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This article is Professor Murray's Keynote Address at the Multistate Tax Commission's Annual Seminar in Topeka, KS in August of 2006. Professor Murray examines the impact of the growing service sector on state and local tax policy. He finds that the non-uniformity in state and local tax structures leads to a perception of unfairness on the part of multijurisdictional taxpayers. This perception of unfairness leads to pressure on Congress to intervene in state and local tax matters. In short, the current structure of state and local taxes does meet the tenets of good tax policy and is ill suited for today's economy.

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In recent years, a number of analysts of state and local finances have observed extremely robust growth instate corporate income tax revenues, reversing the long-term trend of slow or stagnant growth. However, despite increases in corporate tax rates and the tightening of some "loopholes", this recent boom in corporate tax revenues has not truly reversed the previous long-term trends.

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This article, adapted from Mr. Laskin's article which will be published in the Spring 2007 issue of the University of Akron Law Journal, is a comprehensive legal analysis of why a common practice of many multistate companies to avoid state corporate income taxes - the establishment of Passive Investment Companies (PICs) - does not provide the legal tax shelter as has been commonly believed. Mr. Laskin reviews the long line of U.S. and State court cases to show why PIC's should be subject to tax in the states where intangible asset owned by the PICs are used.

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Preserve Federalism and Tax Fairness

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The opinions expressed in the Review are those of the authors and do not necessarily represent the official position of the Multistate Tax Commission or any of its Member States.

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FROM THE EXECUTIVE DIRECTOR

These are exciting times for the Multistate Tax Commission—we have new states involved in MTC programs, new MTC personnel, and a new website. The State of Alaska joined the MTC Audit Program this past spring and Georgia became the 40th state to join the Multistate Tax Commission's National Nexus Program.

The additions to our staff will provide more robust and effective support to the states in the coming years. Last spring, Gregory S. Matson, formerly of Tax Executives Institute, became our new Deputy Director. On January 15th, Bruce J. Fort joined the Commission as Counsel. Prior to joining the MTC, Fort served as a Special Assistant Attorney General with the New Mexico Taxation and Revenue Department for sixteen years. During that time, he was the state's Lead Counsel in several significant cases involving corporate income tax matters, income apportionment and jurisdiction to tax. The additions of Robert Schauer as Computer Audit Specialist and David A. Novak as Income Tax Auditor will strengthen the Joint Audit Program. Allison Kelly joined the Commission as Website Content Manager in November. (I urge those of you who have not yet visited the new MTC website to do so. The new website is accessible at the same address, www.mtc.gov). Andy Nicholas, a doctoral candidate at American University, is a Policy Research Intern. Andy is working on telecommunications tax issues.

The Commission faces several major opportunities in 2007, including working with the 110th Congress on federal issues affecting state taxation. The addition of many new faces in the House and Senate makes it even more important that we carry the message of state tax sovereignty to our elected federal representatives. This will be the focus of our Legislative Day on May 9, 2007, when state tax administrators will visit their congressional delegations.

We also look forward to working with the National Conference of Commissioners of Uniform State Laws (NCCUSL) to update the Uniform Division of Income for Tax Purposes Act (UDITPA). It is widely recognized that UDITPA does not adequately address apportionment of income from sales of services or intangibles and it is time to reconsider the apportionment model for the states. We have invited NCCUSL, the organization that formulated UDITPA, to discuss amendments to the uniform act, which is part of the Multistate Tax Compact.

With this issue, the *Review* resumes its role of informing the states and the tax community on multistate tax events and issues. I welcome your suggestions for topics for future issues of the *Review*.

Joe Huddleston, *Executive Director*
Multistate Tax Commission

State and Local Tax Policy and the Growing Service Sector

Matthew N. Murray
Professor of Economics and Associate Professor, CBER
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Thank you for giving me the opportunity to speak to you today. It is a great honor to be able to share my views with such an esteemed audience of policymakers and policy analysts.

I would like to focus my remarks on the topic of today's program, namely tax fairness in a service economy. Let me briefly note my perspective when it comes to state and local tax policy so you have a sense of where I am coming from. I view myself as a pragmatist—perhaps we all do—and simply recognize the need to fund public services demanded by taxpayers. I am not driven by ideology but by core principles of sound governance and good tax policy. At the same time, I am probably viewed as a liberal in Tennessee where I live but a conservative in Maine where I have recently done some tax policy work. The fundamental issue as I see it is how to best fund services using standard instruments of tax policy. I clearly recognize the political realities that can shape tax policy, steering it away from sound principles. Politics matter, for better or worse.

The fact that fairness is the topic today suggests the perception—if not reality—of *unfairness* in state and local taxation. The roots of unfairness, however one sees it, largely lay in the uneven structure of state and local taxes especially for multijurisdictional taxpayers, including both people and firms.

Consider the words of some sages in the tax policy arena and think about when these comments were made:

> *The tax methods are almost as numerous as the taxing jurisdictions*
>
> (Mudge, 1934)

> *There is lack of uniformity not only in the method by which corporations in general are taxed, but also in the taxation of specific types of corporations*
>
> (Hunter and Allen, 1940)

Some 70 years later these quotes still aptly characterize the view of many. I think we can all agree that the complexity and nonconformity in state and local tax structure is certainly not a new phenomenon. Many of the tax structure problems of today have their roots in the independent and sovereign tax policy choices made by the states yesterday. Some of you might be dreaming…. "What if we only had a clean slate?" But do you really think the independent actions of the states would take this clean slate and produce a fundamentally different system than we now have?

The tax methods are almost as numerous as the taxing jurisdictions

(Mudge, 1934)

There is lack of uniformity not only in the method by which corporations in general are taxed, but also in the taxation of specific types of corporations

(Hunter and Allen, 1940)

The states have their own interests, goals, and objectives; each state's population and industry structure is unique; and each state has its own political climate. So a high degree of uniformity is not realistic in a federalist system like ours, absent strong federal intervention. Of course, strong federal intervention effectively means the demise of federalism, at least as we know it today.

Complicating the fairness issue is the fact that the environment within which tax systems operate has changed markedly in the last 20 years. This has given rise to some new problems and issues, while sustaining some long-standing problems like the tension between the federal and state/local governments over the sovereignty of subnational taxation.

The problem of what constitutes "food" under the sales tax is a problem that has been around for some time. There is a bit of fun in debating whether Gummi Bears or marshmallows are food. This cute example alone doesn't have significant revenue consequences associated with it nor does it entail substantial administration and compliance costs. But it is illustrative of the serious definitional problems that plague the tax system. (By the way,

the Gummi Bear problem could have been avoided by taxing all consumables and providing targeted equity relief at lower revenue cost to low-income households rather than all households.)

And consider how we might situs or apportion a service consumed across states under a transaction tax. What of a plane or bus ticket? How about situsing or apportioning a hair cut? Sound a bit silly? This is an interesting thought experiment if you believe in the principle of destination taxation. I guess this is the sort of thing you can do if you are a university professor. A hair cut is a classic service, but at least a service transaction that in principle could be physically observed and subject to tax. Of course I haven't answered the situsing question, that is for another day.

So what are the parallels of these problems today? Well we still have the Gummi Bear problem, but now in the form of cell phone services versus telephony services. What transaction tax rate do we impose on such activities? And what about VOIP, which is an Internet service, versus traditional telephony, generally subject to telecommunication taxes? The differential rates mean an uneven playing field for consumers and producers which smacks of unfairness. This is a vexing problem with serious consequences as services grow, accompanied by rapid technological change. These definitional issues relate back to tax statutes and administrative rulings that can be highly specific and not amenable to accommodating economic change because they are based on form over substance.

The situsing issues are arguably more serious today than 20 years ago. VOIP is not quite the same in practice as a plane ticket, bus ticket or hair cut; you cannot observe VOIP transactions, or the endpoints of the service. Services, coupled with new technologies, are a daunting problem for tax administrators and a threat to the tax base.

As I noted above, the environment within which our tax system has changed markedly. Let me amplify further the role of services and our ever-changing economy. Service consumption as a share of total consumption has drifted up over time, although it may surprise you that the peak was in 1992 (at 60.2 percent). But technology has continued to roll forward, lowering product prices and expanding the scope of the services we consume. Cell phones today versus cell phones in 1992 are a good example. Taxpayer mobility—and the ability to avoid or escape taxation—has long been a concern. But services and new technologies add a near costless and timeless extension to the mobility problem, as you might be able to locate production anywhere and sales (i.e. consumption) are very difficult to observe. What about good old fashioned border shopping? At least there was a brick and mortar store over the border that filed a sales tax return.

Along with a changing economy are important economic development pressures, including the decline of manufacturing, outsourcing, wage pressures, and so on. Competition is intense and firms today lack the market power they once enjoyed. So tax incentives have become more common, leading to an erosion of the tax base, especially for mobile capital. The business tax wedge will continue to be subject to the big squeeze.

The long-term decline in corporate tax revenues, despite a recent rebound, has captured much attention. But the public sees the trend as corporate abuse through tax shelters and corporate welfare through the public sector's granting of tax incentives. This makes it politically difficult to reduce business tax burdens even if it is good tax policy (as would be the case with expanded sales tax exemptions for business input purchases).

And the political climate? It has never been particularly hospitable toward raising taxes. But it seems today that there is an outright hostility towards taxes. The tax limitation movement and TABORS are perhaps the best examples of this hostility. Add to this the fundamental asymmetry in the federal versus state/local perspective on subnational government finance. The ITFA, inaction on sales tax nexus, and recent federal BAT nexus legislation are all good examples of federal action or inaction that affects state tax systems. The states should see this intrusion as a great risk.

Adding the long-standing problems to the new environment makes it difficult to draft sound tax policy initiatives that can survive the legislative process. I don't see this as a train wreck, but simply a continuation of the big squeeze on state and local finances. Of course it also means job security for economists, lawyers and accountants.

All of this discussion is meant to suggest that the tax system we have today does not fit well with standard tenets of a good tax system. So what are the consequences of a poorly structured tax system? Revenue yield may be compromised as taxpayers seek to evade and avoid taxes. The complexity of tax systems and their non-conformity

across jurisdictions means potentially burdensome administration and compliance costs. Uncertainties regarding tax policy and tax enforcement (e.g. the nexus and audit lottery in a highly competitive business environment) may hurt business climate. And tax rate and tax base disparities may lead to efficiency losses by distorting consumer and investor behavior; consider state and local telecom taxes that differ by a wide margin across the states. All of these consequences help stir up voters and politicians since they heighten perceptions of unfairness.
Importantly, I ask whether these are the ultimate or penultimate consequences of a poorly-structured tax system? None of us should lose sight of the possibility of federal intervention and loss of state taxing sovereignty...this is the ultimate consequence of a poorly structured tax system.

Step back in time with me for a moment to put the current situation in perspective. The pressures today hark back to the era surrounding the Congressional Willis Commission Report of the 1960s which raised the specter of the imposition of federal will on the structure of state and local taxation. What were the roots of the Willis Commission? Complaints from the business community that the tax system was not uniform and that compliance costs were correspondingly onerous. Read the history of the 30s and 40s and you will find much of the same debate over the lack of uniformity of state tax systems.

For the time being Congress has stepped back from expanding PL 86-272…a law that was initially passed by Congress as a "temporary" measure. Expanding the scope of PL 86-272 is estimated to cost the states at least $1billion (and, somewhat ironically, raise federal tax collections). Federal politicians have much to gain and little to lose by constraining the tax reach of states and localities, something we should never forget.

Let's go back to the issue of services. Why should we tax them in the first place? Taxation of services is an important if not essential element of the state tax portfolio. Consider first transactions taxes. Including services in the base enhances both revenue yield and elasticity; promotes neutrality with respect to goods; and a broader base can support lower tax rates.

For business taxes, including corporate income and franchise taxes, services clearly fit with the principle of benefit taxation, and like transaction taxes, their inclusion in the base and in apportionment formulas enhances revenue yield and neutrality as well. And service-market states, like market states for tangibles, represent a source of income.

How do you structure taxes on services? This policy decision should be guided by the stalwart requirements of a good tax system which I have alluded to above. But in keeping with the theme for today, let me emphasize fairness (i.e. equity) since I think it can be a powerful guiding light. What does fairness mean? Popular interpretations might be no tax breaks for millionaires and no corporate welfare, at least that is what surfaces from a Google search. Beach says "fairness can (and probably does) mean something different to each person," while Wolf states, "How tax fairness should be judged is more debatable, more difficult and probably unresolvable."

I'll go with a name you may be familiar with, Adam Smith: "equal treatment of equals." I myself think this is pretty darn clear. What does such a simple rule imply? Treat all consumption similarly and treat all businesses and production/income similarly. In practice this translates to similar taxation of *functionally* equivalent activities. Form should not dominate substance in the design of tax policy.

What does this get you? Reduced distortions, less revenue erosion, enhanced certainty, and simplified administration and compliance. And let's not forget that it may help forestall federal intervention as well.

Here are some basic principles that should be followed. First, for the taxation of service transactions: exempt business services as is possible; avoid discriminatory levies and use uniform rates; level rates down rather than up; broadly tax consumer services as well as goods; let the functional equivalence of the activity trump mode of production/delivery/storage; and avoid special levies and the earmarking of revenue that creates rigidities and limits fiscal flexibility.

Now, for business activity, first and foremost—avoid discriminatory levies across firms and industries. Service firms should be treated like firms that produce tangible goods. Is there a legitimate reason for doing otherwise? Only short-run revenue needs can justify such discrimination. Second, destination situsing of service sales should be pursued as practical in apportioning multistate income. Finally and more generally, nexus should be based on economic contacts with a state; service-oriented contacts are contacts.

I would be remiss if I did not make some comment about CATS and BATS which are the focus of the next session this morning. These privilege taxes have some desirable features. Rates could be modest, as with Ohio's new tax, dampening some distortions. In addition, in the spirit of benefit taxation, most firms will pay the tax unlike a corporation income tax which is based on ability to pay (or income). A particularly important strength is the ability to impose tax on firms that might not have nexus under a corporate income tax. But the big drawback is pyramiding. The evidence from New Mexico is that about one-third of the revenue from their general gross receipts tax comes from pyramiding. Additionally, some will grumble that firms without profit will still be compelled to pay tax.

So what keeps us from making the tax system fairer? One problem is the current nexus quagmire. With PL 86-272 for corporate income taxes, an uneven playing field exists for firms with and without nexus. With National Bellas Hess and Quill for sales taxes, there is an uneven playing field for brick and mortar versus click and order businesses. A second and closely related point is one that I made earlier: Congress is loath to expand the state authority to tax since it costs votes. Third is the general opposition to tax increases at the state and local level, e.g. incrementally taxing more consumer services. Fourth is opposition to any reduction in business taxes as this is perceived as corporate welfare. Next on the list is the practical problem of making up for revenue losses if taxes are leveled down; telephony reform alone could cost states and localities billions in forgone revenue.

Finally, there are the unique features of the states that drive tax policy and manifest themselves in the form of tax structure provisions that vary across jurisdictions. I cannot overstate the importance of these state-specific features. What can we expect the states to do? Should we expect interstate cooperation or competition in pursuing tax fairness? This is something that I examined with my friends and colleagues Bart Hildreth and Dave Sjoquist a year or so back when we took a close look at the MTC. The MTC has a notable and longstanding role in promoting uniformity, something that requires cooperation, not competition. For better or worse, the lack of binding authority as a compact limits MTC's effectiveness in securing uniformity. Just look at the extensive array of provisions promulgated by the MTC and then the limited adoption by the individual states. The MTC promotes good policy initiatives but politics puts the brakes on legislative adoption.

Do the states and the business community really want uniformity? I don't think so, even though it would yield a superior tax system. The fundamental problem is one of self interest for both parties. The states will pursue self interest, as with Delaware and Nevada and their corporate tax systems and more generally the use of sales-weighted apportionment formulas by the states. And there is the great example of the zero-sum economic development incentives game whereby one state may gain but at the expense of another state. Nonconformity is likely to be preferred by the states. Note that the states did not want a binding interstate tax compact in the aftermath of the Willis Commission. Of course the states would prefer to see all of this as sovereignty, rather than nonconformity.

And multistate businesses? I don't think uniformity is what they want either. There is a preference for tax code variation, special provisions and some degree of complexity because it facilitates tax planning. In the face of stiff global competition putting pressure on profits, this is to be expected. When tax relief is requested, it generally comes in a form that would provide some degree of certainty regarding things like nexus, but at the expense of state taxing powers.

Unfortunately the threat of federal preemption will be sustained insofar as significant non-conformity prevails and the perceptions and realities of unfairness are sustained. Any pre-emption would limit, *not* expand, the state's power to tax.

What would federal intervention look like? We have tasted this intervention before. Consider the corporate income tax and a continuum with varying degrees of federal intervention. On one end we have federalization of the state corporate income tax that yields uniformity of administrative procedures, the tax base and perhaps the tax rate as well. On the other end is federalism, sovereignty, competition and…yes, nonconformity. The issue is striking a balance along this continuum; how much non-conformity will Congress find acceptable? I think this will depend on the evidence. At this point there has been little hard evidence presented on the burden of the current system, something that may keep the federal government at bay.

It would be good to see a more substantial degree of conformity across the states in the definition of the base and in administrative procedures. This would be good tax policy and it would be a good faith gesture to multistate taxpayers.

Unfortunately, in reviewing history and considering the nature of the political process, I am not optimistic about the prospects for achieving a high degree of uniformity. Thus the fairness of the tax system will continue to be compromised in the eyes of many. Why would the response today differ from the response of the past? Look at the recent experience of sales tax streamlining. It is moving forward, not quite at glacial speed, but slowly nonetheless. A major point of contention across state legislatures is the issue of base conformity.

It has been about 70 years since the quotes of Mudge and Hunter and Allen that I introduced to you were put to paper. I think that in another 70 years we will still be able to cite them and it will be assumed that the words come from a modern-day sage. ■

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Trends in State Corporate Income Taxes Revisited

Elliott Dubin, Director of Policy Research

Abstract

This article updates the article that appeared in this review in September 2000. The previous article was written at a time when state corporate income taxes were, according to some observers, disappearing. However, in the recent past, this revenue source has been growing at double digit rates – significantly faster than other sources of state tax revenues. Projections for the near future of state corporate income taxes are for slower growth.

Introduction

According to the National Association of State Budget Officers (NASBO), state fiscal conditions improved significantly in fiscal year 2005. Total balances – ending balances and amounts in budget stabilization funds – totaled $38.5 billion, or 6.9 percent of expenditures in fiscal year 2005. In contrast, total balances were $27.5 billion in fiscal 2004 – 4.6 percent of expenditures. In fiscal years 2002 and 2003, total balances were $18.3 billion and $16.4 billion – 3.7 percent and 3.2 percent of expenditures respectively.[1] However, the improvement in state fiscal conditions is expected to reverse itself in fiscal 2006; NASBO projects total year end balances to be $26.7 billion, or 5.1 percent of expenditures.[2]

The National Income and Product Accounts (NIPA) also shows state and local fiscal conditions worsening somewhat in fiscal 2006. **Figure 1** below shows the trend in state and local fiscal conditions as measured by net savings – the difference between current receipts and current expenditures. In the first quarter of 2003, state and local government net dissaving was $67.8 billion. In the second quarter of 2005, net saving reached $21.3 billion. In the third and fourth quarters of 2005 net dissaving were $6.4 billion and $10.2 billion respectively.[3] This worsening of state and local fiscal conditions is attributed, to a significant extent, to the impact of Hurricanes Katrina and Rita, which resulted in lower tax receipts and higher expenditures in the third quarter and a rebound in the fourth quarter.[4]

To some extent, the recent improvement in state fiscal conditions can be attributed to the robust growth in state corporate income taxes. Whether these recent trends will continue is not clear – every silver lining has a cloud.

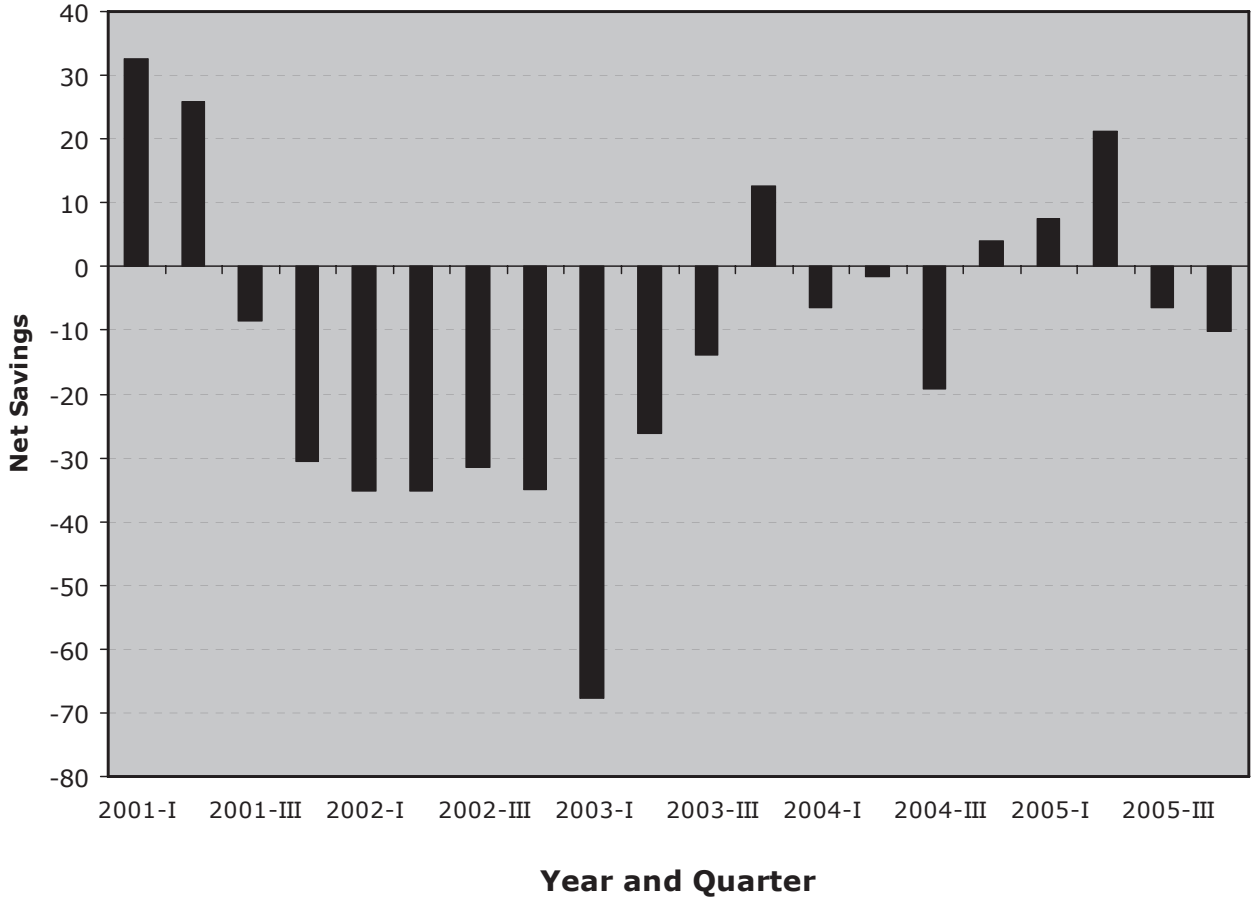
Trends in State Corporate Income Taxes

Until recently, most of the literature on state corporate income tax trends was devoted to the decline in this source of state tax revenue.[5] Today, most analysts of state corporate income taxes are noting its explosive growth. For example, Nicholas Jenny of the Rockefeller Institute of Government, in a recent report, shows that with the exception of the third quarter of 2002 and the third quarter of 2003, state corporate income taxes have grown at double digit rates between the third quarter of 2002 and the fourth quarter of 2005. Between the first quarter of 2004 and the first quarter of 2005, state corporate income taxes grew at a phenomenal rate of 61.6 percent.[6] Harley Duncan, Executive Director of the Federation of Tax Administrators, exclaimed at the February 1 at the Outlook in the States 2006 conference in Washington hosted by *Governing* magazine:

> "In the 20 years I have been in this business, corporate income [tax] growth has never been as high as it has been for the last 12 months. This is the highest it has ever been. Nobody can figure out why."[7]

Indeed, state corporate income taxes have grown at a pace not seen in many years. The reason for this growth, as will be shown later in this article, is the extremely rapid growth in corporate profits. State corporate income taxes, on a NIPA basis, grew from $41.5 billion in 2004 to $58.6 billion in 2005 – a 41.2 percent increase.[8] Previously, the most rapid increase in state corporate income tax revenues was approximately 27 percent from 1967 to 1968 -- $2.6 billion to $3.3 billion. From the trough in 2001, to 2005, state corporate income taxes have grown at an annual average rate of 18.2 percent. **Figure 2** below presents state corporate income tax revenues and corporate profits of domestic industries,

Figure 1
State and Local Net Savings[1]
Billions of Dollars:
2001-I to 2005 IV



[1]Current receipts less current expenditures.

Source: Bureau of Economic Analysis and Multistate Tax Commission.

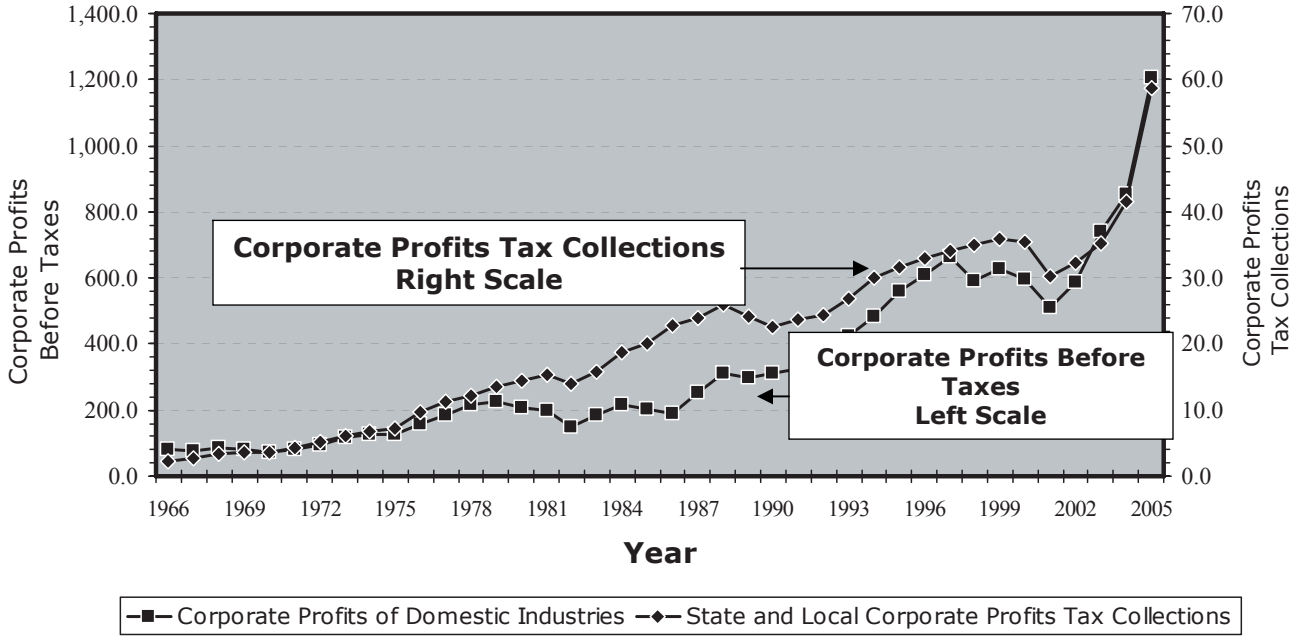
excluding earnings of Federal Reserve Banks, on a NIPA basis, over the past 40 years.

Relative Importance of State Corporate Income Taxes

Despite the rapid rise in corporate income tax collections in recent years, it (corporate income taxes) generally remains a relatively small portion of total state tax collections. In fiscal year 2002, state corporate income tax receipts, using Bureau of the Census data, were $25.1 billion or, 4.7 percent of state tax collections. In fiscal year 2005, state corporate income tax receipts were $38.7 billion, an increase of 54 percent over the 2002 figure, and 6.0 percent of total state tax collections.[9] In contrast, corporate income taxes were $13.5 billion or 9.7 percent of state tax collections in fiscal year 1981 (see **Figure 3**).

As a result of the severe economic downturn in the early 1980's, corporate profits taxes, as proportion of total state tax collections fell from 9.7 percent in fiscal 1981 to 7.7 percent in fiscal 1984. Profits tax collections, relative to total tax collections, recovered with the economic recovery in the mid to late 1980's. State corporate profits taxes accounted for 8.5 percent of total state tax collections in 1989. Corporate profits tax collections as proportion of all state tax collections fell from about 8.5 percent in 1989 to about 6.5 in fiscal 1992. This was a sharp decline in this trend considering the mildness of the recession. Again corporate profits taxes rose faster than total state taxes – rising to 7.3 percent

Figure 2
Corporate Profits of Domestic Industries Before Taxes[1] and State and Local Corporate Profits Tax Collections: 1966 to 2005
(Billions of Dollars)



[1] Excludes earnings of Federal Reserve Banks

Source: U.S. Department of Commerce, Bureau of Economic Analysis and Multistate Tax Commission

of state tax revenues in fiscal 1995. Between fiscal years 1995 and 2002, state corporate income taxes, as a proportion of total state taxes, steadily declined. This decline in the relative importance of corporate income taxes to state tax collections came at a time of generally rising corporate profits.

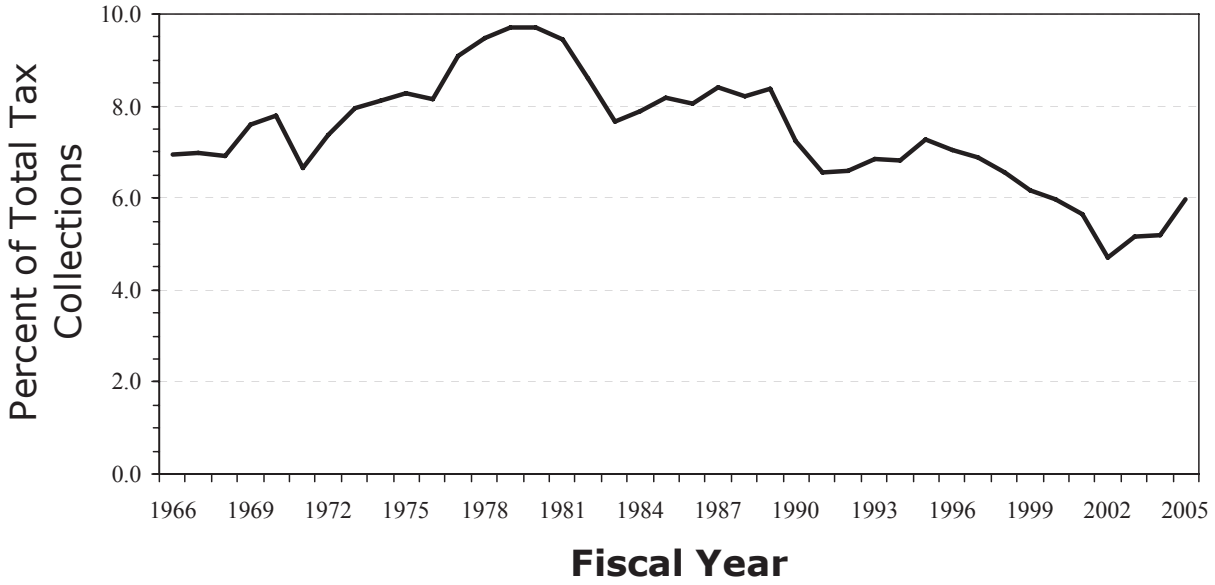
Corporate Profits Taxes in Relation to Corporate Profits

Total state corporate tax collections are the product of total corporate profits and the average state corporate profits tax rate. The ratio of corporate profit tax liability accruals to domestic corporate profits, as defined by the U.S. Bureau of Economic Analysis, National Income and Products Accounts (NIPA) is used as a proxy of the average state corporate income tax rate. Corporate profit tax liability accruals estimate the taxes on profits currently earned, net of applicable credits. Domestic corporate profits include capital gains and exclude deposits by Federal Reserve Banks and earnings of U.S. businesses in foreign countries.[10]

Between 1966 and 1986 state corporate income tax accruals, as a proportion of domestic corporate profits rose from slightly less than 3 percent to slightly less than 12 percent in 1986 (**Figure 4**). To some extent, the increase in the ratio of profits tax accruals to profits during the 1960's and 1970's was due to the increase in the number of states imposing corporate income taxes. Between 1966 and 1971, eight states – Florida, Illinois, Maine, Michigan, Nebraska, New Hampshire, Ohio, and West Virginia adopted corporate income taxes. Michigan replaced its corporate income tax with the Single Business Activity Tax in 1976 – a variant of a value-added tax. During the late 1970's and early 1980's, higher than anticipated rates of inflation resulted in taxes on profits rising faster than profits.

The decline in the profits tax rate since 1986 is more difficult to explain because there are at

Figure 3
State Corporate Profits Tax Collections as Percent of Total State Tax Collections: Fiscal Years 1966 to 2005



Source: Bureau of the Census and Multistate Tax Commission.

least four non-mutually exclusive factors that caused the effective rate of profits tax to fall: 1) measurement errors; 2) changes in the Federal corporate tax base; 3) growth of more aggressive and sophisticated tax planning; and 4) actions of state policy makers.[11]

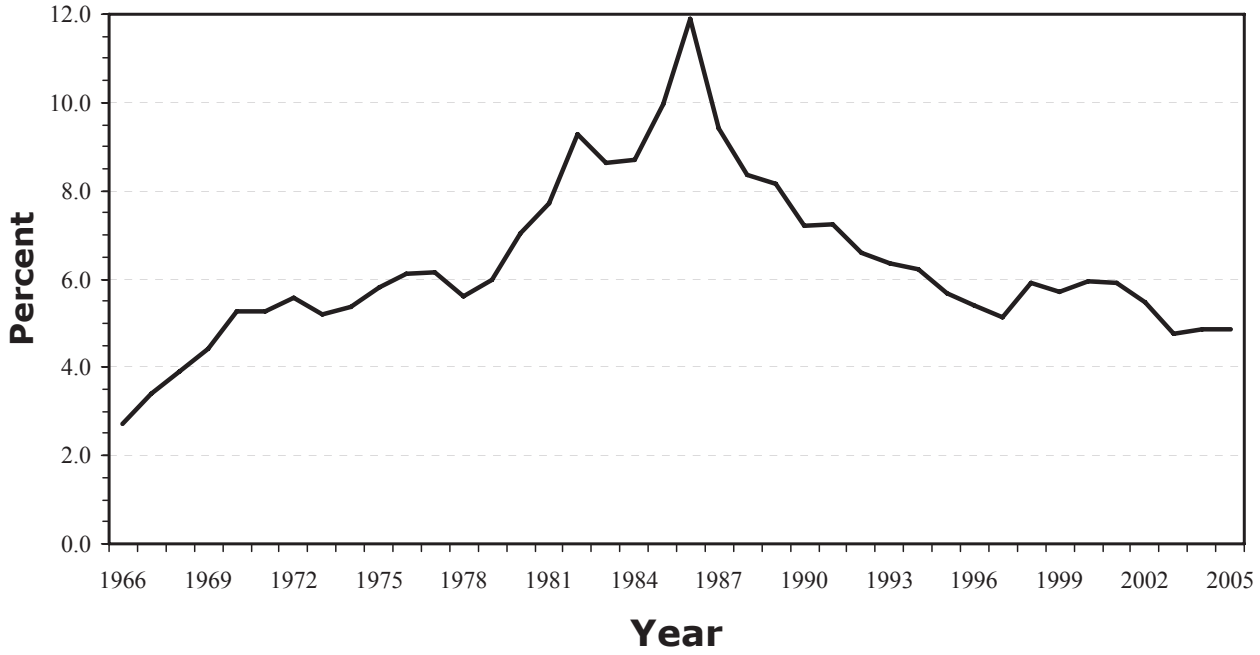
Errors in Measurement: A partial explanation for the decline in the effective rate of state corporate profits taxes is the growing use of "pass-through" entities (Subchapter S corporations, limited liability partnerships, and limited liability corporations). The net income of these entities is classified as corporate profits. However, the net income of these entities is taxed at the shareholder level and the resulting revenues are therefore considered individual income taxes. The growing share of corporate profits taxed as individual income taxes reduces the measured effective corporate profits tax rate.[12]

Changes in Federal Tax Base: As noted by Fox and Luna, most state corporate income taxes are tied to the Federal definition of taxable income with some additions and subtractions. Decreases in the Federal tax base, for whatever reasons, will result in reduced state corporate income tax bases. State corporate income tax revenues will therefore decline, unless states raise their tax rates.

Corporate Tax Planning: Part of the decline in the ratio of corporate income tax revenues to corporate profits can be attributed to more sophisticated tax planning by businesses. Many firms have used the non-uniformity in nexus rules and the definition of business and non-business income among states to minimize their state tax liabilities. In addition, some firms use the separate reporting laws of the majority of the states imposing corporate income taxes to shift income to states with no taxes or very low taxes on certain types of income. A study by the Multistate Tax Commission in 2003 estimated the loss in state corporate income tax revenue resulting from tax sheltering in 2001 was between $8.3 billion and $12.4 billion.[13]

State Policy Actions: The decline in the effective rate of corporate income taxes, as measured by the ratio of corporate income tax collections to corporate profits, is due in part to a number of state tax policies that reduce the effective rate of tax (ETR) while keeping the basic structure (bases, exemptions, deductions, etc.) of their corporate income taxes. The ETR for the aggregate of all states has declined from 8.2 percent in 1989 to 4.9 percent in 2005 while the aggregate legislated increases in corporate income tax revenues totaled $1.8 billion between fiscal years 1990 and

Figure 4
State and Local Government Taxes on Corporate Profits as Percent of Corporate Profits[1]: 1966 to 2005



[1.] Corporate profits of domestic industries before tax less earnings of Federal Reserve Banks.

Source: Multistate Tax Commission from Bureau of Economic Analysis

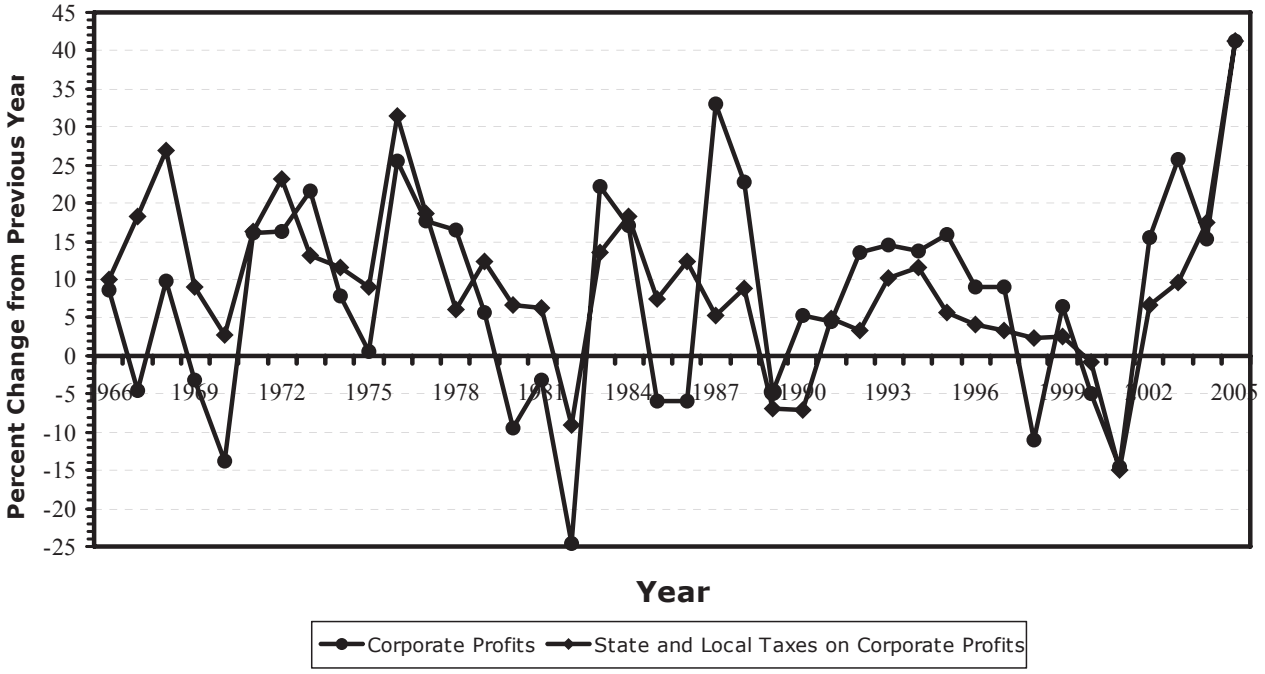
2005.[14] Increasing tax rates in the face of growing interstate competition for attracting new businesses does seem counterintuitive. However, other state policy actions have mitigated these legislated tax increases. Three types of state policy actions that work to reduce the ETR are:

- Tax concessions and incentives
- Increasing the weight of the sales factor in income apportionment formulas
- Recognizing the adoption of LLC's and other pass-through entity business structures.

Tax concessions and incentives are the most visible policy actions that states have used to attract new businesses to their state, or to keep existing business from leaving. Often these concessions take the form of negotiated tax abatements with specific businesses. Other incentives, such as credits against tax liability, are less visible because they are embedded within the state tax code. However both the highly visible and less visible tax incentives act to reduce effective tax rates on business income.

States use a formula based on sales, payroll, and property to apportion the income of multistate firms among the states in which does business. The formula adopted in 1957 by the Uniform Division of Income for Tax Purposes Act (UDITPA) weighted each factor equally. Over time, a number of states have adopted other formulas that place a heavier weight on the sales factor. As of January 1, 2006, of the 47 states and the District of Columbia that levy corporate income taxes, only 13 states use the equally weighted three factor apportionment formula, with some exceptions, 21 states use a double weighted sales factor, 7 states use a more than double weighted sales factor, and 6 states use only the sales factor as the apportionment weight. Georgia, Minnesota, New York, and Wisconsin are increasing the weight of the sales factor in stages to eventually achieve a single sales factor apportionment formula.[15] Overweighting the sales factor in the apportionment formula reduces the weights given to the payroll and property factors (the sum of the factor weights must equal one) thereby reducing the tax liabilities of firms with

Figure 5
Corporate Profits Before Taxes and State and Local Taxes on Corporate Profits: Percentage Change from Previous Year -- 1966 to 2005



Source: Bureau of Economic Analysis and Multistate Tax Commission.

relatively large payroll and property within a state but relatively low sales. Conversely, firms with little payroll and/or property within a state but with relatively high sales volume will incur greater tax liabilities.

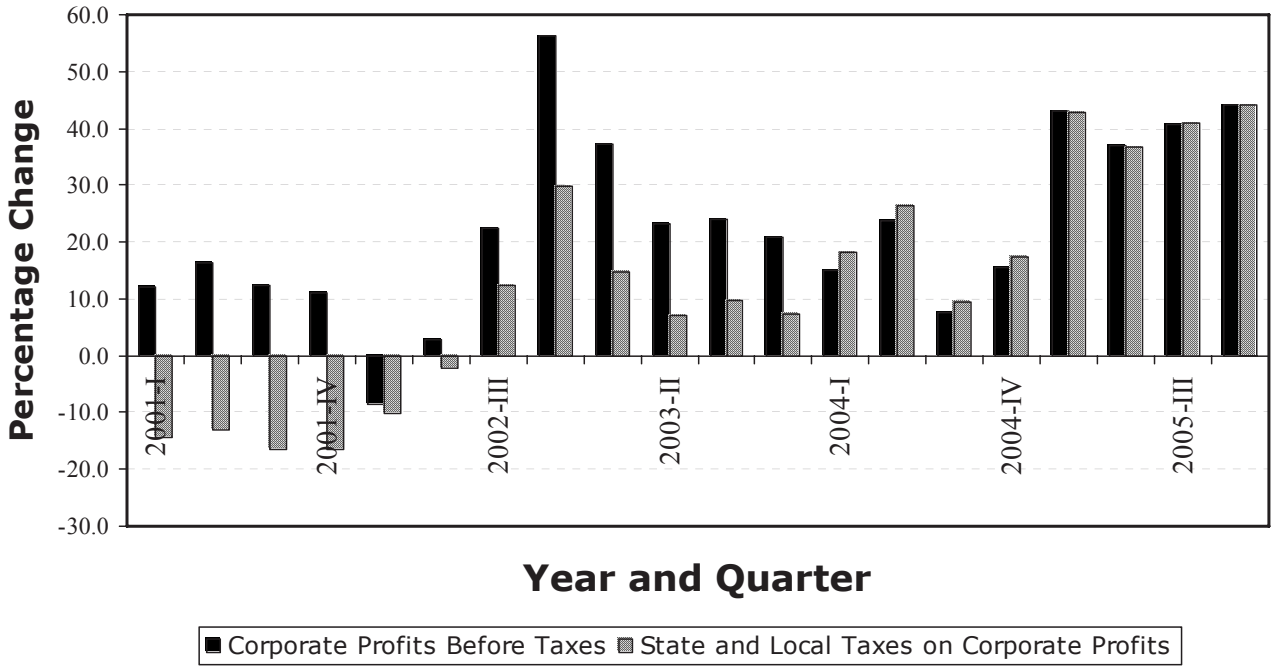
State recognition of Limited Liability Corporations (LLC's) and other pass-through business entities provides a mechanism for multistate corporations to legally shift income from the state in which it was earned to a state which imposes either no tax on income derived from the ownership of intangible assets, or a very low rate of tax. For example, a C corporation in a given state subject to that state's corporate income tax creates an LLC in which it holds a 1 percent ownership share. The other 99 percent is owned by an out-of-state corporation which does not tax income derived from the ownership of intangible assets (ownership of the LLC qualifies as an intangible asset). A simple business structure such as the one described here can effectively shift 99 percent of the income earned in a state to another state in which that income is not taxed. Fox and Luna have shown that the growth of LLC's has been an important factor in the decline in corporate tax revenues.[16]

The four factors briefly described here, and possibly others, partially explain the long run decline in the ETR of state corporate income taxes. The relative importance of each of the factors in explaining this trend has not yet been determined.

The Future of State Corporate Income Taxes

The question raised in the beginning of this article is: will the recent rapid growth in state corporate income tax revenues continue? Given the volatility of both the base of the tax and the revenues derived from that base (see **Figure 5** above), it is extremely difficult to forecast the trend in corporate income revenues. In contrast to the seemingly steady long-run growth trends shown in Figure 2, the year-to-year percentage changes in both profits and corporate income tax revenues are erratic.

Figure 6
Corporate Profits Before Taxes and State and Local Taxes on Corporate Profits: Year-Over-Year Percentage Change: 2001-I to 2005 IV



Source: Bureau of Economic Analysis and Multistate Tax Commission.

Annual increases in corporate profits have reached 30 percent, or more in 1987, and 25 percent or more in 1976 and 2003; annual declines 15 percent and 25 percent were experienced in 1982 and 2001 respectively. Similarly, annual increases in state corporate income tax revenues of 27 and 32 percent were experienced in 1968 and 1976 respectively; and declined by 9 percent and 15 percent in 1982 and 2001 respectively.

This extreme volatility can be seen in the short run. **Figure 6** below shows the percentage changes of both corporate profits and corporate income taxes from the level in a three month period of a year to the corresponding quarter of the following year. Corporate profits in the fourth quarter of 2002 was 56 percent greater than corporate profits in the fourth quarter of 2001. Both corporate profits and the taxes on corporate profits in each quarter of 2005 were more than 40 percent greater than they were in the corresponding quarter of 2004, with the exception of the third quarter of 2005. Third quarter profits and taxes were about 36 percent higher than the corresponding quarter in 2004.

Sustaining such a rapid growth in corporate income taxes in the future would require a similar sustained growth in profits. Mark McMullen of Economy.com lists several reasons why he expects the growth of state corporate income taxes to be significantly weaker in the near term:

1. Firms have become more adept at avoiding taxes.
2. States are continuing to offer significant tax incentives to attract high-wage jobs.
3. Profit growth in the recent past was concentrated in small firms which receive smaller incentives and are not as able to exploit "loopholes" as are larger firms. Future profits will be more concentrated in larger firms that are better able to exploit these "loopholes."
4. The pace of business investment is expected to increase which will reduce the rate of growth of profits and the volume of investment tax credits will rise.[17]

Summary and Conclusion

With the exception of the third quarter of 2002 and the third quarter of 2003, state corporate income taxes have grown at double digit rates between the third quarter of 2002 and the fourth quarter of 2005. Between the first quarter of 2004 and the first quarter of 2005, state corporate income taxes grew at a phenomenal rate of 61.6 percent. State corporate income taxes, on a NIPA basis, grew from $41.5 billion in 2004 to $58.6 billion in 2005 – a 41.2 percent increase. From the trough in 2001, to 2005, state corporate income taxes have grown at an annual average rate of 18.2 percent. State corporate income taxes accounted for 6.0 percent of total state tax collections in fiscal year 2005 compared to 4.7 percent in fiscal 2002.

Does this robust growth mean that corporate income taxes will provide the same proportion of revenues that it did in the late 1970's and early 1980's; or, is it just a blip? It is extremely difficult to forecast state corporate income tax revenues because of the extreme volatility of the base – corporate profits. However, given the fact that despite rate increases in the past, growth in corporate income tax collections lag growth in corporate profits; and the projections for the growth of profits in the near future are not as rosy as the very recent past, this extremely robust growth in corporate income taxes will be more like the previous blips.

(Footnotes)

[1] National Association of State Budget Officers, ***The Fiscal Survey of States***, December 2005, p. 14.

[2] ***Ibid.***

[3] http://www.bea.gov/bea/dn/nipaweb/csv/NIPATable.csv Revised May 8, 2006.

[4] U.S. Bureau of Economic Analysis, ***Survey of Current Business***, April 2006, p. 8.

[5] See, for example, Elliott Dubin, "Recent Trends in State Corporate Income Taxes," ***Multistate Tax Commission Review,*** Volume 2000, No.1, September 2000, pp. 7-15; Peter Fisher, "Tax Incentives and the Disappearing State Corporate Income Tax," ***State Tax Notes***, March 4, 2002, pp. 767-774; William Fox and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," ***National Tax Journal***, Vol LV., No. 3, September 2002, pp. 491-509; and Steven Maguire, Average Effective Corporate Tax Rates: 1959 to 2002, Updated September 5, 2003, ***CRS Report for Congress***, Order Code RL30469, pp. 6-7.

[6] Nicholas Jenny, "A Blip? State Revenue Growth Weakens in the Fourth Quarter," ***State Revenue Report*** No. 63. The Nelson A. Rockefeller Institute of Government, Fiscal Studies Program, March 2006, p.2.

[7] Karen Setze, "Governing Conference Topics Include State Revenue Growth, Toll Roads," ***State Tax Notes***, Tax Analysts, Inc., Arlington, VA, February 6, 200 6Doc 2006-2106.

[8] http://www.bea.gov/bea/dn/nipaweb/csv/NIPATable.csv Revised May 8, 2006

[9] U.S. Bureau of the Census***, State Tax Collections***, Fiscal Years 2002 and 2005. See: http://www.census.gov/govs/statetax

[10] U.S. Bureau of Economic Analysis, ***Survey of Current Business,*** April 1998, pp. M-6 and M-7.

[11] For a more thorough discussion of factors 2 through 4, see: Fox and Luna, ***op. cit***., pp. 495-501.

[12] Martin A. Sullivan, "News Analysis – Shelter Fallout? Corporate Taxes Down, Profits Up," ***Tax Notes Today***, DOC 1999-25781, Tax Analysts, Arlington, VA, July 30, 1999, p.4.

[13] Multistate Tax Commission, "Corporate Tax Sheltering and the Impact of State Corporate Income Tax Revenue Collections." July 15, 2003, http://www.mtc.gov/TaxShelterRpt.pdf.

[14] National Association of State Budget Officers, ***Fiscal Survey of the States***, fiscal years 1990 through 2005.

[15] Federation of Tax Administrators website, http://www.taxadmin.org/fta/rate/corp_app.html.

[16] William F. Fox and LeAnn Luna, "Do Limited Liability Companies Explain Declining State Corporate Tax Revenues?" ***Public Finance Review***, Vol 33, No. 6, pp. 690-720 (225).

[17] Mark McMullen, "Moody's Economy.com 2006 U.S. State and Local Government Outlook," http://www.economy.com/dismal//pro/article.asp?cid=20464&p=1, February 10, 2006. ■

Only A Name?
Trademark Royalties, Nexus and Taxing That Which Enriches

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Adapted from 22 AKRON TAX J. (forthcoming Spring 2007)

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I. INTRODUCTION

The value of a good name is often the greatest asset a business can have. Trade names and trade marks are very big business indeed. A trade name is a name, style, or symbol used to distinguish a company, partnership or business (as opposed to a product or service). It is the name under which a business operates. A trade mark is a word, phrase, logo, or other graphic symbol used by a manufacturer or seller to distinguish its product or products from those of others[1] In 2004, Coca-Cola's trade mark was valued at more than $67 billion, Microsoft's brand was worth $61 billion, IBM's mark came in at $54 billion, GE's at $44 billion and Intel's at $33 billion. Rounding out Business Week's list of the 10 most valuable brands in 2004 were Disney at more than $27 billion, McDonald's ($25 billion), Nokia ($24 billion), Toyota ($23 billion) and Marlboro ($22 billion).[2] The value of intellectual property – copyrights and patents as well as trade marks and trade names – reflects the increased importance of intangible assets to the current economy and the corresponding decreased importance of land and other fixed assets.[3]

The use of an asset as valuable as a trade mark raises significant state taxation issues. For tax purposes, where is a trade mark to be located? Does it matter for state tax purposes whether the record title holder of the trade mark is an affiliate of the entity that uses the trade mark in conducting a retail business? If a state has a sufficient connection with the trade mark holder to tax its income, what is the most appropriate method to apportion royalty income received by the trade mark holder? And what is the most appropriate constitutional nexus standard to apply to businesses that realize income entirely through the sale of digital goods or services via electronic commerce? This article explores these and related questions.

Given the amount of money involved, it is understandable that holders of intellectual property will seek to minimize their state tax responsibilities through various tax planning techniques. But those tax planning techniques can only succeed if done in accordance with all applicable legal principles, including federal constitutional principles that govern when a state has a sufficient nexus, or connection, with a taxpayer to tax its income. This article contends that the formation of a passive investment company (PIC) – a common tax planning technique to shield royalty income derived from the use of intellectual property from state taxation – should be an ineffective tax planning technique because it does not sever the nexus between the PIC and the taxing state.

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This article further asserts that the correct constitutional nexus standard for state taxation of royalty income derived from the use of trade marks and trade names is the well established business situs rule for taxing intangibles. Pursuant to the business situs rule, a state may, consistent with federal constitutional requirements, levy an appropriately apportioned tax on the trade mark royalty income of a business that has purposefully availed itself of the benefits and opportunities of doing business in that state. That is, intellectual property is presumed to have a taxing situs at any location where it is used to realize income. A state may therefore assert income tax nexus with a business located in another state if the business derives trade mark royalty income in the taxing state; the creation of a PIC in a state that does not tax the royalty income --a "tax haven state" -- is ineffective in shielding the trade mark holding company from income tax nexus in its affiliate's market states.

Part II is a brief discussion of the general differences between combined and separate entity income tax reporting, the primary methods by which a multistate business reports its income to the states in which it operates. Part III describes how separate entity reporting encourages the formation of PICs so as to avoid income tax on operating income earned in the separate entity states; and, also explores state responses to this tax avoidance technique. Part III then analyzes the physical presence use tax collection nexus rule and examines the state case law that has addressed the issue of whether the physical presence nexus rule should also apply to the corporate income tax. Part IV presents an historical overview of the business situs rule for taxing income derived from intangibles. Part IV also explains why the Supreme Court's use tax collection nexus jurisprudence does not preclude application of the business situs rule in taxing trade mark royalty income. Part V discusses several ramifications of the business situs rule as applied to PICs, including implications for the taxation of an author's royalty income and the appropriate apportionment formula for taxing trade mark royalty income. Part VI is a critique of recent proposed federal legislation that would create a physical presence income tax nexus standard. Part VII provides a broad analytical framework for approaching income tax nexus as applied to electronic commerce.

The article concludes that a physical presence nexus rule for taxing the income derived from intangibles is inconsistent with well-established and soundly reasoned Supreme Court jurisprudence and would be totally incongruous in our modern, service-based economy. Instead, the business situs rule for taxing intangibles remains the appropriate nexus rule for taxing the income of a PIC. Finally, the article proposes that nexus should be determined through the use of uniform, easily verifiable economic thresholds that would apply irrespective of the form in which the business provides its services or products.

II. THE CORPORATE INCOME TAX: COMBINED AND SEPARATE ENTITY REPORTING

Forty-five states and the District of Columbia currently impose an income-based tax on corporations.[4] Of those states, approximately half require or allow each affiliate of a related corporate group that does business within the state to file separate tax returns for that affiliate; not surprisingly, these states are called "separate entity" states. Of the 45 states, plus the District of Columbia, that are listed in Healy & Schadewald as imposing a corporate income tax, 21 states are listed as either mandating a combined return in all circumstances or allowing the state to require a combined return if certain conditions are met. This leaves 25 states where combined reporting is either not allowed or is available entirely at the election of the taxpayer. The term "separate entity states" as used in this article, refers to those 25 states.[5] The remaining states require all members of a corporate unitary business to file a "combined report." A combined report is not a consolidated return, in that each affiliate of a unitary business must ordinarily file a separate return. A combined report simply requires all affiliates of a unitary business to include the factors and income of those affiliates on the report. A corporate enterprise is said to be "unitary" if there are significant flows of value between the affiliates as measured by the following factors: functional integration, centralization of management and economies of scale.[6] In most combined reporting states, membership in a combined unitary group generally requires more than a 50% ownership interest.

Separate entity states calculate the taxable income and apportionment percentage of each corporate affiliate doing business within the state as if those affiliates were unrelated strangers.[7] As a result, the income (or loss) of one affiliate has no effect on the calculation of income or loss for any other affiliate, and the apportionment factors of each affiliate are calculated separately.

Conversely, combined reporting states calculate business income for unitary affiliates as if they

were divisions of the same entity.[8] "Intercorporate transactions between them would be eliminated and the income reported … [by] the subsidiary would be added to the income reported … [by] the parent …. Similarly, the apportionment percentage would be calculated by taking into account the factors of both the parent and the subsidiary."[9]

III. THE PASSIVE INVESTMENT COMPANY (PIC)

A. The Pic and Separate Entity Reporting

As a general rule, a combined report does not systematically lead to a higher or lower tax liability than would separate reporting.[10] However, separate entity reporting does present opportunities for tax avoidance that are not available in a combined reporting state. One particularly widespread tax avoidance technique is the creation in a tax haven state of a holding company that owns the intellectual property of affiliates doing business in the separate entity states.[11] These holding companies have been historically referred to as Delaware holding companies.[12] Currently, they are commonly referred to as passive investment companies (PICs).

Perhaps the first thing to say about a Delaware holding company is that it need not be based in Delaware; the technique works equally well if the holding company is located in any state that does not tax passive investment income, or has no income tax at all. A Delaware-based corporation, whose activities in Delaware is limited to maintaining and managing intangible assets that generate income, such as capital gains, dividends, interest and royalties, is exempt from Delaware income tax. Similarly, royalty income is not subject to Michigan's Single Business Tax. Nevada, South Dakota and Wyoming do not impose a corporate income tax. Washington also does not impose a corporate income tax. But the Washington business and occupation tax would include gross receipts from royalties received by a Washington – based holding company in the tax base.[13] Another strategy is to create a holding company in a state where the taxpayer is already filing a combined return.[14] This does not increase the combined state tax liability for the unitary business, as intracorporate transactions within the unitary business are ignored in a combined report.[15]

A leading authority in state taxation has described how a PIC[16] is used to shelter royalty income derived from the use of trade marks and trade names from taxation in the separate entity states.

> One typical use of a [PIC] is for a corporation to transfer valuable trade marks and trade names to a holding company. The holding company executes a license agreement allowing its parent to use the transferred property. In return, the parent pays its subsidiaries a royalty, which it deducts in calculating the taxable income it apportions to the states where it does business. …
>
> The licensing of a trade mark is only one way of using a [PIC] in an attempt to generate a deduction to the payor without any tax to the payee. Another way would involve loans made by the [PIC] to related corporations. The two techniques are often combined. A PIC receiving trade mark royalties from its affiliates often lends the royalty income back to those affiliates, who then deduct the interest on the loans from their taxable income in the states in which they operate.[17] The objective would be for the payor to deduct the payment of interest in calculating its apportionable taxable income and for the payee to be exempt from taxation by [the tax shelter state] (and by any other state) on the receipt of the interest.[18]

The amount of income sheltered from taxation as a result of the creation of a PIC is huge. In one case, nine wholly-owned subsidiary PICs of the Limited, Inc. received royalty payments and interest from their affiliates in the amount of $423,098,963 in one year.[19] Furthermore, these PICs often demonstrate little, if any, economic substance. The nine Limited PICs had no employees and shared office space, equipment, and supplies.[20] Their listed primary office space in Delaware was also the primary office address of approximately 670 other companies unrelated to the Limited or its wholly-owned subsidiaries.[21]

B. State Responses to the Pic

States have sought to address the use of PICs to avoid income taxation in a variety of ways. A number of states have sought to deny the deductions taken by the affiliates on a case-by-case basis, asserting that the formation of the PIC lacked business purpose or economic substance. However, the outcome of these cases often turns on subtle factual distinctions, and the states that have gone this route have met with mixed results.[22] A number of states have enacted statutes that require a company to add back deductions taken for payments made to an affiliated PIC. As of

2006, nineteen states have adopted statutes or regulations that disallow related party expenditures between a PIC and its operating affiliates under a variety of circumstances. These provisions generally provide an exemption from disallowance in several contexts, including when the formation of the PIC had a business purpose or there is economic substance to the PIC.[23] In addition, the Multistate Tax Commission (MTC) has proposed a Model Statute Requiring the Addback of Certain Intangible and Interest Expenses.[24]

Other states have addressed the issue by allowing the in-state affiliate to take deductions for the payments made to the PIC, while asserting jurisdiction to tax the out-of-state PIC on the income received from the affiliates. Invariably, the PIC in these cases has asserted that there is an insufficient connection, or "nexus", between the state and the PIC for the state to assert its taxing authority under the Due Process Clause and the Commerce Clause of the United States Constitution. In support of their argument, the PICs rely on nexus principles developed, not in the context of the corporate income tax, but in the very different context of use tax collection. It is therefore necessary to briefly discuss the Supreme Court's use tax collection nexus jurisprudence.

C. The Physical Presence Use Tax Nexus Rule

In 1967, the Supreme Court (National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753 (1967) first addressed the issue of whether a state can constitutionally require an out-of-state seller whose only connections with its customers in the taxing state are by common carrier or U.S. mail to collect use tax on its sales to those customers. Prior to Bellas Hess, the Court had sustained a state's constitutional authority to require a remote seller to collect use tax in a variety of contexts.[25]

In *Bellas Hess,* the Court ruled that a state was barred by both the Due Process Clause and the Commerce Clause from requiring an out-of-state mail order company to collect use tax on its sales to customers in the taxing state, if the company's connections to those customers were limited to the solicitation of orders by advertisements mailed to the customers, with any resulting orders filled by U.S. mail or common carrier.[26]

The Court in *Bellas Hess* created a safe harbor from use tax collection for sellers whose only connection with the taxing state is by U.S. mail or common carrier – a safe harbor which mirrored the existing practices of the states that then imposed a use tax.

> In order to uphold the power of Illinois to impose use tax burdens on National in this case, we would have to repudiate totally the sharp distinction … between mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business. But this basic distinction, *which until now has been generally recognized by the state taxing authorities,* is a valid one, and we decline to obliterate it.[27]

The Court noted that, as of 1965, eleven states besides Illinois required mail order sellers to collect use tax.[28] However, none of the tax administrators in those states considered in-state advertising alone to be sufficient to create nexus.[29] Read in this light, the *Bellas Hess* decision can be viewed as a judicial rebuke to the one outlier state that had exceeded the limit of state use tax jurisdiction universally applied by every other relevant state.

In contrast, at least twenty-seven states take the position that licensing a trade mark or trade name creates corporate income or franchise tax nexus.[30] To the extent that the *Bellas Hess* nexus rule merely mirrored state practice, the Court's rationale supports a contrary income tax nexus rule as applied to income received by a PIC from its affiliates.

The Court further explained its holding in *Bellas Hess* by stating,

> [I]f the power of Illinois to impose use tax burdens upon National were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote. For if Illinois can impose such burdens, so can every State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes.[31]

It is important to note that the Court specifically spoke of *use tax burdens*, not the general burden of paying taxes and filing returns. Under the Court's Commerce Clause jurisprudence, "with certain restrictions, interstate commerce may be required to pay its fair share of state taxes."[32] The Court has long made clear that "[i]t was not the purpose of the commerce clause to relieve

those engaged in interstate commerce from their just share of [the] state tax burden even though it increases the cost of doing the business."[33]

The Court was very clear in *Bellas Hess* precisely which use tax burdens informed its holding:

> The many variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose a fair share of the cost of local government.[34]

Finally, the Court noted that the prevailing system of use tax collection required a remote seller to administer rules that varied from one State to another and which required the remote seller in each taxing jurisdiction to interpret facts that were often too remote and uncertain for the level of accuracy mandated by the system.[35] These concerns are generally inapplicable to a corporate income or franchise tax.[36]

In 1992, the Supreme Court revisited its holding in *Bellas Hess.* In *Quill Corp. v. North Dakota*,[37] the Supreme Court once again addressed the question of whether a state can require an out-of-state mail order company to collect use tax when the company's only connections with the taxing state are by U.S. mail or common carrier.

The Court first recognized that the evolution of its due process jurisprudence since 1967 allowed a state, consistently with the Due Process clause, to require a mail order company that purposefully avails itself of the market in that state to collect its use tax notwithstanding that the company's only contacts with the state are by U.S. mail or common carrier.[38]

However, the Court declined the invitation to overrule *Bellas Hess* under the Commerce Clause.[39] The Court did so on two grounds. First, the Court felt that the existence of a use tax collection bright-line rule "furthers the end of the dormant Commerce Clause ... by the demarcation of a discrete realm of commercial activity that is free from interstate taxation." Although the text of the Commerce Clause contains only an affirmative grant of authority to Congress to regulate interstate commerce, the Court has long interpreted it to include an implied, or "dormant", limitation on the power of the states to burden interstate commerce.[40] The Court viewed such a use tax collection safe harbor as establishing "the boundaries of legitimate state authority to impose a duty to collect sales and use taxes, and reduces litigation concerning those taxes." The Court's bright line rationale is highly dubious in view of the volume of post-*Quill* litigation over the nature and extent of physical presence necessary to establish Commerce Clause use tax collection nexus.[41]

Second, the Court noted that "a bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment by businesses and individuals."[42] In this context, the Court speculated that "the mail order industry's dramatic growth over the [previous] quarter century is due in part to the bright-line exemption from state taxation created in *Bellas Hess*."[43] Therefore, the Court viewed the "interest in stability and orderly development of the law that undergirds the doctrine of stare decisis" as counseling in favor of affirming *Bellas Hess*.[44]

None of the concerns that motivated the Court in *Quill* are applicable in the income tax context. First, the Court twice noted that it had never imposed a physical presence requirement for any tax other than for use tax collection. Indeed, as the cases in Part IV, demonstrate, the Court has consistently upheld the constitutionality of the business situs rule for the taxation of intangibles or the income derived from the licensing of intangibles – a rule that by its very terms, rejects physical presence as a jurisdictional requirement for taxation.

For the same reason, there is no settled expectation of a physical presence rule as applied to the income taxation of intangibles. Neither in *Quill,* nor in any previous or subsequent case, has the Court even hinted that intangibles are entitled to the same safe harbor from nexus that *Bellas Hess* created for use tax collection. In contrast, the grudging nature of the Court's affirmance of *Bellas Hess*[45] should caution against relying on *Quill* as authority for a physical presence safe harbor for intangibles.

Lastly, running through the Court's opinion is a concern for the same unique burdens of use tax collection that informed the Court's decision in *Bellas Hess.* The Court noted that North Dakota required any seller who advertised in the State three times per year to collect use tax and that similar obligations might be imposed by any of the more than 6,000 taxing jurisdictions that imposed a use tax as of 1992.[46] These concerns are simply irrelevant in the income tax context. Only 45 states and the District of Columbia impose a

corporate income tax.[47] In addition to the District of Columbia, only one other locality – New York City – imposes a general corporate income tax.[48]

The burdens of filing annual income tax returns reporting one's own income to no more than 47 taxing authorities are simply not of the nature or magnitude of reporting use tax collected from hundreds of thousands, if not millions, of purchasers in thousands of taxing jurisdictions, on a quarterly or even monthly basis. Therefore, the burdens of use tax collection that provided the primary foundation for *Quill* simply do not apply to the corporate income tax.[49]

D. State Caselaw Supports Economic Presence as the Correct Nexus Standard for the Income Taxation of a Pic

The issue of whether the Commerce Clause requires a PIC to have physical presence within a state before the state may tax income received by the company from its licensing of intangibles to its affiliates has generated considerable academic controversy.[50] However, the issue has proven to be far less controversial in the state appellate courts. As of this writing, every state appellate court that has squarely addressed the issue has ruled that physical presence is not required for a state to have Commerce Clause income tax nexus with a PIC. In other contexts, state appellate courts have also held that the Commerce Clause does not require physical presence for a state to impose a tax other than use tax collection [51]

In ruling that the *Quill* physical presence requirement is inapplicable to an income tax, state courts have noted that the Supreme Court explicitly limited its Commerce Clause ruling in *Quill* to use tax collection.[52] Next, the courts have recognized that the Supreme Court in *Quill* was heavily motivated by stare decisis concerns to preserve the bright-line, physical presence rule for use tax collection originally declared in *Bellas Hess* twenty-five years previously.[53] No such stare decisis concerns inform the issue of income tax nexus, because the Court has never previously required physical presence for a state to impose a tax on income derived from intangibles.[54]

Some commentators have asserted that it would be incongruous to allow an economic presence nexus test for income tax since physical presence is required for use tax collection.[55] However, as recognized by the state courts that have decided the issue, both the distinctions between the nature of the two taxes and the differing burdens imposed on taxpayers by those taxes justify a different nexus standard.

As the New Mexico Court of Appeals stated;

> [A] sales and use tax can impose a special burden on interstate commerce beyond just the payment of money.[56] Unlike an income tax, a sales and use tax can make the taxpayer an agent of the state, obligated to collect the tax from the consumer at the point of sale and then pay it over to the taxing entity. Whereas, a state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate, a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates. … Thus, collecting and paying a sales and use tax can impose additional burdens on commerce that the Supreme Court has repeatedly identified in prior opinions.[57]

In addition, use tax collection is based on the nature and extent of the seller's activities in the state, whereas income and franchise taxes imposed on income derived from intangibles is based on the use of the intangible property in the state, irrespective of whether the owner of the intangible is engaged in activities in the state.[58] These differences make it inappropriate to require physical presence before a state can tax income received as a result of use within the state of an intangible which, by definition, has no physical presence anywhere.[59]

In the final analysis, the economic presence income tax nexus test for taxing income received by a PIC is neither new nor remarkable. It is nothing more than the business situs rule for taxing intangibles, dressed up for the modern economy. For more than a century, the Supreme Court has recognized the constitutional authority of the states to apply the business situs rule for the taxation of intangibles. It is to those cases that we now turn.

(Footnotes)

[1] BLACK'S LAW DICTIONARY 1501 (7th ed. 1999). .

[2] Diane Brady et al., *Cult Brands,* BUS. WK., Aug 2, 2004, at 59 (ranking 100 most valuable worldwide trade marks). *Id.*

[3] DAVID BRUNORI, STATE TAX POLICY: A POLITICAL PERSPECTIVE 28 (2d ed. 2005) ("The service industry relies far more on human capital and intangible property … than does the traditional manufacturing industry. … Plants, equipment and land – the inputs that are most

difficult to move – are relatively minor components of today's booming electronic commerce").

[4] JOHN C. HEALY & MICHAEL S. SCHADEWALD, I 2006 MULTISTATE CORPORATE TAX GUIDE I-3 (2006).

[5] HEALY & SCHADEWALD, *id.,* at I-455 – I-458.

[6] . 2 RICHARD D. POMP & OLIVER OLDMAN, STATE & LOCAL TAXATION 10-38 (5th ed. 2005). Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, 166 (1983) and cases cited therein. HEALY & SCHADEWALD, *id.,* at I-444.

[7] 2 POMP & OLDMAN*, id.,* at 10 -37. For a discussion of the apportionment of corporate income for tax purposes, see Part V.B, *infra.*

[8] POMP & OLDMAN*, id.,* at 10 -37.

[9] *Id.*

[10] *Id*.

[11] Although this article focuses on the use of a passive investment company to shelter trade mark royalty income, separate entity reporting provides opportunities for additional forms of tax avoidance through the formation of holding companies in tax shelter states. For example, the formation of a holding company in Delaware to own stock and bonds of its parent corporation that would otherwise result in apportionable business income results in tax-free dividends and interest to the holding company. POMP & OLDMAN, *supra note* 9, at 10-41.

[12] An early use of the term "Delaware holding company" appears in Wesley Yang, *Utilization of Delaware Holding Companies to Save State Income Taxes,* THE TAX EXECUTIVE (April 1982).

[13] DEL. CODE ANN., tit. 30, §1902(b) (8) (2006). MICH. COMP. LAWS §208.9(7) (c) (2006). HEALY & SCHADEWALD, *supra,* note 6, *at* I-455 – I-458. HEALY & SCHADEWALD, *id.,* at I-200 – I-201.

[14] POMP & OLDMAN, *supra note* 8, at 10-41.

[15] *Id.,* at 10-37.

[16] Because the term Delaware holding company falsely implies that the company must be located in Delaware, this article instead uses the terms "passive investment company" or "PIC."

[17] *See, for example,* A&F Trade mark, Inc. v. North Carolina Secretary of Revenue, 167 N.C. 150, 605 S.E. 2d 187 (NC Ct. App. 2004), *cert. denied* 126 S. Ct. 353, 163 L.Ed. 2d 62 (2005).

[18] POMP & OLDMAN, *supra,* note 9, at 10-41.

[19] A&F Trade mark, Inc., 605 S.E. 2d 187, 189.

[20] *Id.*

[21] *Id.* at 189 -190.

[22] Compare*,* Syms Corp. v. Commissioner of Revenue, 436 Mass. 505, 765 N.E. 2d 758 (2002) *and* Sherwin-Williams Company v. Commissioner of Revenue, 438 Mass. 71, 778 N.E. 2d 504 (2002) Also see*,* Sherwin-Williams Co. v. Tax Appeals Tribunal, 12 A.D. 3d 112, 784 N.Y.S. 2d 178 (NY App. Div. 2004) .

[23] *See, for example,* ALA. CODE §40-18-35(b) (1) (2005); IND. CODE §6-3-2-20 (2006); KY. REV. STAT. §141.205 (2006). Tammy Hunter, Current Developments in Multistate Taxation, Presentation at the Georgetown University 29th Annual Advanced State and Local Tax Institute (May 18, 2006), (on file with author), at slide 15. Philip M. Plant, *The Addback Statute Wars – The Taxpayers' Case,* 37 STATE TAX NOTES 585 (2005).

[24] http://stage-mtc.emagination.com/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/Adopted_Recommendations/Model_Statute_Updates_11-10/Add-Back%20-%20FINAL%20version.pdf (last visited December 21, 2006). The Commission adopted the Model Addback Statute at its annual meeting in Topeka, KS on August 17, 2006.

[25]. Felt & Tarrant Manufacturing Co. v. Gallagher, 306 U.S. 62 (1939) (in-state agents); Nelson v. Sears, Roebuck & Co., 312 U.S. 359 (1941)); Nelson v. Montgomery Ward & Co., 312 U.S. 373 (1941) (same); General Trading Co. v. State Tax Commission, 322 U.S. 335 (1944) (; Scripto, Inc. v. Carson, 362 U.S. 207 (1960).

[26] Bellas Hess, 386 U.S. 758. The Court did not analyze the case separately under the Due Process and the Commerce Clauses.

[27] *Id.,* internal footnote omitted, emphasis added.

[28] *Id.,* 386 U.S. 758, 759, n. 11.

[29] *Id.*

[30] HEALY & SCHADEWALD, *supra* note 6, at I-69 – 72.

[31] Bellas Hess, 386 U.S. 759, internal footnote omitted. The Court noted that in 1965, local sales taxes were imposed by over 2,300 localities and that in most states, the local sales tax was complemented by a use tax. *Id.,* n. 12.

[32] D.H. Holmes Co. v. McNamara, 486 U.S. 24, 31 (1988). *Accord,* Quill Corp. v. North Dakota, 504 U.S. 298, 310, n. 5 (1992).

[33] Western Live Stock v. Bureau of Revenue, 303 U.S. 250, 254 (1938). *Accord,* Colonial Pipeline Co. v. Traigle, 421 U.S. 100, 108 (1975); Commonwealth Edison Co. v. Montana, 453 U.S. 609, 623 – 624 (1981); Quill, 504 U.S. 310, n. 5.

[34] Bellas Hess, 386 U.S. 759, 760, internal footnotes omitted. As of 1965, there were eight different rates of sales and use tax in the United States. *Id.,* 386 U.S. 759, n. 13.

[35] *Id.,* 386 U.S. 759, 760, n. 14.

[36] See discussion in text beginning at n. 52 and Part III. D, *infra.*

[37] 504 U.S. 298 (1992).

[38] *Id.,* at 306 – 308.

[39] *Id.,* at 309 – 319.

[40] *Id.,* at 314 – 315. South Carolina State Highway Department v. Barnwell Bros., Inc., 303 U.S. 177, at 184 – 185 and n. 2 (1938); Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, at 236 (1824) (Johnson, J., concurring).

[41] *Id.,* at 315. *Compare* Orvis Company, Inc., et al. v. Tax Appeals Tribunal, 86 N.Y.2d 165, 654 N.E.2d 954 (NY), *cert. denied,* Vermont Information Processing, Inc. v. Tax Appeals Tribunal, 516 U.S. 989 (1995) *with* Florida Department of Revenue v. Share International, Inc., 667 So. 2d 226 (FL Ct. App. 1995), *aff'd* 676 So. 2d 1362 (1996), *cert. denied,* 519 U.S. 1056 (1997).

[42] *Id.,* at 316.

[43] *Id.*

[44] *Id.,* at 317.

[45] "While contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today, Bellas Hess is not inconsistent with Complete Auto and our recent cases." *Id.,* at 311. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), established the modern four-part test for

determining whether a state tax on interstate commerce is consistent with the Commerce Clause. The four requirements are: the tax must be applied to an activity with a substantial nexus with the taxing state, must be fairly apportioned, must not discriminate against interstate commerce, and must be fairly related to services provided by the state.

[46] *Id.,* at 313, n. 6.

[47] JOHN C. HEALY & MICHAEL S. SCHADEWALD, I 2006 MULTISTATE CORPORATE TAX GUIDE I-3 (2006).

[48]US DEPARTMENT OF COMMERCE, US CENSUS BUREAU, ECONOMICS AND STATISTICS ADMINISTRATION, COMPENDIUM OF GOVERNMENT FINANCES: 2002, Table 45 at 92, 101 and 125 (2005).

[49] *See, e.g.,* MBNA America Bank, 2006 W. Va. LEXIS 132, (W. Va. 2006), *25 – *26.

[50] *Compare* Tun-Jen Chiang, State *Income Taxation of Out-of-State Trade mark Holding Companies,* 70 U. CHI. L.REV. 1533 (2003) (physical presence required); Philip M. Plant, *supra* note 25 (same) and Michael T. Fatale, Geoffrey *Sidesteps* Quill: *Constitutional Nexus, Intangible Property and the State Taxation of Income,* 23 HOFSTRA L.REV. 407 (1994) (physical presence not required); Cory D. Olson, *Comment: Follow the Giraffe's Lead – Lanco, Inc. v. Director, Division of Taxation Gets Lost in the Quagmire that Is State Taxation,* 6 MINN. J.L. SCI. & TECH. 789 (2005) (same).

[51] See cases cited in n. 27, *supra.* Couchot v. State Lottery Commission, 74 Ohio St. 3d 417, 1996 Ohio 262, 659 N.E. 2d 1225, *cert. denied* 519 U.S. 810 (1996)); Borden Chemicals & Plastics, L.P. v. Zehnder, 312 Ill. App. 3d 35, 726 N.E. 2d 73 (Ill. 1st Dist. Ct. App. 2000), *petition for leave to appeal denied* 189 Ill. 2d 656, 731 N.E. 2d 762 (2000). *But see* Joe E. Lanzi III v. Alabama Department of Revenue, 2006 Ala. Civ. App. LEXIS 406 (Ala. Civ. App. 2006

[52] Kmart Properties, Inc., 2006 NMCA 26, *21, 131 P. 3d 27, **35; A&F Trade mark, Inc., 167 N.C. App. 150, 160, 605 S.E.2d 187, 194; Geoffrey, Inc., 2006 OK CIV APP 27, *10, *12, 2005 Okla. Civ. App. LEXIS 124, **7 – **8, **11 – **12; MBNA America Bank, 2006 W. Va. LEXIS, *20.

[53] Kmart Properties, Inc., 2006 NMCA 26, *21, 131 P. 3d 27, **35; A&F Trade mark, Inc., 167 N.C. App. 150, 159 – 160, 605 S.E.2d 187, 194; Geoffrey, Inc., 2006 OK CIV APP 27, *15, 2005 Okla. Civ. App. LEXIS 124, **16; MBNA America Bank, 2006 W. Va. LEXIS, *18.

[54] See cases cited at n. 68, *infra,* and accompanying text.

[55] Paul H. Frankel, Hollis L. Hyans & Amy F. Nogid, *Lanco – It Isn't Over Yet,* 40 STATE TAX NOTES 227 at 228 (2006). *See also,* Xuan-Thao N. Nguyen, *Holding Intellectual Property*, 39 GA. L. REV. 1155, 1173 n.93 and accompanying text (2005).

[56] The Supreme Court has repeatedly ruled that the routine burdens of paying a state tax and filing a return do not raise any issues under the Commerce Clause. See discussion *supra* at nn. 37, 38 and accompanying text.

[57] Kmart Properties, 2006 NMCA 26, *22, 131 P. 3d 27, **35. *Accord,* A&F Trade mark, 167 N.C. App. 150, 161 – 162, 605 S.E. 2d 187, 195; Geoffrey, Inc., 2006 OK CIV APP 27, *15, 2005 Okla. Civ. App. LEXIS 124, **16 – **17; MBNA America Bank, 2006 W. Va. LEXIS, *22 - *24.

[58] A&F Trade mark, 167 N.C. App. 150, 161, 605 S.E. 2d 187, 194, 195.

[59] *Id.*

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