]

Nor is it sufficient simply to divide Company *X*'s income among the three states on the basis of where each sale occurs. This is because the income that a multistate business derives from a sale is not generated solely by its activity within the state where the product is delivered to the consumer. For example, suppose a customer in State *C* places a telephone order with Company *X* at its main office in State *A*. The warehouse in State *B* then fills the order and ships it to the customer in State *C*. To apportion all of the resulting income to State *C* would ignore the fact that much of the economic activity that generated the income derived from the sale—such as the manufacture of the goods, and the filling and shipping of the order—occurred in states *A* and *B*. As a result, allocating Company *X*'s income

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34. *See* John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 378 n.331 (2004) ("Taxes are what we pay to live in a society that allows a market to operate in the first instance. Like it or not, the government is a 'silent partner' in the economy . . . that often is not appreciated until it ceases to function . . . .").

35. *See* JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION: CORPORATE INCOME AND FRANCHISE TAXES ¶ 9.02 (2d ed. 1993) ("It is because of such competing claims of the States [and] . . . the difficulty of . . . attaching the entire proceeds of sales to a single State, that allocation . . . of the proceeds of sales under net income taxes has been largely rejected by the States."). Mazerov elaborates:

> Services provided to corporations by *states in which their production occurs* include police and fire protection provided to their facilities and their employees while at work, water and sewage services, transportation infrastructure, and K–12 and higher-education services that enable corporations to find adequately-prepared workers. Public services provided by *states in which corporations' customers are located* are also crucial to their ability to earn a profit; these services include roads on which their goods are transported to their customers and a judicial system that ensures that their customers pay their debts.

MICHAEL MAZEROV, CTR. ON BUDGET & POLICY PRIORITIES, THE "SINGLE SALES FACTOR" FORMULA FOR STATE CORPORATE TAXES: A BOON TO ECONOMIC DEVELOPMENT OR A COSTLY GIVEAWAY? 77 n.6 (rev. 2005) (emphasis added), *available at* http://www.cbpp.org/files/3-27-01sfp.pdf.

entirely on the basis of the destination of its sales is also an unsatisfactory solution.[36]

Instead, the states that impose a corporate income tax rely on formulary apportionment to determine what portion of a multistate firm's income each may tax.[37] Formulary apportionment uses certain factors—sales, capital, and labor—to measure the business activity of a particular corporate taxpayer in a particular state.[38] A company's total taxable income is then apportioned to each state according to the formula.[39] There are at least six basic types of apportionment formulas employed by states.[40] For simplicity, let us assume that States *A*, *B* and *C* all use the most common apportionment formula, the double-weighted sales factor formula, which is used by twenty states.[41] With respect to State *A*, the formula would provide as follows:

$$\frac{2\left(\frac{Sales\ in\ A}{Sales\ in\ A, B, and\ C}\right) + \frac{Property\ in\ A}{Property\ in\ A, B, and\ C} + \frac{Payroll\ in\ A}{Payroll\ in\ A, B, and\ C}}{4} \text{ X } Taxable\ Income$$

Substituting the figures from our hypothetical yields the following:

$$\frac{2\left(\frac{100}{200}\right) + \frac{12}{16} + \frac{6}{8}}{4} = 0.625$$

36. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 35, ¶ 9.02 ("Whatever the law of contracts as to where the contract is made, or the law of sales as to where title passes, such considerations ought not be decisive in determining State fiscal policy as to how the receipt of income should be taxed."); MAZEROV, *supra* note 35, at 77 n.6 (describing benefits that businesses derive from states in which they produce goods and from states in which they sell goods); *see also infra* notes 50–53 and accompanying text (critiquing sales-only apportionment).

37. *See* CONGRESSIONAL RESEARCH SERVICE, *supra* note 21, at 2 (describing the methods of formulary apportionment employed by the forty-five states that impose a corporate income tax).

38. *See* MAZEROV, *supra* note 35, at 15–17 (describing formulary apportionment). *But see* Charles E. McLure, Jr., *The State Corporate Income Tax: Lambs in Wolves' Clothing*, *in* THE ECONOMICS OF TAXATION 327, 328 (Henry J. Aaron & Michael J. Boskin eds., 1980) ("[S]tate corporate income taxes levied on multistate firms have essentially the same effect as discriminatory state taxes on corporate payrolls, property, or sales . . . if the profits of the firm are allocated among the states for tax purposes that include payrolls, property, or sales . . . .").

39. MAZEROV, *supra* note 35, at 15–17.

40. *See* CONGRESSIONAL RESEARCH SERVICE, *supra* note 21, at 6 (describing the following apportionment schemes: even-weight, even-weight hybrid, double-weight sales, double-weight sales hybrid, single-factor sales, and "other").

41. MAZEROV, *supra* note 35, at 22.

The result is an apportionment factor of 0.625, meaning that State *A* would levy its corporate income tax on 62.5% of Company *X*'s total taxable income. Similarly, State *B*'s apportionment factor would be 0.250 and State *C*'s would be 0.125, meaning the States *B* and *C* would levy tax on 25% and 12.5%, respectively, of Company *X*'s total profit. In this example, it is only because each state uses the same formula that the apportionment factors from all three states add up to one, thus ensuring that Company *X* pays state corporate income tax on precisely 100% of its taxable income.[42] If each state used different apportionment formulas, Company *X* would likely end up paying tax on less—or more—than 100% of its income, depending on the particular formula used by each state.[43] Thus, the lack of a uniform method of income apportionment among the states produces undesirable "gaps and overlaps in the tax bases of the various states."[44]

The problems inherent to a nonuniform system of apportionment are exacerbated by the increasing popularity of sales-only apportionment.[45] States that switch from three-factor apportionment to a formula based only

42. *See, e.g.*, R. Todd Ervin, Comment, *The Taxation of Financial Institutions: Will Physical Presence or Economic Presence Win the Day?*, 19 VA. TAX REV. 515, 530–31 (2000) ("The problem of multiple taxation would be largely eliminated if all states asserting jurisdiction adopted uniform apportionment and allocation standards . . . .").

43. *See* CONGRESSIONAL RESEARCH SERVICE, *supra* note 21, at 16 ("Many economists and other researchers who analyze state corporate income taxes agree that . . . [t]he current mosaic of state corporate income tax rules creates economic inefficiencies [due to] . . . potential gaps and overlaps in taxation.") Judging from the data in Part II, however, it does not appear that the taxation of *more* than 100% of multistate corporation income is a rampant problem. Corporations likely devote significant resources to structuring their operations in ways that avoid this result. Increased uniformity among state apportionment methods would free up such finite resources for use in economic activities that actually benefit society—say, building better widgets—rather than mere navigation through the varied patchwork of state income tax rules so as to avoid multiple taxation. Uniformity would also reduce tax planning opportunities that are problematic from both an equity and efficiency perspective, as discussed in Parts VI.A.–B.

44. Charles E. McLure, Jr., *The Nuttiness of State and Local Taxes—and the Nuttiness of Responses Thereto*, 25 STATE TAX NOTES 841, 849 (2002).

45. *See id.* at 850 ("There has been a recent trend for states using the traditional equally weighted three-factor apportionment formula to reduce the weight on payroll and property and increase the weight on sales."). Only nine states continue to use an equally weighted three-factor formula. MAZEROV, *supra* note 35, at 22. Twenty states double-weight the sales factor in their three-factor formula, as stated previously. *Supra* note 41 and accompanying text. Moreover, fourteen states have eliminated the property and payroll factors entirely and rely instead on sales-only apportionment formulas. MAZEROV, *supra* note 35, at 22. The number of states employing sales-only apportionment has doubled since 2002. *Compare* McLure, *supra* note 44, at 850 (finding seven such states in 2002), *with* MAZEROV, *supra* note 35, at 22 (finding fourteen such states in 2005).

on sales typically do so in the hope of spurring economic development.[46] A state that employs sales-only apportionment will tax a multistate business based solely on how many sales are made within its borders; the amount of property and payroll a firm has in that state becomes irrelevant for income tax purposes. Consequently, certain corporate taxpayers, especially manufacturers, stand to benefit from a shift to sales-only apportionment in their states of production (where capital and labor inputs are high), especially if three-factor apportionment remains the rule in their market states (where capital and labor inputs are low).[47] Under such a scenario, less income is attributed to the taxpayer's production states with no corresponding increase in income attributed to its market states. This creates what is referred to as "nowhere income" that is untaxed by any state.[48] To illustrate this point, suppose that Company *X* persuades State *A* to adopt a sales-only apportionment formula, which would provide as follows:

$$\frac{Sales\ in\ A}{Sales\ in\ A, B, and\ C}\ X\ Taxable\ Income$$

Substituting the figures from our hypothetical yields the following:

$$\left(\frac{100}{200}\right) = 0.5$$

The result is an apportionment factor of 0.5, meaning that State *A* would levy its corporate income tax on 50% of Company *X*'s total taxable income. This is in marked contrast to the apportionment factor of 0.625 in the prior example, in which State *A* employed a double-weighted sales factor formula. Assuming that States *B* and *C* do not change their formulas,

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46. *See* McLure, *supra* note 44, at 851 ("The shift to sales-only apportionment is probably best attributed to an economic development objective."). *But see* MAZEROV, *supra* note 35, at 37–55 (questioning the economic development rationale for states to switch to sales-only apportionment).

47. *See* MAZEROV, *supra* note 35, at 1–2 (discussing the rise of sales-only apportionment). As Mazerov notes:

> If *all* states adopted a sales-only formula, much of the tax savings received by particular multistate corporations in particular states would be offset by higher tax payments by these same corporations in other states. That is why multistate corporations are pushing adoption of the single sales factor formula in a limited number of states but *not* on a nationwide basis.

Id. at 2.

48. *Id.* at 24.

the outcome is that 12.5% of Company *X*'s entire taxable income "disappears" for state income tax purposes.[49]

From a tax policy standpoint, this result makes little sense. A metric based solely on sales does a poor job of approximating the degree of income-producing activity that occurs in each state.[50] Indeed, McLure has declared sales-only apportionment to be downright "nutty."[51] It is also not necessarily a taxpayer-friendly approach to income apportionment,[52] as sales-only apportionment may arbitrarily increase state income taxes for some businesses even as it arbitrarily reduces state income taxes for others.[53]

B. Jurisdictional Limitations on State Income Taxation

A state may not levy an income tax on a business if it lacks jurisdiction to do so. There are three basic limitations on state income tax jurisdiction:

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49. $0.625 - 0.5 = 0.125$ or 12.5%.

50. *See* McLure, *supra* note 44, at 850 ("It would be ludicrous, at best, to suggest that the sales-only apportionment formula reflects where income originates better then the three-factor formula."). McLure continues:

> Does anyone seriously believe that only sales—which are determined on a destination-basis—accurately reflects where income is earned in the oil industry? Would that have been equally true during the energy crisis, when oil companies were making above-normal profits? Should a firm attribute no more income to a state where it has oil wells and refineries than to other states where it has the same amount of sales?

Id.

51. *Id.* at 849.

52. *See* MAZEROV, *supra* note 35, at 2 (stating that sales-only apportionment "provides tax cuts to some corporations and imposes tax increases on others"). As Mazerov explains:

> Corporations with relatively large shares of their nationwide property and payroll in a state . . . but a relatively small share of their nationwide sales in that state receive tax cuts. Corporations with relatively little property and payroll in a state . . . but significant shares of their nationwide sales in that state experience tax increases.

Id. "Manufacturers are most likely to fit th[e former] profile, typically producing goods for a regional, nationwide, or worldwide market from a relative handful of plants." *Id.* at 21.

53. To be more precise, this result is arbitrary from a tax policy perspective. As a matter of *realpolitik*, however, it makes perfect sense. Of the fourteen states that have switched to sales-only apportionment, five states apply the formula primarily or exclusively to manufacturers—the taxpayers with the most to gain from the enactment of sales-only apportionment in their states of production. *Id.* at 22–23.

the Due Process Clause,[54] the Commerce Clause,[55] and Public Law 86-272 (P.L. 86-272).[56]

1. *The Due Process Clause*

The Due Process Clause of the Fourteenth Amendment provides that "[n]o . . . state shall deprive any person of life, liberty or property without due process of law."[57] In regard to state income taxation, the relevant inquiry is "whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state—that is, whether the state has given anything for which it can ask return."[58] Thus, the income of a multistate business may not be taxed by a state unless there is some "minimal connection"[59] between the income-generating activities of the business and the taxing state.[60]

This minimal connection requirement is essentially the same test used to determine whether a state court may assert personal jurisdiction over a defendant in civil litigation.[61] The analysis required under *International*

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54. *See* U.S. CONST. amend. XIV, § 1 ("No State shall . . . deprive any person of life, liberty, or property, without due process of law . . . .").

55. *See* U.S. CONST. art. 1, § 8, cl. 3 ("The Congress shall have Power . . . To regulate Commerce . . . among the several States . . . .").

56. Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified at 15 U.S.C. §§ 381–391 (2006)).

57. U.S. CONST. amend. XIV, § 1.

58. *See* MeadWestvaco Corp. v. Ill. Dep't of Revenue, 128 S. Ct. 1498, 1505 (2008) (describing due process limitations on state income tax jurisdiction (quoting Asarco, Inc. v. Idaho Tax Comm'n, 458 U.S. 307, 315 (1982))).

59. The term "nexus" has also been used to describe the minimal connection an entity must have with the taxing state in order to satisfy due process requirements. *See, e.g.*, Quill Corp. v. North Dakota, 504 U.S. 298, 312 (1992) ("Despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical . . . ."). This creates the potential for confusion because the Commerce Clause also imposes a nexus requirement for state assertion of taxing authority. *See id.* (distinguishing between Due Process nexus analysis and Commerce Clause nexus analysis).

60. Moorman Mfg. Co. v. Bair, 437 U.S. 267, 272–73 (1978) (quoting Norfolk & W. Ry. Co. v. Mo. State Tax Comm'n, 390 U.S. 317, 325 (1968)).

61. *See Quill*, 504 U.S. at 306–08 (applying the standard minimum contacts analysis for personal jurisdiction to find that a state's assertion of sales and use tax jurisdiction violated due process); Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945) ("To say that . . . [a] corporation is so far 'present' . . . [in a state] as to satisfy due process requirements, *for purposes of taxation* or the maintenance of suits against it in the courts of the state, is to beg the question to be decided." (emphasis added)).

Shoe Co. v. Washington[62] is whether the defendant to be sued, or the corporation to be taxed, "ha[s] certain minimum contacts with . . . [the state] such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.'"[63] The standard set out in *International Shoe* has evolved over the years as economic and social realities have dictated. In *McGee v. International Life Insurance Co.*,[64] for example, the Court noted: "[A] trend is clearly discernible toward expanding the permissible scope of state jurisdiction over out-of-state corporations and other nonresidents. In part this is attributable to the fundamental transformation of our national economy over the years. Today, many commercial transactions touch two or more states."[65] Current doctrine holds that if an entity "purposefully avails itself of the privilege of conducting activities within the forum state" then it can be brought under that state's jurisdiction.[66] Moreover, the Court has stated that "[s]o long as a commercial actor's efforts are 'purposefully directed' toward residents of another state, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there."[67]

2. *The Commerce Clause*

The Commerce Clause grants Congress the power to "regulate commerce . . . among the several states."[68] This power of Congress is plenary and absolute, except as otherwise limited by the Constitution.[69]

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62. *See Int'l Shoe*, 326 U.S. at 319–21 (holding that an out-of-state corporation that "exercises the privilege of conducting activities within a state" is subject to suit and taxation in that state within the limits of due process).

63. *Id.* at 320 (citations omitted).

64. *See* McGee v. Int'l Life Ins. Co., 355 U.S. 220, 223 (1957) (holding that an out-of-state corporation that enters into a contract with a "substantial connection" to a state is subject to suit in that state within the limits of due process).

65. *Id.* at 226.

66. World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 297 (1980) (quoting Hanson v. Deckla, 357 U.S. 235, 253 (1958)).

67. Burger King Corp. v. Rudzewicz, 471 U.S. 462, 476 (1985) (citations omitted).

68. U.S. CONST. art. 1 § 8, cl. 3.

69. *See* Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 423 (1946) ("The commerce clause is . . . as [Chief Justice John] Marshall declared in *Gibbons* v. *Ogden*, a grant to Congress of plenary and supreme authority over those subjects. The only limitation it places upon Congress' power is in respect to what constitutes commerce . . . ."); Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 196–97 (1824) ("This power, like all others vested in Congress, is complete in itself, may be exercised to its utmost extent, and acknowledges no limitations, other than are prescribed in the constitution . . . . [T]he sovereignty of Congress, though

The modern interpretation of the Commerce Clause grants Congress regulatory power over the channels and instrumentalities of interstate commerce, as well as activities that substantially affect interstate commerce.[70] Yet, the Commerce Clause is not simply an affirmative grant of legislative authority to Congress to regulate interstate commerce. By implication, it also prohibits states from acting within this sphere of legislative authority allocated exclusively to Congress.[71] This implicit restriction on the states is referred to as the "negative" or "dormant" Commerce Clause.[72] Thus, states may not "unjustifiably . . . burden the interstate flow of articles of commerce."[73] In regard to state taxation, the Court has outlined this prohibition as follows:

> [W]e will sustain a tax against a Commerce Clause challenge so long as the "tax [1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State."[74]

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limited to specified objects, is plenary as to those objects . . . ."). In regard to state income taxation, the most relevant limitation on Congress' commerce clause power is the Due Process Clause. *See supra* Part III.B.1 (describing the due process limitations on state tax jurisdiction).

70. *See* United States v. Lopez, 514 U.S. 549, 558 (1995) ("Congress may regulate the use of the channels of interstate commerce[,] . . . the instrumentalities of interstate commerce, . . . [and] those activities having a substantial relation to interstate commerce.").

71. *See* Wilson v. Black Bird Creek Marsh Co., 27 U.S. (2 Pet.) 245, 252 (1829) ("We do not think that the act . . . can . . . be considered as repugnant to the power to regulate commerce in its dormant state, or as being in conflict with any law passed on the subject."); Wyoming v. Oklahoma, 502 U.S. 437, 454 (1992) ("It is long established that, while a literal reading evinces a grant of power to Congress, the Commerce Clause also directly limits the power of the States to discriminate against interstate commerce." (citing Welton v. Missouri, 91 U.S. 275 (1876))).

72. *See* Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 298, 311 n.9 (1994) ("Our jurisprudence refers to the self-executing aspect of the Commerce Clause as the 'dormant' or 'negative' Commerce Clause.").

73. Or. Waste Sys., Inc. v. Dep't of Env't Quality, 511 U.S. 93, 98 (1994).

74. Quill Corp. v. North Dakota, 504 U.S. 290, 311 (1992) (quoting Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977)). As the Court explained:

> The *Complete Auto* analysis reflects . . . concerns about the national economy. The second and third parts of that analysis, which require fair apportionment and nondiscrimination, prohibit taxes that pass an unfair share of the tax burden onto interstate commerce. The first and fourth prongs, which require a substantial nexus and a relationship between the tax and state-provided services, limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce.

Id. at 313.

Moreover, the Supreme Court has long held that Congress, in the exercise of its affirmative Commerce Clause authority, may eliminate the restrictions that the dormant Commerce Clause places upon states.[75] In other words, Congress may authorize state activity that would otherwise violate the dormant Commerce Clause.[76] This general proposition applies with equal force to the specific matter of state taxation of multistate businesses, which clearly affects interstate commerce.[77] Furthermore, the Supreme Court has stated that "[i]t is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income."[78]

Congress has exercised its Commerce Clause power to expand state taxing authority. For example, Congress has authorized states to tax out-of-

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75. *See* Int'l Shoe Co. v. Washington, 326 U.S. 310, 315 (1945) ("It is no longer debatable that Congress, in the exercise of the commerce power, may authorize the states, in specified ways, to regulate interstate commerce or impose burdens upon it."); Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 434 (1946) ("This broad authority Congress may exercise alone . . . or in conjunction with coordinated action by the states, in which case limitations imposed for . . . preservation of their powers become inoperative and only those designed to forbid action altogether by any power or combination of powers in our governmental system remain effective.").

76. Of course, the same cannot be said of the Due Process Clause. *See Quill*, 504 U.S. at 305 ("[W]hile Congress has plenary power to regulate commerce among the States and thus may authorize state actions that burden interstate commerce . . . it does not similarly have the power to authorize violations of the Due Process Clause.").

77. *See* Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 434 (1946) (holding that Congress was within its power under the Commerce Clause to authorize state taxation of national insurance companies that would otherwise violate the dormant Commerce Clause). As the Court explained:

> The power of Congress over commerce exercised entirely without reference to coordinated action of the states is not restricted, except as the Constitution expressly provides, by any limitation which forbids it to discriminate against interstate commerce and in favor of local trade. Its plenary scope enables Congress not only to promote but also to prohibit interstate commerce, as it has done frequently and for a great variety of reasons.

Id. Even the narrower conception of Commerce Clause authority set forth in more recent cases—such as United States v. Lopez, 514 U.S. 549 (1995), Printz v. United States, 512 U.S. 898 (1997), and United States v. Morrison, 529 U.S. 598 (2000)—poses no threat to the well-recognized principle that Congress has the authority to regulate state taxation of interstate commerce. *See, e.g.*, Walter Hellerstein, *Federal Constitutional Limitations on Congressional Power to Legislate Regarding State Taxation of Electronic Commerce*, 53 NAT'L TAX J. 1307, 1324 (2000) ("There is no doubt that Congress has the power under the Commerce Clause to . . . permit the states to tax [interstate] commerce in ways that the [dormant] Commerce Clause currently forbids.").

78. Moorman Mfg. Co. v. Bair, 437 U.S. 267, 280 (1978).

state insurance companies more heavily than local insurers,[79] even though such a policy, without congressional approval, would discriminate unconstitutionally against interstate commerce.[80] Similarly, Congress has empowered states to levy sales taxes on certain interstate telephone calls when it would otherwise violate the dormant Commerce Clause.[81]

Congress has also exercised its Commerce Clause authority to restrict state taxation of interstate commerce.[82] The broadest limitation Congress has imposed on state taxing authority is P.L. 86-272,[83] which carves out a range of activities in which out-of-state vendors of tangible personal property may engage without establishing a substantial nexus in a market state.[84] Congress has also imposed narrower, industry-specific limitations

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79. McCarran-Ferguson Act, 15 U.S.C. §§ 1011–1015 (2006). Specifically, § 1011 provides:

> Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.

Id.; *see also* Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 410, 430–31 (1946) (relying on the McCarran-Ferguson Act to reject a dormant Commerce Clause challenge to a 3% tax on premiums that applied only to out-of-state insurance companies).

80. *See supra* note 77 and accompanying text (noting that Congress may remove dormant Commerce Clause restrictions on state taxation authority); *see also* Quill Corp. v. North Dakota, 504 U.S. 298, 311 (1992) (reaffirming the *Complete Auto* test for state taxation under the dormant Commerce Clause).

81. *See* Charles E. McLure, Jr. & Walter Hellerstein, *Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals*, 102 TAX NOTES 1375, 1378–79 (2004) (discussing the Mobile Telecommunications Sourcing Act (MTSA)). Congress passed the MTSA in response to the Supreme Court's decision in *Goldberg v. Sweet*, which held that the dormant Commerce Clause prohibited states from taxing particular interstate telephone calls. *Id.* at 1379; Goldberg v. Sweet, 488 U.S. 252, 263 (1989). The ruling had the effect of preventing *any* state from taxing certain calls. McLure & Hellerstein at 1379. Congress responded by simultaneously expanding and restricting state taxation authority:

> The expansion of state power is provided by the grant of authority to the state of the customer's home service provider to tax the charge for wireless services regardless of whether that state possesses power to tax the call under the preexisting standards of *Goldberg v. Sweet*. The contraction of state power is contained in the final clause that prevents any state other than the state of the customer's home service provider from taxing those charges, even if that state possessed power under *Goldberg v. Sweet* to tax the charge.

Id.

82. *See* McLure & Hellerstein, *supra* note 81, at 1376 ("Apart from . . . [P.L. 86-272], Congress has restricted states' power (other than their power to tax the federal government or its instrumentalities) only in narrowly defined circumstances.").

83. Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified at 15 U.S.C. §§ 381–391 (2006)).

84. *See infra* Part III.B.3 (discussing P.L. 86-272).

on state taxing authority.[85] For example, Congress has prohibited states from taxing certain property—such as that of railroads,[86] motor carriers,[87] and air carriers[88]—more heavily than other commercial and industrial property.

3. The "Safe Harbor" of Public Law 86-272

Passed in 1959, P.L. 86-272[89] was the first statutory limitation on state tax jurisdiction ever imposed by Congress, and it remains the broadest.[90] It carves out a range of activities in which out-of-state vendors of tangible personal property may engage without establishing a substantial nexus with a market state for business activity tax purposes.[91] Specifically, P.L. 86-272 permits such firms to engage in the "solicitation of orders" within a market state without becoming taxable there, as long as it approves and ships those orders from outside the state.[92]

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85. *See* Kendall L. Houghton & Walter Hellerstein, *State Taxation of Electronic Commerce: Perspectives on Proposals for Change and Their Constitutionality*, 2000 B.Y.U. L. REV. 9, 63 n.127 (2000) (listing examples of such limitations).

86. Railroad Revitalization and Regulatory Reform Act of 1976, 49 U.S.C. § 11501 (2006).

87. *See* 49 U.S.C. § 14502(b) (2006) (prohibiting states from taxing "motor carrier transportation property" more heavily than "other commercial and industrial property").

88. *See id.* § 40116(2)(A) (2006) (prohibiting states from taxing "air carrier transportation property" more heavily than "other commercial and industrial property of the same type").

89. Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified at 15 U.S.C. §§ 381–391 (2006)).

90. *See* Michael T. Fatale, *Federalism and State Business Activity Tax Nexus: Revisiting Public Law 86-272*, 21 VA. TAX REV. 435, 437 (2002) ("Public Law 86-272 . . . was the first federal statute to impose general restrictions upon the state's power to tax."); McLure & Hellerstein, *supra* note 81, at 1376 ("Public Law 86-272, which limits . . . states' power to tax income that an out-of-state vendor derives from sales into a state when the vendor's only activities in the state are the solicitation of orders for tangible personal property, is the most significant piece of federal legislation restricting state taxing power.").

91. *See* McLure & Hellerstein, *supra* note 81, at 1376 ("Public Law 86-272 limits . . . states' power to tax income that an out-of-state vendor derives from sales into a state when the vendor's only activities in the state are the solicitation of orders for tangible personal property . . . .").

92. *See* 15 U.S.C. § 381(a) (2006) (describing activities out-of-state firms may engage in without establishing a substantial nexus with a market state). Congress did not define "solicitation," however, and the lack of a clear definition remains problematic to this day. *See* Fatale, *supra* note 90, at 477–78 n.245 (describing the lack of a clear definition of "solicitation"). As one commentator explains:

> For years, tax practitioners urged the Supreme Court to step in and define the

A return to our hypothetical illustrates the effect of P.L. 86-272 on state income tax jurisdiction. Clearly, State *A* may tax Company *X* because it established a substantial nexus with State *A* by incorporating and operating a manufacturing plant there. State *B* may also tax Company *X* because the maintenance of a warehouse within its borders creates a substantial nexus there. State *C*, however, may not tax any portion of Company *X*'s income. This is because Company *X* has no physical presence in State *C* and is engaged in the solicitation of orders for tangible personal property—widgets, in this case—that are filled and shipped from outside the state.[93] The business operations of Company *X* therefore fall within the "safe harbor" of P.L. 86-272. As a result, 12.5% of Company *X*'s total profit—the amount attributable to State *C*—potentially will not be taxed by *any* state, resulting once again in nowhere income.

Public Law 86-272 was passed in haste[94] amid concerns that a recent Supreme Court decision, *Northwestern States Portland Cement Co. v. Minnesota*,[95] had created uncertainty about the level of activity in which an out-of-state corporation could engage within a market state without establishing a substantial nexus for income tax purposes.[96] The safe harbor of P.L. 86-272 was therefore intended as an "effective stopgap or temporary solution while further studies are made of the problem."[97] Fifty years later, however, a permanent legislative fix has yet to materialize.[98]

> term 'solicitation.' Thirty-three years after the enactment of Public Law 86-272, the Court did so in *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, whereupon commentators concluded that the term remains ambiguous . . . .

Id.

93. *See* 15 U.S.C. § 381(a) (2006) (describing activities out-of-state firms may engage in without establishing a substantial nexus with a market state).

94. *See* Fatale, *supra* note 90, at 437 ("Responding to intense business lobbying, Congress quickly deliberated the Act and passed it in just over six months, giving the states very little input.").

95. *See* Nw. States Portland Cement Co. v. Minnesota, 358 U.S. 450, 452 (1959) (holding that an out-of-state corporation that uses its employees to solicit orders within a market state may establish a substantial nexus there for income tax purposes).

96. *See* Heublein, Inc. v. S.C. Tax Comm'n, 409 U.S. 275, 280 n.5 (1972) ("'Persons engaged in interstate commerce are in doubt as to the amount of local activities within a State that will be regarded as forming a sufficient 'nexus' . . . with the State to support the imposition of a tax on net income from interstate operations and 'properly apportioned' to the State.'" (quoting S. REP. NO. 658, at 2–3 (1959))).

97. S. REP. NO. 658, 2–3 (1959).

98. *See* Fatale, *supra* note 90, at 438 ("Congress passed Public Law 86-272 as a 'temporary' or 'stop-gap' measure, but has not revisited the Act in the forty-three years since its enactment." (quoting S. REP. NO. 658, 2–3 (1959))).

4. Quill Corp. v. North Dakota

At issue in *Quill Corp. v. North Dakota*[99] was whether North Dakota could require Quill Corporation (Quill), a mail-order retailer of office equipment and supplies, to collect sales tax[100] from its North Dakota customers and remit the revenue to the state. The disputed North Dakota law imposed a sales tax collection duty on any vendor that advertised three or more times a year in the state.[101] The validity of North Dakota's assertion of sales tax jurisdiction turned on whether Quill had established with the state the minimum contacts required under the Due Process Clause and the substantial nexus required under the dormant Commerce Clause.[102]

Quill had no physical presence in North Dakota. No Quill employees lived or worked there, and Quill owned no tangible property in the state.[103] However, Quill generated roughly $1 million in sales to approximately 3,000 North Dakota customers by solicitation through "catalogs and flyers, advertisements in national periodicals, and telephone calls."[104]

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99. *See* Quill Corp. v. North Dakota, 504 U.S. 298, 315 (1992) (reaffirming that the dormant Commerce Clause protects "vendors 'whose only connection with customers in the [taxing] state is by common carrier or the United States mail'... from state-imposed duties to collect sales and use taxes" (quoting Nat'l Bellas Hess, Inc. v. Dep't of Revenue, 386 U.S. 753, 758 (1967))).

100. This Note uses the term "sales tax" to refer to "use tax" as well as sales tax. Sales taxes are generally imposed on consumers that purchase tangible personal property within the taxing state, whereas use taxes are imposed on consumers that purchase tangible personal property outside the taxing state for use within the taxing state. *See* JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION: SALES AND USE, PERSONAL INCOME, AND DEATH AND GIFT TAXES ¶¶ 12.03, 16.01 (2d ed. 1992) (discussing the difference between sales taxes and use taxes). Use taxes are therefore designed to "safeguard State sales tax revenues from erosion by purchases of goods outside the State, and to protect local merchants from loss of business to border and other States that either have no sales tax or whose sales tax rate is lower than that of the merchant's State." *Id.* ¶ 16.01. Thus, sales taxes and use taxes can be thought of as complementary sides of the same coin, and the technical distinctions that exist between the two are not relevant to this Note.

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

102. *See id.* at 313 ("[A] corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause.").

103. *Id.* at 302. Technically, Quill did hold title to "a few floppy diskettes" in the state as it "licensed a computer software program to some of its North Dakota customers that enabled them to check Quill's current inventories and prices and to place orders directly." *Id.* at 315 n.8, 302 n.1. However, the State conceded that this seemed "a slender thread upon which to base nexus," and the Court agreed. *Id.* at 315 n.8.

104. *Id.* at 302.

The Court ruled that the Due Process Clause did not bar North Dakota's assertion of sales tax jurisdiction over Quill because the corporation purposefully directed its activities at North Dakota residents.[105] Given the evolution of Due Process Clause jurisprudence over the latter half of the twentieth century,[106] this determination by the Court was hardly surprising. It simply represented a straightforward application of the minimum contacts test first set forth in *International Shoe*.[107] As a result, Quill's lack of physical presence in North Dakota was of no moment for due process purposes.[108]

The Court declined, however, to extend this reasoning to its dormant Commerce Clause analysis:

> Despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical. The two standards are animated by different constitutional concerns and policies.
>
> Due process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him. We have, therefore, often identified "notice" or "fair warning" as the analytic touchstone of due process nexus analysis. *In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy.*[109]

The Court went on to find that North Dakota's assertion of sales tax jurisdiction over Quill violated the dormant Commerce Clause.[110] It noted that there are more than 6,000 state and local sales tax jurisdictions, each of

105. *Id.* at 308.

106. *Supra* Part III.B.1.

107. *See* World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 297 (1980) (holding that an entity which "purposefully avails itself of the privilege of conducting activities within the forum State" is properly subject to its jurisdiction (quoting Hanson v. Denckla, 357 U.S. 235, 253 (1958))).

108. *See* Burger King Corp. v. Rudzewicz, 471 U.S. 462, 476 (1985) ("So long as a commercial actor's efforts are 'purposefully directed' toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there." (citations omitted)).

109. *Quill*, 504 U.S. at 312 (emphasis added). The term substantial nexus is also sometimes used to describe the minimum contacts required to sustain a state tax levy under the Due Process Clause. *See id.* ("Despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical.").

110. *Id.* at 317–18.

which might impose a similar collection duty upon Quill.[111] The Court concluded that such a result would unduly burden interstate commerce.[112]

In reaching its conclusion, the Court was influenced by the need for "settled expectations" in the sales tax arena.[113] In reaffirming the physical presence definition of substantial nexus for sales tax, the Court preserved a twenty-five-year-old safe harbor for mail-order catalogue companies first established in *National Bellas Hess, Inc. v. Department of Revenue*.[114] Stare decisis considerations weighed heavily in the *Quill* decision, as the Court acknowledged that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue [of substantial nexus] to arise for the first time today."[115] And while the Court conceded that the physical presence distinction established by *Bellas Hess* was indeed somewhat "artificial at its edges," it accorded great value to the clarity that the bright-line rule provided.[116]

It remains an open question, however, whether *Quill* represents a jurisdictional limitation on state income taxation. *Quill* is important primarily because it clarified the difference between the Due Process Clause and dormant Commerce Clause limitations on state tax jurisdiction.[117] Unfortunately, because the case dealt with state *sales* tax jurisdiction, this clarity does not extend to the state *income* tax arena.[118] As

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111. *Id.* at 313 n.6.

112. *Id.* at 317–18.

113. *Id.* at 316.

114. *See* Nat'l Bellas Hess, Inc. v. Dep't of Revenue, 386 U.S. 753, 758 (1967) (holding that the Due Process Clause and Commerce Clause prohibit states from imposing a sales and use tax collection duty on vendors whose only connection with customers in the taxing state is by common carrier or the United States mail).

115. *Quill*, 504 U.S. at 311.

116. *Id.* at 315. As the majority explained:

> Such a rule firmly establishes the boundaries of legitimate state authority to impose duty to collect sales and use taxes and reduces litigation concerning those taxes. This benefit is important, for as we have so frequently noted, our law in this area is something of a "quagmire" and the "application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation.

Id. at 315–16 (citations omitted).

117. *See id.* at 305 ("[A]lthough we have not always been precise in distinguishing between the two [in state taxation cases], the Due Process Clause and the Commerce Clause are analytically distinct.").

118. *See id.* at 314 ("[W]e have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes . . . .").

Part IV discusses how state courts disagree over whether *Quill's* physical presence standard for sales tax nexus is applicable to income tax jurisdiction, and how the Supreme Court has declined to reconcile such conflicting interpretations of its ruling in *Quill*. At the very least, then, *Quill* represents an influential source of confusion under the current state corporate income tax system.[119]

C. *"Throwback"*

States have at their disposal several tools to close existing tax loopholes under the current jurisdictional framework. "Throwback" is a statutory mechanism available to states in which sales originate and applicable to businesses that have established a substantial nexus with that state.[120] A throwback rule allows such a state to tax nowhere income by treating sales to certain other states (states in which a business has *not* established a substantial nexus) as sales that occurred within the taxing state where the sale originated.[121] Such receipts are essentially "thrown back" to the taxing state and factored into the numerator of its apportionment formula. Approximately half of the states that impose a corporate income tax have enacted throwback provisions.[122]

To illustrate the effect of throwback, recall from our hypothetical that Company *X* had established a substantial nexus in both State *A* and State *B*.

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119. *See, e.g.*, MICHAEL MAZEROV, CTR. ON BUDGET & POLICY PRIORITIES, CLOSING THREE COMMON CORPORATE INCOME TAX LOOPHOLES COULD RAISE ADDITIONAL REVENUE FOR MANY STATES 21 n.19 (rev. 2003), *available at* http://www.cbpp.org/archiveSite/4-9-02sfp.pdf (discussing the unclear state of the law); Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425, 445 (1997) ("[A]t this juncture, the law of nexus is in a state of . . . considerable uncertainty. One cannot state with certainty precisely what sorts of connections with a state will suffice for . . . income . . . tax jurisdiction.").

120. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 35, ¶ 9.21[1][b] (describing the throwback rule). As Hellerstein and Hellerstein explain:

> [Throwback] is based on the premise that the State of origin of a shipment of goods is not justified in increasing its apportionment of net income of an interstate seller, if a State that has the power to tax chooses not to exercise it, but that such an increase is justified if the State of the destination lacks the constitutional power to subject the vendor to its income tax.

Id. Whatever the validity of this distinction, it does lead circuitously back to the original problem that it is often not clear whether a state has the constitutional power to subject a vendor to its income tax. This illustrates one major shortcoming of throwback as a tool for reducing nowhere income. *Infra* notes 126–28 and accompanying text.

121. *Supra* note 120 and accompanying text.

122. *See* MAZEROV, *supra* note 119, at 5 (listing states that have adopted a throwback rule).

However, Company *X* had not established a substantial nexus with State *C* because its activities there came within the safe harbor of P.L. 86-272. As a result, while State *A* may levy its income tax on its apportioned share of Company *X*'s income (62.5%), and State *B* may levy its income tax on its apportioned share (25%), State *C* may not levy income tax on its share (the remaining 12.5% of Company *X*'s income). This income potentially would not be taxed by any state. In such circumstances, State *A* and State *B* may assert taxing jurisdiction over this nowhere income if it is derived from shipments that originate in their state.[123] So if State *A* were to employ a throwback mechanism, the portion of the sales that Company *X* generated in State *C* by shipping goods there from its plant in State *A* would be apportioned to State *A*, even though such sales would otherwise be attributable only to State *C*. Similarly, if State *B* were to adopt a throwback rule, the remaining portion of the sales that Company *X* generated in State *C* by shipping goods from its warehouse in State *B* would be thrown back to State *B*. In this simplified example, then, the throwback rules employed by States *A* and *B* succeed at eliminating all of Company *X*'s nowhere income from State *C* by allocating it based on where the shipment of sold goods originated.

Nevertheless, throwback rules suffer from three serious flaws that render them an unsatisfactory solution to the nowhere income problem. First, they do not provide for the equitable distribution of the tax revenue that results from the captured nowhere income.[124] That is, even if throwback rules are able to eliminate the nowhere income of a particular business, they still fail to ensure that each state that furnishes a market exploited by that business is able to receive its fair share of the tax revenue created by activity within its borders.[125] To return to our hypothetical, for example, why should States *A* and *B* receive a windfall in tax revenue at the expense of State *C*, where the revenue originated? There is no justification for this result. This effect is particularly unfair when one considers that windfall States *A* and *B* already enjoy the job creation and other economic

123. *See supra* note 120 and accompanying text (explaining the throwback rule).

124. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 35, ¶ 9.21[1][c] ("In some cases, the nexus of the origin State with the sale may warrant a throwback, but in others the relationships of the State of origin to the transactions may be minimal, so that the throwback rule results in distortion."); *see also* Cass Vickers, *Do States Want Uniform Corporate Income Taxes? Interview with Bruce Johnson and Stephen Kranz*, 50 STATE TAX NOTES 803, 806 (2008) ("The real villain in the piece is P.L. 86-272. The throwback and throwout rules are very imperfect attempts to deal with a bad federal law." (statement of Bruce Johnson)).

125. *See supra* notes 34–35 and accompanying text (describing the benefits that out-of-state firms derive from market state governments).

development benefits—such as property and payroll tax revenue—associated with Company *X*'s manufacturing plant and warehouse. If State *C* is denied the ability to tax the income generated within its borders, out-of-state businesses may avail themselves of its market and laws while passing all of the cost of upkeep onto their in-state competitors.

The second problem with throwback rules is that their utility depends on a clear definition of substantial nexus, but no such definition exists.[126] States that utilize throwback measures (and the taxpayers that comply with them) must determine not only which of the other forty-nine states to which sales were made but also whether the taxpayer has established a substantial nexus with each such state; otherwise, the taxing state cannot know which sales to throw back.[127] Thus, throwback is merely a band-aid solution that fails to address the more fundamental problem—the lack of a clear definition of substantial nexus under current law—while further complicating an already needlessly complex state of affairs. Indeed, such "fixes" illustrate why state corporate income taxes have been criticized as "probably the most inefficient, least cost-effective revenue source available to the states."[128]

Third, throwback rules do not apply to certain types of income.[129] For example, income derived from the sale or lease of intangible property is not subject to throwback.[130] Because some of the most significant state tax loopholes involve income derived from intangibles,[131] throwback is not effective at combating nowhere income in a way that ensures an equitable distribution of tax revenue among the states in which income is generated.[132]

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126. *See infra* Part IV (discussing contradictory conclusions state courts have drawn regarding *Quill*'s applicability to income tax jurisdiction).

127. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 35, ¶ 9.21[1][c] (citing the lack of "ease of compliance and administration" as a shortcoming of the throwback rule because it "requires the taxpayer to identify by State of origin all sales whose destination is a State lacking the requisite taxing power").

128. David Brinori, *Stop Taxing Corporate Income*, 25 STATE TAX NOTES 47, 48 (2002).

129. *See* Craig J. Langstraat & Emily S. Lemmon, *Economic Nexus: Legislative Presumption or Legitimate Proposition?*, 14 AKRON TAX J. 1, 7 (1999) ("[S]ales of intangible personal property and services are not subject to [throwback].").

130. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 35, ¶ 9.21[1][b] (explaining that throwback rules apply only to sales of *tangible* personal property).

131. *See infra* Part IV (discussing the taxation of out-of-state holding companies and out-of-state financial services institutions).

132. A slightly more effective variation of throwback is "throwout." *See* HELLERSTEIN & HELLERSTEIN, *supra* note 35, ¶ 9.21[1][c] (describing throwout). Under a throwout rule, sales to states where a business has not established a substantial nexus are "thrown out" of both the

D. Combined Reporting

Combined reporting, or combination, is the final piece of the current state corporate income tax puzzle. Combined reporting is another statutory mechanism that states may apply to businesses that have established a substantial nexus with their state. A state may require such a corporation to file a combined report that includes the income of all out-of-state corporate affiliates that participate in the unitary business of the in-state entity.[133] The state then applies its apportionment formula to the combined income of the unitary business group rather than simply to that of the in-state affiliate.[134] Combined reporting eliminates many of the benefits a corporation might otherwise receive from certain tax planning maneuvers, such as the use of out-of-state corporate subsidiaries to funnel income from a market state into

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numerator and the denominator of the sales factor by the state, or states, in which the business is taxable. The effect of the throwout variation is to "distribute non-taxable receipts among all the States that impose income taxes, whereas the throwback rule attributes the entire receipt to the State of origin of the shipments." *Id.* Thus, throwout still suffers from some of the same basic flaws as throwback. That is, neither method remedies the inequity that results when market states are prevented from taxing their fair share of income generated within their borders. *Supra* notes 124–25 and accompanying text. In addition, neither method applies to income generated from intangibles, thereby failing to counteract some of the most significant state tax loopholes. *See supra* notes 129–30 and accompanying text (explaining that throwback is limited to sales of tangible personal property); *infra* Part IV (discussing the taxation of out-of-state holding companies and out-of-state financial services institutions).

133. *See* MeadWestvaco Corp. ex rel. Mead Corp. v. Ill. Dep't of Revenue, 128 S. Ct. 1498, 1508 (2008) ("[W]e have described the 'hallmarks' of a unitary relationship as functional integration, centralized management, and economies of scale." (citing Mobil Oil Corp. v. Comm'r of Taxes of Vt., 445 U.S. 425, 438 (1980), and Butler Brothers v. McColgan, 315 U.S. 501, 506–08 (1942))). Despite these "hallmarks" offered by the Court, it is often difficult to determine whether a particular operation constitutes a unitary business. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 35, ¶ 8.11[1] ("Such generalizations, however, offer little practical guidance in deciding unitary business controversies, and, indeed, they have been repeated both by courts whose implementation of the doctrine has been highly restrictive, and by others that have applied it on a very broad basis."). To complicate matters further, states have developed their own varying definitions of a unitary business—which they are free to do, subject to the limits of the Due Process Clause and the dormant Commerce Clause. *See id.* (describing both broad and restrictive state definitions of a unitary business).

134. *See* McLure, *supra* note 44, at 848 (discussing combined reporting). As McLure explains:

> [S]ome states . . . "combine" the activities of affiliated corporations deemed to be engaged in a "unitary" business. Under unitary combination transactions between members of the group (for example, sales, royalties, interest payments, and dividends) are ignored and the income of the group is apportioned on the basis of the apportionment factors of the group.

Id.

another state that taxes such income less heavily or not at all.[135] Combined reporting therefore provides individual states with a unilateral method of remedying some of the same problems that this Note proposes to address through federal legislation.[136] Approximately half of the states that impose a corporate income tax currently require combined reporting.[137]

While a state-by-state, combined reporting approach is not the focus of this Note,[138] it is instructive to consider why this alternative is consistent with the jurisdictional limitations on state income taxation imposed by the Due Process Clause and the dormant Commerce Clause. After all, combined reporting allows a state to apportion the income of certain out-of-state affiliates that have not established a substantial nexus with the state, which at first blush might seem to raise concerns regarding extraterritorial taxation.[139] Nevertheless, the constitutionality of combined reporting is well-established.[140] It hinges on the principle that apportionment formulas are meant to provide only a *rough approximation* of the income-producing activity attributable to a particular state.[141] As a matter of federal

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135. *Infra* Part IV.A.

136. Combined reporting would not, however, resolve the two core defects of the current state corporate income tax system: the lack of a clear and fair definition of substantial nexus and the lack of uniformity in income apportionment. *Supra* Part I. Only Congress has such power. *Supra* Part III.B.2. Nor would combined reporting address situations in which an out-of-state firm is able to do a substantial amount of business in a market state without the need for an in-state corporate affiliate. In such cases, there would be no entity within the unitary business group that established a substantial nexus with the market state, and therefore no entity that the market state could require to file a combined report. *See supra* Part III.B.2 (discussing dormant Commerce Clause limitations on state tax jurisdiction). Examples of such taxpayers might include the out-of-state financial services institution, discussed in Part IV.B, as well as firms that operate primarily over the internet.

137. MICHAEL MAZEROV, CTR. ON BUDGET & POLICY PRIORITIES, A MAJORITY OF STATES HAVE NOW ADOPTED A KEY CORPORATE TAX REFORM—"COMBINED REPORTING" 1 (rev. 2009), *available at* http://www.cbpp.org/files/4-5-07sfp.pdf (finding that twenty-three of the forty-five states that impose a corporate income tax currently require combined reporting).

138. *See supra* note 136 and accompanying text (contending that federal intervention is necessary).

139. *See* Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 181 (1983) ("Under both the Due Process and the Commerce Clauses of the Constitution, a State may not, when imposing an income-based tax, 'tax value earned outside its borders.'" (citations omitted)).

140. *See id.* at 165 ("This Court long ago upheld the constitutionality of the unitary business/formula apportionment method, although subject to certain constraints." (citing Hans Rees' Sons, Inc. v. N.C. ex rel. Maxwell, 283 U.S. 123 (1931))).

141. *See id.* (describing the constitutional rationale for combined reporting). As the Court explained:

> In the case of a more-or-less integrated business enterprise operating in more than one State . . . arriving at precise territorial allocations of "value" is often an

constitutional law, then, states enjoy considerable leeway in how they choose to apportion the income of a multistate corporation that has established a substantial nexus with their state.[142] Objections that combined reporting violates the Due Process Clause or the dormant Commerce Clause due to its lack of geographic specificity will fail, for as the Supreme Court has held, such objections are "based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place."[143] Instead, the critical issue in such tax controversies is often whether an out-of-state affiliate is properly includable as part of the unitary business group operating in the taxing state.[144]

*IV. Post-*Quill *Jurisprudence and the Problematic Physical Presence Standard for Income Tax Nexus*

Let us now return to *Quill.* State courts have struggled to determine whether *Quill*'s physical presence requirement for sales tax jurisdiction applies to income tax jurisdiction. Some state courts and commentators answer this question affirmatively.[145] One justification for this view is that a state's assertion of sales tax jurisdiction merely imposes an administrative duty upon the affected business—the duty to collect the sales tax from the customer and remit it to the market state—whereas an income tax is imposed directly on the firm's earnings.[146] It is therefore argued that the

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> elusive goal, both in theory and in practice. For this reason and others, we have long held that the Constitution imposes no single formula on the States, and that the taxpayer has the "distinct burden of showing by clear and cogent evidence that [the state tax] results in extraterritorial values being taxed . . . ."

Id. (citations omitted).

142. *See id.* at 181 (stating that fair apportionment requires only a "rational relationship between the income attributed to the State and the intrastate values of the enterprise" so that the income apportioned is not "out of all appropriate proportion to the business transacted" in the taxing state (citations omitted)).

143. *Id.*

144. *See supra* note 133 and accompanying text (discussing the unitary business principle).

145. *See, e.g.*, J.C. Penney Nat'l Bank v. Johnson, 19 S.W.3d 831, 839 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000) ("While it is true that . . . *Quill* . . . focused on use taxes, we find no basis for concluding that the analysis should be different in the present case . . . for franchise [taxes]."); Ervin, *supra* note 42, at 544 ("[A]doption of an economic presence standard of nexus in the assessment of income taxes is inappropriate as long as a physical presence standard applies in the context of sales and use taxes.").

146. *See* Ervin, *supra* note 42, at 544 ("[A] sales and use tax is nothing more than a

degree of presence required for income tax nexus should be at least as substantial as that required for sales tax nexus.[147]

Other state courts and commentators have countered that *Quill*'s physical presence standard does not extend to the income tax arena. This view emphasizes that *Quill* was concerned with subjecting multistate businesses to the onerous burden of collecting and remitting sales tax in up to 6,000 different state and local sales tax jurisdictions.[148] But as one commentator notes, "[t]hese concerns are simply irrelevant in the income tax context. Only 45 states and the District of Columbia impose a corporate income tax."[149] Consequently, the potential burden on interstate commerce is much less severe for income taxation.[150] Furthermore, the Court stated explicitly in *Quill* that "we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes."[151]

As a matter of federal policy, of course, it is irrelevant whether *Quill* limits state income tax jurisdiction. Congress is free to pass legislation extending or rejecting *Quill*'s physical presence requirement in the income tax context; it has the power to decide precisely what level of contact with a state will subject a business to taxation. Before drawing any normative conclusions regarding the appropriate standard for income tax nexus, however, it is helpful to examine how a physical presence requirement would apply to two important types of taxpayers: the out-of-state holding company, discussed in Part IV.A, and the out-of-state financial services institution, discussed in Part IV.B. Moreover, the implications of these examples extend to many other sorts of taxpayers, including those engaged in electronic commerce. As this Part demonstrates, an income tax nexus standard based on physical presence is quite problematic. The appropriate

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collection duty imposed on the taxpayer, whereas a direct income tax is actually borne by the taxpayer.").

147. *See id.* ("[A]doption of an economic presence standard of nexus in the assessment of income taxes is inappropriate as long as a physical presence standard applies in the context of sales and use taxes.").

148. *Supra* note 111 and accompanying text.

149. Sheldon H. Laskin, *Only A Name? Trademark Royalties, Nexus, and Taxing That Which Enriches*, 22 AKRON TAX J. 1, 13 (2007).

150. *See id.* ("[B]urdens of filing annual income tax returns reporting one's own income to no more than 47 taxing authorities are . . . [substantially less than those] of reporting use tax collected from hundreds of thousands, if not millions, of purchasers in thousands of taxing jurisdictions, on a quarterly or even monthly basis."). Forty-five states impose a general corporate income tax, as do New York City and the District of Columbia. *Id.*

151. Quill Corp. v. North Dakota, 504 U.S. 298, 315 (1992).

standard should instead be based on economic presence, as proposed in Part V.A.

A. Geoffrey I*: The Out-of-State Holding Company*

The widespread use of out-of-state holding companies to shelter income from state taxation illustrates why it is problematic to employ a physical presence nexus standard for state income tax jurisdiction. A classic example of this type of tax shelter is found in *Geoffrey, Inc. v. South Carolina Tax Commission* (*Geoffrey I*).[152] *Geoffrey I* involved an attempt by Toys R Us to use an out-of-state holding company to funnel all of its income, tax-free, out of a state in which it operated retail toy stores. The scheme worked as follows: Toys R Us, a New Jersey corporation, incorporated a wholly owned subsidiary in Delaware named Geoffrey and transferred the Toys R Us name and trademark rights to it.[153] Geoffrey then leased these rights back to Toys R Us in exchange for royalties of one percent on all sales by Toy R Us.[154] Pursuant to the agreement, Toys R Us began operating in South Carolina and paying royalties to Geoffrey, which Toys R Us deducted from its South Carolina taxable income as a business expense.[155] Geoffrey, which by design had no office or employees in South

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152. *See* Geoffrey, Inc. v. S.C. Tax Comm'n (*Geoffrey I*), 437 S.E.2d 13, 17–18 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993) (refusing to apply *Quill*'s physical presence requirement to limit state income tax jurisdiction).

153. *Id.* at 15.

154. *Id.*

155. *Id.* While it was not an issue in this case, out-of-state holding companies may often take the additional tax-avoidance step of lending their royalty income back to the parent company—a nontaxable event—which allows the parent company to then funnel additional money out of the state in which it is operating by deducting the interest payments to the holding company from its taxable income in the operating state. *See, e.g.*, A&F Trademark, Inc. v. Tolson, 605 S.E.2d 187, 189 (N.C. Ct. App. 2004) ("[Royalty] payments were made by an accounting journal entry. No checks were written and no physical transfer of funds occurred. Subsequently, the [out-of-state holding companies] entered into agreements loaning . . . [the] funds back to the related retail companies in the form of notes receivable bearing a market rate of interest . . . ."). The physically present retail companies then deducted these interest expenses from their North Carolina taxable income, while the out-of-state holding companies claimed that their resulting interest income could not be taxed by North Carolina because they had no physical presence within the state and thus had not established a substantial nexus there. *Id.* While this argument was unsuccessful in *A&F Trademark*, *id.* at 194–95, it likely would prevail in states that interpret *Quill* as a limit on state income tax jurisdiction. *See, e.g.*, *infra* note 166 (listing states that have rejected an economic presence standard for income tax nexus); *infra* note 168 (discussing cases that have adopted a physical presence standard for income tax nexus).

Carolina, did not report this royalty income to South Carolina on the ground that the company lacked a substantial nexus with the state.[156] Nor was Geoffrey required to report the royalty income to its domicile state of Delaware, which does not tax holding companies on income from intangible assets.[157] By interacting similarly with Toys R Us operations across the country, Geoffrey—a company without a single full-time employee—generated $55 million in profit in 1990 without paying any income tax to any state.[158]

The South Carolina Supreme Court resolved this problem by effectively adopting an economic nexus standard for state income taxation. It began by dismissing Geoffrey's due process objections.[159] It stated that Geoffrey had "purposefully directed its activities toward South Carolina's economic forum . . . by licensing intangibles for use in South Carolina and receiving income in exchange for their use."[160] The court held that this activity was sufficient to establish the minimum connection required by due process for South Carolina to assert taxing authority.[161] Turning to the dormant Commerce Clause, the court refused to extend the physical presence requirement of *Quill* to income tax jurisdiction.[162] It concluded that "by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a 'substantial nexus' with South Carolina" such that taxation of its income would not violate the first prong of the *Complete Auto* test.[163] The Supreme Court denied certiorari,[164] declining to clarify whether *Quill* applies to state income taxation. A number of other states

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

157. *See* Laskin, *supra* note 149, at 6 n.15 ("A Delaware-based corporation whose activities in Delaware are limited to maintaining and managing intangible assets that generate income, such as capital gains, dividends, interest and royalties, is exempt from Delaware income tax." (citations omitted)). Nor is the availability of such tax shelters limited to holding companies located in Delaware: "Similarly, royalty income is not subject to Michigan's Single Business Tax. Nevada, South Dakota, and Wyoming do not impose a corporate income tax." *Id.*

158. Geoffrey, Inc. v. S.C. Tax Comm'n (*Geoffrey I*), 437 S.E.2d 13, 15 n.1 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

159. *See id.* at 19–20 (rejecting Geoffrey's due process objections on the basis of its purposeful availment of the South Carolina market).

160. *Id.* at 16.

161. *Id.*

162. *See id.* at 18 ("In our view, Geoffrey's reliance on the physical presence requirement of *Bellas Hess* is misplaced.").

163. *Id.*

164. 510 U.S. 992 (1993).

have since followed *Geoffrey I*'s economic presence standard for income tax nexus.[165]

B. J.C. Penney National Bank*: The Out-of-State Financial Services Institution*

Other states have taken the opposite tack, rejecting economic presence as a sufficient jurisdictional basis for taxing the income of an out-of-state corporation, and instead extending the physical presence rule of *Quill*.[166] The leading such case, *J.C. Penney National Bank v. Johnson*,[167] did not involve an out-of-state holding company, but rather an out-of-state financial services institution that operated through the mail.[168] At issue in *J.C. Penney* was Tennessee's assertion of taxing jurisdiction[169] over the

165. *See, e.g.*, John J. Cronin & Maryann B. Gall, *Economic Nexus: A Case Study*, 14 STATE TAX NOTES 535, 537–39 (1998) (finding that nine states have "formally adopt[ed] a Geoffrey analysis": Arkansas, Florida, Hawaii, Iowa, Maine, Massachusetts, New Jersey, North Carolina, and Wisconsin).

166. *See id.* at 539–40 (finding that seven states have "illustrated a reluctance to enforce Geoffrey['s economic nexus doctrine]" via judicial decisions, administrative determinations, or legislation: Alabama, Connecticut, Michigan, New York, Ohio, Pennsylvania, and Texas).

167. *See* J.C. Penney Nat'l Bank v. Johnson, 19 S.W.3d 831, 839 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000) (applying *Quill*'s physical presence requirement to limit state income tax jurisdiction).

168. To be sure, pre-*Quill* versions of the physical presence nexus doctrine have been used to prevent state taxation of out-of-state holding companies. *See, e.g.*, Acme Royalty Co. v. Dir. of Revenue, 96 S.W.3d 72, 75 (Mo. 1992) (finding a trademark licensing agreement between a physically present corporation and its non-physically present Delaware holding company to be an insufficient basis upon which to tax the income of the holding company). Moreover, *J.C. Penney* is not the only judicial decision to explicitly extend the holding in *Quill* to income tax jurisdiction. *See, e.g.*, Rylander v. Bandag Licensing Corp., 18 S.W.3d 296, 299 (Tex. App. 2000) ("Although written in the context of sales and use taxes, *Quill Corp.* and *Bellas Hess* do not purport to apply a standard [to businesses activity taxes] other than the "substantial nexus" test applied in *Complete Auto* . . . ."); *In re* Wascana Energy Mktg., No. 817866, 2002 WL 1726832, at *17 n.6 (N.Y. Div. Tax App. July 18, 2002) (applying *Quill*'s physical presence requirement to limit state income tax jurisdiction). As the administrative law judge in *Wascana* reasoned:

> The *Quill* opinion seems to suggest that the nexus standard as applied to the duty to collect sales and use taxes may be different from the standard as it applies to a tax measured by income. However, the holding in *Quill* explicitly relies on and reaffirms the vitality of the substantial nexus requirement expressed in *Complete Auto*, which is applicable to franchise and income taxes.

Id.

169. Technically, the Tennessee franchise tax at issue is not an income tax because it is

Delaware-incorporated J.C. Penney National Bank (JCPNB).[170] While JCPNB had no physical presence in Tennessee, it engaged in credit card solicitation activity through the mail with potential customers throughout the United States, including Tennessee.[171] It maintained between 11,000 and 17,000 credit card accounts with Tennessee residents that generated an undetermined but presumably substantial amount of revenue for JCPNB.[172] In addition, JCPNB engaged a Tennessee collection agency to pursue debt collection efforts against its customers through the Tennessee court system.[173]

The Tennessee Court of Appeals found that due process did not bar taxation of JCPNB's Tennessee receipts, holding that "JCPNB has reached out to the citizens of the State of Tennessee through the solicitations for credit cards . . . [and] purposefully availed itself of the substantial privilege of doing business in the State of Tennessee."[174] However, the court went on to rule that Tennessee's assertion of taxing jurisdiction over JCPNB violated the dormant Commerce Clause.[175] Applying *Quill*, the court found that JCPNB's activities did not establish a substantial nexus because the bank lacked a physical presence in the state.[176] As the court concluded:

> Any constitutional distinctions between the franchise . . . taxes presented here and the use taxes contemplated in . . . *Quill* are not within the purview of this court to discern. As such, we feel that the outcome of

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levied on apportionable gross receipts, rather than taxable income, but it nonetheless falls within the broader category of business activity taxes with which this Note is concerned. *See supra* note 18 and accompanying text (defining business activity taxes).

170. *See J.C. Penney*, 19 S.W.3d at 832 ("[JCPNB] was a federally chartered national banking association incorporated under the laws of Delaware . . . . The present appeal arises from . . . [the Tennessee Commissioner of Revenue's] imposition of franchise and excise taxes against JCPNB on income allegedly generated by JCPNB's credit card activities in the State of Tennessee.").

171. *Id.*

172. *Id.* at 840.

173. *See id.* at 842 n.21 ("There is an indication in the record that one of JCPNB's affiliates used a Tennessee collection agency in order to recover moneys owed to JCPNB. Apparently, these collection efforts were aided through the use of the Tennessee court system.").

174. *Id.* at 837.

175. *See id.* at 839 ("While it is true that . . . *Quill* . . . focused on use taxes, we find no basis for concluding that the analysis should be different in the present case . . . for franchise taxes.").

176. *See id.* at 842 ("[T]he Commissioner has pointed to no case in which the Supreme Court of the United States has upheld a state tax where the out-of-state taxpayer had absolutely no physical presence in the taxing state.").

this case is governed by *Bellas Hess* and *Quill*, as those decisions interpret the first prong of the *Complete Auto* test.[177]

C. Discussion

The Tennessee Court of Appeals was bound by *Quill* once it determined (however questionably) that there was no relevant distinction to be drawn between sales tax and income tax.[178] The broader policy question for Congress is whether there *should* be a physical presence requirement for income tax nexus. The answer must be no. It is clear that JCPNB engaged in a substantial amount of commercial activity in Tennessee.[179] It would be an odd policy indeed to exempt JCPNB from paying Tennessee franchise tax on the receipts it derived from within Tennessee. Yet this is precisely the result that a physical presence rule dictates, as JCPNB had no physical presence in Tennessee.

The modern economic reality is that a physical presence is simply not necessary for a business to operate within a particular state. A nexus standard for state income taxation based on economic presence would acknowledge this reality. It would permit states to require out-of-state firms that do a significant amount of business within their borders to shoulder an income tax burden similar to that of their physically present, in-state competitors. As explained in Part VI, such an approach would greatly increase the horizontal equity of the current state corporate income tax system, ensuring that similar enterprises are taxed at similar levels regardless of whether they have a physical presence within a market state.

V. State Corporate Income Tax Reform: A Two-Pronged Approach

A. A Proposed Economic Presence Standard for Income Tax Nexus

Congress has failed to resolve the jurisdictional problems of the state corporate income tax system, and its "temporary" solution, P.L. 86-272, is now over fifty years old. The states, for their part, have failed to correct the

177. *Id.* at 839.

178. *See supra* notes 148–51 and accompanying text (discussing important distinctions between sales and use taxes and income taxes).

179. *See supra* notes 172–73 (noting that JCPNB cultivated tens of thousands of credit card accounts with customers in Tennessee and contracted with a debt collection agency to pursue legal action against its customers through the Tennessee court system).

myriad of inconsistent apportionment methods that have inhibited the efficient functioning of our national system of commerce for at least as long.[180] Federal intervention is long overdue.

The proper solution is two-fold. First, Congress should "expand"[181] state income tax jurisdiction by adopting the economic nexus standard proposed by the Multistate Tax Commission (MTC).[182] Second, Congress should require that states adhere to a uniform method of income apportionment, such as the Uniform Division of Income for Tax Purposes Act (UDITPA).[183] The tandem effect of this proposal would be to establish nexus certainty with a bright-line rule based on objective criteria, as well as to greatly reduce the existing risk of both nowhere income and multiple taxation by increasing uniformity in income apportionment.[184] Such legislation would also ease compliance and

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180. *See infra* note 205 and accompanying text (explaining that efforts to achieve uniformity in income apportionment among the states date back at least to the drafting of the Uniform Division of Income for Tax Purposes Act (UDITPA) in 1957).

181. The term "expansion" should be qualified because some states have already adopted an economic nexus standard. *Supra* note 165 and accompanying text. For these states, such legislation would confirm, rather than expand, their income tax jurisdiction. However, for the states that have "illustrated a reluctance to enforce *Geoffrey*['s economic nexus doctrine]" via judicial decisions, administrative determinations, or legislative direction, this proposal would constitute an expansion of taxing authority. *Supra* note 166 and accompanying text.

182. The MTC is "an intergovernmental state tax agency working on behalf of states and taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises." Multistate Tax Commission, About the Multistate Tax Commission, http://www.mtc.gov/About.aspx?id=40 (last visited Feb. 23, 2010) (on file with the Washington and Lee Law Review). The economic nexus standard put forth by the MTC was developed by Dr. Charles E. McLure, Jr., Senior Fellow with the Hoover Institution at Stanford University. *See generally* Charles E. McLure, Jr., *Implementing State Corporate Income Taxes in the Digital Age*, 53 NAT'L TAX J. 1287 (2000) (proposing a "factor presence" standard for income tax nexus); MULTISTATE TAX COMM'N, *supra* note 18, at n.7 (noting that McLure "originated the idea of factor presence nexus").

183. UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT (1957). A voluntary, uniform act for income apportionment, UDITPA was drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL). *Id.* prefatory note. It is widely agreed that UDITPA is in need of updating to account for changes in the national economy that have occurred since its drafting in 1957. *See, e.g.*, Benjamin F. Miller, *Current Problems with UDITPA and Possible Solutions*, 38 STATE TAX NOTES 125, 125 (2005) ("UDITPA was designed for a different and, almost assuredly, simpler economic and business environment."). The proper adjustments are a subject of much debate among commentators and somewhat beyond the scope of this Note.

184. *See supra* note 42 and accompanying text (noting that the risk of multiple taxation is virtually eliminated if states employ a uniform method of apportionment); *see also* Vickers, *supra* note 124, at 808 ("[F]ederal legislation . . . is the only solution [for producing uniformity]. States have little incentive to adopt a uniform state income tax allocation and

administrative burdens for businesses and states and reduce needless litigation over nexus. Moreover, it would help ensure that multistate and local businesses share similar income tax burdens in the states in which they operate, and provide much-needed fiscal relief to states struggling with dire budgetary shortfalls for years to come. Finally, such an approach would reduce the attractiveness of certain tax shelters, thereby freeing up finite business resources for use in efficient economic activity rather than mere tax avoidance.

The economic nexus standard proposed by the MTC provides that a substantial nexus is established when an out-of-state business entity exceeds any of the following thresholds in a state:

(a) a dollar amount of $50,000 of property; or

(b) a dollar amount of $50,000 of payroll; or

(c) a dollar amount of $500,000 of sales; or

(d) 25% of total property, total payroll or total sales.[185]

The MTC's economic nexus standard effectively eliminates the out-of-state holding company as a tax shelter by broadly defining "sales" to include: "The sale, lease or license of services, *intangibles*, and digital products for primary use by a purchaser known to the seller to be in . . . [the market] State."[186] Thus, if an out-of-state holding company derives more than $500,000 in royalties from the licensing of its intangible property—such as trademarked brand names—to its physically present, in-state affiliate, then both entities would be subject to taxation by the market state on an apportioned share of their income. Additionally, if an out-of-state firm generates gross receipts of more than $500,000 in a market state—through credit card lending, for example—then it would

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apportionment statute . . . . Without the federal government overriding state sovereignty the states will never achieve uniformity in the apportionment arena." (statement of Stephen Kranz)).

185. MULTISTATE TAX COMM'N, *supra* note 18, at D-1. The threshold amounts would be indexed for inflation. *Id.* Furthermore, the specific thresholds could just as easily be fixed at different reasonable amounts; the crucial benefit is that they provide bright-line rules based on objective criteria. *See* MICHAEL MAZEROV, CTR. ON BUDGET & POLICY PRIORITIES, FEDERAL "BUSINESS ACTIVITY TAX NEXUS" LEGISLATION: HALF OF A TWO-PRONGED STRATEGY TO GUT STATE CORPORATE INCOME TAXES 3 (2005), *available at* http://www.cbpp.org/1-26-05sfp.pdf ("Congress could implement a proposed model nexus threshold carefully crafted by the Multistate Tax Commission, which would base the existence of . . . [income tax] nexus on relatively objective measures of the amount of a corporation's property, payroll, or sales present in a state.").

186. MULTISTATE TAX COMM'N, *supra* note 18, at D-2 (emphasis added).

also be subject to taxation by the market state on an apportioned share of its income. And because sales are also defined to include the sale, "lease[,] or license of *tangible* personal property"[187] in a state, congressional adoption of the MTC's economic nexus standard would effectively repeal P.L. 86-272.

It is important to note that the MTC's proposed economic nexus standard does not *require* any state to tax any source of income. This preserves the sovereign power of the states to set their own fiscal policies and compete for economic development with other states by providing favorable climates in which to do business, which might include offering incentives such as decreased nominal tax rates or increased deductions, exemptions, and credits.[188] Delaware and Michigan, for example, could continue not to tax royalty or interest income of certain entities;[189] Nevada could continue not to impose any corporate income tax at all.[190] The MTC's economic nexus standard would simply ensure that any state that wishes to exercise its legitimate right to tax an apportioned share of the income generated within its borders is free to do so. It would also ensure that whatever "tax competition" does occur between states takes place within a coherent national framework with clear and predictable ground rules—thereby greatly reducing the inequities and inefficiencies that result when states compete haphazardly in the anarchic state corporate income tax environment that exists today. To borrow a concept from economics, a blanket nexus standard based on economic presence would provide the necessary "market regulation" that would allow tax competition among the states to flourish in a properly functioning "market" for favorable business environments, in which states are the "producers" and multistate businesses the "consumers."

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187. *Id.* (emphasis added).

188. Of course, rather than focusing myopically on tax considerations, states might also consider their competitiveness with regard to other factors that affect firm investment decisions, such as "the quality of public services, the availability of an adequately-trained labor force, and the cost of energy." MAZEROV, *supra* note 35, at 39. Indeed, "a large body of research suggest[s] that a state's business tax structure—including the design of specific taxes and the aggregate tax burden—has at most a small impact" on a state's economic development objectives. *Id.*

189. *See supra* note 157 and accompanying text (noting that Delaware and Michigan do not tax certain royalty income).

190. *See* CONGRESSIONAL RESEARCH SERVICE, *supra* note 21, at 2 (listing states that do not impose a corporate income tax).

B. Imposing Uniformity: An Updated UDITPA

Congressional blessing of an economic nexus standard for income tax jurisdiction, while critical, cannot by itself provide for an effective reform of the state corporate tax system. If the economic nexus solution is to function properly, Congress must also require states to follow uniform rules for income apportionment. Otherwise, the nowhere income problem will not be resolved,[191] the potential reduction in compliance and administrative burdens will not be achieved,[192] and the risk of multiple taxation of multistate businesses will not be eliminated.[193]

The question of precisely what that uniform method of apportionment should be, however, is somewhat beyond the scope of this Note, and not necessarily crucial to its thesis.[194] Indeed, divining the ideal uniform apportionment formula is a task worthy of its own separate inquiry.[195] For the purpose at hand, it suffices to identify the approaches taken in two previous uniformity-driven reform efforts, and to offer some observations on how they might be improved upon for a third go-round.

The most ambitious reform effort culminated in 1965 with a report issued by a special House subcommittee appointed to study state taxation of interstate commerce.[196] The Willis Report, as it is known, represents the high-water mark of federal attempts to establish a uniform system of income apportionment.[197] It recommended a uniform two-factor

191. *See supra* notes 42–44 and accompanying text (discussing the "gaps and overlaps" inherent to a nonuniform system of income apportionment); *supra* notes 45–53 and accompanying text (discussing the problematic shift to sales-only apportionment).

192. *See supra* note 40 and accompanying text (listing six basic types of apportionment formulas employed by states).

193. *See supra* note 184 and accompanying text (describing the need for uniformity in order to ensure accurate income taxation of multistate businesses by the states).

194. *See* Charles E. McLure, Jr., *Legislative, Judicial, Soft Law and Cooperative Approaches to Harmonizing Corporate Income*, 14 COLUM. J. EUR. L. 377, 394 (2008) ("Within limits, uniform application of the same formula by all states is probably more important than the particular formula chosen."). "Thus all states should use the same formula (or the same sector-specific formulas) and all corporations (or at least all corporations in a given sector of the economy) should use the same formula . . . ." *Id.*

195. *See generally* Charles E. McLure, Jr., *A Comprehensive and Sensible UDITPA*, 37 STATE TAX NOTES 929 (2005) (proposing a redraft of several UDITPA provisions); Miller, *supra* note 183 (identifying several problematic aspects of UDITPA).

196. H.R. REP. NO. 89-952 (1965).

197. *See* Michael T. Fatale, Geoffrey *Sidesteps* Quill*: Constitutional Nexus, Intangible Property, and the State Taxation of Income*, 23 HOFSTRA L. REV. 407, 452 n.262 (1994) ("Since the enactment of Public Law 86-272 [in 1959], Congress has enacted only minor legislation with any effect upon state corporate taxation.").

apportionment formula based on the amount of property and payroll in each state,[198] as well as a blanket nexus standard that limited income tax jurisdiction to states in which a business had either real property or payroll.[199] The Willis Report recommendations were never enacted, however.[200]

Conceptually, this Note shares the same basic approach as the Willis Report. Both proposals call for Congress to establish a national standard for state income tax nexus and a uniform method of income apportionment. However, this Note contends that the nature of commerce today allows firms to do a substantial amount of business in a given state without having any real property or payroll there—i.e., without establishing a physical presence.[201] It is therefore necessary to update the Willis Report recommendations to account for this reality. This could be achieved by adding a sales factor to both its blanket nexus standard and its uniform apportionment formula. The result would be the two-pronged approach advocated by this Note.

The second major uniformity effort is UDITPA,[202] a multilateral state initiative that contrasts with the top-down federal approach of the Willis Report. This voluntary, uniform act for income apportionment was drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1957 and later "adopted"[203] by roughly half of the states[204] as

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198. H.R. REP. NO. 89-952, at 1144–50.

199. *Id.* at 1155–58. The income tax nexus standard proposed by the Willis Report was effectively a physical presence requirement, as the ownership of real property or the maintenance of payroll in a state necessarily creates a physical presence there.

200. *See* McLure, *supra* note 194, at 427 ("[P]articular states feared the revenue consequences of several features [of the Willis Report]. Market states objected to elimination of the sales factor, and states that serve disproportionately as the commercial domicile of corporations feared the loss of revenue from the taxation of non-business income implicit in full apportionment.").

201. *Supra* Part IV.

202. UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT (1957).

203. *See* HELLERSTEIN & HELLERSTEIN, *supra* note 35, ¶ 9.06 n.72 (stating that the ostensible adoption of UDITPA by many states "should not be taken as implying the formulas of all the States . . . that have adopted UDITPA . . . are identical" but rather "the statutes are studded with variations, including departures from the language of UDITPA as promulgated"); Vickers, *supra* note 124, at 804 ("[T]he MTC claims today that over 40 states have 'adopted' UDITPA. This number is deceiving and is designed to . . . [suggest] that UDITPA is still widely adopted. In fact, only three states currently follow all of UDITPA's core statutory principles; the rest have substantially modified the uniform language.").

204. *See* McLure, *supra* note 194, at 433 ("About half of the states have adopted the Compact [that incorporates UDITPA].").

an effort to ward off federal imposition of uniformity in income apportionment.[205] This voluntary effort succeeded in warding off federal intervention, but not in establishing uniformity, as states continued to deviate from UDITPA as they pleased.[206] Recently, as an attempt to address some outdated features of the act, the MTC requested that NCCUSL update UDITPA to reflect the changed twenty-first century economy.[207] More recently, however, this effort has lost steam,[208] perhaps illustrating the difficulty of a voluntary, state-by-state approach to achieving uniformity in income apportionment.

Nevertheless, UDITPA represents a natural starting point for the establishment of a uniform method of income apportionment.[209] For example, UDITPA already provides for an equally weighted, three-factor apportionment formula based on sales, property, and payroll to be applied to all business income.[210] This core principle is a sound one that should be left undisturbed, as it seems to represent the best available metric for approximating where the income-producing activity of a multistate business occurs.[211] For its part, this Note will merely suggest one particular way in which UDIPTA should be adapted so as to complement the blanket nexus standard proposed in Part V.A.

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205. UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT prefatory note (1957); *see also* John S. Warren, *UDITPA—A Historical Perspective*, 38 STATE TAX NOTES 133, 133 (2005) ("Then came the 1965 introduction [of federal legislation that would have imposed a uniform method of apportionment] .... The states' response was a rush to adopt UDITPA to show that they could solve the uniformity problem without congressional interference.").

206. *Supra* note 203 and accompanying text.

207. *See* Letter from Joan Wagnon, Chair, Multistate Tax Comm'n, and Joe Huddleston, Executive Dir., Multistate Tax Comm'n, to Robert A. Stein, Esq., Chair, Comm. on Scope and Program, Nat'l Conference of Comm'rs on Unif. State Laws (Sept. 6, 2006) ("We believe model amendments or a complete rewrite are critical to preserving the original uniformity goals of UDITPA....") (on file with the Washington and Lee Law Review).

208. *See* John Buhl, *ULC Committee Recommends Halting UDITPA Revision Study*, 124 STATE TAX TODAY 1 (2009) ("A Uniform Law Commission (ULC) panel on June 30 passed a motion recommending that the group terminate its study of whether to revise the Uniform Division of Income for Tax Purposes Act, with the option of restarting the effort later.").

209. *See* Miller, *supra* note 183, at 125 ("For being almost 50, [UDITPA] has aged fairly well, but like most of us in our middle age, it could be improved with the replacement of some body parts.").

210. UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT § 9 (1957).

211. *See supra* notes 50–51 and accompanying text (discussing the superiority of three-factor apportionment as compared to sales-only apportionment).

The primary shortcoming of UDITPA with which this Note is concerned is the distinction it draws between business and nonbusiness income. While business income—such as the profit derived from the sale of a manufactured good—is apportioned according to a three-factor apportionment formula, nonbusiness income—such as the types of royalty and interest income described in Part IV.A—is not apportioned at all, but instead allocated entirely to the state in which the corporation has its commercial domicile.[212] This distinction prevents full apportionment of all forms of corporate income.[213] While this may have been reasonable in the mid-twentieth century, it makes little sense in today's national economy,[214] and has contributed to the proliferation of tax planning opportunities.[215]

In combination with providing for a nationwide standard for income tax nexus based on economic presence, as urged in Part V.A, Congress should establish a uniform method of income apportionment by building on the stalled UDITPA reform efforts initiated by the MTC. Specifically, Congress should either prescribe a formula itself, or mandate state adoption of an updated UDITPA within a short period of time. If Congress must dictate a formula, UDITPA's equally weighted, three-factor apportionment formula would seem to be the optimal choice, provided it is coupled with the elimination of the problematic distinction between business and nonbusiness income. In the alternative, if history is any guide, the mere threat of federal intervention may reinvigorate the UDITPA redrafting effort and perhaps facilitate an agreement among the states regarding a uniform method of income apportionment.[216]

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212. UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT §§ 4, 9 (1957); *see also* Walter Hellerstein, *The Business-Nonbusiness Income Distinction and the Case for Its Abolition*, 21 STATE TAX NOTES 725, 725 (2001) ("Under UDITPA and similar statutes, all business income is apportioned; all nonbusiness income is allocated.").

213. *See* Hellerstein, *supra* note 212, at 725 (describing how full apportionment of all income requires the elimination of UDITPA's distinction between business and nonbusiness income).

214. *See* McLure, *supra* note 195, at 933 ("UDITPA's treatment of sales of intangible property, promulgated when the U.S. economy was quite different, is unsatisfactory. . . . Like sales of tangible products, sales of intangible products should be attributed to the state of destination.").

215. *See supra* Part IV.A (discussing the use of out-of-state holding companies to shelter income from state taxation).

216. *See* Vickers, *supra* note 124, at 808 ("[T]he original UDITPA sat idle for years before being adopted by many states. The catalyst for this adoption was the recommendation from a congressional committee that suggested federal legislation governing allocation and apportionment." (statement of Stephen Kranz)). But as one commentator contends:

VI. Evaluative Criteria: Equity, Efficiency, and Simplicity

There are three basic criteria used in tax policy evaluation: equity, efficiency, and simplicity.[217] These criteria can provide a helpful framework for analysis of any proposed reform of the state corporate income tax system. To reiterate, this Note proposes a two-pronged approach: the establishment of an economic presence standard for income tax nexus, coupled with the imposition of a uniform method of apportionment upon the states.[218] This Part concludes that such an approach would greatly increase the equity, efficiency, and simplicity of the current system.

A. Equity

The first core tax principle, equity, includes two components—horizontal and vertical equity.[219] Horizontal equity refers to what is "[p]erhaps the most widely accepted principle of equity in taxation . . . that people in equal positions should be treated equally."[220] To take a simple example, recall from the hypothetical in Part III.A that Company *X* generates $50 million in receipts from the sale of tangible personal property in State *C*, but may not be taxed by State *C* on the income generated by those sales because of the safe harbor of P.L. 86-272. Now suppose that Company *Y*, a similar widget manufacturer that *is* physically present in State *C*, also generates $50 million in sales there, and therefore *is* taxed by State *C* on the income generated on those sales. At least

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> [F]ederal legislation . . . is the only solution [for producing uniformity]. States have little incentive to adopt a uniform state income tax allocation and apportionment statute . . . . Without the federal government overriding state sovereignty the states will never achieve uniformity in the apportionment arena.

Id.

217. *See, e.g.*, Swain, *supra* note 34, at 374 ("Questions of tax policy are generally addressed with reference to three overarching values: equity, efficiency, and administrability [or simplicity]."); C. Eugene Steuerle, *And (Equal) Tax Justice for All?*, *in* TAX JUSTICE: THE ONGOING DEBATE 253, 255 (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002) ("Equity's status as a political principle is unique, but it is not always the driving force behind action. Other objectives—efficiency, growth, simplicity—often take precedence.").

218. *Supra* Part V.

219. *See* RICHARD MUSGRAVE, THE THEORY OF PUBLIC FINANCE: A STUDY IN PUBLIC ECONOMY 160 (1959) (discussing horizontal and vertical equity). Vertical equity, which is concerned with "how the taxation of people in different positions should differ," *id.*, is of no relevance to the taxation of corporations.

220. *Id.*

with respect to the two businesses' operations in State *C*, P.L. 86-272 serves to violate the principle of horizontal equity, as two similarly situated taxpayers with the same ability to pay are treated quite differently for state income tax purposes.[221] The MTC's economic presence standard for income tax nexus would reduce this horizontal inequity by requiring both Company *X* and Company *Y* to bear a similar income tax burden in State *C*—regardless of physical presence—because both companies generate the same amount of sales there.

Current law also violates the principle of horizontal equity to the extent that it permits the use of out-of-state holding companies as tax shelters. Thus, the lack of a national standard for state income tax jurisdiction results in larger multistate businesses being treated more favorably for tax purposes than their smaller, local competitors.[222] While there is no de jure advantage—in theory, the out-of-state holding company tax shelter is available to all businesses—in practice, this option is available primarily to large-scale operations.[223] This is due in large part to several well-recognized judicial doctrines under the common law of corporate taxation:[224] the sham transaction doctrine,[225] the economic substance doctrine,[226] and the business purpose doctrine.[227] The

221. It is true that physically present Company *Y* derives a *greater degree* of benefits from State *C* than non-physically present Company *X*—presumably Company *X* does not enjoy the same police and fire protection, infrastructure, and workforce education benefits that Company *Y* enjoys by virtue of its physical presence. Nonetheless, this difference is accounted for by the typical three-factor apportionment formula. That is, Company *Y* will pay tax to State *C* on a *greater share* of its nationwide income than Company *X* because its more extensive presence in State *C* is accounted for in the property and payroll factors. These factors will be zero for Company *X*, thereby decreasing the percentage of its nationwide income that is taxable by State *C*.

222. *Supra* note 23 and accompanying text.

223. *Id.*

224. These judicial doctrines have been defined in inexact and overlapping ways. *See* STEPHEN A. LIND ET AL., FUNDAMENTALS OF CORPORATE INCOME TAXATION 10 (7th ed. 2008) ("[Such] judicial doctrines are imprecise. The very vagueness of these pronouncements, however, has contributed to their influence."). "Viewed most broadly, the[se] judicial doctrines ask a simple question .... Have the taxpayers actually done what they ... represent, or are the economic realities of the transaction—and the attendant tax consequences—other than what the taxpayers purport them to be?" *Id.* at 11.

225. *See id.* ("A sham transaction is best defined as a transaction that never actually occurred but is represented by the taxpayer as having transpired—with favorable tax consequences of course.").

226. *See id.* ("The ... essence [of the economic substance doctrine] is that claimed tax benefits should be denied if the transactions that give rise to them lack economic substance apart from the tax considerations even if the purported activity actually occurred.").

227. *See id.* (describing how, under the business purpose doctrine, "[a] transaction motivated by a business purpose is usually compared to one that has no substance, purpose,

general thrust of these doctrines is to require a taxpayer to proffer some legitimate business reason for its activity; if tax avoidance is the *sole* motivation, the attendant tax benefits are denied, notwithstanding the letter of the law.[228] One state revenue director explains how these principles operate in the context of tax shelters involving out-of-state holding companies:

> For example, a corporation cannot simply establish an affiliate in a low-tax state and assign all of its income to that affiliate; if that were to happen, the original taxing state could disregard the second corporation as a sham. Instead, there must be at least the appearance of a business purpose for setting up that second corporation, and that appearance is more available to larger corporations that will be able to segregate various operations, for example, by having their trademarks put into another entity and then licensed back to the original operating entities. Mom-and-pop operations most likely don't have those options, and most likely don't have the resources to pay for the tax-planning services necessary to develop and implement them.[229]

The MTC's economic nexus standard would virtually eliminate out-of-state holding companies as tax shelters because such entities would be subject to taxation in their market states on the basis of the royalty income they derive from leasing their trademarks to in-state affiliates. This would substantially increase the equity of the current state corporate income tax system by tying income tax jurisdiction not to physical presence, but to the amount of revenue derived from a particular state.

B. Efficiency

The principle of tax efficiency, or tax neutrality, is premised on the notion that tax policy should distort economic behavior as little as possible.[230] By their very nature, of course, taxes create market

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or utility apart from tax avoidance"). "As originally formulated by Judge Learned Hand, the business purpose doctrine was applied to deny tax-free status to a transaction that would not have been consummated but for the tax savings that would result if its form were respected." *Id.*; *see also* Helvering v. Gregory, 69 F.2d 809, 810–11 (2d Cir. 1934) (explaining the rationale for the business purpose doctrine).

228. *See* LIND ET AL., *supra* note 224, at 10–13 (describing the common law of corporate taxation).

229. Bucks, *supra* note 22, at 3.

230. *See* Swain, *supra* note 34, at 375 ("[T]he goal of good tax policy is to minimize the interference of a tax with the economic decisions that would be made in an otherwise efficient market.").

inefficiency.[231] The principle of tax efficiency merely suggests that this distortion should be minimized as much as possible. Put another way, the more that a tax system incentivizes business activity that would otherwise never take place—activity for which the primary motivation is tax avoidance—the more inefficient that tax system is. A perfect example of business activity undertaken predominantly for tax purposes is the use of out-of-state holding companies to shelter income from state taxation. While large corporations may be able to proffer some legitimate business purpose for incorporating a subsidiary in Delaware to hold its trademarks—thereby withstanding scrutiny under the somewhat deferential common law doctrines of corporate taxation[232]—it is obvious that such action is driven almost completely by tax considerations.[233]

Admittedly, under our federal system of government, any state income tax regime will incentivize such behavior to some degree. For example, as long as states like Delaware or Michigan choose not to tax the interest or royalty income of certain entities,[234] or states like Nevada choose not to tax income at all,[235] corporations will always have incentives to incorporate or move operations there for tax purposes. But the attractiveness of this option—and the distorting effect it has on economic activity—can be minimized by ensuring that the states from which businesses derive their revenue have the opportunity to tax their fair share of the income generated by the exploitation of their markets *if they so choose.* Federal adoption of the MTC's economic nexus standard for income taxation, as proposed in Part V.A, would ensure this result by permitting market states to tax any entity whose sales within their borders exceed the $500,000 jurisdictional

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231. *See id.* ("Economists generally view taxes as necessarily distorting economic behavior and resulting in economic inefficiencies.").

232. *Supra* notes 224–28 and accompanying text.

233. *See, e.g.*, A&F Trademark, Inc. v. Tolson, 605 S.E.2d 187, 189–90 (N.C. Ct. App. 2004) (describing a tax sheltering system involving nine Delaware holding companies that possessed little economic substance). As the North Carolina Court of Appeals explained, the out-of-state holding companies at issue in the case had "no employees and share office space, equipment, and supplies; their listed primary office address is also the primary office address of approximately 670 other companies unrelated to the [parent company] . . . or its wholly-owned subsidiaries." *Id.* at 189–90. Despite not having any full-time employees, these nine entities generated over $423 million per year from their affiliated, physically present North Carolina retailers. *Id.* at 189. Similarly, in *Geoffrey I*, the Delaware holding company owned by Toys R Us generated $55 million per year without a single full-time employee. *Supra* note 158 and accompanying text.

234. *Supra* note 157 and accompanying text.

235. CONGRESSIONAL RESEARCH SERVICE, *supra* note 21, at 2.

threshold.[236] This would increase the tax efficiency of the current system because it would no longer be as worthwhile for businesses to devote resources to elaborate tax sheltering schemes that have little, if any, economic substance.

The efficiency, or neutrality, of the current state corporate income tax system could also be increased by the imposition of a uniform method of income apportionment, as proposed in Part V.B. As the Congressional Research Service concludes, "[t]he critical issue with the current state corporate income tax structure is the variability in the allocation and apportionment of corporate income from state to state. The current mosaic of state corporate income tax rules creates economic inefficiencies . . . [because of the resulting] increased opportunities for tax planning by businesses."[237] If all states used the same method of income apportionment, the variability—and attendant inefficiency—of the current regime would be greatly reduced. Again, the benefit of such reform would be to free up resources for use in more efficient economic activity, as there would simply be much less to be gained from structuring business operations based on state tax concerns.

C. Simplicity

The third tax criterion, simplicity, stands for the proposition that the tax system should be as simple as possible for all parties involved.[238] Tax liability should be easy to calculate for the taxpayer and easy to administer for the state. The current state corporate income tax system fails miserably on this count. First and foremost, multistate businesses face uncertainty as to whether they are subject to taxation in a particular state.[239] Even when nexus is established so clearly as to eliminate the need for litigation under the dormant Commerce Clause, businesses still confront significant compliance burdens created by the variations in the manner states apportion income for tax purposes.[240] States that impose an income tax face equally

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236. *Supra* Part V.A.

237. CONGRESSIONAL RESEARCH SERVICE, *supra* note 21, at 16.

238. *See* Swain, *supra* note 34, at 376 ("Administrability [or simplicity] is probably the most easily understood tax policy value. A tax should be easy to administer and pay.").

239. *Infra* note 261 and accompanying text; *supra* Part IV.

240. *See supra* note 40 and accompanying text (listing six basic types of apportionment formulas employed by states).

daunting administrative burdens, as well as costly litigation for which its taxpayers must ultimately foot the bill.

The lack of simplicity is partly due to the tension that exists between equity and simplicity. Complicated provisions of state and federal tax law are often the result of elaborate attempts to ensure that a "fair" result is reached when a simpler rule might not guarantee such an outcome.[241] Too often, tax policy must choose between simplicity and equity. On the one hand, a simple, bright-line rule provides clarity and is easy to administer, but may result in unjust outcomes when applied to particular situations. On the other hand, an elaborate and complicated set of rules allows for consideration of all sorts of special circumstances in due regard for equity, but simplicity is sacrificed as a result. The state corporate income tax system, however, presents somewhat of an anomaly to the general truism that simplicity may only be increased at the expense of equity. Perhaps one of the most compelling justifications for a blanket economic presence standard for income tax nexus is that state income tax jurisdiction would finally be delineated clearly by bright-line, objective criteria—dollar thresholds in property, payroll, or sales within a state. Similarly, the imposition of a uniform method of income apportionment would drastically reduce compliance burdens for multistate businesses. Clearly, such reform would do wonders from a *simplicity* standpoint. But as this Note has demonstrated, these measures would also greatly increase the *equity* of the current system by ensuring that out-of-state enterprises bear tax burdens in market states that are similar to that of their in-state competitors.[242]

VII. The Undesirable Alternative: BATSA's Physical Presence Standard for Income Tax Nexus

A. Proposed Legislation

To provide a basis of comparison for the approach advocated by this Note, it is helpful to analyze a competing proposal for federal reform in light of the same criteria. The Business Activity Tax Simplification Act

241. *Cf.* Swain, *supra* note 34, at 376–77 (discussing the "trade-off between equity and simplicity"). "A complex set of rules is often required to accurately delimit a class of similarly situated taxpayers or transactions. The Internal Revenue Code is replete with examples of the complexity caused by trying to ensure that only the 'right' person or transaction is taxed." *Id.*

242. *See supra* note 229 and accompanying text (explaining how certain state tax shelters are effectively available only to larger, multistate businesses).

(BATSA)[243] is useful in this regard as it represents the polar opposite of the economic nexus standard for income taxation. However, as this Part will demonstrate, BATSA would exacerbate, rather than alleviate, the inequity and inefficiency that exists under the current state corporate income tax system.

BATSA has been proposed, in various forms, in every Congress since 2003.[244] BATSA has three major thrusts, all of which overlap to some extent. First, and most significantly, BATSA would establish a physical presence standard for state income tax nexus. It provides that "[no] State shall have the power to impose, assess, or collect a net income tax or other business activity tax on any . . . [business's] activities in interstate commerce unless . . . [it] has a physical presence in the State."[245] It goes on to define physical presence narrowly so as to permit an out-of-state business to use independent agents "to establish or maintain the market" in a state without creating a substantial nexus for income tax purposes.[246] An independent agent is defined to include any entity that provides "business services" to at least one other person or business in the state in the same taxable year.[247]

The effect of BATSA's physical presence requirement would be to permit out-of-state businesses to engage in a substantial amount of commercial activity within a market state without being subject to taxation by that state on the resulting income.[248] This could be achieved through a variety of tax planning strategies. One specific example is illustrated by a return to the hypothetical in Part III.A. Recall that Company *X* is

243. Business Activity Tax Simplification Act of 2009, H.R. 1083, 111th Cong. (2009).

244. *Id.*; H.R. 5267, 110th Cong. (2008); S. 1726, 110th Cong. (2007); H.R. 1956, 109th Cong. (2006); H.R 1956, 109th Cong. (2005); H.R. 3220, 108th Cong. (2003).

245. Business Activity Tax Simplification Act of 2009, H.R. 1083, 111th Cong. (2009).

246. *Id.*

247. *Id.* Mazerov suggests that this expansive definition of independent agent would open up a sizable loophole for tax planning purposes. Specifically, an out-of-state business could incorporate a subsidiary in a market state to engage in the commercial activity necessary to do business in a state. *See* MICHAEL MAZEROV, CTR. ON BUDGET & POLICY PRIORITIES, CLOSING THREE COMMON CORPORATE INCOME TAX LOOPHOLES COULD RAISE ADDITIONAL REVENUE FOR MANY STATES app. 6 (rev. 2008), *available at* http://www.cbpp.org/6-24-08sfp-appendix.pdf (explaining the ramifications of BATSA's agency provisions). As long as the in-state subsidiary provided business services to at least one additional entity—including, even, another corporate affiliate—the out-of-state business would not be taxable on the income it derives from effectively operating in the market state. *Id.* The in-state subsidiary, for its part, would only be taxable on the relatively minor amount of income it received for its services. *Id.*

248. MAZEROV, *supra* note 247, at 1–3.

incorporated in State *A* and thus taxable by State *A* on the apportioned share of income derived from within its borders. Company *X* also maintains a warehouse and payroll in State *B* and thus is taxable in State *B* for the income derived from within *its* borders. BATSA would not change this. Instead, BATSA would allow a competing widget manufacturer, Company *Z*, to engage in similar commercial activity in State *B* without paying any income tax to State *B* on those profits.[249] Under BATSA, Company *Z* could simply use a third-party warehouse to hold its goods in State *B* for delivery as needed. As long as that warehouse provided business services to at least one additional entity in State *B*, it would qualify as an independent agent of Company *Z*, thereby shielding Company *Z* from tax liability in State *B*.[250] In fact, Company *Z* could even operate its own warehouse in State *B* through a corporate subsidiary, and as long the subsidiary provides business services to at least one additional entity, then Company *Z* would still come within BATSA's expanded safe harbors.[251] As discussed in Part VI, treating similar taxpayers differently violates the tax principle of horizontal equity. It also produces market distortion and inefficient, tax-driven economic behavior, thereby violating the principle of tax efficiency or neutrality. Unfortunately, BATSA would prevent states from treating similar businesses similarly for income tax purposes,[252] as it would effectively repeal the economic nexus doctrine wherever it is currently employed.[253]

A second, somewhat overlapping provision of BATSA would extend the safe harbors of P.L. 86-272 to include sales or transactions of intangible property and services.[254] (Currently, P.L. 86-272 only applies to sales of tangible personal property.)[255] This provision of BATSA would codify into federal law certain state tax shelters that rely on intangible property

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249. *Supra* note 247 and accompanying text.

250. *Supra* note 246 and accompanying text.

251. *Supra* note 246 and accompanying text. Of course, if State *B* required combined reporting, this maneuver would produce no benefit for Company *X*. *See* Part III.D (discussing combined reporting).

252. *See supra* notes 245–47 and accompanying text (discussing BATSA's physical presence standard for income tax nexus).

253. *See supra* note 165 and accompanying text (identifying states that have adopted—as yet, without either the approval or rejection of the Supreme Court—an economic presence standard to combat certain state tax shelters by subjecting out-of-state holding companies to taxation based on the income derived from within the taxing state).

254. Business Activity Tax Simplification Act of 2009, H.R. 1083, 111th Cong. (2009).

255. 15 U.S.C. § 381(a) (2006).

transactions—such as the licensing of trademark rights in exchange for royalties—between an out-of-state business and its in-state affiliate.[256]

The third major component of BATSA would expand the range of permissible solicitation activities protected under P.L. 86-272. This provision would allow businesses to engage in a more extensive degree of commercial activity within a state without establishing a substantial nexus.[257] Of course, because Congress did not define solicitation under P.L. 86-272 to begin with,[258] it is difficult to state precisely how BATSA expands a non-existent definition.[259] Nonetheless, to the extent that it delineates specific activity not explicitly included in the current safe harbors, BATSA would exacerbate the existing problems created by P.L. 86-272.[260]

B. Critique

BATSA proponents, in making their case for federal intervention, emphasize the value of establishing a clear nexus standard so as to provide

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256. *See supra* Part IV.A (discussing the out-of-state holding company tax shelter). This provision of BATSA is somewhat duplicative of its physical presence standard for income tax nexus, which arguably also codifies this corporate tax loophole. *Supra* notes 245–47 and accompanying text.

257. Currently, the safe harbor activities under P.L. 86-272 are limited to the "solicitation" of orders within a market state that are filled and shipped from outside that state. 15 U.S.C. § 381(a)(1). BATSA would expand permissible solicitation activities to include:

> [T]he furnishing of information to customers or affiliates in . . . [a] State, or the coverage of events or other gathering of information in . . . [a] State . . . [if the] information is disseminated from a point outside the State; and [all] those business activities directly related to . . . [a business'] potential or actual purchase of goods or services within the State if the final decision to purchase is made outside the State . . . .

Business Activity Tax Simplification Act, H.R. 1083, 111th Cong. (2009).

258. *See supra* note 92 and accompanying text (noting that Congress failed to define "solicitation" when it enacted P.L. 86-272 in 1959, and that the lack of a clear definition remains problematic to this day).

259. Mazerov has identified numerous concrete examples of how BATSA would expand permissible solicitation activities under P.L. 86-272. *See generally* MAZEROV *supra* note 247 (analyzing BATSA). Furthermore, it is not altogether clear to what extent additional commercial activities BATSA would immunize from income taxation by a market state—in practice, such immunization may turn out to be broader than anticipated.

260. *See supra* Part III.B.3 (explaining how P. L. 86-272 contributes to the nowhere income problem).

certainty to multistate businesses and reduce litigation in state courts over nexus. As one trade group testified before Congress:

> Conflicting state laws and court decisions create tremendous uncertainty and expense for taxpayers.... The uncertainty created by conflicting interpretations of the Constitutional standard for tax jurisdiction has long resulted in unnecessary administrative and litigation expense for both taxpayers and states, and will certainly increase the costs and risks of operating a multistate business in the foreseeable future.[261]

Nexus certainty is best ensured, it is argued, by a physical presence standard for state income taxation.[262] The claim is made that nonphysically present businesses do not receive "meaningful benefits or protections" from market state governments, and therefore should not be subject to income taxation by them.[263]

This Note is in agreement with BATSA proponents on the need for federal intervention in the state corporate income tax arena. Providing nexus certainty to multistate businesses, reducing compliance and administrative burdens of state income taxation, and minimizing costly litigation over nexus issues are all compelling justifications for federal intervention. Indeed, such policy concerns strike at the very heart of the constitutional prerogative—and duty—of Congress to properly "regulate commerce... among the several states."[264] But BATSA is not the appropriate way to do so, for at least three reasons.

First, at the heart of the rationale for BATSA's physical presence standard is the notion that out-of-state firms do not benefit from the services provided by market state governments. This is simply not true. As *Geoffrey I* illustrates, a physical presence standard for income nexus would allow multistate firms to operate in a market state and enjoy all of the governmental benefits associated with a physical presence—such as police and fire protection, infrastructure, and a public school system that supplies

261. *The Business Activity Tax Simplification Act of 2008: Hearing on H.R. 5267 Before the Subcomm. on Commercial and Administrative Law of H. Comm. on the Judiciary*, 110th Cong. 121 (2008) (statement of Council on State Taxation (COST)).

262. *See id.* at 122 ("Congress must recognize physical presence as the jurisdictional standard for business activity taxes.").

263. *See id.* ("Determinations of jurisdiction to tax should be guided by one fundamental principle: a government has the right to impose burdens... only on businesses that receive meaningful benefits or protections from that government."). "[B]usinesses that are not physically present in a jurisdiction and are therefore not receiving meaningful benefits or protections from the jurisdiction should not be required to pay tax to that jurisdiction." *Id.*

264. U.S. CONST. art. 1 § 8, cl. 3.

a competent local workforce—while funneling the resulting income out to non-physically present holding companies.[265] A physical presence standard for income tax nexus permits these businesses to "free-ride" on the tax burden borne disproportionately by the remaining taxpayers that cannot take advantage of such state tax sheltering opportunities. Moreover, even firms that truly lack a physical presence in a state still enjoy significant governmental benefits by doing business there. In addition to furnishing a market for such firms to exploit,[266] states also maintain court systems that allow firms to enforce the legal obligations of their customers and business partners in the area.[267] The justification for BATSA thus cannot stand on a benefits-received analysis.

Second, BATSA would significantly increase the inequity and inefficiency of the present state corporate income tax system. It would exacerbate the current inequity of P.L. 86-272 by extending its safe harbors to transactions of intangible property and services. It would deal an additional blow to equity by effectively repealing the economic nexus doctrine that some states have adopted in an attempt to treat economically similar taxpayers similarly regardless of physical presence.[268] Tax efficiency would fare no better, as BATSA's proposed physical presence standard would engender a new era of purely tax-motivated business activity designed to take advantage of the plethora of tax planning opportunities created by a jurisdictional standard that elevates form over substance. Such an approach ignores the modern economic reality that physical presence is no longer necessary to do business in a particular state.

The third problem with BATSA is that it would impose enormous costs on state governments in the form of additional lost corporate income tax revenue.[269] Estimates predict that BATSA would cost states anywhere

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265. *See supra* Part IV.A (describing how out-of-state holding companies are used as state tax shelters).

266. Swain, *supra* note 34, at 378 n.331 ("Taxes are what we pay to live in a society that allows a market to operate in the first instance. Like it or not, the government is a 'silent partner' in the economy . . . that often is not appreciated until it ceases to function . . . .").

267. *See supra* note 173 and accompanying text (noting that non-physically present JCPNB engaged a debt collection agency to pursue debt collection efforts through the court system of the market state); *supra* note 35 and accompanying text (describing the benefits out-of-state businesses derive from market state governments).

268. *See supra* note 165 and accompanying text (listing states that have adopted an economic presence standard for income tax nexus).

269. These costs would be in addition to the substantial revenue losses that result from nowhere income under the current system. *Supra* Part II.

from $3 billion to $8 billion per year in lost tax revenue once multistate businesses have fully conformed their operations to take advantage of the additional tax planning opportunities created by the bill.[270] The states, already in poor fiscal health that is expected to continue for years to come, cannot bear such a blow.

VIII. Conclusion

Only Congress has the power to resolve the jurisdictional uncertainty and multifarious methods of income apportionment that plague state corporate income taxation. Its failure to intervene in this area inhibits the efficient functioning of our national system of commerce and hamstrings state attempts to craft sound tax policy. However, the wrong *kind* of federal intervention—such as BATSA's physical presence standard for income tax nexus—would only exacerbate these problems. The proper course of action for Congress is the two-pronged solution proposed by this Note: The establishment of a nationwide standard for income tax nexus based on economic presence, coupled with a uniform method of income apportionment.

270. *See* Bucks, *supra* note 22, at 3, 9 (citing estimates by the Congressional Budget Office and the National Governors Association).