

State Tax Nexus Issues in a Mobile Economy: The Evolving Legal Landscape

**John A. Swain
University of Arizona
Rogers College of Law**

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Abstract

As a general proposition, when a state asserts substantive jurisdiction over the subject matter of a tax, the state should also have enforcement jurisdiction over a person who can effectively remit the tax. Administrative and compliance considerations may justify an exception when the item to be taxed falls below a certain threshold. Because the administrative and compliance costs associated with foreign persons may be higher than for domestic persons, the appropriate thresholds for foreign persons may be higher. An alternative to granting a tax exemption to persons who fall below a threshold is to lower their administrative and compliance costs through a simplified compliance regime. In the American sub-national system, the major impediments to the alignment of substantive and enforcement jurisdiction are the Quill physical presence test and the income tax safe-harbor of P.L. 86-272. These physical presence tests have had the unintended consequence of stimulating “economic development nexus” rules that are even more protective of remote businesses, thus driving substantive and enforcement jurisdiction even further out of alignment. Finally, the tax law has responded to mobility in various ways, as illustrated by the diverse approaches to the problem of sourcing intangibles for income tax purposes.

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“[T]he [nexus] question seems a trivial one, albeit one that has attracted a great deal of litigation in the courts.” Peggy B. Musgrave¹

1. Introduction: Substantive and Enforcement Jurisdiction

Tax nexus involves two separate, but related, inquiries: (1) nexus with the subject matter of the tax and (2) nexus with a person² who can be compelled to remit the tax.

Hellerstein (2003) identifies these as “substantive jurisdiction” and “enforcement jurisdiction,” respectively. That terminology will be employed here, except that alternative terms for “substantive jurisdiction,” such as “sourcing” or “attribution,” may sometimes be used.

1.1 Substantive Jurisdiction

Substantive jurisdiction means power to tax an item that is otherwise part of a state’s tax base.³ For example, if a state generally taxes dividend income, the question of substantive jurisdiction over dividend income will arise. If a state chooses not to tax dividends, however, then no question of substantive jurisdiction arises because dividends are not included in the state’s tax base. With respect to income taxes, the question of

¹ Musgrave (1984).

² Unless otherwise indicated, “person” means individual, firm or other entity.

³ The term “jurisdiction” can be used to denote a political territory as well as to denote the power and authority to impose a tax on a subject matter of a tax or a person. To enhance readability and avoid ambiguity, this paper often will substitute other terms for “jurisdiction” as a territorial taxing unit, such as “state” and “country.”

substantive jurisdiction usually is answered by identifying the “source” of the income and/or the “residence” of the income recipient. Thus, with respect to dividends, we might expect tax to be imposed either by the state (or states) in which the dividend payor does business or by the state of residence of the dividend payee, or both.

Absent a coordinating mechanism, an otherwise taxable item can be subject to the substantive jurisdiction of more than one state (or no state at all). For example, both the state of source and the state of residence may each assert substantive jurisdiction over an item of income.⁴ Additionally, there may be conflicting views as to the definition of source or residence, which can also result in substantive jurisdiction being asserted by more (or less) than one state.⁵ Often one tax system will yield to another, either by allowing a tax credit or by the exercising restraint in adopting substantive jurisdictional rules. For example, substantive jurisdictional rules often limit the taxation of passive income to residents, and thus do not extend to the passive income received by nonresidents from in-state sources. Thus, we can speak of both legally permissible substantive jurisdiction and actually asserted substantive jurisdiction.

1.2 Enforcement Jurisdiction

Enforcement jurisdiction concerns the problem of tax remittance. Given that a particular item is within a state’s substantive jurisdiction, who lawfully can be asked to remit the tax? Note that the person against whom enforcement jurisdiction is asserted may or may not be the beneficiary or nominal owner of the item that is subject to the

⁴ Sometimes there is an under-assertion of substantive jurisdiction because an item of income may be taxed on a residence basis in the source jurisdiction and on a source basis in the jurisdiction of residence.

⁵ By over- or under-taxation it is meant that an item is taxed more than once or less than once.

state's substantive tax jurisdiction. For example, considering again the payment of a dividend, enforcement jurisdiction might be sought over a withholding agent such as the dividend payor or a financial intermediary involved in facilitating the dividend payment.

This aspect of enforcement jurisdiction highlights an important distinction between enforcement jurisdiction and substantive jurisdiction that is sometimes blurred. Hellerstein (2003) cautions that the question of whether an item is subject to a state's substantive jurisdiction is not the same question as whether a person fairly may be asked to assist the state in collecting and remitting a tax on that item. Thus, it is a non sequitur, for example, for a remote seller to argue that it should not be subject to a use tax collection obligation because the seller does not benefit from in-state government services.⁶ Unless the seller wishes to challenge the validity of consumption taxes generally, the argument against enforcement jurisdiction is limited to consideration of legal/constitutional constraints on state powers that stand apart from normative theories of substantive taxation.⁷

Enforcement jurisdiction implicates both practical and legal considerations. With respect to consumption taxes, for example, individual consumers are almost always within the enforcement jurisdiction of the state that has substantive jurisdiction (the state in which consumption occurs). It is often impractical, however, to collect the tax from

⁶ The premise of this argument is disputable, and from a due process perspective, the Supreme Court has held that a remote seller receives benefits from the state for which the state can ask something in return. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

⁷ Complexity arises under a full economic analysis of this argument. Where a collection agent is either a payor or payee, some part the economic burden of the tax will ordinarily fall on it. Thus, it might be argued that the collection agent is a taxpayer in an economic sense and that the economic tax burden on it should be evaluated in light of normative substantive theories of taxation. The short answer for the purposes of this paper is that once the substantive decision has been made to tax, say, consumption, the question of economically burdening the parties to the transaction has already been answered, and the question of who may be asked to remit the tax invokes only other considerations. See Slemrod (2008) for a discussion of the economics of tax remittance.

these individuals notwithstanding that the state has enforcement jurisdiction over them as a legal matter. Accordingly, states generally look to sellers to remit the tax. Collecting tax from foreign⁸ sellers, however, has both practical and legal limitations. As a legal matter, the state may not have the authority to impose a tax collection obligation on some foreign persons, and, even if such authority does exist, it may be impractical to effectively compel remittance of the tax or to enforce a tax judgment.⁹

2. Misaligned Rules of Substantive and Enforcement Jurisdiction

Tax systems face a problem when there is substantive jurisdiction to tax an item, but the taxing authority has no enforcement jurisdiction over a person who can effectively remit the tax. When this occurs, the tax policy values of neutrality and efficiency usually suffer, as economically identical subject matters are treated differently. Hellerstein (2004) suggests that the logical solution to this problem is either to expand enforcement jurisdiction to accommodate the existing substantive jurisdictional landscape or to “reverse engineer” the rules of substantive jurisdiction so that when substantive jurisdiction is asserted there also will be enforcement jurisdiction.

An example of a substantive jurisdictional “reverse engineering” is the “throwback” rule adopted under the Uniform Division of Income for Tax Purposes Act (UDITPA).¹⁰ The throwback rule provides that if a seller of tangible personal property is not taxable in the state of the purchaser, then its receipts from the sale of those goods are

⁸ Unless otherwise indicated, “foreign” is used in this paper to mean both out-of-state and out-of-country.

⁹ Tax judgments are generally given full faith and credit among the states of the United States, but foreign countries generally will not enforce the tax judgments of other nations.

¹⁰ UDITPA § 16(b). See Fox, Murray and Luna (2005) for a normative analysis of the throwback rule.

attributed to the numerator of the sales factor for the state from which the goods were shipped. The UDITPA rule for the attribution of receipts from items other than tangible personal property embodies a similar reverse engineering approach. It attributes such receipts to the place of performance rather than to the destination of the service or intangible. Unlike the throwback rule for tangible personal property, however, this rule applies regardless of whether the destination state has enforcement jurisdiction over the seller.¹¹ In adopting this approach, the original drafters of UDITPA commented that they feared that a destination approach to the attribution of receipts from non-tangible items would result in attribution to states that have no enforcement jurisdiction over the taxpayer.¹² Reverse engineering is also done in the context of consumption taxes. When a seller is not subject to the enforcement jurisdiction of the destination state, substantive jurisdiction sometimes is asserted in the jurisdiction from which the goods were shipped (“place of supply”).

A problem with the reverse engineering in the above examples, however, is that while it superficially may preserve neutrality by shifting substantive jurisdiction to the place of supply or production, preservation of neutrality is unlikely. This is because the destination and origin jurisdictions may impose tax at different rates, and because origin-based rules encourage taxpayers to locate production activities in tax havens. Thus, as a

¹¹ More specifically, receipts from services and intangibles attributed to the location of the “income-producing activity,” measured by “costs of performance.” UDITPA § 17.

¹² Pierce (1957). It is not clear why they did not use the throwback approach that is used for sales of tangible personal property, although it is probable that they assumed that the place of performance was generally a good proxy for the destination of most services. Advances in technology, however, which allow services to be performed remotely, diminish the attractiveness of the place of performance proxy.

practical matter, origin states cannot be relied on to enforce this sort of neutrality. The wages of tax enforcement virtue are often economic development poverty.¹³

As a result, it is natural for those who focus on substantive tax policy to consider the expansion of enforcement jurisdiction to be the preferred solution when substantive and enforcement jurisdiction are misaligned. Expanding enforcement jurisdiction, however, may entail increased costs of administration and compliance. Thus, whether we are reverse engineering the rules of substantive jurisdiction to accommodate limitations on enforcement jurisdiction, or are expanding enforcement jurisdiction to accommodate substantive jurisdictional ambitions, we are at bottom engaged in the time-honored tradition of balancing substantive tax policy values with considerations of administrative practicality.

3. Thresholds, *De Minimis*, and Enforcement Jurisdiction

One sensible way to view the question of enforcement jurisdiction is through the lens of *de minimis* thresholds. In order to reduce administrative and compliance costs, tax systems often exclude from tax reporting obligations persons whose taxable activities fall below certain thresholds. VATs, for example, often have threshold levels of turnover.¹⁴ Similarly, tax enforcement jurisdiction is frequently treated as a question of *de minimis*, with the constitutional thresholds being articulated as either “minimum

¹³ This discussion implicates the concepts of capital import and capital export neutrality. Though beyond the scope of this paper, it can be noted in passing that reverse engineering of the type described in this paper would generally lead to inconsistent applications of these principles, because whether import or export neutrality would be preserved would depend on the vagaries of the taxpayer’s contacts with the destination state, at least in the case of sales of tangible personal property.

¹⁴ See Keen and Mintz (2004).

contacts” or “substantial nexus.” Absent legislation establishing quantitative *de minimis* thresholds, constitutional tests tend to focus on the qualitative aspects of a taxpayer’s contacts with a jurisdiction, the most notorious qualitative threshold being “physical presence” within the jurisdiction.¹⁵

Thresholds based solely on levels of income or sales are conceptually broader than enforcement jurisdiction standards, because they apply to all potential taxpayers, including residents and other persons who are clearly subject to the state’s enforcement jurisdiction. Thresholds are relevant to the inquiry into enforcement jurisdiction because (1) minimal levels of activity within the state may be indicative of one’s foreignness, and (2) compliance burdens for foreign persons are generally higher than for local persons, and so it may be sensible to require a minimum threshold of local activity before subjecting a foreign person to local tax remittance rules.¹⁶ Where generalized thresholds are already in place, thresholds for foreign persons arguably should be set higher because they bear a greater compliance burden than local persons.

The Multistate Tax Commission’s model factor presence nexus standard for business activity taxes is an interesting example of a quantitative enforcement jurisdiction rule designed to address both minimum thresholds and foreignness.¹⁷ Under the factor presence nexus standard, a multistate business is subject to enforcement jurisdiction if its income is subject to the state’s substantive jurisdiction, provided either (a) its in-state property, payroll, or sales exceed a minimum dollar amount, or (b) one-fourth or more of

¹⁵ This is the test for the American retail sales and use tax, and income tax treaties typically require a non-resident to have a “permanent establishment” before being subject to tax. Even absent a treaty, it appears that the U.S. requires a physical presence. Avi-Yonah, Ring and Brauner (2006).

¹⁶ Foreign persons are generally less familiar with the local language, law, and accounting rules; and even in today’s world, there is still a correlation between distance and cost. Additionally, foreign persons are more likely to be doing business in multiple jurisdictions, which can increase their overall compliance burden relative to a person doing business in a single state.

¹⁷ Multistate Tax Commission, Factor Presence Nexus Standard for Business Activity Taxes (2002).

the business's total property, payroll, or sales are in-state. Thus, nexus rule "(a)" identifies multistate businesses with a sufficient quantity of in-state activities to be asked to remit business activity taxes, while nexus rule "(b)" identifies multistate businesses whose activities are concentrated sufficiently locally to allow the businesses to be regarded as local taxpayers regardless of whether they meet any absolute dollar threshold.

As noted, statutory thresholds and constitutional nexus rules are intended to relieve qualifying persons from the compliance burden of remitting a tax. Of course, qualifying persons are not only relieved of the compliance burden, but they are also relieved of the substantive tax burden. Differential treatment of persons falling above and below a nexus threshold, however, gives rise to economic distortions. Persons not subject to tax enforcement jurisdiction may enjoy a competitive advantage over those persons who must remit the tax. A sensible solution would be to equalize relative compliance burdens while keeping the tax remittance obligation in place. This is can be done through implementing simplified compliance regimes for persons falling below a specified threshold.¹⁸

Some states have experimented with simplified compliance regimes for out-of-state businesses. Missouri, for example, tried this approach by adopting a single, blended use tax rate for out-of-state sellers. The intent was to remove the burden of determining the tax rate for each Missouri locality. Despite the fact that this regime reduced the overall tax and compliance burden for remote sellers, the Supreme Court held that Missouri's blended use tax rate unconstitutionally discriminated against interstate commerce because there were Missouri municipalities in which the blended rate

¹⁸ See Keen and Mintz (2004).

applicable to sales made from out-of-state was higher than the rate applicable to local sales.¹⁹

Variations of the Missouri approach, however, would still be feasible. A state could, for example, ask remote sellers to collect tax only at the lowest possible combined state and local rate. Out-of-state sellers often would still enjoy a competitive advantage (measured by any excess local tax that otherwise would have been due), but their advantage would be less than they would enjoy if no tax were imposed at all. A further variant might involve only making this simplified compliance regime available to remote sellers whose sales volume fell below a certain threshold.²⁰

A related strategy is to simplify compliance for all taxpayers. The Streamlined Sales and Use Tax Agreement (SSUTA) is an example of this approach. The goal of streamlining is to replace the current physical presence “threshold” with an enforcement jurisdiction rule based on economic nexus. SSUTA is discussed in greater detail in Part 4.3.

4. Sales and Use Tax Jurisdiction

On the American sub-national level, the most notorious disconnect between substantive jurisdiction and enforcement jurisdiction arises in connection with the retail sales and use tax.²¹ Under current dormant Commerce Clause doctrine, as enunciated by

¹⁹ *Associated Indus. of Mo. v. Lohman*, 511 U.S. 641 (1994).

²⁰ Although these variations would not discriminate against interstate commerce, they would only be fully effective if the *Quill* physical presence test were overruled or repealed, so non-physically present seller could be required to comply.

²¹ For the purposes of this paper, “sales tax” and “sales and use tax” are used interchangeable to express the generic concept of retail sales and use taxes. “Use tax” and “use tax collection obligation” will be used to refer to those specific concepts.

the Supreme Court in *Quill Corp. v. North Dakota*, a seller must have a “physical presence” in a state in order to have the “substantial nexus” necessary for a state to impose a sales or use tax collection obligation on the seller.²² Although purchasers generally have an obligation to self-report use tax on purchases for which no tax was collected, as a practical matter such tax is only self-reported (at best) by business purchasers. Thus, sales or use tax is not remitted on a large percentage of taxable remote sales.²³

4.1 The *Quill* Decision

In the *Quill* case, the Supreme Court undertook to reevaluate its decision in *National Bellas Hess*. In *Bellas Hess*, the Court had held that to impose a use tax collection obligation on a seller whose “only connection with customers in the State is by common carrier or the United States mail” would violate both the Due Process and Commerce Clauses of the United States Constitution.²⁴ The *Quill* Court began by observing that its “jurisprudence ha[d] evolved substantially in the 25 years since *Bellas Hess*.”²⁵ In a modern economy “it matters little that [] solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: The requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State.”²⁶ Accordingly, the Court overruled *Bellas Hess* “to the extent that [it] indicated that the

²² *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

²³ One study suggests that business purchase comprise about 40 percent of the total sale and use tax base. Ring (1999).

²⁴ *National Bellas Hess, Inc. v. Dep't of Rev.*, 386 U.S. 753 (1967).

²⁵ Interestingly, even at the time that *Bellas Hess* was decided, the Court had already held that economic exploitation of a market was sufficient for the assertion of jurisdiction in other contexts.

²⁶ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax.”²⁷

Then, in an unprecedented move, the Court decoupled Commerce Clause nexus analysis from due process nexus analysis:

[D]ue process nexus analysis requires that we ask whether an individual’s connections with a State are substantial enough to legitimate the State’s exercise of power over him ... [while] the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by the structural concerns about the effects of state regulation on the national economy.²⁸

The Court continued by observing, like the *Bellas Hess* court had before it, that sales and use tax regimes are multitudinous and non-uniform, and thus they impose a substantial compliance burden on multistate vendors. The court also stated that multistate vendors had developed a significant reliance interest in the *Bellas Hess* rule, “which has become part of the basic framework of a sizable industry.”²⁹ Thus, combining concerns of both burden on interstate commerce and *stare decisis*,³⁰ the Court reaffirmed the *Bellas Hess* rule.

Because of the Court’s partial reliance on *stare decisis*, its tone is somewhat apologetic. It acknowledged that “contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today.”³¹ The Court

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ The doctrine of *stare decisis* means to let past decisions stand. One of the policies underlying *stare decisis* is the value of not disturbing past reliance on an existing rule.

³¹ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

concluded, however, that it might be best to leave the issue for Congress to resolve under its affirmative Commerce Clause powers “even if we were convinced that *Bellas Hess* was inconsistent with our Commerce Clause jurisprudence.”³²

4.2 The Frozen Judicial Landscape

The *Quill* decision has essentially frozen the judicial landscape with respect to sales and use tax enforcement jurisdiction. Unless Congress exercises its affirmative Commerce Clause powers or the Court again revisits the issue, the physical presence test is the law of the land, and lower court decisions will focus on practically important yet rudderless inquiries into what constitutes physical presence within the meaning of *Quill*. By rudderless it is meant that there is no normative principle or underlying policy that informs us when a physical presence is sufficient to “count” for enforcement jurisdiction purposes. This is because there is little if any correlation between physical presence and compliance burden, at least on the margin of presence/no presence, which is where the facts of litigated cases ordinarily perch. With that caveat, the following is a short discussion of the physical presence test as the lower courts have interpreted it.

For business entities (which strictly speaking are incorporeal), physical presence generally means owning real or tangible personal property located in a state or having employees located in a state. Temporary, occasional, or sporadic physical presence of property or employees, however, is sometimes dismissed as a mere “slightest presence” falling short of the “substantial nexus” required by *Quill*.³³ The more active legal

³² *Id.*

³³ See Hellerstein and Hellerstein (1998-2008), ¶ 19.02[4].

battleground involves questions of attributional nexus: when can the physical presence of a third-party or a corporate affiliate be attributed to the seller?

The activities of salespersons and others acting on behalf of the seller in “developing and maintaining the local market” are undisputedly attributable to the seller for sale and use tax nexus purposes.³⁴ Controversy swirls around the edges of this test, such as whether the presence of independent contractors fulfilling post-sale warranty and service contract obligations counts, although this particular issue usually has been resolved in favor of the taxing authorities.³⁵ Additionally, there is debate over whether a third-party must be an “agent” of the seller in order for the third-party’s presence to be attributed to the seller.³⁶ “Agent,” however, is a rather flexible legal term, and one senses that cases in which the question of agency is raised are frequently decided based on the peculiar facts of those cases, with a finding of “agency” (or not) appearing as a post-hoc rationale. These cases are well-reported and analyzed elsewhere, and those discussions will not be repeated here.³⁷

Also hotly contested is the question of whether and under what circumstances the physical presence of an in-state corporation can be attributed to its out-of-state affiliates. As a general proposition, the law respects the separate legal identity of a corporation, even a corporation that is a wholly-owned subsidiary of another. Accordingly, courts generally hold that mere control of Company A by Company B will alone not be sufficient to attribute the activities of one to the other. This general rule emboldened

³⁴ See *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960); *Tyler Pipe Indus., Inc. v. Washington Dep’t of Revenue*, 483 U.S. 232 (1987).

³⁵ See, e.g., *Dell Catalog Sales LP v. Tax’n and Rev. Dep’t*, __ N.M. __, __ P. 3d __ (Ct. App. 2008).

³⁶ See Harper and Sedon (2008).

³⁷ See Hellerstein and Hellerstein (1998-2008), ¶ 19.02[2].

many retailers, particularly in the early stages of the development of the Internet retailing industry, to separately incorporate nexus creating assets in an attempt to avoid incurring a sales tax collection obligation on their remote sales. This tax planning technique is known as entity isolation.³⁸

The major weakness of entity isolation from the standpoint of the corporate group attempting to avoid tax is that relationships among members of the corporate group often extend beyond mere affiliation. If, for example, a corporation acts as the in-state agent of an out-of-state affiliate for the purpose of developing and maintaining the in-state market, then the agency principle will apply and the physical presence of the in-state agent/affiliate will be attributed to the remote principal/affiliate. Courts have held, for example, that the cross-marketing of products and the acceptance of return merchandise by an in-state brick-and-mortar retailing affiliate of an out-of-state Internet retailer are sufficient to deem the out-of-state retailer to be physically present in the state within the meaning of *Quill*.³⁹ As a result of the agency principal and the increasing willingness of courts to enforce it, taxpayers have had to reconsider the efficacy of the entity-isolation technique. Cowan (2007) suggests that many sellers are coming to the conclusion the business advantages of exploiting the synergies among members of its corporate group outweigh the tax benefit of the balkanizing and contorting business operations to avoid creating agency relationships.

As noted earlier, because physical presence has little logical relation to compliance burden, it is difficult to bring any analytical coherence to these nexus disputes. Thus, courts are reduced to something of a scholastic exercise. Nevertheless,

³⁸ See Swain (2002) for a discussion and critique of this tax planning technique.

³⁹ See, e.g., *Borders Online, LLC v. State Bd. of Equalization*, 129 Cal. App. 4th 1179, 29 Cal. Rptr. 3d 176 (1st Dist. 2005).

Baez (2006) observes that courts sometimes interject questions of fairness (a due process concern) when considering the Commerce Clause issue of physical presence. The interjection of due process analysis is erroneous in Baez’s view because due process already has been satisfied in most cases because of the seller’s purposeful availment of the state’s market. Thus, for example, it may be analytically incorrect for courts to rely on due process jurisprudence—which often respects the separateness of corporations for the purposes determining whether a defendant corporation has sufficient minimum contacts with a forum to be haled into court there—when considering whether corporate affiliation can give rise to a physical presence for sale and use tax nexus purposes. Due process has already been satisfied by the remote affiliate’s purposeful availment of the state’s marketplace.

4.3 Legislative Initiatives

One salutary effect of *Quill* is that it has incentivized states to attempt to reduce compliance burdens in an effort to eliminate *Quill*’s compliance burden predicate. States hope that reduced compliance burdens will clear the path for Congressional repeal of the physical presence test, and, more remotely, increase the odds that *Quill* will be overruled if the Supreme Court chooses to revisit the issue. The primary vehicle for this effort is the Streamlined Sales and Use Tax Agreement (SSUTA). SSUTA requires that member states adopt various administrative and substantive simplifications, such a state level-only tax reporting and uniform definitions of key items such as “sale,” “tangible personal

property,” and “food and food ingredients.”⁴⁰ To date, 19 states have brought their sales and use tax regime into compliance with SSUTA and have become full members of its governing board.

A particularly important feature of SSUTA is its uniform, destination-based, sourcing rules. In essence, these are substantive jurisdictional rules, identifying when an otherwise taxable transaction is subject to the substantive jurisdiction of a state and/or locality. The physical presence test, however, prevents a state from asserting enforcement jurisdiction with respect to many of the sales that are sourced to the state under these substantive jurisdictional rules. The states are seeking to rectify this problem through federal legislation that would empower a state to enforce a use tax collection obligation against remote sellers, provided that the state has adopted SSUTA’s reforms. Current legislative proposals would still require that a remote seller exceed a *de minimis* threshold of taxable sales before it is subject to a use tax collection obligation. One proposed threshold seems to be far above any reasonable conception of *de minimis*—\$5 million in taxable sales nationwide—especially considering the administrative simplifications embodied in SSUTA. These simplifications include the provision of third-party tax compliance services and tax compliance software. In addition to these compliance aids, SSUTA also provides vendor compensation; which, in theory, could be calibrated to compensate for the increased compliance burden on smaller vendors while avoiding granting an outright tax exemption.

⁴⁰ See Hellerstein and Swain (2007-08) for an exposition and analysis of SSUTA.

5. State Income Tax Jurisdiction

5.1 Substantive Jurisdiction and the Sales Factor

Substantive state tax jurisdiction over business income is almost universally determined by formulary apportionment. The UDITPA (or similar) property, payroll and sales factors are generally employed for this purpose. These factors are separately calculated ratios of in-state property, payroll, and sales, to property, payroll, and sales everywhere (or at least nationwide). These ratios are then averaged to determine the taxpayer's apportionment ratio, although the sales factor is often super-weighted for this purpose, and some jurisdictions apportion income based solely on sales.

As noted earlier, sales of tangible personal property generally are attributed to the sales factor numerator on a destination basis. Receipts from services and intangibles, however, generally are attributed based on where the "income-producing activity" occurs, which, in turn, is determined by where the "costs of performance" are incurred. Thus, when services and intangibles are provided remotely, the associated receipts are generally attributed to the sales factor based on an origin approach.

There are some important exceptions to the rules for attributing receipts from services and intangibles. Many states, for example, have adopted destination-based sales factors for financial institutions, broadcasters, publishers, and transportation companies. Also, a growing number of states have adopted a market state approach for all services and intangibles. Additionally, extending the destination approach to sales other than

sales of tangible personal property is one of the primary motives underlying current efforts to reform UDITPA.

The trend towards attributing receipts from services and intangibles on a destination basis can be explained by four major factors. First, the destination approach is more consistent with one of the purposes of the sales factor, which is to reflect the contribution of the market state to the taxpayer's income. Second, the destination approach is already used for attributing receipts from the sale of tangible personal property, thus the universal application of the destination principle would obviate the thorny characterization questions that arise in mixed (tangibles/intangibles/services) transactions. Third, a destination approach is sometimes more administrable, particularly in cases in which the costs of performance are geographically scattered or are incurred over many accounting periods, some quite ancient. Fourth, and perhaps most importantly, measuring the sales factor numerator based on the location of production can discourage mobile factors of production from locating in a state, negatively affecting the state's economy. This consideration goes far to explain the increased reliance by states on the (generally destination-based) sales factor relative to the property and payroll factors for the purpose of income tax apportionment.

5.2 Enforcement Jurisdiction

As stated earlier, once a normative set of substantive jurisdictional rules is established, the jurisdictional problem becomes one of finding a practical and legal mechanism to enforce the tax. Viewed in this light of this framework, the existing

income tax enforcement jurisdiction rules are a mixed bag. In an encouraging trend, state courts are generally reaching the conclusion that the *Quill* physical presence test is limited to sales and use taxes. Thus, a state income tax imposed on a business that exploits the state's marketplace but that has no physical presence in the state will not run afoul of either the Due Process or Commerce Clause limits on state taxation. As the Supreme Court of West Virginia explained in a case involving a remote credit card issuer:

James Madison, Benjamin Franklin, and the other Framers at the Constitutional Convention who adopted the Commerce Clause lived in a world that is impossible for people living today to imagine. The Framers' concept of commerce consisted of goods transported in horse-drawn, wooden-wheeled wagons or ships with sails. They lived in a world with no electricity, no indoor plumbing, no automobiles, no paved roads, no airplanes, no telephones, no televisions, no computers, no plastic credit cards, no recorded music, and no iPods. . . . It would be nonsense to suggest that they could foresee or fathom a time in which a person's telephone call to his or her local credit card company would be routinely answered by a person in Bombay, India, or that a consumer could purchase virtually any product on a computer with the click of a mouse without leaving home. This recognition of the staggering evolution in commerce from the Framers' time up through today suggests to this Court that in applying the Commerce Clause we must eschew rigid and mechanical legal formulas in favor of a fresh application of Commerce Clause principles tempered with healthy doses of fairness and common sense.

Because, however, the U. S. Supreme Court has declined to review these state court decisions,⁴¹ the actual compliance behavior of taxpayers is uneven, and many taxpayers still take the position that they can rely on the *Quill* physical presence test in good faith and not report income tax to jurisdictions in which they are not physically

⁴¹ See *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 313 S.C. 15, 437 S.E. 2d 13 (1993), cert. denied, 510 U.S. 992, 114 S. Ct. 550 (1993); *Tax Commissioner v. MBNA America Bank, N.A.*, 220 W. Va. 163, S.E. 2d (2006), cert. denied, US, 127 S. Ct 2997 (2007); *Lanco Inc. v. Director, Div. of Taxation*, 21 N.J. Tax 200 (2003), rev'd, 379 N.J. Super., 562, 879 A. 2d 1234 (App. Div. 2005), aff'd, 188 N.J. 380, 908 A. 2d 176, 177 (2006), cert. denied, U.S., 127 S. Ct. 2974 (2007).

present. Additionally, some states either continue to take the position that physical presence is required or have been lax in their enforcement efforts.⁴²

Although state courts that have rejected extending the *Quill* physical presence test to other taxes have not expressly stated that they are seeking to match substantive jurisdiction with enforcement jurisdiction, this is the general effect of their decisions. The Multistate Tax Commission has sought to make this connection more explicit through adoption of the previously discussed model factor nexus regulations. Under these model regulations, enforcement jurisdiction arises whenever a taxpayer has a property, payroll, or sales factor that is greater than zero (i.e., whenever the taxpayer's income is subject to the substantive jurisdiction of the state), provided that one or more of these factors also exceeds certain thresholds.

A significant exception to the trend of aligning state corporate income tax enforcement jurisdiction with substantive jurisdiction is Public Law 86-272.⁴³ Originally enacted in 1959, this federal statute prohibits states from asserting income tax enforcement jurisdiction over a seller of tangible personal property if the seller's in-state activities are limited to the solicitation of orders that are accepted and filled out-of-state. Consequently, P.L. 86-272 causes a substantial misalignment of substantive and enforcement jurisdiction for this class of seller.⁴⁴ As with sales and use tax cases interpreting the scope of the physical presence test, the disputed cases are essentially scholastic. The Supreme Court of the United States, for example, has opined on whether the replacement of stale gum on a retailer's display rack by a Wrigley's sales

⁴² See generally Hellerstein and Hellerstein (1998-2008), ¶ 6.11.

⁴³ Codified as 15 U.S.C. § 381-84, but still commonly referred to by its public law number.

⁴⁴ It is important to emphasize that this statute is limited to sellers of tangible personal property, and does not limit a state's power to tax service businesses or businesses selling or licensing intangibles.

representative exceeds mere “solicitation of orders.”⁴⁵ Such weighty matters should be left to academics.

To summarize, recent court decisions have generally supported an alignment between state corporate income tax substantive jurisdiction and enforcement jurisdiction for businesses engaged in other than the sale of tangible personal property. Still, there is uneven enforcement and compliance, and a decreasing handful of courts still adhere to the physical presence test in the income tax context. Widespread adoption by the states of the MTC’s uniform factor nexus regulations would lead to greater certainty and presumably more consistent enforcement and compliance, provided that the courts continue to limit the *Quill* physical presence test to sales and use taxes. P.L. 86-272 remains an obstacle to jurisdictional alignment for sellers of tangible personal property.

6. Selected Mobility and Tax Jurisdiction Topics: Intangibles and Economic Development Nexus

Mobility affects tax systems in various ways. From an enforcement perspective generally, mobility can make it difficult to catch non-compliant taxpayers. Stockcar racing, for example, has its roots in the vehicles that moonshiners modified for speed, handling, and cargo carrying capacity in order to outrun revenueurs. With respect to enforcement jurisdiction specifically, state tax collectors may have had to stop at the state line unless in hot pursuit.

⁴⁵ Wisconsin Dep’t of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214, 112 S. Ct. 2447 (1992) (replacement of stale gum by sales representatives fell outside the scope of activities protected by P.L. 86-272) (O’Connor, J., concurring, disagreeing with the court’s opinion with respect to replacement of state gum).

Indeed, the automobile was one of the primary inducements for the American legal system to shift from a (non-tax) enforcement jurisdiction regime grounded in territoriality to one based on “minimum contacts.”⁴⁶ It is fair to say that in the area of personal jurisdiction—the private law analogue to tax enforcement jurisdiction—the response to mobility almost always has been to extend the long arm of the law. This has been facilitated by a mature legal/federal system, in which expanding the states’ jurisdictional reach is more a matter of inducing a judicial or legislative stroke of the pen than of addressing enforcement practicalities. This is not to discount the costs of enforcing foreign judgments—a topic beyond the scope of this paper—but simply is to report that the American legal system generally has not recoiled from expanding the rules of personal jurisdiction in order to respond to the challenges of mobility.

Although the legal system general does, or could, effectively extend the scope of tax enforcement jurisdiction to adjust to technological advances and the associated increase in mobility, tax base design and substantive jurisdictional rules certainly have been heavily influenced by enforcement issues. The property tax is a classic example. As a greater portion of wealth began to be held in personal property, both tangible and intangible, the “modern” response would have been to (continue to) include personalty within the scope of the property tax. The inherent mobility of personalty, however, made it more difficult to enforce the tax. Tax often could be avoided by moving personalty out of the jurisdiction. Sometimes all that was necessary was to remove it from the jurisdiction on “tax day.” Tax evasion was also commonplace, because personalty is much easier to hide, both within and without the taxing jurisdiction. As a result of these and other factors, the property tax is now limited primarily to real estate.

⁴⁶ See Rutherglen (2001).

6.1 Intangibles

The state corporate income tax faces issues similar to those faced by the property tax a century or more earlier.⁴⁷ Sometimes the policy response is the same. For example, intangibles are generally excluded from the calculation of the property factor because of their often-indeterminate situs and the low cost at which they can be “moved” without effecting a business’s actual operations. This approach is sometimes rationalized by the notion that the situs of a taxpayer’s tangible property is a good proxy for the situs of its intangibles.⁴⁸

The various approaches to attributing *receipts from* intangibles to the sales factor similarly reflect the tax system’s struggle with the conceptual and practical issues that intangibles pose. As noted earlier, UDITPA provides that receipts from the sale of items other than tangible personal property are attributed to the sales factor based on “costs of performance.” For an intangible this generally means where the costs of developing, acquiring, and managing the intangible were/are incurred. This rule tends to duplicate the property and payroll factors rather than to reflect the contribution of the market state to income. Thus, in states that have adopted sales factor only sourcing, the costs of performance approach to the attribution of receipts from intangibles (and services) has the effect of resurrecting the discarded payroll and property factors to some degree.⁴⁹

⁴⁷ Intangibles (and services) are also presenting sourcing challenges to consumption tax policymakers.

⁴⁸ Hellerstein also suggests that situsing intangibles in this manner is supportable normatively by the notion that the situsing of a corporation’s physical assets is where the corporation is imposing social costs. Hellerstein and Hellerstein (1998-2008), ¶ 9.18[4].

⁴⁹ Often taxpayers implement the UDITPA rule by simply by assigning intangible receipts to their commercial domicile, and some states provide explicitly that receipts from intangibles are attributable to the taxpayer’s commercial domicile.

The task of determining where the costs of performance were incurred can be daunting, both conceptually and practically. For example, the development costs of an intangible were often incurred in past accounting periods for which information is not readily available. As a concession to these and other challenges that intangibles sometimes impose, the MTC regulation implementing the UDITPA sales factor excludes (throws out) receipts from intangibles from the sales factor computation “where business income from intangible property cannot readily be attributed to any particular income-producing activity of the taxpayer.”⁵⁰

Because a primary purpose of the sales factor is to reflect the contribution of the market to a taxpayer’s income, it would be logical to attribute receipts from intangibles on a destination basis—to the place where the licensee employs them. This is the federal income tax rule,⁵¹ as well as the UDITPA rule for “non-business” royalties.⁵² In practice, however, the impact of the UDITPA rule is relatively trivial because the preponderance of royalties received by corporations are treated as “business” income. Further, pursuant to tax treaties to which most of the major trading partners of the U.S. are signatories, many royalties are sourced for federal income tax purposes on the basis of the residency of the owner of the intangible, rather than on a destination basis, when the royalties are not attributable to a permanent established associated with the owner’s business in the country.⁵³

⁵⁰ MTC Reg. IV.18.(c)(3).

⁵¹ I.R.C. §§ 861(a)(4), 862(a)(4).

⁵² UDITPA § 8.

⁵³ I.R.C. § United States Model Income Tax Convention, art. 12.

One of the troublesome aspects of implementing a destination-based rule is the problem of identifying the location to which to attribute intangible receipts in B2B transactions. For example:

1. Where should receipts be attributed when a licensor in State A licenses an intangible to a licensee in State B who sublicenses the intangible to customers in State C? (a “wholesale” intangible transaction).

2. Where should receipts be attributed if a licensor in State A licenses an intangible to a licensee State B but provides the intangible directly to the State B licensee’s customers in State C? (a “drop-shipped” intangible transaction).

Reasoning by analogy from the shipping address attribution rules for sales of tangible personal property, then in case 1 the head licensor’s receipts would be attributed to State B, and in case 2 the head licensor’s receipts would be attributed to State C.

These “wholesale” and “drop-shipped” intangibles transactions, however, raise legitimate tax avoidance concerns, because intangibles (and electronic services) can be delivered and redelivered by wholesalers and intermediaries who require very little capital investment and who can easily locate in tax haven jurisdictions. Also, while it may be conceptually feasible to attribute these receipts to the place of ultimate consumption, the compliance burden on head licensors could be substantial in some cases.

Notwithstanding these concerns, eight states have adopted destination-based receipts attribution rules for services and intangibles.⁵⁴ Additionally, the Multistate Tax Commission has signaled that it is interested in amending UDITPA to provide for a destination-based approach to service and intangible receipt attribution, and a UDITPA reform project is now underway at the MTC's prodding. A fertile ground for exploring the viability of this policy option would be the experience of states that already have abandoned the costs of performance rule in favor of a destination-based approach.

6.2 Economic Development Nexus

Mobility correlates positively with tax minimization, including locational changes in substantive economic activities, tax avoidance, and tax evasion. Thus, mobility is a significant if not over-arching issue when designing a tax system and its associated jurisdictional rules. It is now commonplace to acknowledge that it can be self-defeating to tax mobile factors.

An example of the operation of this principle arises, not without irony, in connection with a phenomenon that might be called "economic development nexus." If we imagine a world in which the states were unconstrained by the dormant Commerce Clause prohibition of discriminating against interstate commerce, the states might be expected, for example, to impose sales and use taxes only on purchases from remote sellers. Purchases from local sellers would be exempt.⁵⁵ Instead, the dormant Commerce

⁵⁴ Swain (2008).

⁵⁵ This would have many features of a tariff. The assumption that states would want to pursue this tax policy is simplistic, and ignores, for example, the principle of comparative advantage and other arguments for free trade.

Clause and the *Quill* physical presence test compel the opposite tax regime: Purchases from sellers with a physical presence are taxable, while purchases from remote sellers are effectively untaxed. Driven mainly by revenue considerations and a desire to level the economic playing field for in-state sellers, the policy response of the states generally has been to push the nexus rules to their permissible limits, often testing those boundaries in the courts.

States have behaved differently, however, in the case of no/low nexus sellers with highly mobile in-state investments or activities. The Maine statute is illustrative. On the one hand, the Maine statute flatly imposes a tax collection obligation on “[e]very seller of tangible personal property or taxable services that has a substantial physical presence in this State sufficient to satisfy the requirements of the due process and commerce clauses of the United States Constitution.”⁵⁶ On the other hand, the following activities are deemed not to constitute “substantial physical presence”:

...

- (2) Attending trade shows, seminars or conventions in this State;
- (3) Holding a meeting of a corporate board of directors or shareholders or holding a company retreat or recreational event in this State;
- (4) Maintaining a bank account or banking relationship in this State; or
- (5) Using a vendor in this State for printing, drop shipping or telemarketing services.⁵⁷

The common thread among these exceptions is that they all address highly mobile economic activities that states fear might be lost to competing jurisdictions if they took a

⁵⁶ Me. Rev. Stat. Ann. § 1754-B (Westlaw 2008).

⁵⁷ Me. Rev. Stat. Ann. § 1754-B(2) through (5) (Westlaw 2008).

more aggressive approach to enforcement jurisdiction.⁵⁸ Similar economic development nexus legislation has been adopted in some states for remote sellers using in-state fulfillment houses, and taxing authorities in at least two states have issued private rulings assuring remote sellers that their relationships with wholly-owned subsidiaries operating in-state fulfillment houses do not give rise to a use tax collection obligation.⁵⁹

In short, the physical presence test has a certain corrosive effect. If the nexus standard were based on economic presence, then it would be difficult for states to enact physical presence based exceptions to enforcement jurisdiction that did not run afoul of the Commerce Clause prohibition against discriminating against interstate commerce. An enforcement jurisdictional rule, for example, that taxed remote sellers generally but not ones with in-state bank accounts would be unconstitutional.⁶⁰ In a physical presence nexus regime, however, these economic development nexus rules are on much more constitutionally supportable ground. This is because they extend a tax break that already is available to non-physically present sellers, rather than condition a tax break on initiating some in-state activity.

7. Conclusion

As a general proposition, when a state has substantive tax jurisdiction over an item, the state should also have enforcement jurisdiction over a person who, as a legal and practical matter, can be asked to remit the tax on that item. Administrative and

⁵⁸ These are also grey areas in the law of nexus, and so states undoubtedly are also simply trying to give bright-line guidance so that businesses have some certainty in planning their affairs.

⁵⁹ Hellerstein and Hellerstein, Chapter 19 (2001).

⁶⁰ Because a reduction in tax liability is conditioned on engaging in specific in-state activity.

compliance considerations may justify an exception when the item to be taxed falls below certain thresholds. Because administrative and compliance costs may vary among different classes of taxpayers, the appropriate thresholds may differ for different classes of taxpayers. Because (a) foreign persons may have higher costs of compliance, and (b) the costs of asserting enforcement jurisdiction over foreign persons may be greater, the appropriate thresholds for foreign persons may be higher than for domestic persons, all else being equal. An alternative to granting a tax exemption to persons who fall below a threshold would be to lower their administrative and compliance costs through a simplified compliance regime. The benefit of this approach is that it enhances neutrality by avoiding granting an outright tax exemption while it still adjusts for relative administrative and compliance burdens.

The major impediments to the alignment of substantive and enforcement jurisdiction are the *Quill* physical presence test, which is applicable to sales and use taxes, and the “solicitation of orders” safe-harbor of P.L. 86-272, which is applicable to state net income taxes imposed on sellers of tangible personal property. The most commonly asserted arguments supporting these misalignments are based on the administrative and compliance considerations. UDITPA and SSUTA are examples of state-initiated efforts to reduce compliance burdens and otherwise coordinate state taxes. These efforts have met with varying degrees of success in reaching these policy goals, and have yet to have persuaded either the Congress or the Supreme Court to repeal or overrule these barriers to fuller alignment of substantive and enforcement jurisdiction. The law and tax systems have responded to mobility in various ways: sometimes by chasing it (the law of personal jurisdiction) and sometimes by surrendering to it (the real

property tax). The varied approaches to solving the thorny problem of sourcing intangibles reflect this fight or flight dichotomy. Finally, the artificial limits placed on enforcement jurisdiction by the Supreme Court and the Congress have had the unintended consequence of stimulating “economic development nexus” rules that are even more protective of remote businesses, thus driving substantive and enforcement jurisdiction even further out of alignment.

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