---x	SUPERIOR COURT OF NEW JERSEY
LANCO, INC., :	APPELLATE DIVISION
a Delaware corporation, :	DOCKET NO. A-3285-03T1
:	
Plaintiff-Respondent, :	Civil Action
:	
v. :	On Appeal from a Final Judgment
:	Of the Tax Court of New Jersey
DIRECTOR, DIVISION	:
OF TAXATION, :	Sat Below:
:	Hon. Peter D. Pizzuto, J.T.C.
Defendant-Appellant. :	
---x	

BRIEF OF AMICUS CURIAE
MULTISTATE TAX COMMISSION

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INTEREST OF *AMICUS CURIAE*

The Multistate Tax Commission ("MTC") files this brief pursuant to R. 1:13-9, N.J. Court Rules, 1969, as *amicus curiae* in support of the Director, Division of Taxation of the State of New Jersey. The MTC is the administrative agency created by the Multistate Tax Compact ("Compact"). Twenty-one States have legislatively established full membership in the Compact. In addition, five States, including New Jersey, are sovereignty members and nineteen States are associate members.[1]

The purposes of the Compact are to (1) facilitate proper determination of state and local tax liability of multistate taxpayers; (2) promote uniformity or compatibility in significant components of tax systems; (3) facilitate taxpayer convenience and compliance; and (4) avoid duplicative taxation. *Id*.

In furtherance of the identified goals of the Compact, the MTC seeks a correct and uniform understanding of the constitutional nexus standard for the imposition of state income taxes. A correct nexus standard ensures that interstate commerce pays its fair share of state taxes. *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 184 (1995). A uniform nexus standard facilitates taxpayer convenience and compliance because taxpayers will more readily understand constitutional limits on state income taxes. The MTC takes issue with the nexus standard employed by the Tax Court below. The Tax Court failed to follow longstanding U.S. Supreme Court precedent permitting States to impose income tax on taxpayers not physically present in the State and failed to

[1] **Compact Members** (legislative enactment of the Compact)**:** Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Maine, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. **Sovereignty Members** (Executive decision to join the Commission)**:** Florida, Kentucky, Louisiana, New Jersey, and Wyoming. **Associate Members** (participation in Commission programs)**:** Arizona, Connecticut, Georgia, Illinois, Maryland, Massachusetts, Mississippi, New Hampshire, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, West Virginia, and Wisconsin.

recognize the explicit limitation on the mail order safe harbor the Court set in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). The appropriate standard is that reiterated by the U.S. Supreme Court in numerous corporate income tax cases: "nexus is established if the corporation 'avails itself of the "substantial privilege of carrying on business" within the State.'" *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 220 (1980).

ARGUMENT

THE PHYSICAL PRESENCE REQUIREMENT FOR COMMERCE CLAUSE "SUBSTANTIAL NEXUS" FOR SALES AND USE TAXES UNDER *QUILL CORP.* v. *NORTH DAKOTA* DOES NOT EXTEND TO INCOME TAXES.

1. The Issue before the Court is Whether New Jersey May Constitutionally Impose a Fairly Apportioned Income Tax on Lanco on Profits it Earns in New Jersey from Licensing the Right to Put its Trademarks on New Jersey Retail Stores.

The constitutional question turns on whether requiring Lanco to pay tax in New Jersey is either "fundamentally unfair" in violation of the Due Process Clause of the Fourteenth Amendment or "unduly burdensome on interstate commerce" in violation of the Commerce Clause. Your amicus submits that these are reasonable tests to require state taxes to meet and are precisely the tests imposed by the United States Supreme Court's modern due process and commerce clause jurisprudence. The New Jersey tax on Lanco passes these tests.

The facts are not at issue. Lanco licenses its affiliate "Lane Bryant, Inc." to place Lanco's revered and valuable trademarked name "Lane Bryant" on stores to attract customers. The value of that trademark in New Jersey derives from the goodwill that exists within the hearts and minds of New Jersey customers, developed through their long and happy experiences in New Jersey Lane Bryant stores. The marketplace confirms that value of Lanco's property in New Jersey because these New Jersey retail stores are

willing to pay millions of dollars in royalty fees to obtain the right to display the name "Lane Bryant" there. That royalty is fittingly measured by a percentage (5.5%) of the retail sales made in those New Jersey Lane Bryant stores.

State corporate income taxes from their inception have been both source based—imposed on the portion of income non-residents earn in a State—and residence based—imposed on the total income of a State's residents. *Shaffer v. Carter*, 252 U.S. 37 (1920). Source-based taxing is the only way to impose an income tax successfully on modern business. If tax were based on residency alone, the use of artificial and mobile corporate entities could ensure that a corporation's "residence" was located in a jurisdiction that imposes little or no tax. Only source-based taxation has the promise of imposing tax where income is earned.

To determine where income is earned, States have long used the factors of property, payroll and sales. The Supreme Court has affirmed that basing tax on these factors meet due process requirements that state tax be fairly related to benefits provided and commerce clause requirements that income of multistate businesses be fairly apportioned. *Butler Bros. v. McColgan*, 315 U.S. 501, 506 (1942) ("We read the statute [California's three factor apportionment formula] as calling for a method of allocation which is 'fairly calculated' to assign to California that portion of the net income 'reasonably attributable' to the business done there"). Forty years later, the Court noted that "not only has the three-factor formula met our approval, but it has become . . . something of a benchmark against which other apportionment formulas are judged." *Container Corp v. Franchise Tax Board*, 463 U.S. 159, 170, 183 (1983) ("The three-factor formula used by California has gained wide approval precisely because payroll,

property, and sales appear in combination to reflect a very large share of the activities by which value is generated.") Lanco clearly earned considerable income in New Jersey from the sale of the right to use its valuable property in the State by allowing the name "Lane Bryant" to be put on big signs—in lights no less—at stores there.

Lanco asserts that New Jersey cannot tax the profits it earns in New Jersey because it has no physical presence there. Looked at initially from a common-sense policy perspective, this makes no sense. Why should physical presence be required when Lanco is earning these profits from selling something in New Jersey that has no physical presence? Lanco is selling the right to use its trademarked name "Lane Bryant," an intangible that has no corporeality. Indeed, Lanco, itself, which exists solely to own and license these "Lane Bryant" trademarks, barely has any physical presence anywhere.

The legal basis for Lanco's assertion, adopted by the Tax Court below, is that the bright line, physical-presence nexus standard for imposing a use tax collection obligation on mail order sellers reluctantly retained by the Supreme Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), should be extended to state corporate income taxes.

Long-standing Supreme Court precedent authorizes States to impose income tax on taxpayers with no physical presence in the State on income earned from the use of intangibles there. The language and the reasoning of the Court in *Quill* provide no basis to overrule those decisions or to extend the physical presence requirement to income taxes. To evaluate what effect *Quill* has on the nexus standard for income tax, it is helpful to understand the source and development of the income tax nexus standard and then analyze the language and the reasoning of the *Quill* decision.

2. Early State Income Tax Nexus Decisions Did Not Require Physical Presence

The Supreme Court in *Wisconsin v. J.C. Penney*, 311 U.S. 435, 444-445 (1940), set out at length the underlying conceptual basis for nexus to impose income tax.

> Constitutional provisions are often so glossed over with commentary that imperceptibly we tend to construe the commentary rather than the text. We cannot, however, be too often reminded that the limits on the otherwise autonomous powers of the states are those in the Constitution and not verbal weapons imported into it. 'Taxable event', 'jurisdiction to tax', 'business situs', 'extraterritoriality', are all compendious ways of implying the impotence of state power because state power has nothing on which to operate. These tags are not instruments of adjudication but statements of result in applying <u>the sole constitutional test</u> for a case like the present one. That test is whether property was taken without due process of law, or, if paraphrase we must, <u>whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return</u>. (Emphasis added.)

Most States have enacted as the statutory standard for the application of corporate income and franchise taxes some variation of this "fiscal relation" labeled "doing business in the state" or "deriving income from an in-state source". *See, e.g.*, N.J. Rev. Stat. §54:10A-2.[2]

Of specific relevance here are the Supreme Court's repeated authorizations of States to tax intangibles of non-residents who have no physical presence in the State. As early as 1869, the Court authorized state property tax on nonresidents on their intangibles employed in a State. In *National Bank v. Commonwealth of Kentucky*, 76 U.S. 353 (1869), the Court approved a tax on the shares of stock in a Kentucky bank owned by nonresident shareholders with no presence in the State. In *City of New Orleans v. Stemple*, 175 U.S.

[2] "Every domestic or foreign corporation which is not hereinafter exempted shall pay an annual franchise tax for each year, as hereinafter provided, for the privilege of having or exercising its corporate franchise in this State, or for the privilege of deriving receipts from sources within this State, or for the privilege of engaging in contacts within this State, or for the privilege of doing business, employing or owning capital or property, or maintaining an office, in this State. And such franchise tax shall be in lieu of all other State, county or local taxation upon or measured by intangible personal property used in business by corporations liable to taxation under this act."

309 (1899), the Court approved a local property tax on notes and mortgages belonging to a person whose only contact with the State was the presence of that property in the State.

After States began imposing income taxes, it was inevitable that such taxes would be applied to income earned from intangibles. The Court affirmed the authority of the States to impose income tax on taxpayers without physical presence in such cases. In *New York ex rel. Whitney v. Graves*, 299 U.S. 366 (1937), the Supreme Court upheld New York's authority to assess income tax on a non-resident with no physical presence in New York. The Court phrased the issues as follows: "The question here presented relates to the constitutional validity of a tax imposed by the State of New York upon the profits realized by a nonresident upon the sale of a right appurtenant to membership in the New York Stock Exchange." *Id.* at 369. The relator, Whitney, had "contended that the assessment of the tax under the provisions of the state act contravenes the Fourteenth Amendment of the Federal Constitution as an extraterritorial tax." *Id.* at 370. The Court emphasized Whitney's assertion that he and his partners were neither residents of New York nor came to New York to transact business:

> The relator, in challenging the jurisdiction of the State of New York to lay the tax, stresses the points that the relator and his copartners have always been domiciled in Massachusetts; that they have never had an office or abode in New York and have never carried on business there; that while they advertise themselves in Boston as members of the New York Stock Exchange and accept orders from customers at their Boston office for execution on the New York Stock Exchange, none of that business is conducted by the relator or his copartners on the floor of that Exchange; that they do not buy and sell securities on the Exchange for their firm account; that orders requiring execution on the Exchange are telegraphed to members of the Exchange who have business offices in New York and who execute their orders on the Exchange in their own names, acting as correspondents, lending money on the security of the stock purchased and other collateral delivered to them.

Id. at 371. Unquestionably, the Court was dealing with a New York income tax imposed on someone lacking the kind of physical presence within that State for which Lanco argues. The Court concluded that the source of the income, the seat on the NYSE, had a business situs in New York, and "that in laying the tax upon the profits derived by the relator from the sale of the right appurtenant to his membership the State did not exceed the bounds of its jurisdiction." *Id*. at 374.

Seven years later, the Supreme Court upheld another state tax imposed on non-residents with no physical presence within the State. *International Harvester Co. v. Wisconsin Dept. of Taxation*, 322 U.S. 435 (1944). The tax was for the privilege of receiving dividends measured by the Wisconsin portion of distributed earnings. Although there was some contention concerning on whom the incidence of the tax fell, the Court made clear that it was imposed on the stockholders. "For present purposes we assume that . . . the tax is thus, in point of substance, laid upon and paid by the stockholders." *Id.* at 440. The Court found no problem with Wisconsin's laying this tax on persons who had no physical presence within the State.

> Personal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them. A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers.

Id. at 441-442. Its affirmation of the lack of need for physical presence was unequivocal. "And the fact that the stockholder-taxpayers never enter Wisconsin and are not represented in the Wisconsin legislature cannot deprive it of its jurisdiction to tax. It has

never been thought that residence within a State or country is a sine qua non of the power to tax." *Id*. at 443. Finally, the Court concluded "that appellants' stockholders can have no constitutional objection to the withholding by Wisconsin of a tax measured by their dividends distributed from Wisconsin earnings." *Id.* at 445. While it is not clear whether the Court viewed the stockholders' intangibles—the shares of stock in the International Harvester Corporation—as having a business situs in Wisconsin, it is clear that the Court premised its decision on the reality that those intangibles were used in Wisconsin to earn income for the stockholders. The fact that the entity in which the shareholders had an ownership interest—the corporation—had a physical presence in Wisconsin had the same relevance there as the fact here that Lanco and Lane Bryant, Inc., are commonly owned and Lane Bryant has a physical presence in New Jersey. While it does not provide the owner a physical presence, it does establish where the owner's intangible earns income.

These cases provide early and direct support for the authority of States to impose tax on non-residents earning income from the use of their intangibles in a State.

3. The Modern Due Process Nexus Standard Does Not Require Physical Presence

The modern "minimum contacts" due process nexus standard was announced just a year after *International Harvester* in the seminal case of *International Shoe Co. v. Washington*, 326 U.S. 310 (1945). The Court ruled that a State has jurisdiction where a company has "certain minimum contacts with it such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.'" *Id*. at 316. Subsequent cases applying the "minimum contacts" test have focused on whether an out-of-state business "purposefully avails" itself of the benefits of the economic market in the forum State. If so, it is subject to that State's jurisdiction even if it has no physical

presence in the State. *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985). Clearly, physical presence is not required under the modern due process nexus doctrine.

Recognizing this evolution of due process nexus by the late 1980s, North Dakota sought a declaratory judgment that the Quill Corporation, a mail-order seller that annually sent close to $1 million worth of products to North Dakota customers, had sufficient nexus with North Dakota to be subject to the obligation to collect use tax. The State argued that the Supreme Court's decision in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), was no longer good law.[3] The North Dakota Supreme Court agreed that subsequent development of the Court's due process jurisprudence undermined the authority of *Bellas Hess*, and it upheld the collection obligation. *State v. Quill Corp*., 470 N.W.2d 203 (N.D. 1991).

The U.S. Supreme Court affirmed the North Dakota court in part and reversed in part. It affirmed that North Dakota's analysis of modern due process jurisprudence was correct, and that as a matter of due process, there was sufficient nexus for North Dakota to impose on Quill the obligation to collect use tax. "[T]here is no question that Quill has purposefully directed its activities at North Dakota residents, that the magnitude of those contacts is more than sufficient for due process purposes, and that the use tax is related to the benefits Quill receives from access to the State." 504 U.S. at 308.

The Court then identified for the first time, however, a separate commerce clause nexus standard.

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[3] In *Bellas Hess*, the Court had ruled that a Missouri mail order seller whose only contact with Illinois was to send catalogues and products there by U.S. mail and common carrier did not have sufficient nexus for Illinois to impose a use tax collection obligation on the company. The decision was based on both due process and commerce clause grounds, described by the Court as "closely related" and "similar." *Id.*, at 756.

> Due process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him. . . . In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy.

Id. at 312. The Court ruled that the Commerce Clause "'substantial nexus' requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce." *Id*. at 313. Noting the burden imposed by North Dakota and the "similar obligations [that] might be imposed by the Nation's 6,000 plus taxing jurisdictions," *id*. fn. 6, the Court opted to continue the bright-line physical presence test from *Bellas Hess*, recognizing the settled expectations of the industry on this rule.

Here, then, is where the physical presence requirement surfaces. But just as the due process nexus standard has evolved into the modern doctrine based on economic presence, modern dormant commerce clause jurisprudence has eclipsed earlier, more rigid doctrine. The context of this development of dormant commerce clause jurisprudence informs the scope of *Quill*'s newly-minted, commerce clause "substantial nexus" standard.

4. Commerce Clause Limitations on State Taxation Require Even-handed Treatment of Intrastate and Interstate Commerce.

The Commerce Clause, unlike the Due Process Clause, is not a restriction on state power. Rather it is one of Congress's enumerated powers under Art. 1, §8: "To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." Remarkably, Congress did not use that affirmative grant of power to regulate

state taxation of interstate commerce until 1959 when it enacted Pub. Law 86-272, 73 Stat. 555 (1959), codified in part at 15 U.S.C. §381*ff*. But long before that, the Supreme Court had filled the vacuum under its "dormant commerce clause" doctrine by limiting state taxation of interstate commerce even though Congress had not acted at all.

In its first decision invalidating a state tax expressly on commerce clause grounds, the Court turned the clause empowering Congress on its head to bar the States from taxing anything that Congress could regulate, even though Congress had not actually regulated it. The Court held "whenever the subjects over which a power to regulate commerce is asserted are in their nature national . . . they may justly be said to be of such a nature as to require exclusive legislation by Congress." *Case of the State Freight Tax*, 82 U.S. 232, 279 (1872). Congress had not acted, but it could, and therefore the States could not. The Court initially treated interstate commerce as a free-trade zone. "No state has the right to lay a tax on interstate commerce in any form." *Leloup v. Port of Mobile*, 127 U.S.640 (1888).

The Court soon realized that barring state taxation of all aspects of interstate commerce ended up precluding considerably more state taxes than seemed justified. The Court proceeded over the next 70 years to create a series of formal and sometimes artificial distinctions between "direct" and "indirect" taxation of interstate commerce, between taxing transactions that were still in "the stream of commerce" or had "come to rest," between taxes imposed on a "local activity" or on goods destined for "delivery to out of state customers."[4] As more and more commerce became interstate in nature, the unfairness of excluding interstate commerce from state taxation became palpable.

[4] *Hope Natural Gas Co. v. Hall*, 274 U.S. 284 (1927); *American Mfg. Co. v. St.* Louis, 250 U.S. 459 (1919); *Adams Express Co. v. Ohio*, 165 U.S. 194 (1897); *Coe v. Errol*, 116 U.S. 517 (1886).

Finally, in 1938, the Court began to articulate its modern dormant commerce clause jurisprudence with its decision in *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938). It was crafting a theory that in the absence of congressional regulation, the Commerce Clause did not bar States from taxing interstate commerce, but rather required only a level playing field between interstate and intrastate commerce. The Court recognized "the double demand that interstate business shall pay its way, and that at the same time, it shall not be burdened with cumulative exactions which are not similarly laid on local business." *Western Live* Stock, 303 U.S. at 258. Gone was treating interstate commerce as a tax free zone.

After some backsliding toward the free-trade-zone concept of the dormant commerce clause during the 1940s and 1950s, *see Freeman v. Hewitt*, 329 U.S. 249 (1946), and *Spector Motor Services Inc. v. O'Connor*, 340 U.S. 602 (1951), the Court continued its modern commerce clause analysis in *Northwestern States Portland Cement*, 358 U.S. 450 (1959). It held that "net income from the interstate operations of a foreign corporation may be subjected to state taxation provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the same." *Id.* at 452. The Court accepted that interstate commerce should not be disadvantaged as compared to local commerce, but it should not be advantaged, either.

Ultimately, with *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), the Court completely abandoned formalistic distinctions of "direct" and "indirect" taxes and enunciated its authoritative and oft-quoted four-pronged test of the validity of state taxes imposed on multistate business activity. The state tax is permitted "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned,

does not discriminate against interstate commerce, and is fairly related to services provided by the State. *Id.* at 279.

Following *Complete Auto*, the Court proceeded in a series of cases to confirm the utility of its modern dormant commerce clause doctrine by cogently identifying how States can disadvantage interstate commerce. The States gave the Court ample fodder to test its dormant commerce clause analysis by enacting a number of state taxes that managed in a variety of clever ways to discriminate against multistate businesses. *See Armco Inc. v. Hardesty*, 467 U.S. 638 (1984) (exemption from gross receipts tax on wholesale sales granted to local manufactures who pay a manufacturing tax discriminates against interstate commerce because exemption is not available to out of state manufacturers who may be subject to a manufacturing tax in their State); *Bacchus Imports Ltd. v. Dias*, 468 U.S. 263 (1984) (tax exemption for locally produced wine discriminates against interstate commerce); *Tyler Pipe Indus. Inc. v. Washington DOR*, 483 U.S. 232 (1987) (business and occupations tax exemption granted on in-state wholesale sales to local manufacturers paying tax on manufacturing discriminates against out-of-state manufacturers selling into Washington); *New Energy Co. v. Limbach*, 486 U.S. 269 (1988) (gasoline tax credit granted for ethanol manufactured in Ohio or a State granting a reciprocal credit); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) (tax on sale of milk to local retailers, largely borne by out-of-state dairies, discriminatory because the proceeds of the tax are distributed to Massachusetts dairies).

As the Court limned the limits on state cleverness in each of these decisions, it became reassuringly clear that the modern dormant commerce clause doctrine worked. It treated interstate commerce on a level playing field with intrastate commerce. Interstate

commerce was no longer a protected "free trade" area that did not pay its fair share of tax, but it was protected from shouldering a greater burden of state tax than local commerce.

5. The Language and Reasoning in *Quill* Limit its Applicability to Sales and Use Tax

Against this backdrop, the Court decided *Quill*. The separate commerce clause "substantial nexus" standard it announced was based on the archetypal commerce clause consideration that state regulation and taxation must not unduly burden interstate commerce. Protecting interstate commerce from undue burden has long been considered a primary concern of dormant commerce clause jurisprudence, generally appearing in state regulation cases where the Court has balanced the burden placed on interstate commerce with the nature of the local interests and whether a less burdensome alternative is available. *Kassel v. Consolidated Freightways Corp*., 450 U.S. 662 (1981); *Southern Pacific Co. v. Arizona*, 325 U.S. 761 (1945). Taxation of multistate businesses can also impose an undue compliance burden as the Court noted in *Bellas Hess* and *Quill*, citing the "welter of complicated obligations" facing a mail order seller having to collect tax for some 6000 separate jurisdictions with "many variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements" *Quill* at 313, fn. 6.[5]

What, then, does the Court's decision and reasoning in *Quill* tell us concerning any purported extension of a physical presence requirement to income taxes?

A. The Court Used Specific Language in *Quill* Excluding Application of the Physical Presence Requirement to Other Taxes.

[5] Some commentators have noted the illogic of using "undue burden" as a *nexus* requirement. Nexus, after all, is all about the degree of contact with a state. Undue compliance burden can exist even for taxpayers with a great deal of contact with a number of states. *See* Robert D. Plattner, "*Quill*: 10 Years After", State Tax Notes, Vol. 25, No. 24, p. 1017, Sept. 30, 2002. The burdens inquiry is entirely appropriate, but conceptually the analysis properly should focus on whether the multiplicity of jurisdictions with whose diverse and conflicting taxes a multistate business must comply unduly burdens interstate commerce in a manner that puts it at a discriminatory disadvantage with local commerce.

First and foremost, one must look to the actual language of the *Quill* decision. The Court was clear that the physical-presence safe harbor applies *only* in the area of use tax collection. The Court did not say that it had not dealt with the issue of requiring physical presence for other taxes. To the contrary, it acknowledged that when it had affirmatively reviewed "other types of taxes it had not articulated the same physical presence requirement." *Quill*, 504 U.S. at 314. Thus, we need not look anywhere else for authority that the physical presence requirement for substantial nexus is limited to the mail order, use tax situation. Indeed, the Court reiterated that the physical presence requirement had not been extended to other taxes even after *Bellas Hess*. "In sum, although in our cases subsequent to Bellas Hess and concerning other types of taxes we have not adopted a similar bright-line . . . ." *Quill*, 504 U.S. at 317. The Court's unequivocal statements in *Quill* certainly sets a strong presumption that the physical presence requirement for "substantial nexus" under the Commerce Clause applies only to use tax collection obligations of mail-order sellers and does not extend to other taxes.

B. The Two Bases for the *Quill* Decision—*Stare Decisis* and Undue Burden—Reinforce its Limitation to the Use Tax Collection Obligation.

The Court's underlying reasons for its decision in *Quill* further supports limiting the physical presence requirement to use tax collection for mail order sellers. The Court gave two principal reasons for retaining the bright-line physical presence requirement from *Bellas Hess*. First, the Court relied on *stare decisis* to preserve "settled expectations" in the mail order industry.[6] Secondly, the Court relied upon the very basis it

[6] 504 U.S. at 316 ("a bright-line rule in the area of sales and use taxes also encourages settled expectations . . . it is not unlikely that the mail-order industry's dramatic growth over the last quarter century is due in part to the bright-line exemption from state taxation created in Bellas Hess"), and 317

gave for articulating a separate commerce clause nexus standard—limiting undue burdens on interstate commerce—and noted the undue burden that could result from requiring remote sellers to comply with the disparate use taxes of potentially 6,000 sales and use tax jurisdictions requiring monthly tax returns.

(1) *Stare Decisis* Points the Other Way Since the Court Has Long Found Income Tax Nexus Without Physical Presence.

The Court indicated great concern with *stare decisis*. Three concurring Justices based their decision entirely on *stare decisis* (perhaps based on their discomfort with the doctrinal atavism of the lead opinion). In the 25 years after *Bellas Hess*, the mail order industry had relied on this bright-line rule and had not collected use tax from its customers. Even though the Court acknowledged that current Commerce Clause jurisprudence might lead it to a different conclusion if it were writing on a clean slate, it felt constrained by industry's settled expectation. *Quill*, 504 U.S. at 311("contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today . . . .")

When one shifts to income taxes, however, considerations of *stare decisis* lead to the opposite conclusion—no physical presence is required. Clear U.S. Supreme Court precedent has long supported the imposition of state income taxes on non-residents without the kind of physical presence in the taxing State for which Lanco argues. See, *Whitney v. Graves*; *International Harvester* discussed in Part 2, above.

Whitney v. Graves and *International Harvester* found nexus over income of a person not physically present in a State based on Fourteenth Amendment due process

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("the *Bellas Hess* rule has engendered substantial reliance and . . . therefore counsels adherence to settled precedent.").

challenges. Commerce clause "substantial nexus" was not discussed because there was no separate commerce clause "substantial nexus" until *Quill*. Prior to *Quill*, there was only one kind of nexus.[7] No physical presence requirement was articulated as being applicable in those income tax cases. Indeed, these decisions are obvious examples of cases the Supreme Court may well have had in mind when stating in *Quill* that "we have not, in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes . . . ." 504 U.S. at 314. No Supreme Court decision has applied the *Quill* physical presence requirement to a state income tax.[8] No taxpayer could reasonably have expected constitutional protection from paying an income tax in States where her intangible property—be it a seat on the stock exchange, a share of stock, or a trademark—earns income for her.

Furthermore, any taxpayer who consulted the scholarly commentary on the *Quill* decision would find little assurance that the same physical presence requirement applied to use taxes of mail-order sellers would be extended to income tax. *See*, *e.g.*, John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 41 WILLIAM AND MARY L. REV. 319 (2003); Jerome R. Hellerstein and Walter Hellerstein, STATE TAXATION, ¶ 6.02[2] (3rd ed.1998); Jerome R. Hellerstein, *Geoffrey and the Physical Presence Nexus Requirement of Quill*, STATE TAX NOTES, February 13, 1995;

[7] Indeed, the physical presence requirement in *Bellas Hess*, affirmed in *Quill*, derives from due process nexus concepts. *See* Pomp & McIntyre, *State Taxation of Mail-Order Sales of Computers after Quill: An Evaluation of MTC Bulletin 95-1*, 11 STATE TAX NOTES 177, 180-181 (July 15, 1996). Although the Court in *Quill* recognized that it had abandoned a physical presence requirement for due process nexus, it retained the requirement for commerce clause nexus for use tax collection obligations. The lack of any physical presence requirement in *New York ex rel. Whitney v. Graves* and *International Harvester* thus implicates both due process and commerce clause nexus with regard to state income taxes.

[8] Since the Court has denied review in both *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993), and *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.2d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000), it is up to the state courts in the first instance to determine whether the physical presence requirement applies to income taxes.

Michael T. Fatale, *Geoffrey Sidesteps Quill: Constitutional Nexus, Intangible Property and The State Taxation Of Income*, 23 HOFSTRA L. REV. 407 (1994). Any reliance on *Quill* to defeat nexus for imposing an income tax would be risky at best.

Consequently, *stare decisis*, so strongly the basis for the Court's retaining the bright-line test in *Quill*, points the other way in the income tax area. Settled precedent supports nexus to impose income tax on nonresidents without physical presence in the taxing State. Such precedent removed any basis for "settled expectations" that physical presence in a State is a prerequisite to States' imposing income tax.

(2) State Income Taxes Impose No Undue Compliance Burden on Multistate Taxpayers.

The Court identified the second basis for its decision in *Quill* in articulating the distinction between due process and commerce clause nexus standards as follows:

> The two standards are animated by different constitutional concerns and policies.
>
> Due process centrally concerns the fundamental fairness of governmental activity. . . . In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy. . . . Accordingly, we have ruled that that Clause prohibits discrimination against interstate commerce [citation omitted] and bars state regulations that *unduly burden* interstate commerce.
>
> * * * The first and fourth prongs [of *Complete Auto Transit, Inc. v. Brady*], which require a substantial nexus and a relationship between the tax and state-provided services, limit the reach of state taxing authority so as to ensure that state taxation does not *unduly burden* interstate commerce. Thus, the "substantial nexus" requirement is not, like due process' "minimum contacts" requirement, a proxy for notice, but rather a means for *limiting state burdens* on interstate commerce.

504 U.S. at 312, 313 (emphasis added, footnote omitted). Emphatically, *undue burden* is the essence of commerce clause "substantial nexus." The burden the Court described was a *compliance* burden with diverse and complicated state and local taxes.

> North Dakota's use tax illustrates well how a State tax might unduly burden interstate commerce . . . [when] similar obligations might be imposed by the Nation's 6,000 plus taxing jurisdictions . . . [such] that the "many variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements could entangle [a mail-order house] in a virtual welter of complicated obligations."

504 U.S. at 313, fn 6, quoting *Bellas Hess*, 386 U.S. at 759-760.

The burden at issue was not the burden of paying tax. Due process determines whether it is fair for a state to impose a tax burden—"whether the state has given anything for which it can ask a return." *Wisconsin v. J.C. Penney*, 311 U.S. at 445. The Court in *Quill* answered that question with a resounding yes: "the use tax is related to the benefits Quill receives from access to the State." 504 U.S. at 308. Laying a tax obligation on someone who purposefully avails himself of a state's market fully conforms to the fairness standard of due process. It also conforms to the cardinal principle of modern commerce clause jurisprudence that interstate commerce should pay its fair share of taxes.

As Robert Plattner perceptively observed in *Quill Ten Years After*, 25 State Tax Notes at 1019, there is a whiff of the discredited free-trade aspect of earlier dormant commerce clause doctrine in *Bellas Hess* that was carried over in *Quill*. See the Court's comment that the bright-line test provides "the demarcation of a discrete realm of commercial activity that is free from interstate taxation." 504 U.S. at 315. The Court was clearly struggling in *Quill* with this doctrinal throwback in noting that "contemporary Commerce Clause jurisprudence might not dictate the same result," and that "[l]ike other

bright line tests, the Bellas Hess rule appears artificial at its edges." *Id.*, at 311, 315. The Court was hardly suggesting that the exclusively interstate character of mail order transactions *ipso facto* entitles the industry to a safe harbor from state taxes. Rather, the Court continued the safe harbor because of the undue burden of compliance with the diverse state and local sales and use taxes. Once the sales and use taxes are simplified and made more uniform, as the States are doing with the Streamlined Sales Tax Project, then the undue burden will have been removed and the safe harbor will no longer be appropriate.

The Tax Court below misconstrued this distinction in tax burdens in stating, without discussion or analysis, that "it does not appear that the differences between the use tax collection obligation, on the one hand, and liability for income taxation, on the other, are so significant to justify a different rule for each concerning physical presence as an element of commerce clause nexus." The constitutional rule, of course, must be the same for all taxes. But that rule turns on whether imposing a tax obligation on interstate commerce would create an undue compliance burden. The Tax Court failed to recognize that the compliance burdens differ for sales and use taxes as compared to income taxes.

No undue compliance burden now exists with respect to state income taxes. The Supreme Court explicitly so held in *Barclay's Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994), just one year after *Quill*. Barclay's had argued that the burden for a large, multinational bank to prepare the records necessary to file California income tax on a worldwide combined reporting basis was unduly burdensome and therefore discriminated against interstate and foreign commerce. Barclay's complained in particular of the extra complexity caused from translating language, accountancy principles, and exchange rates

in applying apportionment factors to its foreign operations. "Barclays urges that imposing this 'prohibitive administrative burden' . . . on foreign-owned enterprises gives a competitive advantage to their U.S.-owned counterparts and constitutes 'economic protectionism' of the kind this Court has often condemned." *Id.* at 313. The Court agreed that this could be a problem. "Compliance burdens, if disproportionately imposed on out-of-jurisdiction enterprises, may indeed be inconsonant with the Commerce Clause. *Id*. The Court found, however, that California's simplified reporting procedures for foreign operations removed any undue burden and, as a result, there was no discrimination against foreign commerce. "In sum, Barclays has not demonstrated that California's tax system in fact operates to impose inordinate compliance burdens on foreign enterprises. Barclays' claim of unconstitutional discrimination against foreign commerce therefore fails." *Id.* at 314. Since the Court found no undue compliance burden even with the added complexity of including foreign operations under California's world wide combined reporting system, necessarily there is no undue burden under the substantially simpler, separate entity reporting system used in New Jersey.

There are significant differences in the compliance burdens for sales and use taxes and income taxes that support the *Barclay's* holding. The most salient distinction is the number of jurisdictions. Only some 46 States (including the District of Columbia) impose a state income tax—a far cry from the 6,000 plus jurisdictions cited in *Quill*.

The second significant distinction is the extent of uniformity among the States in their income tax laws. This uniformity was the salutary consequence of the 1959 Supreme Court decision in *Northwestern States Portland Cement* and federal and state legislative reactions to that decision. *Northwestern States* recognized for the first time

that States had the sovereignty to impose an income tax on a nondomiciliary business engaged exclusively in interstate commerce. Within just over six months, Congress reacted by enacting Pub. Law 86-272, Title I of which bars States from imposing a net income tax on income from the sale of tangible personal property where an out-of-state company's contacts with the taxing State are limited to the prescribed safe harbor.

Title II of Pub. Law 86-272 mandated a congressional study of state income taxes as applied to interstate commerce. In discharge of this mandate, Congress formed the Willis Committee (so named for the chair of what actually was a Special Subcommittee of the House Judiciary Committee). The Committee conducted extensive hearings as a part of its exhaustive review of state taxes as applied to interstate commerce. Consistent with the controversy that greeted *Northwestern States* surrounding the application of state income taxes to interstate commerce, the Willis Committee observed:

> While each of the State laws contains its own inner logic, the aggregate of these laws—comprising the system confronting the interstate taxpayer—defies reason. Indeed, so varied are the provisions concerning jurisdiction, division of income, and tax base, that it is rare to find a statement which is true of all income tax States. [H.R. REP. NO. 952, 89th Cong., 1st Sess., Pt. VI, at 1143 (1965)]

The Willis Committee made extensive recommendations for federal legislation to preempt and regulate the application of state taxes to interstate commerce, including state income taxes. *Id.* at 1139*ff*. The recommendations for state income taxes sought, among other things, more uniformity in the rules for the division of income among the States and in the starting point used to compute the state income tax, the tax base. These and other recommendations attempted to address numerous problems that flowed from a substantial lack of uniformity that resulted in complexity, uncertainty, compliance burden, administrative challenge, and overtaxation and undertaxation.

The enactment of Pub. Law 86-272 and the recommendations of the Willis Committee galvanized the States into resolving a practical problem—state income taxes were not then well framed to be applied to interstate business. State income taxes required reform, especially in the development of substantial uniformity, in order for States realistically to exercise their sovereignty to impose income tax on interstate commerce. The States could not ignore the immediate need for reform of state income taxes because Congress stood ready to enact the reform itself through federal legislation that would preempt and regulate these and other state taxes.

The need for the States to solve their own problems prompted States to enact the Uniform Division of Income for Tax Purposes Act (UDITPA), to adopt the Multistate Tax Compact, and to form the Multistate Tax Commission. Consequently, uniformity is now a significant part of the state income taxes. "Of the forty-six states (including the District of Columbia) with corporate income taxes, twenty-three have adopted UDITPA, and most other states have similar statutory schemes." Jerome R. Hellerstein & Walter Hellerstein, STATE TAXATION, ¶ 9.01 (3rd ed. 1998).[9] Congressional action was forestalled. These enactments greatly simplified the burden for multistate corporations in filing income tax in numerous States. As a result, the Supreme Court has never struck down the imposition of a fairly apportioned state income tax on a multistate business doing business within several States as unduly burdensome because of compliance difficulties.

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[9] While it is true that States no longer maintain uniform apportionment formulas, the Supreme Court has ruled that the Commerce Clause does not require total uniformity. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) (use of a single factor for sales in apportioning income does not result in impermissible double taxation notwithstanding that other states use a three factor apportionment formula). In any event, such relatively minor differences that exist do not cause great *compliance* difficulty. Double weighting the sales factor, for instance, requires only the simple arithmetic calculation of an eighth grader.

Not only have the Multistate Tax Compact and UDITPA created significant apportionment uniformity among the States, but the starting point to figure the income tax—the tax base—is also generally uniform. Most States piggyback their state income tax on federal income tax calculations, further simplifying multistate compliance. Few of the definitional problems, the extensive varying exemptions and deductions, and the myriad of rates with frequent changes that are all characteristic of sales and use taxes apply to state income taxes. Furthermore, state income taxes require only one annual return, not monthly returns as sales and use taxes generally do. Finally, the calculations of the property, payroll and sales factors necessary for apportionment under UDITPA for one State furthers the calculations needed to determine other States' apportionment.

Ultimately, with regard to Lanco, whose entire income derives from royalties paid by Lane Bryant based on Lane Bryant's receipts at each of its locations, figuring the tax base and apportioning the tax is straightforward and simply done. Affiliate Lane Bryant already employs tax accountants to file income tax returns in each State.[10]

In sum, no credible reason can be found to extend a physical-presence nexus requirement to state income taxes. This conclusion is based on long-standing Supreme Court precedent allowing States to impose income tax on persons who earn income from doing business within their jurisdiction but who are not physically present there. It is

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[10] We note the failure of Lanco to meet its burden to establish the existence of any undue burden on interstate commerce that would flow from its obligation to pay the New Jersey income tax. *See Norton Co.* v. *Dept. of Revenue*, 340 U.S. 534, 537 (1951) (burden to establish exemption from state tax based upon constitutional principles rests on the taxpayer); *General Motors Corp.* v. *Washington*, 377 U.S. 436, 441-42 (1964) (to same effect); *Container Corp. of America* v. *Franchise Tax Bd.*, 463 U.S. 159, 175-76 (1983) (to same effect); *Silent Hoist & Crane Co. v. Director, Div. of Taxation*, 100 N.J. 1, 10, 494 A.2d 775, 779, (1985) ("the [U.S. Supreme] Court appeared resolved to take itself out of the business of being a tax commission and made it clear that the taxpayer has the 'distinct burden of showing by clear and cogent evidence that the state tax results in extraterritorial values being taxed…'".) Significantly, the only reasons for any additional burden on Lanco to file separate income tax returns in each State is because Lane Bryant chose to create the complication itself as a tax planning attempt to avoid paying tax on all of its income earned in each of these States. Any burden on the taxpayers here is entirely self-induced.

based on the language of *Quill* itself limiting the physical presence requirement to mail-order sellers' use tax collection obligation. It is based on the reasons articulated by the Court in *Quill* for continuing the physical presence nexus requirement for mail order sellers—*stare decisis* and undue burden—reasons that are clearly not applicable to the income tax area. And finally, it is based on the only sensible response to the modern economy where value is increasingly generated from intangibles that have no physical presence. Excluding from tax all income earned from intangibles within the state will inevitably destroy the state income tax (such intangibles can always be put in an overseas holding company with no presence in any State and excluded even from water's edge combined reporting). Recognizing the authority of States to impose a fairly apportioned income tax based on economic presence affirms how and where intangibles earn income, proving once again the utility, and the fairness, of the Court's modern due process and commerce clause jurisprudence.

CONCLUSION

For the reasons elaborated above, your amicus respectfully requests that the Judgment of the Tax Court of January 9, 2004 be reversed.

Respectfully submitted,

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