Broken Silence: Congressional Inaction, Judicial Reaction, and the Need for a Federally Mandated Physical Presence Standard for State Business Activity Taxes

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BROKEN SILENCE: CONGRESSIONAL INACTION, JUDICIAL REACTION, AND THE NEED FOR A FEDERALLY MANDATED PHYSICAL PRESENCE STANDARD FOR STATE BUSINESS ACTIVITY TAXES

Marjorie Gell*

In all ages and climes those who are settled in strategic localities have made the moving world pay dearly. This the commerce clause was designed to end in the United States.¹

I. INTRODUCTION

The development of a global economy, massive changes in technology and a shift from a goods-based to a service-based economy, have all brought unprecedented changes in the flow of U.S. commerce. With its status as the clear-cut leader of the economic world in peril, the United States is currently facing increasing competition for the sale of its goods and services from countries such as China and India. How the United States ultimately reacts to this increasing competition, and the extent to which the United States can successfully adapt to a changing world, will determine what the long term economic outcome will be for the U.S. economy.

At the core of this country’s collective economic strategy, just as it was at the time the U.S. Constitution was ratified, is the need for strong and united national market. This principle is found in the Commerce Clause of the U.S.

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Constitution and has been the foundation of this country’s economy for almost two and a quarter centuries. Yet, as important as a strong economic union is to the fiscal health of this country, the unifying principle embodied in the Commerce Clause has been eroded over the last 50 years by the conflicting and burdensome tax policies of individual states. Of particular harm has been the unfettered assertion by states of business activity tax\textsuperscript{2} jurisdiction over out-of-state companies with little or no in-state physical presence.

The purpose of this article is twofold: first, to explore the proper role of Congress in exercising its commerce power to regulate state tax jurisdictional standards for business activity taxes; and second, to evaluate the need for a federally mandated physical presence standard with regard to such taxes. Part II discusses the constitutional framework of the Commerce Clause, the policies underlying it, and its application to state business activity taxes. As well, it will look at the Supreme Court’s calls for Congress to exercise generally its affirmative grant of powers under the Commerce Clause. Part III will review Congressional obligations to address inconsistent jurisdictional nexus standards under the Commerce Clause. It will also discuss

\textsuperscript{2} Business activity taxes are direct taxes imposed on the profits, income, gross receipts or capital stock value of a business taxpayer. Examples are corporate income, franchise, gross receipts or capital stock taxes. These are distinguished from indirect taxes such as sales and use taxes. \textit{See ABA Tax Section, Draft White Paper on Business Activity Taxes and Nexus}, n. 2 (February 26, 2008).
enactment of Public Law 86-272 ("P.L. 86-272"), the temporary measure adopted by Congress in 1959 in response to Northwestern States Portland Cement Co. v. Minnesota, a Supreme Court decision that allowed imposition of a state income tax on interstate commerce. Part IV will discuss Congress’ post-P.L. 86-272 silence regarding fundamental state tax taxation rules, and the corresponding judicial responses to irreconcilable standards by which states impose business activity taxes. In particular, Supreme Court cases will be reviewed, both before and after enactment of P.L. 86-272, with respect to the interpretation of the Commerce Clause in resolving state tax jurisdictional issues. The centerpiece of this discussion will be the seminal Supreme Court case of Quill v. North Dakota, and the extension of the principles of that case to state business activity taxes.

Part V will examine recently introduced federal legislation that would bring clarity to the issue of state business activity tax jurisdiction, and would encourage the development of an economic "united front." This legislation, the Business Activity Tax Simplification Act of 2007 the Business Activity Tax Simplification Act of 2008 (hereinafter

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referred to as “BATSA”),\textsuperscript{5} proposes the enactment of a physical presence standard that would apply to all state business activity taxes. The discussion here will center on the necessity of a physical presence standard, and will consider various alternatives to the physical presence standard including one recently suggested to Congress in a report submitted by the Tax Section of the New York State Bar Association (“New York Tax Section”).\textsuperscript{6} Arguments will be made as to why the imposition of anything less than a purely physical presence standard would create further havoc in the already contentious world of state taxation of business activity. Finally, Part VI will conclude that it is incumbent upon Congress to exercise its powers given to it by our Founding Fathers to enact a clear and decisive physical presence standard upon which companies in interstate commerce can rely in determining their state tax exposure and liabilities, and to once and for all end the ages-old controversy of jurisdictional thresholds for state taxation under the Commerce Clause.

\textsuperscript{5} H.R. 5267, the Business Activity Tax Simplification Act of 2008 ( “BATSA”), introduced on February 7, 2008 by Representatives Boucher and Goodlatte, and S. 1726, the Business Activity Tax Simplification Act of 2007, previously introduced by Senators Schumer and Crapo.

\textsuperscript{6} Its report entitled \textit{Nexus Requirements for Imposition of Business Activity Taxes} (January 25, 2008) (hereinafter referred to as the “New York Tax Section Report”) recommends the adoption of a “hybrid” nexus standard consisting of both a physical and economic presence standard. See \textless http://www.nysba.org/AM/Template.cfm?Section=Tax_Section_Reports_2008&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=13360\textgreater .
II. BACKGROUND

A. The Commerce Clause: Limitations and Policies

Under the Commerce Clause, Congress has the explicit power to "regulate Commerce with foreign Nations, and among the several States." Alexander Hamilton, a staunch nationalist, wrote in the *Federalist Papers* about the underlying purposes of the Commerce Clause and the importance of a free and open market:

> An unrestrained intercourse between the States themselves will advance the trade of each by an interchange of their respective productions, not only for the supply of reciprocal wants at home, but for exportation to foreign markets. The veins of commerce in every part will be replenished and will acquire additional motion and vigor from a free circulation of the commodities of every part. Commercial enterprise will have much greater scope from the diversity in the productions of different States.\(^8\)

The original purpose of the Commerce Clause, then, was to give Congress the power to protect the national economic market by preventing barriers to the free flow of commerce, such as those barriers created by conflicting and burdensome state legislation. The need for such power arose in the 1790s when states began enacting protectionist taxes and regulations in acts of “economic warfare,” that were in part a reaction to the loss of colonial subsidies and preferences previously granted by

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\(^7\) U.S. Const. art. I, 8, cl. 3.

\(^8\) *FEDERALIST NO. 11* (Alexander Hamilton).
England." At the time, under the Articles of the Confederation, Congress was rendered useless, particularly in the face of states that were exercising their respective taxing powers without regard to how such regulations affected the national economy. It was precisely because of the unwillingness of states to concede some of their taxing powers in the name of a unified national economy, that the Framers of the Constitution drafted the Commerce Clause giving Congress the power to intercede when and where appropriate in matters of interstate commerce. Had states been capable of acting altruistically on their own, had they been able to make individual concessions to promote a national marketplace, the Commerce Clause would have been wholly unnecessary.

The extent of Congressional power to exercise the Commerce Clause was made clear in 1824 when the Supreme Court in Gibbons v. Ogden stated that Congressional power under the Commerce Clause "is complete in itself, may be exercised to its utmost extent, and acknowledges no limitations, other than are prescribed in the constitution."\(^9\)

Despite the clear pronouncement of Congress’s authority under the Commerce Clause, Congress has rarely chosen - mostly notably in 1959 - to exercise this power in any meaningful way

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\(^{10}\) 22 US (9 Wheat.) 1 (1824).
with respect to conflicting fundamental state tax policies. And, it has not enacted any statutes giving courts sufficient guidance as to how the courts should reconcile such conflicts. Rather, the responsibility has fallen solely on the shoulders of the courts for deciding whether the lines have been crossed with respect to the erection of state barriers that impede the free flow of commerce.

B. The Supreme Court’s Reluctance to Exercise its Powers under the Negative Commerce Clause in Area of State Taxation

The authority by which the courts have developed standards of state taxation of interstate commerce comes from the "negative" aspect of the commerce clause.\textsuperscript{11} Under this doctrine, where Congress has not exercised its affirmative grant of power under the Commerce Clause, states are nonetheless "negatively" restricted in their ability to tax or regulate interstate commerce.\textsuperscript{12} As a corollary to this doctrine, where Congress has not exercised its power to protect interstate commerce, courts are left with the responsibility of balancing the need for a united, national economy, with the needs of states for sources of revenues. As the Supreme Court noted in \textit{Southern Pacific Co. v. Arizona}:

\begin{table} \centering
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\hline
\textsuperscript{11} See Robert A. Sedler, \textit{The Negative Commerce Clause as a Restriction on State Regulation and Taxation: An Analysis in Terms of Constitutional Structure}, 31 Wayne L. Rev. 885 (1985). \\
\textsuperscript{12} \textit{Id.} at footnote 1. This doctrine was first enunciated in \textit{Cooley v. Board of Wardens}, 53 U.S. (12 How.) 299 (1851). \\
\end{tabular}
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For a hundred years it has been accepted constitutional doctrine that the commerce clause, without the aid of Congressional legislation, thus affords some protection from state legislation inimical to the national commerce, and that in such cases, where Congress has not acted, this Court, and not the state legislature, is under the commerce clause the final arbiter of the competing demands of state and national interests.\textsuperscript{13}

The Court’s application of the "dormant" Commerce Clause to a state’s authority to tax interstate commerce has been a tortuous path, and the Court has long struggled – given the absence of any clear or meaningful guidance from Congress – with how to define interstate commerce, and to discern what limitations on state taxation should be imposed.\textsuperscript{14}

The Court has often recognized the inappropriateness and inadequacy of the judicial branch in making inevitable national policy decisions in order to resolve jurisdictional issues of state taxation of interstate commerce. For example, in \textit{McCarroll v. Dixie Lines, Inc.}, a 1940 case that struck down as violative of the commerce clause an Arkansas gasoline tax on out-of-state buses, Justices Black, Frankfurter and Douglas in their dissenting opinion made the following observation on the need for Congressional intervention in matters of state taxation of interstate commerce:

\begin{quote}
This case again illustrates the wisdom of the Founders in placing interstate commerce under the
\end{quote}

\textsuperscript{13} 325 U.S. 761, 769 (1945).
\textsuperscript{14} For a review of the historical development of the Supreme Court’s approaches to state taxation in the context of the Commerce Clause, see Jerome R. Hellerstein & Walter Hellerstein, \textit{STATE TAXATION}, 4.06.
The protection of Congress... The present problem is not limited to Arkansas, but is of national moment. Maintenance of open channels of trade between the States was not only of paramount importance when our Constitution was framed; it remains today a complex problem calling for national vigilance and regulation.\textsuperscript{15}

The same sentiments were expressed in 1944 in \textit{Northwest Airlines v. Minnesota}.\textsuperscript{16} The issue there was whether either the Commerce Clause or the Due Process Clause of the Fourteenth Amendment barred Minnesota from enforcing its personal property tax imposed on a fleet of airplanes that operated in interstate transportation. Justice Frankfurter, upholding the tax, made clear that “the dangers of harassing state taxation affecting national transportation” were concerns for Congress, and not the judiciary.\textsuperscript{17} Justice Black, in his concurring opinion, stated that

\textsuperscript{15} 309 U.S. 176, 188-89 (1940) (dissenting opinion). The struggles with the scope and application of the dormant commerce clause are also found in non-tax cases. For instance, two years prior to \textit{McCarroll v. Dixie Lines, Inc.}, the Supreme Court in \textit{South Carolina State Highway Dep't v. Barnwell Bros., Inc.} declined to invalidate a state law prohibiting use of highways by trucks over 90 inches wide or 20,000 pounds at a time when virtually all trucks used in interstate commerce exceeded these limits. The Court acknowledged that the state law had a negative effect in interstate commerce but pointed out that it was for Congress - not the judiciary – to decide whether the burdens of interstate commerce justified action:

Congress, in the exercise of its plenary power to regulate interstate commerce, may determine whether the burdens imposed on it by state regulation, otherwise permissible, are too great, and may, by legislation designed to secure uniformity or in other respects to protect the national interest in the commerce, curtail to some extent the state's regulatory power. But that is a legislative, not a judicial function, to be performed in the light of the Congressional judgment of what is appropriate regulation of interstate commerce, and the extent to which, in that field, state power and local interests should be required to yield to the national authority and interest.

...courts do not sit as legislatures, either state or national. They cannot act as Congress does when, after weighing all the conflicting interests, state and national, it determines when and how much the state regulatory power shall yield to the larger interests of a national commerce. 303 U.S. 177, 189-90 (1938)

\textsuperscript{16} 322 U.S. 292 (1944).

\textsuperscript{17} \textit{Id.} at 301.
The differing views of members of the Court in this and related cases illustrate the difficulties inherent in the judicial formulation of general rules to meet the national problems arising from state taxation which bears in incidence upon interstate commerce. These problems, it seems to me, call for Congressional investigation, consideration, and action. The Constitution gives that branch of government the power to regulate commerce among the states, and until it acts I think we should enter the field with extreme caution.\(^{18}\)

Almost 50 years later, in seminal case *Quill Corp. v. North Dakota*,\(^ {19}\) discussed *infra*, the Court reminded Congress of its role in the resolution of state tax jurisdictional issues. *Quill* involved a challenge to a state use tax collection obligation that was imposed on all potential sellers that made “regular or systematic solicitation of a consumer market” in the state.\(^ {20}\) Upholding under *stare decisis* its prior holding in *National Bellas Hess, Inc. v. Department of Revenue*\(^ {21}\) where it invalidated a state sales and use tax collection obligation imposed on a business with no physical presence in the state, the Court stated that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today."\(^ {22}\) In reaffirming *Bellas Hess*, the Court noted that

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\(^{18}\) *Id.* at 302.  
\(^{19}\) 504 U.S. 298 (1992).  
\(^{20}\) *Id.* at 302-03.  
\(^{21}\) 386 U.S. 753 (1967), discussed *infra*.  
\(^{22}\) *Id.* at 311.
This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve.\textsuperscript{23}

More recently, the Court again reminded Congress of its power to resolve interstate tax issues that fall on the application of the negative Commerce Clause. In \textit{MeadWestvaco Corp. v. Ill. Dep’t of Revenue},\textsuperscript{24} the Court considered whether the State of Illinois constitutionally taxed an apportioned share of the capital gain realized by an out-of-state corporation on the sale of one of its business divisions. In vacating the decision of the Appellate Court of Illinois that had upheld the tax, Justice Thomas in his concurrence, stated as follows:

To the extent that our decisions addressing state taxation of multistate enterprises rely on the negative Commerce Clause, I would overrule them. As I have previously explained, this Court’s negative Commerce Clause jurisprudence "has no basis in the Constitution and has proved unworkable in practice." (Citations omitted).

... the Court's involvement in this area is wholly unnecessary given Congress' undisputed authority to resolve income apportionment issues by virtue of its power to regulate commerce "among the several States." See U.S. Const., Art. I, § 8, cl. 3.

\textsuperscript{23} \textit{Id.} at 318 (footnote omitted).
\textsuperscript{24} 2008 U.S. LEXIS 3473, 6-7 (U.S. Apr. 15, 2008).
Although I believe that the Court should reconsider its constitutional authority to adjudicate these kinds of cases, neither party has asked us to do so here, and the Court's decision today faithfully applies our precedents. I therefore concur.

Perhaps the most telling messages from the Court to Congress can be found in the repeated denials to petitions for write of certiorari in matters involving conflicting state laws related to the assertion of jurisdiction to impose income tax on out-of-state companies. Such denials are discussed infra.

III. CONGRESSIONAL OBLIGATION TO EXERCISE ITSAFFIRMATIVE POWER UNDER THE COMMERCE CLAUSE TO ADDRESS INCONSISTENT JURISDICTIONAL NEXUS STANDARDS

A. Congressional Obligation to Uphold the Constitution

Under the Constitution, members of Congress are required to take an oath "to support th[e] Constitution." Specifically, under the U.S. Code, members of Congress must

solemnly swear . . . [to] support and defend the Constitution of the United States against all enemies, foreign and domestic; . . . [to] bear true faith and allegiance to the same; . . . [to] take this obligation freely, without any mental reservation or purpose of evasion; and . . . [to] well and faithfully discharge the duties [of their office].

Notwithstanding this inherent obligation, Congress has failed to fulfill its oath by invoking its affirmative powers under the Commerce Clause to resolve the confusion surrounding

25 U.S. Const. art. VI, cl. 3.
state nexus standards and to move the impediments to interstate commerce created by inconsistent state jurisdictional standards for business activity taxes.\footnote{There are two ways that this affirmative power can be exercised by Congress: (1) by preventing states from exercising their own powers to regulate under the negative commerce clause; and (2) by removing existing restraints on state regulation taxation judicially developed under the negative commerce clause. See Hellerstein & Hellerstein, \textit{STATE TAXATION} 4.23; \textit{see also} Prudential Ins. Co. v. Benjamin, 328 US 408 (1946).} Except for the 1959 adoption of P.L. 86-272, which is limited to sales of tangible personal property under limited conditions and applying solely to net income taxes, Congressional direction and leadership in this important area affecting the national economy have been much less than desirable.

Congressional tendency to leave resolution of contentious constitutional-based problems to the courts, was recognized in an article written a quarter of a century ago by Judge Abner J. Mikva of the United States Court of Appeals for the District of Columbia Circuit. In his article, Judge Mikva criticized Congress for passing over constitutional-based decisions, and leaving such issues to the courts for resolution:

Constitutional issues often present the most difficult value conflicts in society. The very knowledge that the courts are there, as the ultimate nay-sayers, increases the tendency to pass the issue on, particularly if it is politically controversial. Such behavior by Congress is both an abdication of its role as a constitutional guardian and an abnegation of its duty of responsible lawmaking.\footnote{Abner J. Mikva, \textit{How Well Does Congress Support and Defend the Constitution?}, 61 N.C.L. Rev. 587, 610 (1983).}
Congress has been particularly hesitant to prevent “certain impediments to interstate commerce” from persisting. Arguably, by not focusing on the need to establish a clear standard by which business activity tax jurisdiction could be measured, Congress is, in effect, failing to meet its full responsibilities under the Constitution. There are those who would go so far as to say that its failure to act may necessarily imply legislative bad faith.

So why doesn’t Congress act to remove the blatant impediments to interstate commerce caused by the surfeit of imprecise and conflicting jurisdictional standards for imposition of state business activity taxes? The hesitancy to act may in part be function of federalism concerns. As a constitutional principle, federalism is a double edged sword: it both limits the federal government from encroaching upon states’ rights, but also empowers the federal government to carry out duties assigned to it that concern matters of national intent.

From a state perspective, federalism is a matter of state sovereignty, a principle that allows a state to act in its own best interest and to tax within its own borders as it sees fit.

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32 See Bork & Troy, supra note 29.
Under this concept, the federal government under the U.S. Constitution was created with limited powers, and states retain sovereignty authority. As explained by James Madison:

The powers delegated by the proposed Constitution to the federal government are few and defined. Those which are to remain in the State governments are numerous and indefinite. . . . The powers reserved to the several States will extend to all the objects which, in the ordinary course of affairs, concern the lives, liberties, and properties of the people, and the internal order, improvement, and prosperity of the State.

Congressional reluctance in exercising its power under the Commerce Clause to establish a consistent jurisdictional taxing standard may be related to the fact that historically Congress has tread lightly on matters impacting state sovereignty. Congress has nonetheless asserted its power under the Commerce Clause to define the scope of state authority to tax numerous times; can be found in P.L. 86-272, discussed below is Congress’ most plenary, comprehensive enactment in this area.

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33 “The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” U.S. Const., Amdt. 10.
34 THE FEDERALIST NO. 45 (James Madison).
36 Examples include the Federal Aviation Act (prohibiting state and local governments, inter alia, from levying a ticket tax, head charge, “flyover” tax or gross receipts tax on individuals traveling by air); the Mobile Telecommunications Sourcing Act (prohibiting states from taxing mobile telecommunications service unless the state is the user’s place of primary use of the service); the Amtrak Reauthorization Act of 1997 (prohibiting states from taxing Amtrak ticket sales or gross receipts); Public Law 104-95 (prohibiting states from taxing pension income unless the pensioner resides in that state); the ICC Termination Act of 1995 (prohibiting states from taxing interstate bus tickets); the Miscellaneous Revenue Act of 1981 (prohibiting states and localities from imposing property taxes on air carriers’ property at a higher rate than that which is imposed on other commercial or industrial property in the state); the Railroad Regulatory Reform and Revitalization Act of 1976 (prohibiting states from imposing differing taxes on railroad property); and the Soldiers and Sailors Civil Relief Act of 1940 (limiting state taxation of members of the Armed Forces to the member’s state of residence). See generally William J. Quirk & C.
B. Public Law 86-272

In 1959, in response to the public concern about the implications of the Supreme Court’s decision in *Northwestern States Portland Cement Co. v. Minnesota*, where a business had a fully staffed in-state sales office, Congress enacted legislation that prohibited state taxation of net income from interstate commerce where the only in-state activity is the solicitation of orders for tangible personal property. In *Northwestern States*, the Court held that net income from the interstate activities of an out-of-state business may be subjected to state taxation, provided that the tax is nondiscriminatory and fairly apportioned to local activities.

The Court’s treatment of two cases that had been pending when *Northwestern States* was decided engendered the swift enactment by Congress of a statute known as P.L. 86-272 which sets forth certain minimum standards for the exercise of state power to impose a net income tax. It also authorized a Congressional study of uniform standards that should be applied by states in taxing income of interstate businesses.

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Rhett Shaver, *Does Congress Put Federalism at Risk by Limiting States’ Power to Tax?*, 92 TAX NOTES 1489 (Sept. 7, 2001).
37 358 U.S. 450 (1959), discussed infra.
38 Title I of Pub. L. 86-272, codified as 15 U.S.C. §§ 381-384, forbids the imposition of a tax on the net income of out-of-state company where such income is derived from activities within a state, if those activities are limited to the solicitation of orders that are approved, filled, and shipped from a point outside the State.
39 Id.
In 1964 and 1965, the House of Representatives’ Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary issued a detailed report to Congress. Sometimes referred to as the Willis Report, the study refers to existing state tax laws as “the product of a nonobjective artist” and stresses the need to reduce the “multiplicity, variety and mutability” of the multistate tax system. The report concludes as follows:

Certainly, the problems presented are not easy problems, but they are important problems. They are important to the states, and they are important to the vitality of the American common market. Congress has a responsibility to both, and it is time for it to seek a solution.

Despite these clear recommendations, Congress has yet to act on its own recommendations or to deal in any meaningful way to provide parameters to state taxation beyond P.L. 86-272. Legislative proposals for modernizing P.L. 86-272 and to expand its applicability to all business activity taxes and to sales of both tangible and intangible property will be discussed infra in Part IV.

41 Named after Congressman Edwin E. Willis who chaired the Subcommittee.
42 Supra note 40 at 594.
43 Id. at 384.
44 Id. at 599.
IV. EVOLUTION OF A JUDICIAL PHYSICAL PRESENCE STANDARD FOR STATE TAX NEXUS

A. The Modern Era of Commerce Clause Jurisprudence and the Evolution of Physical Presence Requirements in the State Tax Context

Since 1954, the Supreme Court has applied physical presence as a measure of a state’s authority to tax. In *Miller Brothers Co. v. Maryland*, the Court established that an out-of-state business with no in-state physical presence could not be required to collect use taxes on sales to in-state consumers. The Court applied a due process analysis and found that a use tax collection responsibility could only be imposed where there is “some definite link, some minimal connection, between [the] state and the person, property or transaction it seeks to tax.” Because there were no such links or connections to the state (other than the presence of consumers), the Court rejected as a burden to interstate commerce, the imposition of a use tax.

Physical presence was again the focus of the Court’s analysis in *Northwestern States Portland Cement Co. v. Minn.* In that case the Court attempted to clear up the “tangled underbrush of past cases” with regard to the taxing powers of states, and held that the net income of an out-of-state business could be taxed only with respect to in-state activities.

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47 347 U.S. at 344-45.
49 Id. at 457.
Physical presence within a state created the necessary connection to support taxation of the interstate activity.\textsuperscript{50}

The first case to explicitly set forth the rule that actual physical presence is required to sustain a state’s taxing authority from a commerce clause challenge was \textit{National Bellas Hess, Inc. v. Department of Revenue}.\textsuperscript{51} The Court there rejected a state’s argument that a use tax collection obligation could be imposed on a mail order company whose only connection with a state was the solicitation for sales of goods to in-state customers with delivery via common carrier.

\textbf{Bellas Hess} was a Missouri-based mail-order company with customers throughout the United States, including Illinois. Bellas Hess’ only contact with the state was through U.S. mail. Potential Illinois customers were routinely sent catalogs from Bellas Hess and customers would place orders via U.S. mail sent from Illinois to Missouri. Orders were accepted, filled and shipped from outside of Illinois, and goods would be shipped to customers via interstate carrier.

Despite the fact that Bellas Hess had no employees, salespersons, agents or property in Illinois, the state argued that Bellas Hess had established a minimal connection with Illinois. The basis of Illinois’ argument was essentially that

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\textsuperscript{50} \textit{Id}. at 454-55. This case ultimately led to the passage of Public Law 86-272, which restricted a state’s power to tax sales of tangible personal property even where certain physical presence requirements were met. See \textit{supra} Part III.
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\textsuperscript{51} 386 U.S. 753 (1967).
\end{flushright}
it had created a market for Bellas Hess to exploit, and therefore had the requisite nexus for use tax collection purposes.

In rejecting the state’s argument, the Court found that simple exploitation of the market was not enough to create nexus; something more was required in the form of a physical presence in the state. In its decision, the Court relied on the underlying purpose of the Commerce Clause which is "to ensure a national economy free from such unjustifiable local entanglements."\(^{52}\)

In *Complete Auto Transit Inc. v. Brady*,\(^ {53}\) the Court extended its rationale in *Bellas Hess* to all forms of state taxes. Focusing on the potential effect of the tax on interstate commerce (rather than on the particular type of tax), the Court articulated a four part test, and held that a tax on interstate commerce will be sustained where it is “[1] applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State."\(^ {54}\)

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\(^{52}\) 386 U.S. at 510.


\(^{54}\) *Id.* at 279.
In 1991, fourteen years after deciding Complete Auto Transit, the Court in *Quill*\textsuperscript{55} addressed the issue presented by first prong of the Complete Auto Transit test – that of substantial nexus. In so doing, the Court, upheld in the context of sales and use taxation, the physical presence requirement of *Bellas Hess*.

*Quill*, a seller of office equipment and supplies, was a Delaware corporation with offices and warehouses located in states outside of North Dakota. *Quill* had no employees or property in the state, and its contacts with North Dakota consisted of sales solicitations in the form of catalogs sent through U.S. mail, advertisements and telephone calls. All merchandise was sent by *Quill* from outside the state to approximately 3,000 North Dakota customers. On the basis of these contacts, and notwithstanding the fact that *Quill* had no physical presence in the state, North Dakota sought to impose a use tax collection obligation on *Quill*.

In its decision, the Court made clear that claims of constitutionality under the Due Process and Commerce Clauses were distinct and involved different standards and concerns. While Due Process is concerned with fundamental fairness and thus does not require physical presence but merely mandates minimum contacts in order to justify state taxation, the

\textsuperscript{55} 504 U.S. 298 (1992).
Commerce Clause necessitates more: physical presence. In explaining why physical presence was required under the Commerce Clause to sustain a use tax collection obligation, the Court discussed the intent of the Framers of the Constitution to provide a mechanism to deal with state taxes that “hindered and suppressed interstate commerce.”56 A bright line rule, such as physical presence, the Court reasoned, would best define the limits of state authority to tax. Under such a test, Quill had no such presence, and North Dakota was unable to constitutionally impose a use tax collection responsibility.

B. Applicability of Quill to Business Activity Taxes

While Quill provided much clarity and certainty in the sales and use tax area, at least with regard to the types of contacts Quill had with the state of North Dakota, the case has been unable to provide a decisive answer to the question of whether physical presence is also required under the Commerce Clause for purposes of business activity taxes. Arguably, the need for a physical presence standard is even more warranted in the case of business activity taxes than for sales and use taxes. This is so because of the sheer number and complexity of different types of business activity taxes as compared to sales and use taxes which tend to differ only as to rates. Such diversity and complexity

56 504 U.S. at 312.
creates staggering compliance and economic burdens on multistate companies.\textsuperscript{57} However, applicability of Quill to taxes other than sales and use taxes is still an undecided issue, and one that the Supreme Court is apparently unwilling to resolve.

A well-known example of the Supreme Court’s unwillingness to tackle business activity tax jurisdictional issues was \textit{Geoffrey, Inc. v. South Carolina Tax Commission},\textsuperscript{58} a case that arose from a state court’s decision to uphold a net income-based tax against an out-of-state company with no physical contacts in the state. Geoffrey, Inc., a Delaware corporation, was a wholly-owned subsidiary of Toys 'R' Us, Inc. that held certain intellectual property, including trademarks and trade names of Tots ‘R’ Us. Under a licensing agreement with Toys 'R' Us, Geoffrey received a one percent royalty on certain net sales Toys 'R' Us. The issue in Geoffrey arose when Toys ‘R’ Us, which did business in South Carolina, attempted to deduct royalty payments made to Geoffrey. While the deductions were ultimately allowed, South Carolina asserted jurisdiction over Geoffrey based on an “economic presence” standard, and imposed tax on Geoffrey’s royalty income attributable to South Carolina. Geoffrey unsuccessfully challenged the authority of South Carolina, arguing that because no physical presence was created


by the existence of intangibles in the state, South Carolina’s imposition of the tax violated *inter alia* the Commerce Clause of the U.S. Constitution. The South Carolina court’s decision to uphold the tax created an uproar in the multistate tax world, made worse by the fact that the Supreme Court subsequently declined to hear the case.

Several years after *Geoffrey*, another request was made to the Supreme Court to resolve the nationwide controversy over state nexus standards for business activity taxes. In *A&F Trademark, Inc. v. North Carolina*, the issue presented in a petition for *certiorari* was whether the physical presence Commerce Clause standard set forth in *Quill* applied to all state taxes, as some state courts had concluded, or only to state sales and use taxes, as held by courts in other states. Petitioners there were Delaware holding companies wholly owned by Limited, Inc. Headquartered and located in Delaware, the holding companies received royalties from licensing arrangements they had with various other Limited, Inc. subsidiaries operating stores in several states, including North Carolina. Although the petitioners had no physical presence in North Carolina, the North Carolina Department of Revenue, based on an “economic presence” approach, assessed the holding companies for corporate

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income and franchise taxes on the royalties. The petitioners appealed the decision of the North Carolina Court of Appeals upholding the state’s authority to impose the tax; on October 3, 2005, the Supreme Court denied certiorari.\(^6\)

The Supreme Court recently denied certiorari again in \textit{Lanco, Inc. v. Director, Div. of Taxation}\(^{61}\) and \textit{FIA Card Services NA (f/k/a MBNA America) v. West Virginia Tax Commissioner}.\(^{62}\) Lanco Inc. and MBNA filed virtually simultaneous certiorari petitions with the Supreme Court challenging respective business activity tax nexus rulings in New Jersey and West Virginia. Lanco Inc., a Delaware corporation that licensed intellectual property to a women's clothing store with locations in New Jersey, challenged as violative of the Commerce Clause, the taxing of licensing income by New Jersey where the company otherwise lacked physical presence in that state. FIA Card Services N.A. also challenged as unconstitutional under the Commerce Clause, a state’s assertion of tax where no physical presence existed. Specifically, FIA Card Services challenged a state court opinion that upheld West Virginia business franchise and corporate tax imposed on MBNA America Bank N.A., FIA Card Service’s predecessor. MBNA was incorporated in Delaware, but had no physical presence in West Virginia. Its only connection

to that state was in issuing credit cards and serving West Virginia credit card customers. The West Virginia Supreme Court held that because of MBNA's "significant economic presence" in the state, imposition of franchise and corporate taxes did not violate the U.S. Constitution.

Despite the high hopes of industry groups, many of which filed amicus briefs urging the extension of Quill to all state taxes, on June 18, 2007, the Supreme Court once again denied certiorari. The Court’s message in declining to hear these cases seems very clear, and it takes little imagination to discern who is now left with the responsibility of resolving the longstanding questions over the standards by which a state may constitutionally impose a state tax without burdening interstate commerce.

It also is easy to understand how financially strapped states see denials of certiorari, along with the apparent unwillingness of Congress to act, as opportunities to increase their taxing authority over out-of-state businesses with no physical in-state presence. Just as the Framers of the Constitution warned, unless restrained states operate naturally in their own best interests. FN HAMILTON?

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An example of this can be found in the reaction of the New Hampshire legislature just two days after the Supreme Court denied certiorari in Lanco and MBNA.\textsuperscript{65} Amending its statutory definition of business activity to include "a substantial economic presence evidenced by a purposeful direction of business toward the state," the state made clear that it does not intend to follow Quill with respect to its business profits tax. Such actions by states to reach out-of-state businesses and to increase revenues at the expense of a national economy are the very reasons why Congress needs to enact a clear physical presence standard applicable to all business activity taxes.

V. EXAMINATION OF PROPOSED BUSINESS ACTIVITY TAX SIMPLIFICATION ACT AND COUNTER PROPOSALS

A. Proposed Legislation

Two identical bills have recently been introduced in Congress, one in the Senate and one in the House of Representatives. These bills would create a federally mandated nexus standard for state business activity taxes.\textsuperscript{66} Similar to prior bills that were never enacted into law,\textsuperscript{67} the proposed legislation, collectively referred to as “BATSA,” would

\begin{flushright}
\textsuperscript{66} See supra note 5.
\textsuperscript{67} Business Activity Tax Simplification Act of 2005, H.R. 1956, 108th Cong. (2005); Business Activity Tax Simplification Act of 2006, S. 2721, 109th Cong. (2006); H.R. 1956. Both bills sought to impose a physical presence standard for business activity taxes, as well as to expand the scope of P.L. 86-272 to include the sale of intangibles and services.
\end{flushright}
essentially do two things: (1) expand the scope of P.L. 86-272 with respect to protected activities, covered sales and transactions, and applicable taxes; and (2) provide a clear minimum jurisdictional standard of physical presence with respect to the imposition of state business activity taxes.

1. Modernization of P.L. 86-272

BATSA would broaden the scope of P.L. 86-272 to cover not only sales of tangible personal property shipped or delivered from out-of-state, but also the sale (or potential sale) and transactions of all forms of property and services “fulfilled or distributed from a point outside the State.”

Protected activities would be expanded from the mere solicitation of orders to (1) the furnishing of information to customers or affiliates; (2) the coverage of events or other in-state gathering of information or his representative, when such information is used or disseminated from out-of-state; or (3) activities directly related to the potential or actual purchase of goods or services within the State where the final decision to purchase is made out of state. These expanded activities would also be protected where performed by an independent contractor on behalf of the person through maintenance of an office in the state, or where an independent contractor is furnished information “by such person ancillary to the

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68 Id.
solicitation of orders or transactions by the independent contractor on behalf of such person.”

Most important, the provisions would apply to all business activity taxes, not simply to net income taxes as is the case with P.L. 86-272. “Business activity tax” under the legislation is defined as any net income-type tax “measured by the amount of, or economic results of, business or related activity conducted in the State.” The intent of the bills is presumably that a sales or use tax, or any transaction tax on the specific sales or acquisitions of goods and services, would not be included.

2. Codification of a Physical Presence Standard

The second primary feature of the legislation is the adoption of the Quill nexus standard for business activity taxes. BATSA creates a bright-line jurisdictional requirement that would need to be met before a state business activity tax could be imposed. Specifically, a state business activity tax could not be imposed unless the taxpayer had physical presence during the taxable year. The physical presence requirement would be met by (1) an individual’s physical “being” in a state, or by assigning an employee to “be” in the state; (2) using the

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69 Id.
70 Id.
71 Id.
72 Id. A “state” for purposes of BATSA includes any of the several States, the District of Columbia, or any territory or possession of the United States, or any political subdivision of any of the foregoing.”
services of a non-employee agent in the state to establish or maintain a market in the state, but only where the agent performs services in the state exclusively for the potential taxpayer; or (3) leasing or owning tangible personal or real property in the state.\textsuperscript{73}

Certain \textit{de minimis} activities would not give rise to physical presence within meaning of BATSA. These would include the presence in a state for less than 15 days in a taxable year (or a greater number of days if provided by state law); or presence in a state to conduct “limited or transient business activity.”\textsuperscript{74}

Finally, BATSA makes clear that the physical presence requirement does not apply where an individual or domestic business entity is domiciled, incorporated, formed or a resident of the state. In addition, under the legislation, a state is not prohibited from imposing a tax on the owner or beneficiary of a partnership, S corporation, limited liability company (taxed for federal purposes as a partnership), trust, estate or other entity, where physical presence by the entity otherwise exists in the state.\textsuperscript{75}

\textbf{B. Proposal for an Alternative Federal Jurisdictional Standard}

\footnotesize{\textsuperscript{73} Id. \textsuperscript{74} Id. \textsuperscript{75} Id.}
In place of a physical presence standard, some have endorsed the Congressional enactment of an economic presence approach to state business activity tax nexus. Under the guise of such sound tax policy principles such as equity and efficiency, these proponents argue that economic realities, as opposed to physical presence, should be the standard by which nexus is measured for purposes of state business activity taxes.

As an example, the New York State Bar Association’s Tax Section recently issued a letter to Congress (“New York Tax Report”) recomending the adoption of a nexus standard that takes into account economic presence. Asserting that such a standard would provide certainty and clarity, the proposal calls for a “de minimis economic threshold.”

Arguments that the New York Tax Section makes in favor of an economic presence standard include the “viable marketplace” justification, concept based on the principle that a business should pays it “fair share” whenever it derives economic benefits of a state’s marketplace. It is further argued that a physical presence of a business is often unrelated to the business activity in the state, and that economic presence is a

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77 Id. at page 2.
78 Id. See also John S. Swain, State Income Tax Jurisdiction: A Jurisdictional and Policy Perspective, 45 Wm and Mary L. Rev. 319, 377.
better gauge of actual in-state business activity.\textsuperscript{79} The New York Tax Section also claims that a physical presence standard would create incentives for a business to manipulate its nexus with a state, resulting in potentially artificial and inefficient transactions.\textsuperscript{80}

Although the specifics as to how such a standard would work are unclear,\textsuperscript{81} the New York Tax Section concludes that a nexus standard that incorporates an economic presence requirement would strike a proper balance between the revenue needs of states, and the fairness and certainty needs of out-of-state taxpayers.\textsuperscript{82}

The New York Tax Section and other advocates of the codification of an economic presence standard make flawed arguments, and fail to consider some of the grave consequences that could arise if Congress were to adopt an economic presence standard. The next section will explain how the policy arguments advanced by the New York Tax Section and others are misguided and overlook key policy considerations, such as the need for consistency with the international jurisdictional standards.

\textsuperscript{79} New York Tax Report at page 8.

\textsuperscript{80} Id. See also John S. Swain supra note 78.

\textsuperscript{81} Presumably, under the proposal a business could be subjected to a state’s business activity taxes on the basis of either physical presence or economic presence.

\textsuperscript{82} New York Tax Report at 4.
1. The Viable Marketplace Fallacy

A long standing premise upon which a state tax may be asserted is that where an out-of-business receives sufficient benefits and protections from a state, imposition of a state tax is justifiable.\textsuperscript{83} The Supreme Court recognized this fundamental principle in \textit{Wisconsin v. J.C. Penney Co.} when it stated that "The simple but controlling question is whether the state has given anything for which it can ask return."\textsuperscript{84} Thus, New York Tax Section and other proponents of an economic presence standard argue that because an out-of-state seller receives benefits of a "viable marketplace" when in-state consumers are accessed, imposition of a tax on the activities of that out-of-state business is justifiable.\textsuperscript{85} Such arguments are fundamentally flawed for several reasons.

First, a "viable marketplace" is something that is created by a state for the benefit of its own residents – not for the benefit of remote sellers with no in-state physical presence.\textsuperscript{86} A state that is fortunate enough to be able to provide its residents with opportunities to purchase the goods and services of an out-of-state business, which opportunities the residents can freely accept or reject, is doing precisely what it is

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\textsuperscript{83} \textit{Wisconsin v. J.C. Penney Co.}, 311 U.S. 435 (1940).
\textsuperscript{84} \textit{Id.}
\textsuperscript{86} \textit{Lanco, Inc. v. Director, Division of Taxation}, Amicus Brief of the Greater Philadelphia Chamber of Commerce and the Chamber of Commerce Southern New Jersey; 2006 U.S. Briefs 1236C, 17 (U.S. May 8, 2007).
supposed to do for its residents.\textsuperscript{87} To reward such a state by allowing it to tax an out-of-state business with no physical presence is essentially permitting a state to deliberately export its tax burden to non-residents that have no “say” in the state’s political process.\textsuperscript{88} This sort of state-centered action at the expense of interstate interests is precisely what the Framers of the U.S. Constitution sought to guard against when they drafted the Commerce Clause to replace the Articles of the Confederation.

Second, in answering the question articulated in \textit{J.C. Penney} as to what benefits and protections a state provides an out-of-state business whose only physical contact with a state is resident customers, it is virtually impossible to find anything but incidental and inchoate benefits. Such a company receives very little, if any, government services at all, including police and fire protection for its property and personnel, education for its employees, or anything that could possibly justify a state’s imposition of tax.\textsuperscript{89} Without some in-state physical presence of the potential taxpayer, a state gives

\textsuperscript{87} \textit{Id.}
\textsuperscript{88} \textit{Id.}
nothing to the out-of-state business “for which it can ask a
return.”\textsuperscript{90}

Finally, the exploitation-of-the-marketplace theory focuses
solely on due process requirements of fairness, and ignores the
Commerce Clause requirement of substantial nexus – an important
check on the effects of state regulation on interstate
commerce.\textsuperscript{91} While it is acknowledged that Congress could choose
to ignore substantial nexus concerns in adopting a
jurisdictional standard for state taxes, the underlying
importance of the Commerce Clause should be heeded by the
legislature,\textsuperscript{92} and states should not be permitted to unduly
burden interstate commerce by asserting tax on an out-of-state
business based on a nebulous jurisdictional test. Adopting
anything less than a physical presence standard would work
against the ideal of a strong, national and unified economy and
would invalidate longstanding principles of federalism.\textsuperscript{93}

\textsuperscript{90} J.C. Penney at 444. Anything received by the out-of-state business with no physical presence would likely be
along the lines of a general benefit or protection for which as members of society as a whole, federal taxes are paid. See Business Activity Tax Nexus: A Chance for Congress to Call the Game, 2003-5 NYU Institute On State & Local Taxation § 5.04. At least one commentator has raised the issue that indeed an action for malfeasance may even arise against a state government seeks to provide benefits to an outside business with no in-state physical presence. See Rosen supra note 91.

\textsuperscript{91} See Quill, 504 U.S. at 312.

\textsuperscript{92} See Quill, 504 U.S. at 304. (“. . .Congress has plenary power to regulate commerce among the States and thus may
authorize state actions that burden interstate commerce.”) See also International Shoe Co. v. Washington, 326 U.S. 310, 315 (1945).

\textsuperscript{93} Peter L. Faber, Should the States Determine Their Own Tax Destinies? Federalism in the 21\textsuperscript{st} Century, 40 State Tax Notes 111 (April 10, 2006).
2. Economic Realities and Inefficiency Arguments

Opponents of the BATSA physical presence standard also argue that the fundamental premise underlying physical nexus is obsolete in an electronic world, and that an economic presence test better reflects the realities of current business models. The New York Tax Section even goes so far as to claim that physical presence often has no correlation to in-state activities and that therefore nexus should not depend solely on the physical location of employees, real property or capital investment.\(^94\)

Basing a nexus standard on such claims would be unsound from both an economic and a tax policy standpoint. The fundamental flaw of those advocating a nexus standard based on economic presence is that they fail to distinguish between out-of-state businesses that have merely participated *with the economy* of another state, and those that participate *in the economy* of that state. The latter would necessitate as a practical matter a physical aspect evidencing a revenue-generating activity.\(^95\)

In addition, whether a company does business over the Internet or from a brick and mortar storefront, labor and capital will always be needed in order to generate or earn

\(^95\) This argument has also been made in the international tax context. See Gary D. Sprague & Rachel Hersey, *Permanent Establishments And Internet-Enabled Enterprises: The Physical Presence and Contract Concluding Dependent Agent Tests*, 38 Ga. L. Rev. 299, 312 (2003).
income. And it is precisely where the labor and capital investment, as well as risk of investment is located, that the “taxable” value is ultimately created, and where the incidence of business activity tax should naturally fall. Merely accessing a market through electronic means creates no inherent value to the out-of-state business upon which a tax should be asserted.

Along these same lines, proponents of an economic presence standard also make the tenuous argument that requiring a physical presence would create economic inefficiencies in that out-of-state businesses would have artificial incentives to stay physically out of the state, while presumably stepping up electronic dealings with in-state residents. The fear is that businesses could manipulate the form of their transactions in order to shift income away from a state.

To the contrary, however, economic efficiencies are actually created by allowing out-of-state businesses to promote their interests through e-commerce without concern about whether their non-physical, remote contacts will create a taxing obligation. Also, the development of electronic and other means of doing business enhances and increases overall business opportunities across the board, in all states. Collectively, without resorting to amorphous, hard-to-apply nexus standards,

96 Note that it would be virtually impossible for a U.S. business to avoid nexus entirely, or to develop all business through non-physical means. For a like argument in the international tax context, see Reuven S. Avi-Yonah, Tax Competition and E-Commerce, Worldwide Tax Daily, Sept. 17, 2001, 2001 WTD 180-11.
every taxing jurisdiction should benefit from a changing business model that provides its in-state residents and those operating physically in-state, with new ways of reaching customers.

Finally, a business decision to move labor and capital from one jurisdiction to another would never be done for other than bottom-line, economic reasons. In that sense, asserting that such behavior is somehow “artificial” is illogical and runs counter to fundamental principles of economics.

3. Considerations of Clarity, Compliance Burdens and Administrative Workability

Another ludicrous argument made by those advocating an economic presence component to federally mandated nexus standards is that there are clearer, easier and more workable ways of determining taxable presence than the “bright line” physical presence test delineated in Quill. This argument is completely unsupported, and seems to be an attempt to legitimize a “fuzzy” nexus standard that would allow a state to continue asserting what amounts to a national tax jurisdiction over out-of-state companies with otherwise tenuous in-state ties.

The Court in Quill recognized the need to tighten up the nexus standard, to leave as little wiggle room as possible, and “to firmly establish the boundaries of legitimate state

98 Id. at 8.
authority to impose" taxes.\textsuperscript{99} The Quill Court, quoting Northwestern States Portland Cement Co. v. Minnesota,\textsuperscript{100} further referenced the need for “precise guides to the States in the exercise of their indispensable power of taxation.”\textsuperscript{101} Adoption by Congress of an economic nexus standard (as either a stand alone test, or a hybrid one) would be anything but a “precise guide,” and would lead to nothing but continuing disputes over the parameters of substantial nexus.

The Court in Quill also addressed the argument that bright line tests are artificial:

Like other bright line tests, the Bellas Hess rule appears artificial at its edges: whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant, or office. This artificiality, however, is more than offset by the benefits of a clear rule. Such a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes.\textsuperscript{102}

Thus, arguments made by the New York Tax Section that a physical presence standard is “artificial” and therefore should be rejected in favor of the less bright line test of economic presence, are unquestionably misplaced.

Moreover, an economic presence standard would result in a compliance nightmare for multistate businesses. A recent study estimates that there are over 3,300 business activity taxes

\textsuperscript{100} 358 U.S. 450, 3 L. Ed. 2d 421, 79 S. Ct. 357 (1959).
\textsuperscript{102} 504 U.S. at 315. (Citations omitted.)
collected in state and local jurisdictions across the United States. Rather than encouraging unification of a national market, an economic presence standard would discourage businesses from expanding operations due to bottom-line costs of managing and paying for taxes in multiple jurisdictions. In this way, such a standard would unduly interfere and burden interstate commerce—something that Congress is charged with protecting, not harming.

Finally, an economic presence would further exacerbate the difficulties that publicly traded companies are faced with in meeting stringent financial reporting requirements under the standards created under rules promulgated in 2006 by the Financial Accounting Standards Board (FASB). These rules, known as Financial Interpretation No. (FIN) 48, set forth the requirements for disclosing uncertain tax positions on financial statements. Under FIN 48, each tax return position taken or expected to be taken—including the position that a company has insufficient nexus such that it does not have to file a state tax return—must be analyzed under a two step process. Under the first step, a determination is made as to whether the return position is ultimately “more likely than not” to be upheld under

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103 Companies Cite Ernst & Young Study in Petition to Supreme Court, 2007 STT 51-1 (March 14, 2007). More than 12,600 business activity taxes have actually been authorized by state and local governments. Id.
audit and court challenges. Such a determination is based on the technical merits of the position and the likelihood of prevailing on appeal. Where such likelihood is less than 50 percent, the position cannot be recognized on the financial statement, and a full reserve must be created for potential liability.\textsuperscript{106}

FIN 48 and an economic presence standard are a lethal combination when one considers an out-of-state business with no in-state physical presence that would have to apply a standard that is other than a bright-line rule to determine whether sufficient nexus exists. If the test is one of economic presence, it will be more difficult to make the FIN 48 determination with a 50 percent confidence, and such a company will otherwise forced to accrue 100 percent of the potential tax liability, including any potential interest and penalties. Such consequences only add to the onerous burden on a business engaged in interstate commerce in states where it has no labor or capital.

4. International, National and Sub-national Tax Policies

If taken seriously, arguments such as those made by the New York Tax Section that some form of an economic presence standard should be adopted by Congress, threaten international relationships and the resulting cross-border trade between the

\textsuperscript{106} Id.
United States and foreign nations. This is so because of the potential conflict with the longstanding jurisdictional tax standard known as “permanent establishment” that has been negotiated between the United States and the vast majority of developed nations.

Described in most bilateral tax treaties with the United States, this “permanent establishment” standard generally requires, when looked at from a U.S. perspective, that before a U.S. tax can be imposed, the non-resident have a fixed place of business in the United States through which its business enterprise is carried on. Examples of permanent establishments found in most bilateral tax treaties with the United States include warehouses, offices, branches and factories, but do not include certain types of physical presence that are deemed to be preparatory or auxiliary to creation of a permanent establishment. 107 Thus, the non-resident’s requisite presence in the United States must be more than incidental, something that clearly points to a significant relationship between the nonresident and the United States such that imposition of a U.S. income tax would make sense and could be justified.

What is in effect a physical presence threshold of tax jurisdiction, the permanent establishment standard is the

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107 Model Tax Convention on Income and on Capital, art. 7 (Jan. 28, 2003), Organization for Economic Co-Operation and Development.
international norm by which companies of developed nations assess and predict their cross border tax costs. Such calculations are crucial to global company’s fiscal planning, and are routinely relied upon in the international context in determining whether and where to do business. The benefits of the physical presence standard in the international context was explained by Michael F. Mundaca, who is now Deputy Assistant Secretary for International Tax Affairs in the Treasury Department’s Office of Tax Policy, when he testified before the Senate Committee on Finance in connection with the prior BATSA bill:

[O]ur experiences in the international tax area, using the well-established PE [(i.e., permanent establishment)] concept, have demonstrated that a clear physical presence standard has created uniformity, predictability, and certainty. It has helped mitigate double taxation and prevent tax jurisdictional disputes. In addition, it has alleviated the administrative burden that would be imposed if taxpayer were forced to file and pay income tax in every jurisdiction in which they have customers or other sources of business income. Multistate taxpayers, likewise, can benefit from a similarly clear consensus standard.\(^{108}\)

Mr. Mundaca further pointed out that a permanent establishment (i.e., physical presence) standard “helps to mitigate double taxation and prevent tax jurisdictional disputes, which is especially important in a global economy.”\(^{109}\)


\(^{109}\) Id.
It is difficult to predict what the implications would be of the adoption of federally mandated state nexus standard that departs from the physical presence standard found in permanent establishment clauses of bilateral tax treaties. However, it is not difficult to imagine that imposition of an economic presence standard would have an adverse effect on foreign relations between the United States and its tax treaty partners. As Mundaca warns, enacting a less-than-physical presence standard would impact the global economy—presumably by discouraging in-bound investment into the United States.

Even more troubling are the proposed solutions to the anticipated international problems that would be created by enactment of a non-physical nexus standard that conflicts with permanent establishment principles. As an example, the New York Tax Section recommends that Congress consider, along with an economic presence standard, the possibility of enacting a separate nexus standard for non-U.S. residents. Aside from the problems related to discrimination of U.S. companies in favor of non-U.S. businesses, a differentiated nexus standard between U.S. and non-U.S. residents would add unnecessary complexity to an already complex issue.

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It would also encourage the restructuring of multinational operations to benefit from the favorable nexus standards afforded to non-U.S. residents. For example, a U.S. company with operations (i.e., labor and capital) in the United States may decide to restructure its U.S. operations to locations overseas so that it can avoid onerous state taxation in the United States. Ironically, adopting an economic presence standard would likely create the very “artificial incentives” and “economically inefficient behavior” that the New York Tax Section warns a physical presence standard would create.\textsuperscript{111} Rather than “incentiviz[ing] [sic]z inefficient behavior,”\textsuperscript{112} a physical presence test could actually prevent the harmful transfer of U.S. labor and capital to an overseas parent or subsidiary company that could result by applying a physical presence standard to non-U.S. residents, while requiring a U.S. business to use an economic presence standard. Such a situation could only harm - not benefit - the U.S. economy.

In this regard, the enactment by Congress of an economic presence standard, or any standard that departs from a purely physical presence requirement, would run counter to Commerce Clause goals of maintaining a free flowing commerce in the

\textsuperscript{111} New York Tax Report at 8.
\textsuperscript{112} Id.
United States, and could potentially interfere with important foreign relations.

5. The Promotion of Federalism

Congressional adoption of a clear physical nexus standard would also validate the principles of federalism. Such adoption would strike the correct balance between the national interest of a unified market, an interest over which Congress is charged with promoting and protecting, and the ability of states to tax as they see fit any business over which jurisdiction exists. By codifying as a physical presence standard, BATSA would allow the clear determination of whether and when a state has jurisdiction to tax, as opposed to how that tax should be measured.\textsuperscript{113} Rather than treading on a state’s right as to how it will tax those over which it is entitled to tax, BATSA would merely codify a physical presence standard and would make clear when (and when not) an out-of-state business could be subject to a state’s taxing jurisdiction. This would ensure the free flow of national commerce.

Similar to state governmental reaction at the time in our country when the Articles of the Confederation were on the verge of being replaced with a document that would give the federal government the power to reign in abusive and far reaching state tax practices, state governments are now up in arms over having

\textsuperscript{113} 2006-12 NYU Institute On State & Local Taxation § 12.04.
their sovereignty second guessed by BATSA. What is at stake, just as it was when the Constitution was being debated, is the ability of states to generate revenues from out-of-state interests that have no influence over government elections. Thus, any debate in Congress over BATSA (or over any proposals to restrict state taxing authority) will inevitably include state tax administrators who will contend that their respective states under the principles of federalism should be free to tax as they see fit. For example, this states’ rights argument against the codification of a physical presence standard was made at a 2005 hearing of the House Judiciary Committee’s Commercial and Administrative Law Subcommittee. Kansas Secretary of Revenue Joan Wagnon, who also represented 46 states as Multistate Tax Commission Chair, testified on against H.R. 1956, the Business Activity Tax Simplification Act of 2005:

H.R. 1956 runs roughshod over federalism, placing Congress in the position of imposing a smorgasbord of federally-mandated state tax exemptions that would preempt hundreds of existing state and local laws and rules. For almost 230 years, while maintaining its jurisdiction over interstate commerce, Congress has consistently respected the right of states to raise revenues. . . .

Such opponents of BATSA’s physical presence standard, including most if not all state tax administrators as well as the New York Tax Section, obfuscate the true purposes of the

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Commerce Clause. Rather than a sign of respect for state sovereignty as BATSA opponents would like to pretend, the Commerce Clause is, and was adopted as, a means of restraining state powers,\(^{115}\) including the power to tax those engaging in interstate commerce. In that sense, BATSA promotes federalism by allowing the federal legislative branch of government to do what it is charged to do, while at the same time allowing states to tax those within their proper jurisdiction.

Ultimately, a physical presence test reinforces state sovereignty by helping to clearly delineate state geographic borders that are so important to our federalist system of government.\(^{116}\) It is the physical boundaries that mark the outer limits of state taxing authority, and it is the physical nature of contacts within those borders that should guide a state’s taxing authority. Eliminating a physical presence standard in favor of an economic one would allow a state to tax without reference to the physical boundaries that bring integrity to our federalist system.\(^{117}\) To erase these boundaries by allowing states to tax out-of-state businesses based on non-physical economic ties to that state would create a system similar to the one that existed during the time of Articles of the


\(^{117}\) Id. at 19.
Confederation. To give each state a national taxing authority would be the result of Congressional adoption of anything less than a physical presence standard.

VI. CONCLUSION

At no time since shortly after the Revolutionary War, when States in response to a poor economy began to erect barriers to commerce in the form of fees, taxes and trade restrictions, has there been such a need for unification of our national commercial interests. Just as the Federal Convention of 1787 met to address the commercial “disunity” of the States and the resulting threat posed to a national economy, so must Congress step in now and remove current impediments to the continued development of a national market.

The outcome of the Federal Convention was ratification of the Commerce Clause which gave Congress the power to regulate interstate commerce. The outcome today must be the Congressional exercise of this power by enactment of federal jurisdictional legislation that would embody a physical presence standard for state taxation of business activity. Certainty, clarity, a more unified national market and a workable standard consistent with international tax policy would arise from the adoption of a nexus standard that imposes a strict physical presence requirement. Only then will we finally see the eradication of
the “tangled underbrush”\textsuperscript{118} that has developed over the years with respect to the requisite nexus that must exist before a state may properly impose a business activity tax on an out-of-state company.

\textsuperscript{118} Northwestern States Portland Cement, 358 U.S. 450, 457 (1959)