Nexus News*

By Charolette Noel

Substantial Nexus: The "Nexus Gap" Over Intangibles

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While states and interstate businesses have for decades disputed what constitutes "substantial nexus" to allow a state to tax an out-of-state taxpayer, their views on the subject seem to be moving farther apart as states assert broader jurisdiction to tax earnings from intangibles. The authors refer to this recent expansion of diverging views as the "nexus gap."

One reason for this "nexus gap" is that businesses do not expect to be subjected to tax on previously untaxed intangible transactions without some statutory change. Until recently, nexus disputes related to intangibles involved intercompany transactions that had been structured to avoid taxation. The recent wave of intangible nexus claims has nothing to do with tax avoidance or intercompany transactions. These cases involve taxing out-of-state investors, licensors, or franchisors solely on the basis of contracts with third parties in the state.[1] Essentially, states are seeking to expand their reach in the "new economy" by taxing income from Internet activities or intangible investments—common transactions for anyone with an Internet connection or a productive retirement account.

Another reason for the "nexus gap" is that states have begun to assert that "substantial nexus" exists not only through contacts with in-state representatives or tangible property, but also through imputed "one-step-removed" contractual contacts with in-state third parties. These assertions of "substantial nexus" must be examined under the parallel but distinct requirements of the Due Process Clause and Commerce Clause of

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the United States Constitution established in *Quill Corporation v. North Dakota*.[2]

Overview of Taxation of Intangible Income

The United States Supreme Court most recently addressed the constitutional limits on taxation of intangible income in *MeadWestvaco*.[3] In that case, the Supreme Court reiterated the distinct nexus requirements of the Commerce Clause and the Due Process Clause as established in *Quill*:

> The Commerce Clause and the Due Process Clause impose distinct but parallel limitations on a State's power to tax out-of-state activities . . . . The Due Process Clause demands that there exist " 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax,' " as well as a rational relationship between the tax and the " ' "values connected with the taxing State." ' " . . . The Commerce Clause forbids the States to levy taxes that discriminate against interstate commerce or that burden it by subjecting activities to multiple or unfairly apportioned taxation. . . . The "broad inquiry" subsumed in both constitutional requirements is " 'whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state' ". . . .[4]

While "substantial nexus" is a key jurisdictional requirement, with respect to taxation of income from certain intangible rights, "substantial nexus" is not the only required connection. Even if a state has nexus with the taxpayer, the Supreme Court has demanded an additional connection to the value the state seeks to tax. Where the value subject to tax is income, a "unitary" connection is required to justify taxing the intangible income earned by a nondomiciliary taxpayer.[5]

The Commerce Clause prohibits a nondomiciliary state from taxing the income generated from an intangible asset unless the asset serves an operational function of the taxpayer's unitary business.[6] Under the long-standing unitary business principle, if the value the state seeks to tax is derived from a unitary business operating within and without the state, the state can tax an apportioned share of the value of the business instead of isolating the value attributable to the operation of the business within the state.[7] But, if the value is derived from an unrelated business activity that constitutes a "discrete business enterprise," then the nondomiciliary state cannot "tax even an apportioned share of that value."[8]

"[T]he unitary business rule is a recognition of two imperatives: the states' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income; and the necessary limit on the states' authority to tax value or income which cannot in fairness be attributed to *the taxpayer's activities* within the State."[9]

Substantial Nexus vs. Economic Income

The Supreme Court has not directly ruled on the requirements of "substantial nexus" since its 1992 decision in *Quill*,[10] which held that under the Commerce Clause, some physical presence was required to create "substantial nexus" sufficient to impose a use tax on an out-of-state retailer. Almost immediately after *Quill* was decided, an important question emerged: Does *Quill* and its bright-line physical-presence test apply to taxes other than sales and use taxes? The *Quill* Court did not explicitly address that question, which has proved to be fertile ground for state tax litigation. Indeed, a substantial body of case law addresses whether *Quill* is limited to sales and use tax or whether it applies to all forms of state taxation. Some state courts have found that *Quill's* physical presence rule extends outside the sales-and-use-tax context.[11] Other state courts, however, have reached a different outcome by finding that "economic nexus" alone is sufficient for taxation outside the sales-and-use-tax context.

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The concept of "economic nexus" was first introduced by the South Carolina Supreme Court in *Geoffrey, Inc. v. South Carolina Tax Commission*.[12] There, income tax was assessed against Geoffrey, Inc. ("Geoffrey"), a Delaware intangible-holding company that was formed to license the trademarks and other intangibles necessary for affiliates to operate Toys "R" Us stores across the country, including stores in South Carolina. Geoffrey argued before the South Carolina Supreme Court that taxation was improper because the entity owning the intangibles lacked any in-state physical presence as required by *Quill*. The South Carolina court disagreed, finding that Geoffrey's "purposeful direction of activity toward South Carolina as well as its possessing intangible property here provided a definite link between South Carolina and the income derived by [Geoffrey] from the use of its trademarks and trade names in this State."[13] The *Geoffrey* court briefly addressed *Quill*, concluding that while it imposed a physical-presence standard for sales and use taxes, that "requirement [has] not been extended to other types of taxes."[14] The court also appears to have been influenced by the taxpayer's attempt to avoid tax through intercompany transactions among companies that appeared to operate as unitary businesses.

Several states have followed *Geoffrey's* lead by upholding income and franchise tax assessments against mere holding companies that license intangibles to affiliates. For example, the Massachusetts Supreme Judicial Court, the Louisiana Court of Appeal, and the Oklahoma Court of Civil Appeals have all affirmed assessments of corporate income taxes against Geoffrey.[15] The New Jersey Supreme Court and the North Carolina Court of Appeals have similarly upheld the assessment of corporate income and franchise taxes upon affiliated holding companies that licensed the intangibles to in-state affiliates for use in their retail clothing business.[16] Other types of affiliated companies have met the same fate—all based upon findings that: (i) *Quill* does not apply outside the sales-and-use-tax area; (ii) the intangible property was used by an in-state affiliate; and (iii) income and other benefits were derived from the taxing state.[17]

Citing *Geoffrey* and its progeny, other states have upheld income and franchise tax assessments against companies without any substantial in-state physical presence in the credit card context. For example, such an assessment was upheld in *West Virginia Tax Commissioner v. MBNA America Bank, N.A.*[18] MBNA America Bank ("MBNA") had thousands of credit card customers in West Virginia and derived substantial income as a result of its relationship with those customers, but it did not have any in-state locations. The West Virginia Supreme Court of Appeals concluded that "*Quill's* physical-presence requirement for showing a substantial Commerce Clause nexus applied only to use and sales taxes and not to business franchise and corporation net income taxes."[19] The West Virginia court went on to find that MBNA had nexus with West Virginia because its activities generated $18 million of its gross receipts from West Virginia customers and that such a "significant economic" presence warranted taxation.[20] Other states, including Massachusetts and Indiana, have followed *MBNA*, finding sufficient economic nexus in the credit card context.[21]

> The *KFC* case was closely followed because it presented a question never squarely addressed by a court: Can an out-of-state business that lacks any in-state physical presence under *Quill* be subject to state income taxation based upon its licensing of intangible property to unrelated in-state third parties?

In short, economic nexus was born in the context of licensing intangibles to affiliated entities. It was then applied to large-scale credit card businesses. It generally did not extend to other contexts—at least not without an in-state withholding requirement—until the Supreme Court of Iowa decided *KFC Corporation v. Iowa Department of Revenue*.[22]

Imputing Nexus From Intangibles

The concept of economic nexus has been mirrored somewhat by the arguments for imputing nexus from interests in intangibles. Generally, except when a person or entity acts on behalf of

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another as an agent or representative, nexus is not imputed between entities.[23] Despite this general principle, some states have successfully attributed nexus to limited partners to justify taxation of the partners' distributive share of income from an in-state partnership.[24] Except in the controversial case of *International Harvester*, which upheld a state's withholding provision for in-state dividend payors to deduct and remit taxes for in-state and out-of-state investors, the Supreme Court has never found "substantial nexus" from the mere ownership of interests of an entity that conducts business in the state.[25] However, the Court did recently decline to consider the Kentucky Court of Appeals decision in *Revenue Cabinet v. Asworth Corp.*, which permitted taxation of a non-managing, out-of-state investor based on the flow-through income from a limited liability company conducting business in Kentucky.[26]

Perhaps the most concerning attribution of "intangible nexus" to date was upheld recently by the Supreme Court of Iowa in *KFC*.[27] That case, which remains subject to appeal, allowed Iowa to tax a franchisor on the basis of a finding of "substantial nexus" related to third-party franchisees that operate independent in-state businesses. Taxpayers and tax professionals alike had long awaited the *KFC* ruling, which had been pending since 2001. The *KFC* case was closely followed because it presented a question never squarely addressed by a court: Can an out-of-state business that lacks any in-state physical presence under *Quill* be subject to state income taxation based upon its licensing of intangible property to unrelated in-state third parties?[28]

KFC involves a Delaware corporation (KFC) that is headquartered in Kentucky and licenses trademarks and business systems to independent franchisees in Iowa. KFC did not itself own any restaurants or employ anyone in Iowa. The Supreme Court of Iowa framed the issue as "whether the State of Iowa may impose an income tax on revenue received by a foreign corporation that has no tangible physical presence within the state but receives revenues from the use of the corporation's intangible property within the state."[29] In order to answer the constitutional issues, the Iowa court began by turning to the Supreme Court's analysis in *Quill.*

> As assertions of taxing jurisdiction become laughable, the likelihood increases that the Supreme Court (or Congress) will eventually be compelled to establish the constitutional limits of intangible nexus.

The court identified two questions that needed to be answered in order to resolve the constitutional issues presented in the case. Did Iowa satisfy the physical presence test articulated in *Quill*? [30] Alternatively, does *Quill's* "physical presence" test apply to cases involving state income taxation?[31] With respect to the first question, the court found that the case was distinguishable from *Quill* because, unlike the taxpayer in *Quill*, KFC had physical presence in Iowa for two reasons. First, the Iowa court adopted a "functional equivalent" test, concluding that KFC's intangibles licensed for use in Iowa to "its franchisees that are firmly anchored within the state, would be regarded as having a sufficient connection to Iowa to amount to the functional equivalent of 'physical presence' under *Quill*."[32] Second, the court found that revenue-generating transactions in Iowa provide nexus. In other words, according to the court, "the fact that the transactions that produced the revenue were based upon use of the intangibles in Iowa" supports taxation.[33]

With respect to the second question, the Iowa court concluded that physical presence was not required because the Commerce Clause concerns related to the use tax in *Quill* were not a factor in *KFC*.[34] After examining rulings in other states, the court stated, "We also doubt that the Supreme Court would extend the 'physical presence' rule outside the sales and use tax context of *Quill*."[35] The Iowa court further reasoned that " 'physical presence' in today's world is not a meaningful surrogate for the economic presence sufficient to make a seller the subject of state taxation."[36] Accordingly, the court sought to apply a substance-over-form approach that it asserts has been embraced by the United States Supreme Court:

> When a company earns hundreds of thousands of dollars from sales to Iowa customers arising from the licensing of intangibles associated with the fast-food business, we conclude that

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the Supreme Court would engage in a realistic substance-over-form assessment that would allow a state legislature to require the payment of the company's fair share of taxes without violating the dormant Commerce Clause.[37]

The court further held that "by licensing to franchisees within Iowa, KFC has received the benefit of an orderly society within the state and, as a result, is subject to the payment of income taxes."[38]

Practical Implications of Recent and Pending Intangible Nexus Cases

The recent cases are particularly bad news for investors of flow-through entities conducting business in Kentucky, as well as and franchisors and other out-of-state businesses that license intangibles to third parties in Iowa. Those taxpayers should brace themselves for aggressive enforcement, including possible assessments for previous years.

On the basis of the recent Kentucky Court of Appeals decision in *Asworth Corp.*, taxpayers should expect further assertions from additional states seeking to compel taxation of flow-through income earned by out-of-state investors. These assertions may arise from new legislation or regulations, or from states' attempts to stretch interpretations of existing statutes and regulations. At least in some states, the Administrative Procedure Act should provide a backstop against backward-looking policy changes. Unfortunately, however, neither Congress nor the Supreme Court appears poised in the near future to address constitutional limitations of taxing out-of-state investors on the basis of flow-through income.

The next best chance for the Supreme Court to consider the intangible nexus issue appears to be the *KFC* decision. *KFC* is a landmark decision that has significant implications for interstate and international franchisors and other licensors of intangible property. From a legal perspective, *KFC* blazes a new economic nexus trail that extends well beyond *Geoffrey.* Franchisors with franchisees in Iowa should closely monitor the situation and evaluate options for limiting exposure. KFC has 90 days to petition the United States Supreme Court to review the Iowa Supreme Court's decision.[39] Should the Court decline to consider the case, franchisors may have no choice but to navigate *KFC's* new economic nexus frontier in Iowa, and beyond if additional states become emboldened by a Supreme Court decision to decline to rule on the issue.

Still, the "nexus gap" continues as taxpayers and tax practitioners expect the issue of "intangible nexus" will eventually be addressed by the Supreme Court, and that the Court will reiterate the Due Process requirement of minimum contacts as well as the Commerce Clause's higher standard of "substantial nexus." As assertions of taxing jurisdiction become laughable,[40] the likelihood increases that the Supreme Court (or Congress) will eventually be compelled to establish the constitutional limits of intangible nexus.

Conclusion

Until Congress or the Supreme Court addresses whether the dual nexus requirements of the Due Process and Commerce Clauses—that states have both: (i) a connection with the taxpayer; and (ii) a connection with the activity the state seeks to tax[41]—can be satisfied without a physical presence, it will be difficult to close the "nexus gap."

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Endnotes

* The views set forth in this article are the personal views of the authors and do not necessarily reflect the opinions of Jones Day, its clients, or any other organizations with which the authors are associated.

1 *See, e.g., KFC Corporation v. Iowa Department of Revenue*, 792 N.W.2d 308 (Iowa 2010) (asserting right to impose income tax on franchisor based on sales of franchisees in Iowa); *Revenue Cabinet v. Asworth Corp.*, Nos. 2007-CA-002549-MR, 2008-CA-000023-MR, slip op., WL 3877518 (Ky. App. 2009), *rev. denied* (Ky. 2010), *cert. denied*, No. 10-662 (U.S. Jan. 24, 2011) (asserting income tax based on interest in a partnership doing business in Kentucky).

2 504 U.S. 298 (1992); *see also MeadWestvaco Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16 (2008).

3 *MeadWestvaco Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16, 24 (2008).

4 *Id.*, 553 U.S. at 24 (2008) (citing *Quill* and earlier income tax and property tax cases).

5 *Id.*, 553 U.S. at 28–29; *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 777–78 (1992) (distinguishing when assets serve a capital function or an operational function).

6 *See MeadWestvaco.*, 553 U.S. at 28–29 (a nondomiciliary state is permitted to apportion the income from a taxpayer's intangible interest in a nonunitary business only where the income-generating asset "served an operational function" of the taxpayer's unitary business being conducted in the taxing state); *Allied-Signal, Inc.*, 504 U.S. at 777-78 (1992) (distinguishing when assets serve a capital function or an operational function).

7 *Id.* at 26 (citing *Exxon Corp. v. Dep't of*

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Rev. of Wis., 447 U.S. 207, 223 (1980), and *Moorman Mfg. Co. v. Bair*, 437 U. S. 267, 273 (1978)).

[8] *MeadWestvaco*, 553 U.S. at 25, 26; *see also*, *Container Corp. of America v. Franchise Tax Bd.*, 463 U. S. 159, 165-66 (1983).

[9] *Allied-Signal*, 504 U.S. at 780 (emphasis added).

[10] 504 U.S. 298 (1992).

[11] *See, e.g., J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999) (applying *Quill* to franchise/excise tax); *Rylander v. Bandag Licensing*, 18 S.W.3d 296 (Tx. Ct. App. 2000) (*Quill* applies to franchise tax).

[12] 437 S.E.2d 13 (S.C. 1993).

[13] *Id.* at 21.

[14] *Id.* at 23, n. 4.

[15] *Geoffrey, Inc. v. Commissioner of Revenue*, 899 N.E.2d 87 (Mass. 2009); *Bridges v. Geoffrey, Inc.*, 984 So.2d 115 (La. Ct. App. 2008); *Geoffrey, Inc. v. Oklahoma Tax Commission*, No. 99938, 2005 Okla. Civ. App. LEXIS 124 (Okla. Civ. App. Dec. 23, 2005).

[16] *Lanco, Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004).

[17] *See, e.g., Kmart Properties, Inc. v. Taxation and Revenue Dep't of N.M.*, 131 P.3d 27 (N.M. Ct. App. 2001); *Hallmark Mktg. Corp. v. Dep't of Revenue*, No. 981870A, 2000 WL 33225374 (Or. T. C. Oct. 9, 2000).

[18] 640 S.E.2d 226 (W.Va. 2006).

[19] *Id.* at 232.

[20] *Id.* at 234.

[21] *Capital One Bank v. Commissioner of Rev.*, 899 N.E.2d 76 (Mass. 2009); *MBNA Amer. Bank v. Indiana Dep't of State Rev.*, 895 N.E.2d 140 (Ind. T. C. 2008).

[22] 792 N.W.2d 308 (Iowa 2010); *cf. International Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435, 437, 445 (1944) (Due Process permits state to require in-state corporations to withhold and deduct tax from dividends payable to both resident and non-resident shareholders from their in-state investment transactions).

[23] *See, e.g., Scripto, Inc. v. Carson*, 362 U.S. 207 (1960) (corporation subject to tax based on presence of in-state agents acting on its behalf); *Cannon Mfg.Co. v. Cudahy Packing Co.*, 267 U.S. 333 (1925) (North Carolina lacked personal jurisdiction over parent company that owned a subsidiary in the state); *Ytuarte v. Gruner*, 935 F.2d 971 (8th Cir. 1991) (partnership's contacts cannot be imputed to limited partner); *Sher v. Johnson*, 911 F.2d 1357 (9th Cir. 1990) (same).

[24] *See Revenue Cabinet v. Asworth Corp.*, Nos. 2007-CA-002549-MR, 2008-CA-000023-MR, 2009 WL 3877518 (Ky. Ct. App. 2009), *rev. denied* (Ky. 2010), *cert. denied*, No. 10-662 (U.S. Jan. 24, 2011) (owners of up to 99 percent limited and/or general partnership interest held to have substantial nexus with Kentucky on basis of receipt of distributive shares of partnership income from partnership doing business in Kentucky); *Borden Chems. & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (Ill. App. Ct. 2000) (permitting taxation of distributive share of income to nonresident limited partner).

[25] See *International Harvester Co.*, 322 U.S. at 435 (allowing Wisconsin to require in-state corporations to withhold tax on dividends); I Jerome R. Hellerstein & Walter Hellerstein, State Taxation ¶ 6.04[1] (3d ed. 1998) ("The Court's sweeping affirmation of Wisconsin's power to impose a tax on dividends earned by nonresident shareholders may have been premised on a false analogy . . . as Justice Jackson contended in dissent.").

[26] *Revenue Cabinet v. Asworth Corp.*, Nos. 2007-CA-002549-MR, 2008-CA-000023-MR, slip op. at 9–10.

[27] *KFC Corp.,* 792 N.W.2d at 308.

[28] Note, however, that the Arizona Department of Revenue addressed this same issue in a March 27, 2008, administrative decision and reached a similar conclusion. *See* Arizona State Tax Reporter (CCH) 400-947, *Case No. 20070083-C,* Decision of Hearing Officer (Arizona Dep't of Rev. March 27, 2008).

[29] *KFC Corp.*, 792 N.W.2d 308, 309.

[30] *Id.* at 312.

[31] *Id.* at 313.

[32] *Id.* at 324.

[33] *Id.*

[34] *Id., citing Quill*, 504 U.S. at 314.

[35] *Id.* at 326.

[36] *Id.*

[37] *Id.* at 328.

[38] *Id.*

[39] U.S. Supreme Court Rule 13.

[40] *See* Transcript of Oral Argument at 52–53, *MeadWestvaco*, 553 U.S. 16 (No. 06-1413). The transcript reads:

JUSTICE SCALIA: Can you tax me on stock—on stock that I own [i]n companies that do business in Illinois?

MR. BAROV: In the abstract, yes, you could, Your Honor.

JUSTICE SCALIA: Do you know any State that tries to do it.

MR. BAROV: No, Your Honor, but again, Your Honor—

JUSTICE SCALIA: That's extraordinary. I don't know of any tax that a State could possibly impose, that no State has imposed.

[Laughter]

[41] *See Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 777–78 (1992) (requiring a connection to the person the state seeks to tax and, in the case of a tax on an activity, a connection to the activity itself).

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