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This article pays tribute to roger John Traynor was unquestionably one of the most influential jurists of the twentieth century. He was Chief Justice of the California Supreme Court and a professor of law at the University of California. As a professor of law, he was also acknowledged as one of the greatest tax law scholars of his time. He established national legal principles of product liability with strict liability; extension of strict product liability through the distribution chain; action for intentional infliction of emotional distress; "moderate and restrained" doctrine in conflict of laws; the fiduciary obligation owed by majority shareholders to minority shareholders; admission of custom and practice evidence in contract litigation; the "exclusionary rule" barring improperly obtained evidence; abolition of sovereign immunity; no fault divorce through elimination of defense of recrimination; abolishment of laws prohibiting miscegenation; and citation of law review articles in judicial decisions.

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*Sheldon H. Laskin, Counsel, Multistate Tax Commission and
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This article, adapted from Mr. Laskin's article which was 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 PICs should be subject to tax in the states where the intangible assets owned by the PICs are used.

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This article was previously published in *State Tax Notes, Tax Analysts, Inc.*, Falls Church, VA. In this article, Michael Mazerov looks at the growing number of states have given serious consideration to, or have adopted a major reform in their corporate income taxes long advocated by state tax experts -- combined reporting for corporate income taxes. The governors of six states -- Iowa, Massachusetts, Michigan, North Carolina, and Pennsylvania -- all recommended this year that their state implement this policy, which is known as "combined reporting." New York enacted combined reporting legislation on April 1 as part of the state's budget bill for FY2007-08. Most large multistate corporations are composed of a "parent" corporation and a number of "subsidiary" corporations owned by the parent. Combined reporting essentially treats the parent and most subsidiaries as one corporation for state income tax purposes. Their nationwide profits are combined -- that is, added together -- and the state then taxes a share of that combined income. The share is calculated by a formula that takes into account the corporate group's level of activity in the state as compared to its activity in other 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

EVERYTHING OLD IS NEW AGAIN IN STATE TAXATION: JUSTICE ROGER JOHN TRAYNOR, *McCULLOCH*, GRANTOR TRUSTS, AND TRUST THROWBACK RULES

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I. Introduction

As Chief Justice of the California Supreme Court, Roger John Traynor was unquestionably one of the most influential jurists of the twentieth century. In his writing and jurisprudence, he established national legal principles of product liability with strict liability; extension of strict product liability through the distribution chain; action for intentional infliction of emotional distress; "moderate and restrained" doctrine in conflict of laws; the fiduciary obligation owed by majority shareholders to minority shareholders; admission of custom and practice evidence in contract litigation; the "exclusionary rule" barring improperly obtained evidence; abolition of sovereign immunity; no fault divorce through elimination of defense of recrimination; abolishment of laws prohibiting miscegenation; and citation of law review articles in judicial decisions¹ As professor of law at the University of California, he was also acknowledged as one of the greatest tax law scholars of his time.²

From 1928-1940, Professor Traynor served as a consultant to the California Board of Equalization in rewriting California's Revenue Code.³ In 1937, he took a leave of absence to advise the United States Department of Treasury in drafting legislation which shaped the Internal Revenue Code of 1939.

Among his innumerable achievements in law, was the classic law review article, *State Taxation of Trust Income*,⁴ which Professor Traynor published in 1937 in the Iowa Law

Review. The article dealt with the troublesome practical and Constitutional issues of state taxation of nonresident trustees. Even in these early, formative years of our nation's systems for taxation of income, tax advisors were utilizing the complexities of trust law and tax rules to their clients' advantage. Likewise, both the federal government and state governments were examining methodologies to thwart such tax avoidance and to protect their tax revenues.

Professor Traynor's article addressed the legitimate concerns of taxing jurisdictions, Constitutional constraints on taxation of nonresidents, and fairness to all taxpayers, including taxpaying residents of the taxing jurisdictions. These same concerns are prevalent today in the use of trusts with nonresident trustees. Such arrangements result in varying jurisdictional contacts with trustees, trust settlors, and trust beneficiaries. Likewise, the continuing need of states for more revenue is unending.

Since one of the greatest legal minds of the twentieth century began his legal career as a tax scholar addressing these identical issues, it is only appropriate to examine his writings. Thus, this article picks up the thread with Professor Traynor's early article on trust taxation. Next, this thread will be followed into special provisions of the California Revenue and Tax Code which implement Professor Traynor's jurisdictional analysis.⁵ Application of the statute will be seen in the *McCulloch*⁶ case opinion in which Justice Traynor participated as an associate justice of the California Supreme Court. Thereafter, Justice Traynor's analysis

is seen as it formed the basis of federal trust throwback rules and grantor trust analysis. These proposals were ahead of their time but ultimately enacted as part of the U.S. Internal Revenue Code of 1954:

“If income is distributed before year-end, the beneficiary is taxed on such distributed income and the trust deducts the amount so distributed from the trust’s income. The two concepts of a deduction of distributed income by the trust or estate and inclusion of such income by the beneficiary are thus interdependent. “[A] decision on either question becomes authority on the other.”⁷

Finally this article will focus on how grantor trust rules and trust throwback rules which were initially developed by Professor Traynor as tools for use by states, have never been fully and properly adopted by states. State revenue statutes utilizing both taxing systems should be enacted to accomplish their intended goals. Enactment would allow states to Constitutionally tax revenues associated with the taxing state’s residents, but realized by nonresident trustees and sourced outside the state.

II. Traynor’s Classic Article

The status of state and federal tax systems was somewhat different in 1937 than today, though there were many similarities. The general system for taxation of trustees and beneficiaries taxed income realized by the trustee to *either* the trustee *or* the beneficiary, but not both.⁸ The trustee was taxed on income accumulated within the trust relationship at year end. The beneficiary was taxed on income distributed “as income” during the tax year to such beneficiary. The issue was whether a distribution from the trustee to the beneficiary was a distribution of nontaxable trust principal or a distribution of current income thereafter taxable to the beneficiary.

Today, the character of trust distributions is normally determined by application of objective rules such as the federal distributable net

income⁹ rules for trusts and estates. D.N.I. rules determine for tax purposes whether distributions are of income or principal and even determine and prioritize the character of the income being distributed. Since its inception in 1913, the U.S. Internal Revenue Code has excluded from gross income the “value of property acquired by gift, bequest, devise or descent.”¹⁰ This exclusion continues today in section 102(a) of the Code. In the system for taxation of trusts, estates and beneficiaries, it has always been and is essential to determine whether amounts received by a beneficiary are tax-free receipts of bequeathed property, i.e. “principal”, or rather receipts of taxable “income.”

In 1937, state principal and income statutes and trust documents determined whether distributions to beneficiaries during a year constituted distributions of trust income. Distributions may consist either of income earned in such year and taxable to the beneficiary or constituted nontaxable distributions of trust principal. For example, if state law or a trust document stated that all gain on sale of trust property constituted trust principal and not income, such gains were never distributable as trust “income.”¹¹ Such gains were inevitably nondistributable and taxed to the trustee.

For a distribution to be taxable to the beneficiary under federal law in 1937 it had to be distributable as “income.” If an instrument provided that the trustee “shall distribute all trust income quarterly to the beneficiary”, then amounts distributed were characterized as and dependent on the existence of trust income. Such amounts were distributions of “income” rather than distributions of “principal”. If the instrument provided that the trustee “shall pay \$100,000 annually to the beneficiary,” then the \$100,000 payment was neither designated as being from income nor dependent upon the sufficiency of income, but was payable in all events. Thus such a payment was a distribution from nontaxable principal and all trust income remained in the trust and taxable to the trustee, not to the beneficiary. In 1935, the Code required trust income to be divided into two “mutually exclusive categories” as

follows:

(1) Income accumulated for future distribution [as principal] under the terms of the will or trust and (2) income which is to be distributed currently [as income] by the fiduciary to the beneficiaries. The first [category] is taxable to the trust, the second to the beneficiaries." Spreckels v. Commissioner, 101 F.2d. 721, 722 (9th Cir., 1939).¹²

Income which had been accumulated and taxed to the trustee thereafter became intermingled with trust principal and no longer constituted "income." Thus, when later distributed to the beneficiary, such amounts also came to the beneficiary as a nontaxable distribution of trust "principal."¹³ In the year of trust termination and final distribution of the "residue", even current income was not deemed to have been distributed as "income," but as nontaxable principal.¹⁴

It was primarily these state principal and income statutes and state tax systems which allowed a nonresident trustee to avoid making distributions of taxable trust income to a beneficiary.¹⁵ By specific language of trust documents or by carefully planning timing of trust distributions, nonresident trustees could prevent beneficiaries from being taxed even by states in which the beneficiaries resided.¹⁶ There was no doubt that states in which a beneficiary resided had jurisdiction to tax state residents on their worldwide income, i.e. irrespective of the source of such income.¹⁷ However, the problem of such taxing jurisdictions was that their own state taxing systems and Principal and Income Acts did not treat all trust distributions as including "income."

The opinion in *Commissioner v. Simmon*¹⁸ clearly reflects the dilemma in which states found themselves then – and now. In *Simmon*, a state income tax regulation made accumulated income taxable to a resident beneficiary when received from a nonresident trustee. The Massachusetts Supreme Court held the regulation invalid. The opinion noted that Massachusetts' principal and income

laws and the trust document treated the accumulated income amount distributed as nontaxable 'capital' in the hands of the beneficiary and not as 'income'. Thus, Massachusetts could have¹⁹, but did not, treat the distribution as income taxable to the resident Massachusetts beneficiary.

Although a state in which a beneficiary resided could tax such resident beneficiary on current income distributed to such beneficiary, such a state lacked jurisdiction,¹⁹ without in personam jurisdiction over the trustee, the state of the beneficiary's residence lacked power to compel the trustee to pay such a tax, i.e. lacked jurisdiction to tax the nonresident trustee on undistributed income²⁰ Likewise, in the absence of "constructive receipt", the Constitutional requirement that income must be "realized" by a taxpayer might not be satisfied for accumulated income as to which the beneficiary had no current right. Traynor described the lack of jurisdiction as follows:

The state of either the Settlor's or the beneficiary's domicile would likewise have difficulty in collecting a tax from a non-resident trustee on income which was neither produced, received nor enjoyed within its borders during the period of accumulation²¹

Traynor's article then discussed two new tax systems which (1) would allow the state of the settlor's residence to tax current trust income directly to the settlor/grantor, whether or not distributed to the beneficiary, and (2) would allow the state of the beneficiary's residence to tax even accumulated trust income to its resident when subsequently distributed to such taxing state's resident beneficiary. His solution was that each state should tax its own residents, whether settlor or beneficiary, *not* the foreign trustee who lacked nexus with the taxing state.²²

Traynor's taxation of settlor by the settlor's state of residence, i.e. system (1) above, was based on principals later enacted as grantor trust statutes. In 1937, no state or federal grantor trust statutes had been adopted and would not be adopted until 1954.²³ However,

federal common law had begun to establish principals which would tax the trust settlor/grantor on all trust income due to such grantor's retention of too much enjoyment and/or control over the trust property.²⁴ The common law principals treated the trust corpus as still being owned by the grantor so that all income from such property would continue to be taxed solely to the grantor as the true owner.²⁵

Traynor's trust taxation system for resident beneficiaries, i.e. system (2) above, provided that the state of the beneficiary's residence should tax the resident beneficiary when the trustee later distributed previously accumulated trust income to such beneficiary. As stated by Traynor:

[I]f a tax is effectively to reach such income, and thereby the recipient's ability to pay, it must be imposed at the domicile of the beneficiary when the income is currently distributable.²⁶

Although such trust income had been previously taxed by the trustee's state of residence, Traynor recognized that there were no Constitutional barriers to the beneficiary's state taxing its own resident upon such subsequent distributions. When the state's resident beneficiary actually received the distributed income, "realization" had clearly occurred. To minimize the adverse effects of double taxation on interstate commerce, Traynor proposed a tax credit to the beneficiary for taxes previously imposed on such income by the trustee's state of residence.²⁷ From the lesson of *Simmon*²⁸, Traynor also recognized that state principal and income statutes must not themselves cause such a subsequent distribution to be treated as nontaxable principal.²⁹

The foregoing statutory tax system for beneficiaries should also sound very familiar. Traynor's proposal was the forerunner to the federal throwback rules. Again the federal throwback system of taxing beneficiaries directly upon a trustee's distribution of accumulated trust income previously taxed to the trustee would later be enacted as part

of the Internal Revenue Code of 1954 some seventeen years after this system was first proposed by Professor Roger Traynor. Professor Traynor, after all, thereafter became an advisor to the Department of Treasury in drafting important federal tax laws. Professor Traynor also raised the concern that taxation of a lump sum on distribution would throw income into higher brackets than imposition of an annual tax on smaller, annual income. Taxing income annually, as was done in *McCulloch*, is required by the California statute.³⁰

III. California's Enactment of Traynor's Throwback Rules for Beneficiaries

In describing his system of taxing a resident beneficiary on distribution of previously accumulated income, Traynor opposed taxing the entire distribution which consisted of years of accumulated income to the California beneficiary solely in the year of distribution. Progressive rate schedules would impose an inappropriate tax penalty if such beneficiary were taxed on the entire distribution in a single year. Therefore, Traynor proposed an averaging, or "throwback" system for taxing the beneficiary over the income accumulation period.³¹

Thus, following Traynor's philosophy, the beneficiary's tax was to be calculated separately for each year of income accumulation by the trustee.³² Due to the tax credit for taxes paid by the trustee to its state of residence, the beneficiary was effectively taxed only on the excess of his resident state's tax over the tax imposed by the trustee's state of residence on the same income. This was the essence of the later federal throwback rules.

Traynor recognized that the state of a beneficiary's residence was limited to taxation of its resident beneficiary, and to imposing such a tax only when the income was distributable.

Traynor was also concerned about the validity under state law of taxing the resident beneficiary on accumulated trust income even when distributed. As he stated, "The validity of such a tax would depend largely upon the

theories with regard to the nature of capital and income."³³ The issue, as in *Simmon*, was whether state principal and income laws permitted taxation of the distribution as "income." His concern was based on the trust's accumulated income having blended with principal and having become a nontaxable gift, bequest, or return of capital when later distributed.³⁴

The foregoing concerns, along with others,³⁵ and the analysis of Professor Traynor were addressed and reflected in what was at that time a unique California Statute.³⁶ As Advisor to the California State Board of Equalization,³⁷ it is likely Professor Traynor participated in drafting the unique California statutes modeled after his own proposals. First, Professor Traynor's analysis of the Constitutional power "to compel payments"³⁸ by the state of the beneficiary's residence resulted in a tax actually being imposed on a California resident beneficiary.³⁹ Likewise, the Constitutional issue of realization⁴⁰ resulted in California delaying taxation until income was actually distributed to the resident beneficiary.⁴¹ The state statutory issue of capital vs. income⁴² was addressed by revising California's principal and income statutes.⁴³ Risk of multiple taxation criticism under the Commerce Clause was satisfied by allowing the beneficiary a tax credit for taxes paid by the trustee to its state of residence.⁴⁴ Finally, the income realized and taxed to the beneficiary upon distribution was "throwback" and treated as if distributed during each year of the accumulation period, respectively.⁴⁵

The discussion below reflects that Traynor's theories were reflected and implemented in the California statutes. Likewise, Justice Traynor participated as a member of the majority in the first case applying California's "throwback" statute in the *McCulloch* case.⁴⁶ The opinion properly held that the tax 1) was actually imposed on the California resident beneficiary, not the foreign trustee; 2) was calculated on each year's annual

income during the accumulation period, not on the entire accumulated lump sum actually distributed; and 3) was postponed until actual distribution. California's throwback statute is found in subsections of California Revenue and Taxation Code, §17745⁴⁷, entitled "Income Taxable to Beneficiaries."

Former Cal. Rev. and Tax Code, §17980, renumbered today as §18005, provides a credit for taxes paid by the trustee to its state of domicile, e.g. Missouri in *McCulloch*, against California taxes owed by the beneficiary on the same income under the throwback rules of §17745.⁴⁸

IV. Application of the Throwback System in *McCulloch*

On the facts, *McCulloch* was an action to recover income taxes assessed against and previously paid by plaintiff, a California resident who was beneficiary of a foreign trust.⁴⁹ Pursuant to California's statute,⁵⁰ the beneficiary had paid the California tax levied on such resident beneficiary.⁵¹ The California beneficiary's California tax was calculated by inclusion of income distributed from the nonresident trustee in the transferee beneficiary's personal tax returns during the throwback period.⁵²

McCulloch was closely analogous to *Simmon*⁵³, except that California had Traynor's statute which had no equivalent in Massachusetts or anywhere else. The provisions currently in

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effect are found in sections 17742 through 17746 of the California Revenue and Taxation Code.

The *McCulloch*⁵⁴ opinion did only what the statute mandated, no more and no less. In *McCulloch*, no tax levied on the nonresident trustee was ever paid by anyone.⁵⁵ No such tax was paid by the trustee. Nor was any such tax on the nonresident trustee ever paid by the California resident beneficiary. Rather, the California resident beneficiary paid only a separate and distinct tax calculated on the pass through and throwback of the trust's income to and inclusion with the beneficiary's other taxable income and deductions.⁵⁶

Eminent academic commentators have analyzed California's statutes as providing for transferee tax liability on the beneficiary rather than taxing the beneficiary under throwback principals.⁵⁷ Although the *McCulloch* opinion could have been written more clearly, the statute itself is absolutely clear in providing throwback liability. Furthermore, the opinion itself only makes sense when read as a throwback holding.

In *McCulloch*, a Missouri trustee earned, but accumulated, income each year from 1946 through 1950. "The trust paid state income taxes to Missouri upon its income for the years 1946 to 1950 inclusive; it paid no income tax to California during that period."⁵⁸ California "imposed upon plaintiff [beneficiary] liability for income taxes upon the accumulated income [subsequently] distributed by the trust ..."⁵⁹

In 1951, when the terminal distribution was made to the California beneficiary, California, then and only then, levied a separate throwback income tax on the beneficiary.⁶⁰ The tax calculation and its collection clearly and deliberately fell solely on the California beneficiary, *not* the Missouri trustee.⁶¹

Throwback rules are quite effective in minimizing tax savings from use of foreign trustees who accumulate income rather than currently distributing such income to a state's resident beneficiary. Use of grantor trust rules can likewise be effective in directly taxing a resident settlor rather than the nonresident trustee, as described below.

V. Current Federal Grantor and beneficiary Throwback Trust Rules Applicable to "Foreign" Trusts

United States Internal Revenue Code §679 applies grantor trust rules to "Foreign trusts having one or more United States beneficiaries." States which have adopted federal grantor trust principles seem, however, never to have adapted §679 to their own jurisdictional needs.⁶²

The U.S. lacks jurisdiction to tax a "foreign" trust or fiduciary.⁶³ To prevent tax avoidance by a United States "person" through creation and funding of complex foreign trusts which accumulate income on behalf of a United States beneficiary, such a trust is treated as a "grantor" trust. Thus, the United States can tax its own resident grantor on current income earned by such a "foreign" trustee with or without distributions to the U.S. beneficiary.⁶⁴

In the event the grantor/settlor of the "foreign trust" is not a United States "person", then the United States government can and does tax any domestic beneficiary under throwback principles upon receipt of a distribution from such trust.⁶⁵ The United States taxes the beneficiary upon receipt of a distribution from the foreign trust at the time of distribution pursuant to federal throwback rules.

Thus, the United States system of taxation follows the recommendations of Professor Roger Traynor in his 1937 article. In essence, assuming as Professor Traynor does in his article, when the settlor, beneficiary and trustee are all in different jurisdictions, each jurisdiction must⁶⁶ tax its own resident. The settlor's residence can tax the settlor under grantor trust rules. The beneficiary's residence can tax the beneficiary when distributions are made to such beneficiary under throwback principles. The trustee's residence taxes the trustee as income is currently realized. A system of tax credits should be used internationally to minimize multiple tax burdens.⁶⁷ If a similar tax system was established by state governments, the tax

credit or similar equitable reapportionment of income would be mandatory under the negative sweep of the commerce clause.

Federal trust throwback rules were repealed for domestic trusts⁶⁸ when trust rate schedules were greatly compressed in 1994. As a result of the compression, accumulated trust income above a purely *de minimus* amount became taxable at the maximum individual tax rates.⁶⁹ This change in trust tax schedules eliminated use of complex trusts as devices for income assignment as between the trust and its beneficiaries. However, for "foreign"⁷⁰ complex trusts not subject to U.S. compressed rates, accumulations could still be used to minimize U.S. income tax. Therefore, provisions applying trust throwback rules were retained in the Code for application to domestic beneficiaries of foreign trusts if the grantor was not a U.S. person.⁷¹

Thus, the United States Department of Treasury has carefully considered and adopted nationally the same tax systems initially proposed by Professor Traynor in 1937 for state taxation of trusts, settlors, and beneficiaries. Ironically, however, state tax systems, other than California, still have not adopted Traynor's proposals.

Thus, states, such as Connecticut in the *Gavin*⁷² case, are trying to remedy the shortfall in their own statutes by pushing "due process" claims beyond the breaking point.⁷³

VI. Recommendations

In efforts to properly tax income of nonresident trusts or trustees, states should first consider their own tax structures. Grantor trust rules modeled after Code §679 must reconsider their own state's jurisdictional limits. Defining the term "foreign" trust or trustee in terms of United States jurisdictional rules is ill-considered.⁷⁴ Beneficiary throwback rules should be established using Traynor's principles as reflected in the California statutes⁷⁵ and the Code.⁷⁶

In efforts to extend their tax powers as far as possible, states will likely continue to

enact untested statutes stretching their long tax arms. Such statutes claim the ability to tax a nonresident trustee based on suspect contacts, including the mere presence of a settlor or beneficiary within the state's taxing jurisdiction. This author believes that such statutes should inevitably fail Constitutional challenges.⁷⁷ It is at least wise for such states to have well-considered, clearly Constitutional backup statutes in place in order to tax their own residents "[i]f, for any reason, the taxes imposed on income of a trust. . ." are not paid by the nonresident trustee.⁷⁸ This was also part of the wisdom of Professor Traynor in drafting the California statutes.

(Footnotes)

¹I. See generally, "Roger John Traynor", Legal Encyclopedia, published by Thomson & Gale; West's Encyclopedia of American Law, The Gale Group, Inc. 1998. Answers.com 13 Mar 2006. <http://www.answers.com>. Also see Friendly, "Ablest Judge of His Generation," 71 Cal L R 1039-1044 (No. 4, July 1983); White, "Introduction" in *The Traynor Reader: A Collection of Essays by the Honorable Roger J. Traynor*, (San Francisco: The Hastings Law Journal, Hastings College of the Law, 1987)(<http://uchastings.edu/?pid=1408>).

² Professor of Law, University of California, Advisor to the California State Board of Equalization. He "played an important role in drafting important [California] tax laws." National Tax Association Tax Conference, Indianapolis, Indiana, September 29, 1936 @ 157. . . .

³Id

⁴See Roger John Traynor, *State Taxation of Trust Income*, 22 IOWA L. REV. 268 (1937).

⁵See *infra*, Note 47 et. seq. and accompanying text.

⁶*McCulloch v. Franchise Tax Bd.*, 61 Cal. 2d 186, 37 Cal. Rptr. 636, 643 (1964), 390 P.2d 412 (Cal. 1964), (citations omitted), appeal dismissed, 379 US 133, 85 S. Ct. 278 (1964).

⁷Currently, 26 U.S.C.A. §§665-668 (throwback rules) and 671-679 (grantor trust rules).

⁸ 1 A.L.R.2d 1283 (1948)." Blackburn, Unique Alabama Trust and Estate Income Tax Rules Create Traps for Alabama Lawyers, 60 ALLAW 249 (July, 1999).

⁹Referred to as "DNI" rules herein.

¹⁰Revenue Act of 1913 § 11B, 38 Stat. 114.

¹¹See, e.g. *Weigel v. Commissioner*, 34 B.T.A. 237; 96 F.2d 387 (7th Cir.); 141 ALR 1055, 1059-1064 (1941).

¹²Blackburn, *supra*, Note 8.

¹³Id.

¹⁴See, e.g., *Durkheimer v. Commissioner*, 41 B.T.A.

585 (1940); *Wilcox v. Commissioner*, 43 B.T.A. 931 (1941), following Durkheimer; *Whitaker v. United States*, 44 F. Supp. 484 (1941); *Frazer v. Driscoll*, 46 F. Supp. 838 (1942); and *Norris v. United States*, 48 F. Supp. 673 (1943).

¹⁵The beneficiary would typically be a nonresident of the trustee's state of residence. See *infra*, Note ¹⁶*Id.*

¹⁷*Cook v. Tait*, at 265 U.S. 47, 55 (1924) (stating, "the native citizen who is taxed may have domicile, and the property from which his income is derived may have situs, in a foreign country and the tax be legal-- the government having power to impose the tax"). Also see *infra*, *Maguire*, Note 19.

¹⁸*Commissioner v. Simmon*, 198 N.E. 741 (1935). See Ferrell, *State Taxation of Income Accumulated in Trusts*, 51 ABAJ 566 (June 1965).

¹⁹In *Maguire v. Trefry*, 253 U.S. 12 (1920), the Supreme Court held that the state of a beneficiary's residence could tax the beneficiary on distributions of current trust income irrespective of its source. *Maguire* involved current income distributed to the beneficiary, not accumulated income as in *Simmon* and *McCulloch*.

²⁰There are Constitutional "realization" issues in taxing a beneficiary prior to actual distribution, assuming the beneficiary cannot control distribution. If the beneficiary controls distribution, constructive receipt satisfies realization. See *Commissioner v. Glenshaw Glass*, 348 U.S. 426, 75 S. Ct. 473 (1935),

²¹*Traynor, supra*, Note 4. See also, *Mercantile-Safe Deposit & Trust Co. v. Murphy*, 203 N.E.2d 490 (N.Y. 1964); *Pennoyer v. Taxation Division Director*, 5 N.J. Tax 386 (N.J. Tax Ct. 1983); and *Potter v. Taxation Division Director*, 5 N.J. Tax 399 (N.J. Tax Ct. 1983). Again "power" to collect tax is an essential element of jurisdiction to tax. *Traynor* recognized there was no personal jurisdiction, i.e. no power to collect the tax from a nonresident trustee.

²²Again, *Traynor* was analyzing circumstances in which the trustee, settlor, and beneficiary lived in different states, and trust income was accumulated, not distributed.

²³See *supra* Note 7.

²⁴Among the earliest cases establishing grantor trust principles were *Corliss v. Bowers*, 281 U.S. 376 (1930), *Helvering v. Horst*, 311 U.S. 112 (1940), and *Helvering v. Clifford*, 309 U.S. 331 (1940).

²⁵See *infra*, Note 24.

²⁶*Traynor* at 275, *supra*, Note 4. (Emphasis added).

²⁷*Traynor, supra* Note 4, at .

²⁸See *supra*, note 18.

²⁹ *Traynor* at 281, *supra* Note 4. (footnote

omitted). *Simmon* is discussed *supra*, Note 18 and accompanying text.

³⁰*McCulloch v. Franchise Tax Bd.*, 390 P.2d 412, 417 (Cal. 1964).

³¹See *supra*, Note

³²*Supra*, Note 26.

³³Ultimately, *Traynor* capped the throwback period at five years, i.e. if the accumulation period exceeded five years, the income would be averaged over the five year period immediately preceding the distribution. See *infra*, Note 47.

³⁴See *infra*, Note 34

³⁵"The validity of such a tax would depend largely upon the theories with regard to the nature of capital and income. Thus, in *Commissioner v. Simmon*, the Massachusetts Supreme Court held invalid an income tax regulation making accumulated income taxable to the resident beneficiary when received from a nonresident trustee on the ground that such accumulated income constituted 'capital' and not 'income' in the hands of the beneficiary." *Id.*, at 281 (footnote omitted). *Simmon* is discussed *supra*, Note 18.

³⁶Professor *Traynor* also raised the concern that taxation of a lump sum on distribution would throw income into higher brackets than imposition of an annual tax on smaller, annual income. *Id.* at 280-81. Taxing income pro rata over the accumulation period, as was done in *McCulloch*, is required by the California statute. *McCulloch v. Franchise Tax Bd.*, 390 P.2d 412, 417 (Cal. 1964).

³⁷See *infra*, Note 47.

³⁸See *supra*, Note

³⁹Absence of "power" to compel payment from the nonresident trustee equates to lack of in personam jurisdiction over such nonresident trustee.

⁴⁰ See *infra*, Note 47, Cal. Rev. and Tax Code, §17745 (a), (c), and (d).

⁴¹*Glenshaw Glass, supra*, Note

⁴²*Infra*, Note 47.

⁴³See discussion of *Simmon, supra*, Note 18 and accompanying text.

⁴⁴Cal. Rev. and Tax Code, §17745(c).

⁴⁵*Infra*, Note 48. For comparison, see 26 U.S.C.A. §667. Treatment of amounts deemed distributed by trust in preceding years.

⁴⁶*Supra*, Note 35.

⁴⁷*Supra*, Note 6.

⁴⁸Cal. Rev. & Tax Code §§ 17742-17746 (West 1994) applied generally to taxation of trusts and beneficiaries.

⁴⁹Though the *McCulloch* opinion doesn't mention availability of the credit, §18005 provides a credit to the beneficiary for taxes the trustee paid on the same income to its state of domicile, thereby properly minimizing taxation of the same income by two different states as required by the negative

sweep of the commerce clause. See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

⁵⁰*McCulloch v. Franchise Tax Bd.*, 390 P.2d 412, 414-15 (Cal. 1964). The testamentary trust was formed and administered under the laws of the state of Missouri under the will of a Missouri decedent with a Missouri trustee.

⁵¹CAL. REV. & TAX. CODE §§ 17742 et. seq. (West 1994). See *supra*, Note 47.

⁵²*McCulloch*, 390 P.2d at 415.

⁵³*Id.* The Section 17745 throwback provisions taxed the beneficiary upon distribution of accumulated income from the Missouri trustee.

⁵⁴See *supra*, Note 18.

⁵⁵See *supra*, Note 6.

⁵⁶*Infra*, Note 58.

⁵⁷See *supra*, Note 47.

⁵⁸J. Hellerstein & W. Hellerstein, *State Taxation* (2005), ¶ 20.09, states as follows: "Finally, the California Supreme Court relied on the presence of an in-state beneficiary to sustain the state's power to tax a trust, created by a nonresident decedent and administered outside the state, on income it was accumulating for the in-state beneficiary. The trust, which was administered in Missouri, had failed to pay taxes to California on the accumulated income, and, upon distribution of the accumulated income to the beneficiary, the beneficiary became liable for the trust's tax." (Emphasis added). Again, the beneficiary did not "become liable for the trust's tax" as it would have if the statute had actually provided for a "transferee tax." Instead, the beneficiary became liable for the beneficiary's own tax on income passed-through from the trust and thrownback over the accumulation period.

⁵⁹*McCulloch*, 390 P.2d at 416. "Since the trust failed to pay this state's tax upon its annual income, *California can constitutionally tax the beneficiary* at the time he receives the accumulated income; ..." *Id.* at 414-415 (emphasis added).

⁶⁰*Id.* at 415. The statute was the predecessor of the federal "throwback rules" imposing a tax directly on the beneficiary at the time of distribution. See e.g. Int. Rev. Code of 1954, §665. California's very unique tax on the beneficiary of a trust is not a transferee tax provision. In actuality, it is merely a new direct tax on the trust beneficiary as the result of trust income being distributed, i.e., "transferred to," and taxed directly to such beneficiary. For typical transferee tax liability, see e.g., §26 U.S.C.A. 6901 (Transferee of property is liable for Transferor's unpaid income and/or transfer taxes plus a pro rata portion of any interest owed by Transferor thereon to the extent of FMV of property received from the Transferor.)

⁶¹Cal. Rev. & Tax Code, §17745(a), "... such income shall be taxable to the beneficiary when

distributable to him."

⁶²Although the statute ostensibly undertook to initially tax the foreign trustee on its undistributed annual income in 1946, 1947, 1948, 1949 and 1950, both the statute and the Supreme Court of California ultimately placed the real tax burden on the California beneficiary. The opinion did not require the beneficiary to pay the trust's tax or associated interest for late payments back to 1946.

⁶³For example, the State of Alabama adopted federal grantor trust rules for the first time in 2006. However, Section 679 was not modified in anyway to redefine "foreign" in terms of the State of Alabama's jurisdictional needs as contrasted with the United States' definition of "foreign" for purposes of its jurisdictional needs. See *infra*, Note 68.

⁶⁴Statutory jurisdictional concepts are frequently based on "place of organization" and/or "presence." U.S. jurisdictional concepts in international taxation are generally based on "place of organization." See, e.g. §7701, *infra* Note 68. Given the very different breadth available under "due process" minimum contacts standards for states to exercise jurisdiction over persons, state definitions would normally be based more broadly on Constitutional "presence" of the trustee in their state, being mindful of the real, not the imagined, parameters of "minimum contacts."

⁶⁵*Supra*, Note 7.

⁶⁶26 U.S.C.A §665(c) Exception for accumulation distributions from certain domestic trusts.--For purposes of this subpart--(1) In general.--In the case of a qualified trust, any distribution in any taxable year beginning after the date of the enactment of this subsection shall be computed without regard to any undistributed net income. (2) Qualified trust.--For purposes of this subsection, the term 'qualified trust' means any trust other than--(A) a foreign trust (or, except as provided in regulations, a domestic trust which at any time was a foreign trust), or(B) a trust created before March 1, 1984, unless it is established that the trust would not be aggregated with other trusts under section 643(f) if such section applied to such trust.

⁶⁷Obviously if a settlor, trustee or beneficiary has "minimum contacts" with a jurisdiction thereby satisfying due process requirements and state taxes do not violate the negative sweep of the Commerce Clause, states are empowered to tax such nonresident persons. U.S. CONST. amend. XIV, § 1; *Quill*, 504 U.S. at 309. See U.S. CONST. art. I, § 8, cl. 3; *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, (1824) (recognizing the negative power of the Commerce Clause).

⁶⁸See, e.g. 26 U.S.C.A. § 667(d) Special rules for

foreign trust.--(1) Foreign tax deemed paid by beneficiary.--(A) In general.--In determining the increase in tax under subsection (b)(1)(D) for any computation year, the taxes described in section 665(d)(2) which are deemed distributed under section 666(b) or (c) and added under subsection (b)(1)(C) to the taxable income of the beneficiary for any computation year shall, except as provided in subparagraphs (B) and (C), be treated as a credit against the increase in tax for such computation year under subsection (b)(1)(D).

⁶⁹ 26 U.S.C.A. §665(c); 26 U.S.C.A. § 7701--

(a) (1) Person.--The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation;

(a)(30) United States person.--The term "United States person" means--

(E) any trust if--

(i) a court within the United States is able to exercise primary supervision over the administration of the trust, and

(ii) one or more United States persons have the authority to control all substantial decisions of the trust.

(a)(31) Foreign estate or trust.--

(B) Foreign trust.--The term "foreign trust" means any trust other than a trust described in subparagraph (E) of paragraph (30).

⁷⁰In 2005 domestic trusts paid the maximum 35% rate applicable to individuals on taxable income in excess of \$10,050. 26 U.S.C.A. §1(e).

⁷¹*Supra*, Note 68.

⁷²*Supra*, Note 65. Again, if the grantor was a U.S. person, then the grantor would be subject to tax under the grantor trust rules of §679.

⁷³*Chase Manhattan Bank v. Gavin*, 249 Conn. 172, 733 A.2d 782 (Conn. 1999) (referenced in this

article as "Gavin")

⁷⁴Blackburn, *supra*, Note 1.

⁷⁵ See *supra*, Note 63.

⁷⁶ See *supra*, Note 47.

⁷⁷ See *supra*, Note 68.

⁷⁸ Blackburn, *supra*, Note

⁷⁹ See *supra*, Note 50.

New Membership Status

Georgia, Maryland, and West Virginia all moved from being associate members to sovereignty members as of July 1, 2007. Indiana, which hasn't been active with the Commission for years, joined as an associate member as of July 1, 2007.

Only A Name?

Trade mark Royalties, Nexus and Taxing That Which Enriches: Part 2

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I. The Business Situs Rule For Taxing Intangibles:

A. Quill Does Not Establish a Physical Presence Income Tax Nexus Rule

The thesis of this article, stated in the previous edition of this journal, is that the business situs rule for taxing income received from intangibles satisfies the Commerce Clause nexus requirement as applied to royalties and other income received by a trade mark licensor from its affiliated licensees. The business situs of a trade mark is wherever the trade mark is used.¹

In *Quill*, the Supreme Court reaffirmed the Commerce Clause physical presence use tax collection nexus standard it had previously established in *Bellas Hess*.² The Court made clear that it had never applied the physical presence standard to any tax other than use tax collection.³ The Court did not make this declaration in a jurisprudential vacuum. Rather, the Court's dicta regarding other taxes is an implicit recognition that the Court has consistently ruled that the business situs rule satisfies federal constitutional requirements for state taxation of intangibles or income derived from intangibles, precisely because intangibles cannot be said to have a physical presence anywhere. A number of decisions dating back to 1903 illustrate this finding.

In *Louisville & Jeffersonville Ferry Co. v. Kentucky*, 188 U.S. 385 (1903), the Due Process Clause barred Kentucky from imposing franchise tax on value of license granted by Indiana to Kentucky corporation to operate a ferry over the Ohio River from Indiana to Kentucky as Indiana was the business situs of the license. In *Wheeling Steel Corporation v. Fox*, 298 U.S. 193 (1936), the Court found

that West Virginia's ad valorem property tax on accounts receivable and bank deposits of a Delaware corporation did not violate Due Process Clause as West Virginia was the business situs of the intangibles. In *Whitney v. Graves*, 299 U.S. 366 (1937), the Court upheld New York's tax income derived from sale by non-resident of membership in New York Stock Exchange as New York was the business situs of the license. In *First Bank Stock Corp. v. Minnesota*, 301 U.S. 234 (1937), a Delaware corporation was properly subject to Minnesota's ad valorem property tax on value of stock in banks chartered in Montana and North Dakota as Minnesota was the business situs of the stock. In *Wisconsin v. J.C. Penney*, 311 U.S. 435 (1940), Wisconsin's Privilege Dividend Tax properly applied to dividends declared and paid outside of state by foreign corporation doing business in Wisconsin was upheld. In *International Harvester Co. v. Wisconsin Department of Taxation*, 322 U.S. 435 (1944), the same decision applied.

A corollary of this thesis is that the business situs rule as so applied is fully consistent with the Supreme Court's decision in *Quill*. There are at least four arguments to support this thesis.

1. Nothing in *Quill* can fairly be read as overruling the Court's business situs jurisprudence for the taxation of intangibles. Indeed, the opinion never mentions this jurisprudence at all. It is hornbook law that the Supreme Court does not normally overturn earlier authority sub silentio.⁴ That business situs taxation of intangibles satisfies the Due Process Clause is beyond dispute.
2. Notwithstanding that a number of the Supreme Court's business situs cases

involved taxpayers who had real estate and/or tangible property in the taxing state, the Court has explicitly declared that the presence of real estate and/or tangible property is of no constitutional significance. However, the Court ruled that the owner need not have real estate or tangible property within the state in order to subject its intangible property within the state to taxation.⁵

3. Although the Supreme Court's business situs jurisprudence is grounded in the Due Process Clause, it is noteworthy that the Supreme Court located its comments regarding the lack of a physical presence requirement for taxes other than use tax collection in the Commerce Clause portion of the *Quill* opinion.⁶ Consequently, the Court's Commerce Clause physical presence nexus rule for use tax collection was consciously informed – and limited – by its reference to a contrary rule for other taxes, including the business situs rule for taxing intangibles.
4. There is nothing in *Quill* that requires, or even suggests, that the Commerce Clause nexus test must be identical for all taxes.

One commentator has noted that the *Quill* Commerce Clause nexus test is neither higher nor lower than the due process test; it is merely different because the two tests reflect different constitutional values and concerns.⁷ Similarly, the Commerce Clause nexus test itself should not be identical for all taxes, because a "one size fits all" physical presence test does not reflect material differences in the nature of each tax and the characteristics of the asset or income being taxed. Such differences render a physical presence Commerce Clause nexus test entirely unworkable as applied to the taxation of intangibles or the income derived therefrom.

Arguably, the unique burdens of use tax collection justify a restricted physical

presence Commerce Clause nexus test for use tax collection. Those burdens are simply inapplicable to a tax imposed directly on the income derived from intangible property. In contrast, the unique nature of intangibles – that they have no physical presence anywhere – demonstrates that a physical presence test for taxing income from intangibles would be entirely inappropriate. Indeed, such a test would be oxymoronic.

The physical presence test is not without its critics, even as applied to use tax collection. Justice White was of the view that nexus is properly analyzed exclusively under the Due Process Clause, and that any consideration of burdens should be separately addressed under the Commerce Clause. Taking Justice White's position a step further, one commentator has urged that, in lieu of a physical presence nexus test, the Court should adopt a balancing test similar to that used in Commerce Clause regulatory cases – whether the nature and extent of the burdens imposed on interstate commerce outweighs the state interests furthered by requiring out-of-state sellers to collect the use tax.⁸

The Supreme Court has declared, in the context of defining appropriate due process standards for personal jurisdiction over an out-of-state litigant, that:

"...it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted."⁹

In ruling that an individual who "purposefully avails" himself of a forum state's markets thereby subjects himself to suit in that state arising out of those activities, the Court recognized that "courts must not be blind to what all others can see and understand."¹⁰ A number of state courts, in ruling that economic presence establishes income or franchise tax nexus, have also acknowledged the realities of modern commercial life in rejecting a physical presence nexus standard.

"[W]e believe that the Bellas Hess physical-presence test ... makes little sense in today's world. ... The development and proliferation of communication technology exhibited ... by the growth of electronic commerce now makes it possible for an entity to have a significant economic presence in a state absent any physical presence there."¹¹

In affirming the constitutionality of the business situs rule for the taxation of intangibles, the Supreme Court was not "blind to what all others can see and understand." Indeed, in acknowledging that a taxpayer need not have any real and/or tangible property in a state and still be liable for tax on account of the intangibles used by his business in that state,¹² the Court has explicitly seen and understood the unique nature of intangibles that justify economic presence as the appropriate Commerce Clause nexus standard -- intangibles have no physical presence upon which to base nexus. Although the focus of this article is on trade mark holding companies, the principles enunciated here have equal force when applied to income derived from other forms of intellectual property, such as copyrights or patents.¹³ The business situs rule for the taxation of income from intangibles therefore satisfies the Commerce Clause nexus test as applied to the income received by a trade mark licensor from its affiliates.

B. Ramifications of the Business Situs Rule As Applied to PICS

As asserted above, the physical presence Commerce Clause nexus rule is inappropriate as applied to the state taxation of income received by a PIC from its affiliates. Rather, the business situs rule is the appropriate Commerce Clause nexus test, as it is for the taxation of all income from the licensing of intangibles. Consequently, a PIC that receives income from an affiliate has Commerce Clause nexus with all states in which the affiliate uses the intangible property in its business operations.

Having said that, the question remains – what is the correct apportionment formula to apply to the income of PICs? This is a critical question, because an inappropriate apportionment rule will encourage precisely the same tax avoidance techniques as does an inappropriate physical presence nexus rule.

The business income of a multistate business is apportioned for state tax purposes among all the states in which it operates.¹⁴ Business income is defined in UDIPTA as;

[I]ncome arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.¹⁵

Clearly, the income received by a PIC from its affiliates constitutes business income within the meaning of UDIPTA.

The UDITPA rule for the apportionment of the business income of a multistate business is to multiply the business income by the sum of the sales factor, the property factor, and the payroll factor divided by three. The property, payroll, and sales factors are each a fraction, the numerator of which is each factor in the taxing state during the relevant period and the denominator of which is the total factor everywhere.¹⁶

The problem with applying the typical equally-weighted three factor apportionment formula to the income of a PIC is that doing so would not reflect the extent of the PIC's business activity in the state, thereby perpetuating the very tax avoidance planning that the creation of the holding company was designed to foster in the first place. An illustration will explain.

Assume that Retail Corp. creates a wholly-owned affiliate, Hold Co., located in the State of Michigan, which does not tax royalty income.¹⁷ Retail Corp. assigns its trade marks,

its Michigan real and personal property and its Michigan employees to Hold Co., in return for Hold Co.'s stock. That Hold Co. actually operates Retail's Michigan stores, plus its ownership of substantial property in Michigan, makes it highly unlikely that a state could disallow the deductions taken by the affiliates on the ground that Hold Co. lacks economic substance or business purpose. Similarly, the addback statutes generally do not require addback when the formation of the PIC had a substantial business purpose and economic substance.¹⁸ After the transaction, Hold Co. owns property valued at \$10,000,000 and has total payroll of \$7,000,000, all located in the State of Michigan. Hold Co. owns and operates Retail's Michigan stores and owns all of Retail's trade marks.¹⁹

Assume further that Hold Co. receives a total of \$20,000,000 in income in Year 1, \$1,000,000 of which consists of royalties paid by the affiliate in State X for use of the trade marks. The amount of royalties paid is equal to 4% of the net retail sales made by the affiliate. Under an equally-weighted three factor apportionment formula, the amount of royalty income apportioned to State X is \$180,180, notwithstanding that the actual royalty income from the State X affiliate is \$1,000,000.²⁰

The disparity is created by the fact that Hold Co. has no property or payroll in State X to be included in the property and payroll factors. Using a three-factor apportionment formula in this context allows Hold Co. to shift 82% of its State X-sourced royalty income to Michigan, which does not tax it. Similar income shifting would result in every separate entity state in which Retail paid royalties to Hold Co. for the use of the trade marks.

Hold Co.'s business activity in State X would more fairly be represented by use of a single sales factor apportionment formula. The term "sales" in UDITPA means all gross receipts of the taxpayer not allocated to a single state under the statute UDITPA §1(g). It is appropriate to source an apportioned share of Hold Co.'s gross receipts from royalty income derived from trade mark licensing fees to

State X, without regard to Hold Co.'s costs of performance, because the income-producing activity – the licensing of trade marks to Hold Co.'s affiliate for use within State X — takes place wholly in that state.²¹

Section 18(b) of UDIPTA allows a state tax administrator to require the exclusion of any one or more of the factors if the standard apportionment formula does not fairly represent the extent of the taxpayer's business activity in the state.²²

Professor William J. Pierce, the drafter of UDIPTA, explained the purpose of Section 18;

[Section 18] gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle ... the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.^{23,24}

Under UDIPTA, a departure from the standard apportionment formula requires the presence of two elements. First, the statutory formula as a whole must be shown to not fairly represent the extent of the taxpayer's business in the state; it is insufficient to show that only one factor fails to meet this standard in order to invoke Section 18. Second, the alternative apportionment method must be reasonable.

Clearly, the standard three factor formula as a whole does not fairly represent the extent of Hold Co.'s business activity in State X. Although Hold Co. derives substantial royalty income from State X, only a fraction of that income is reported to State X, because Hold Co.'s property and payroll factors in State X are "de minimis compared to the sales factor in both amount and significance in terms of [its] business activity" in the state.²⁵

In addition, it is reasonable for a state tax administrator to require the holding company to use a single sales factor apportionment formula in order to avoid the distortion of income that would result by allowing the company to apportion its income on the basis of the standard three-factor formula. The constitutionality of single sales factor apportionment was upheld in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978). A number of states have adopted the single sales factor formula as the standard apportionment formula. This practice has been severely criticized as poor tax policy, because when it is used in conjunction with the provisions of PL 86-272, it both encourages businesses that sell tangible personal property to locate in tax haven states while substantially reducing the tax base in the market states. This issue is beyond the scope of this article.²⁶

Reasonableness, in the context of UDITPA, has at least three components.²⁷

- (1) The division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of taxpayer's income.²⁸
- (2) The division of income does not create or foster lack of uniformity among UDITPA jurisdictions.²⁹
- (3) The division of income reflects the economic reality of the business activity engaged in by the taxpayer in State X.³⁰

Use of a single sales factor apportionment formula in the above hypothetical would result in precisely 100% of the State X-source royalty payments being apportioned to State X.³¹ The same would be true in every separate entity state in which Retail paid Hold Co. royalties for the use of the trade marks.

It is in the interest of all the separate entity states in which Retail has retail stores to use a single sales factor apportionment formula to apportion Hold Co.'s royalty income. Conversely, Michigan is indifferent to the issue,

because it does not tax the royalty income. Use of the single sales factor apportionment formula therefore neither creates nor fosters a lack of uniformity.

Hold Co.'s business activity in State X is limited to the receipt of royalty income for the use of its trade marks. It has neither employees nor property in the State. The single sales factor apportionment formula perfectly reflects the economic reality of its business activity in State X.

Use of the single sales factor apportionment formula therefore results in apportioning 100% of a PIC's royalty income received from an affiliate in a given state to that state, rather than to a tax haven state that had nothing to do with the retail sales that produced the royalty income. Use of the single sales factor apportionment formula is the appropriate formula to fully effectuate the business situs Commerce Clause nexus rule for PICs.

II. PROPOSED FEDERAL LEGISLATION

[Editor's Note: Since Mr. Laskin's article was submitted for publication in March, Senators Schumer and Crapo have introduced S 1726, The Business Activity tax Simplification Act of 2007.]

Notwithstanding the conceptual incongruity of a physical presence nexus rule for the taxation of intangibles, in recent years bills have been introduced in Congress, the latest is S 1726, the Business Activity Tax Simplification Act of 2007, introduced on June 28, 2007, by Senator Schumer (NY) and Crapo (WY), that, if enacted, would impose such a requirement on a wide range of taxes in addition to use tax collection.

The principal features of the physical presence nexus bills are as follow. First, the Act would impose a physical presence nexus standard for other business activity taxes (BAT), in addition to net income taxes. The term "other business activity tax" is defined broadly to include;

- A tax imposed on or measured by gross

- receipts, gross income, or gross profits.
- A business and occupation tax.
- A franchise tax.
- A single business tax or a capital stock tax.
- Any other tax imposed by a State on a business measured by the amount of, or economic results of, business or related activity conducted in the State.

In addition, the Act would extend the protection of P.L. 86-272 to income derived from services and intangibles.³²

Finally, the Act contains a number of “carve outs” that would allow a business to maintain substantial physical presence in a State and still be immune from business activity tax in that State. For example, a corporation could engage in business activities within a State for up to 15 days in a taxable year without creating business activity tax nexus. The corporation can exceed the 15 day rule if it uses an agent (other than an employee) to establish and maintain a market in the State, as long as that agent performs business services in the State for any other person during the taxable year. There is no requirement that the “other person” be unaffiliated with the corporation.

The fiscal impact of the Act on the states would be substantial. The National Governors Association estimates that the Act would reduce business activity tax revenues by an average of 10.4%, costing states and localities \$6.6 billion annually.³³ The Congressional Budget Office (CBO) estimates that, if H.R. 1956, the predecessor bill to S 1726, were enacted, federal revenues would increase by \$106 million in 2007, by \$1.2 billion over the 2007 – 2011 period, and by \$3.1 billion over the 2007 – 2016 period, as a result of reduced federal corporate income tax deductions for state and local taxes. Conversely, the CBO estimates that state and local governments would lose more than \$1 billion in the first year after H.R. 1956 was enacted. This amount would rise to about \$3 billion annually by 2011. While the CBO’s estimated revenue losses are less than the NGA’s, they still “far exceeds the

threshold established in UMRA (the Unfunded Mandates Reform Act).”³⁴

In its analysis of the Act, the Congressional Research Service (CRS) concluded that it would lead to more “nowhere income,” which results from states using different apportionment formulas and nexus rules. This creates opportunities for a multistate business to avoid state income tax through tax planning. CRS reports that if the Act is enacted, exceptions to its physical presence standard, notably the physical presence rule and the expansion of P.L. 86-272 to services and intangibles, “would ... expand the opportunities for tax planning and thus tax avoidance and possibly evasion.”³⁵

There is little doubt that Congress has the power under the Commerce Clause to enact a physical presence business activity tax nexus standard.³⁶ But the wisdom of imposing such a standard in the modern economy is highly questionable. As one commentator has noted regarding the current physical presence nexus standard for sellers of tangible personal property imposed by P.L.86-272;

“Current rules for determining income tax nexus fail miserably. P.L. 86-272 has been justified as needed to limit extra-territorial taxation and interference with interstate commerce, but it has no conceptual foundation. Instead it reflects the exercise of raw political power and prevents the assertion of nexus by states that should be able to collect income tax from corporations deriving income from within their boundaries.”³⁷

Proponents of the Act often assert that it is inequitable for a state to tax an out-of-state business in the absence of physical presence, because such a business derives no benefit from governmental services provided by its market states. According to Arthur Rosen:

“The underlying principle of this legislation is that states and localities that provide benefits and protections to a business, like education, roads, fire and police protection, water, sewer,

etc., should be the ones who receive the benefit of that business' taxes, rather than a remote state that provides no services to the business. By imposing a physical presence standard for business activity taxes, H.R. 3220 ensures that state tax impositions are appropriately borne only by those businesses that receive such benefits and protection from the taxing state."³⁸

This argument is both conceptually unsound and demonstrably false. The "no benefit" argument is conceptually unsound because it is merely another way of asserting that it is fundamentally unfair for the market states to require the corporation to pay tax in the absence of government services. As such, the argument is grounded in the Due Process Clause and not the Commerce Clause. Due Process centrally concerns the fundamental fairness of governmental activity. The Commerce Clause bars state regulations that unduly burden interstate commerce.³⁹

Whether or not it is "fair" to an individual taxpayer to require it to pay tax to its market states if those states provide it no governmental services is wholly immaterial to whether or not interstate commerce has been unduly burdened. Indeed, even if – as is clearly the case – the market states do provide governmental services to an out-of-state business, the provision of those services, while clearly establishing the fairness of taxing that business, does not reduce the compliance burden imposed on interstate commerce one iota. The "no benefits" argument is merely another way of saying that the State has not given anything for which it can ask return: a classic due process argument. And, after *Quill*, there can be no doubt that a taxpayer has due process nexus with a state if it has purposefully availed itself of an economic market in that state; physical presence is not required.

The "no benefits" argument is demonstrably false because it is clear that the market states **do** provide governmental services to remote business. Proponents of the "no benefits" argument assert that any public benefit

to remote business is at best indirect; the direct beneficiaries being instate businesses and citizens.⁴⁰ In the context of a state's authority to tax a multistate business, any distinction between direct and indirect benefit is of dubious relevance. Be that as it may, the "indirect benefits" argument is predicated on the manifestly false assumption that public benefits are a zero sum game – if residents directly benefit, then non-residents can at most be indirectly benefited.

Remote businesses clearly directly benefit from the public services provided in their market states, as do the residents of those states. Among the services provided to a remote business are a functioning judicial system, a system of publicly built and maintained roads, police and fire protection, and public schools and universities.

First, the existence of a functioning court system directly allows a remote business to enforce its contracts and protect itself from unlawful competition in its market states. Indeed, in the absence of a functioning court system in the market states, any judgment obtained by the remote business in its home state would often be unenforceable. In the digital age, it is highly likely that an intellectual property owner will be obliged to resort to litigation in its market states in order to enforce its rights against numerous unauthorized electronic users of its products.

Second, a functioning system of roads and airports directly allows a remote business to deliver goods to its customers and to send representatives into the state to provide services to those customers.

As is true of public roads, the existence of public police and fire services benefit a remote business by protecting its property, employees and representatives while they are in a market state in the course of business. That these services directly benefit residents do not make them any the less of direct benefit to remote business. Yet the Act would allow remote business to utilize state police and fire services tax free, as long as the business was not in the

state in excess of 15 days per year, or even longer if its activities were entirely within the statutory safe harbors.

Finally, remote business is continually benefited by the existence of a public educational system, including the state university system. The public educational system provides the business with well-educated customers who can afford to purchase the goods or services of the remote business. This directly benefits remote business by providing a market for those goods or services that in turn creates profit for the shareholders. Again, the fact that the customers and employees are also directly benefited by the public educational system in no way detracts from the benefits directly received by remote business through the existence of that system – the public educational system serves both the graduate by making him more employable and business by meeting its need to sell its goods or services.

III. INCOME TAX NEXUS AND ELECTRONIC COMMERCE: SETTING SOME PARAMETERS

A. *Use of Trademarks in Other Than a Physical Location*

In some respects, the PIC cases discussed previously, present a relatively straightforward nexus scenario. In each case, the trade marks were being used at a store, a paradigmatic physical location. Once it is determined that a PIC has nexus as a result of an affiliate's use of the marks, it is an easy enough matter to determine where that use takes place. But how is nexus to be determined in the case of a business that realizes income entirely through electronic commerce? Where, for example, does a licensor of customized software that is downloaded over the Internet in digital form have nexus? ⁴¹

If the business simply advertises its services or products on a passive website, and offers no opportunities for a customer to contract or pay for those services or products online, nexus would not be created merely as a result of the

creation or existence of the website. At the other extreme, nexus would clearly be created if the business entered into a specific contract with a readily identifiable customer to provide its services or products online. In the case of a licensor of customized software, nexus would exist wherever the contract authorized or allowed the customer to use the software. Finally, an interactive website that allows the general public to pay online for specific digital services or products would create income tax nexus where the customer uses the service or product.

It is of course possible to use a digital product while traveling. As one commentator has observed in the related context of electronic commerce and sales and use taxation; "this difficulty must largely be ignored as a result of practical necessity. The knowledge of the service provider as to the location of origination/termination and of the billing/service address will govern. However the provider records the event for its normal business records undoubtedly will become the default for reporting the transaction even though this reporting may not correspond to the actual facts."⁴² This would include most, if not all, digital sales of canned software, such as virus or spy ware protection programs.⁴³

Objections might be raised that a nexus rule based upon the foregoing analysis unfairly penalizes providers of canned digital products or services, because a seller of the identical products in tangible form would be within the safe harbor of PL 86-272 if it limited its activities to the online solicitation of sales. The proper solution to that problem is to establish uniform minimum nexus standards that would apply to all businesses, irrespective of the form in which they provide their products or services.

B. *Factor Presence Nexus Standard*

A leading scholar advocates an income tax nexus standard based on whether the taxpayer conducts significant amounts of the economic activities that are factors in the state's apportionment formula.⁴⁴ The Multistate Tax

Commission has adopted Professor McClure's reasoning in promulgating its Factor Presence Nexus Standard for Business Activity Taxes.⁴⁵ The MTC's Factor Presence Nexus Standard establishes uniform, objective de minimis nexus standards of \$50,000 in property or payroll, \$500,000 of sales or 25% of total property, payroll or sales before a state can impose a business activity tax.⁴⁶

There is nothing sacred about the specific thresholds suggested by the MTC's Factor Presence Nexus Standard. Furthermore, whatever amounts are initially used to establish nexus can and should be updated regularly for inflation. In the digital age, however, it makes eminent sense to base income tax nexus on exceeding an easily verifiable, uniform economic activity threshold rather than an anachronistic physical presence requirement that is unsuited to the current economy.

IV. CONCLUSION

The Supreme Court got it right in promulgating the business situs rule for taxing intangibles; a state's authority to tax intangibles cannot be limited by considerations of the intangible's non-existent physical location. The business situs rule remains the appropriate nexus standard for taxing income from intangibles, including trade mark royalty income. As *Quill* is limited to use tax collection, the state court decisions that uphold the business situs rule for taxing intangibles were correctly decided. Although Congress has the power to impose a physical presence nexus rule on the state taxation of income from intangibles, such a rule would be completely incongruous in the modern economy. Instead, nexus should be determined by the application of uniform, easily verifiable economic thresholds that would apply irrespective of the form in which the business provides its services or products. Such a rule is the appropriate measure of a state's authority to tax the income of remote businesses that benefit from the public services provided by their market state governments.

(Footnotes)

¹The value of a trade mark "is tied to the underlying business that generates the goodwill associated with the trade marks. ... Goodwill is bound to the business with which it is associated, [T] rademark rights in the United States ... are wholly dependent upon actual use." *Kmart Properties*, 2006 NMCA 26, *27, 131 P. 3d 27, **37, internal citations omitted.

²*Quill*, *supra*, 504 U.S. at 317- 318.

³*Id.*, at 314, 317.

⁴*Shalala v. Illinois Council on Long Term Care, Inc.*, 529 U.S. 1, 18 (2000). *Accord San Remo Hotel v. San Francisco*, 364 F. 3d 1088, 1095 n.2 (9th Cir. 2004).

⁵*Virginia v. Imperial Coal Sales Co.*, 293 U.S. 15, 20 (1934), *quoted in* *Wheeling Steel Corporation v. Fox*, 298 U.S. 193, 213 (1936).

⁶*Quill*, 504 U.S. 298 at 314 and 317 (1992). The discussion of the Commerce Clause begins at page 309 of the opinion.

⁷John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV.319, 372 (2003).

⁸. *Quill*, 504 U.S. 298, 325 – 327 (1992) (White, J., dissenting)..Robert D. Plattner, *Quill: 10 Years After*, 25 STATE TAX NOTES 1017, 1020 (2002).

⁹*Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985).

¹⁰*Id.*, at 486.

¹¹*MBNA America Bank*, 2006 W. Va. LEXIS 132, *27.

¹²See cases cited at n. 106, *supra*.

¹³*Cf.*, *General Motors Corp. v. Arizona Department of Revenue*, 189 Ariz. 86 at 101, 938 P.2d 481 (AZ Ct. App. 1996)

¹⁴UDITPA, §9.

¹⁵UDIPTA, §1(A).

¹⁶UDITPA, §§10, 13, 15.

¹⁷MICH. COMP. LAWS §208.9(7)(c) (2006).

¹⁸The transfer of property to a corporation solely in exchange for the corporation's stock is a tax-free exchange under §351 of the Internal Revenue Code, 26 USC §351.

¹⁹See, for example, ALA. CODE §40-18-35(b) (3) (2005). Those facts are irrelevant to the determination of whether a state has nexus with Hold Co.

²⁰ $(0/\$10,000,000 + 0/\$7,000,000 + \$1,000,000/\$20,000,000)/3 \times \$20 \text{ Million} = \$180,180$

²¹UDITPA §17(a), MTC Reg. IV.17(1).

²²UDUPTA, §18 provides;

If the allocation and apportionment provisions of the Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or

the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (a) separate accounting;
- (b) the exclusion of any one or more of the factors;
- (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

²³William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 *Taxes* 747, 781 (1957).

²⁴Professor Pierce also notes that the standard three factor apportionment formula was designed for manufacturing and mercantile businesses. *Id.*, at 749.

²⁵*Kmart Properties, Inc.*, 2006 NMCA 26, *49, 131 P. 3d 27, **42 (2001).

²⁶For an excellent analysis of the issue, see Michael Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boom to Economic Development or a Costly Giveaway?*, Center on Budget and Policy Priorities (revised September 2005).

²⁷*Twentieth Century-Fox Film Corp.*, 700 P. 2d at 1043.

²⁸*Id.*

²⁹*Twentieth Century-Fox Film Corp.*, 700 P. 2d at 1043.

³⁰*Id.*

³¹ $\$1,000,000/\$20,000,000 \times \$20 \text{ Million}/1 = \$1,000,000$

³²*Id.*, §2(a).

³³NAT'L GOVERNORS ASS'N, *IMPACT OF H.R. 1956, BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2005, ON STATES* (2005), at 1. The NGA also notes that the Act would overrule well-established business activity tax nexus jurisprudence in a number of states, upsetting long-standing precedent in such industries as publishing, interstate trucking, general and customized manufacturing, the sale of distributorships, intellectual property licensing, and the leasing of computer hardware and software. *Id.*, at 8 -15.

³⁴Congressional Budget Office, *Cost Estimate H.R. 1956 2006* (2).

³⁵STEVEN MAGUIRE, *STATE CORPORATE INCOME TAXES: A DESCRIPTION AND ANALYSIS*, CONGRESSIONAL RESEARCH SERVICE (updated May 17, 2006), at 15– 16.

³⁶"The Congress shall have power ... to regulate commerce ... among the several States," U.S. CONST. art. I, §8, cl. 3. In recent years, the

Supreme Court has ruled that Congress exceeded its Commerce Clause authority in enacting statutes that regulate purely local, non-economic activity. *United States v. Lopez*, 514 U.S. 549 (1995) (Gun-Free School Zones Act of 1990); *United States v. Morrison*, 529 U.S. 598 (2000) (Section 13981 of the Violence Against Women Act of 1994). *But see* *Gonzales v. Raich*, 545 U.S. 1 (2005) (Congress' Commerce Clause authority includes the power to prohibit the local cultivation and use of marijuana in compliance with state law). Whatever the limits of the *Lopez/Morrison* line of cases, state income taxation of a multistate business clearly implicates interstate commerce.

³⁷Charles E. McClure, Jr., *Implementing State Corporate Income Taxes in the Digital Age*, 53 NAT'L TAX J. 1287, 1297 (2000).. Congressional Budget Office *Cost Estimate: H.R. 1956* (July 11, 2006), at 2. Tennessee, Texas, and Washington. *Id.*, at 4.

³⁸Testimony of Arthur R. Rosen in support of H.R. 3220, Subcommittee on Commercial and Administrative Law, House Judiciary Committee, May 13, 2004. *See also*, Paul H. Frankel, Hollis L. Hyans & Amy F. Nogid, *supra* note 61, at 229.

³⁹*Quill*, 504 U.S. at 312.

⁴⁰Paul H. Frankel, Hollis L. Hyans & Amy F. Nogid, *supra* note 61, at 229.

⁴¹Customized software, as used here, means and includes programming which results when a user purchases the services of a person to create software which is specialized to meet the user's particular needs.

⁴²Paull Mines, *Conversing with Professor Hellerstein: Electronic Commerce and Nexus Propel Sales and Use Tax Reform*, 52 *Tax Law Rev.* 581 at 602, n.117 (1997).

⁴³Canned software, as used here, means and includes programming that has general applicability and/or has not been prepared at the special request of the purchaser to meet his particular needs. It is sometimes known and/or described as "pre-written programming."

⁴⁴McClure, n.163, *supra* at 1296.

⁴⁵[http://www.mtc.gov/uploadedFiles/Multistate Tax Commission/Uniformity/UniformityProjects/Adopted Recommendations/By_Category/FactorPresenceNexusStandardBusinessActTaxes.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/UniformityProjects/Adopted_Recommendations/By_Category/FactorPresenceNexusStandardBusinessActTaxes.pdf) (last visited December 21, 2006).

⁴⁶*Id.*

Growing Number of States Considering a Key Corporate Tax Reform

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I. Introduction

A growing number of states are giving serious consideration to a major reform in their corporate income taxes long advocated by state tax experts. The governors of six states — Iowa, Massachusetts, Michigan, New York, North Carolina, and Pennsylvania — all recommended in 2007, that their states implement this policy, which is known as “combined reporting.” New York enacted combined reporting legislation retroactive to the beginning of 2007 as part of the state’s budget bill for FY2007-08. Michigan included combined reporting in its newly-enacted “Michigan Business tax,” which will take effect in 2008. And West Virginia enacted combined reporting as well, effective with the 2009 tax year.

Most large multistate corporations are composed of a “parent” corporation and a number of “subsidiary” corporations owned by the parent. Combined reporting essentially treats the parent and most subsidiaries as one corporation for state income tax purposes. Their nationwide profits are combined — that is, added together — and the state then taxes a share of that combined income. The share is calculated by a formula that takes into account the corporate group’s level of activity in the state as compared to its activity in other states.

By requiring corporate parents and subsidiaries to add their profits together, combined reporting states are able to nullify a variety of tax-avoidance strategies large multistate corporations have devised to artificially move profits out of the states in which they are earned and into states in which they will be taxed at lower rates — or not at all. These strategies cost the non-combined reporting states billions of dollars of lost corporate

income tax revenue they need to finance essential public services, like education and health care. Households and small businesses, which do not have the opportunities or resources to engage in interstate income-shifting, end up paying higher taxes than necessary to make up for the taxes that large corporations are able to avoid.

II. Growing Consideration of Combined Reporting

Sixteen states — slightly more than one third of the states with corporate income taxes — have mandated and successfully used combined reporting for decades. (**See Figure 1.**) Until recently, however, that group had not expanded at all — not even after the U.S. Supreme Court ruled in 1983 that combined reporting was a fair and constitutional method of taxing multinational (and, by extension, multistate) corporations.

That inertia is now being overcome. Five states have enacted combined reporting legislation in the past three years, and serious consideration of combined reporting is occurring in a number of other states:

- In 2004, Vermont became the first state in more than 20 years to adopt combined reporting, effective in 2006.
- In adopting a new general business tax in 2006 to substitute for its corporate income tax, Texas also mandated combined reporting (effective 2008). Although the new tax differs in significant ways from a traditional income tax, the decision to require combined reporting was based on the same basic understanding that underlies the inclusion of combined reporting in

state corporate income tax structures — that failure to do so gives corporations free rein to artificially shift taxable income out of the state.

- In March 2007, the West Virginia legislature adopted combined reporting, effective with the 2009 tax year.
- As part of the state budget bill approved April 2007, the New York legislature accepted Governor Eliot Spitzer’s recommendation that the state require combined reporting, retroactive to the beginning of 2007.
- In July 2007, Michigan Governor Jennifer Granholm signed into law a new “Michigan Business Tax”. The new tax is a hybrid tax on corporate gross receipts and corporate profits and mandates the use of combined reporting.
- Four other governors — Governor Michael Easley of North Carolina, Governor Chet Culver of Iowa, Governor Deval Patrick of Massachusetts, and Governor Edward Rendell of Pennsylvania — all recommended as part of their FY08 tax and budget packages that their states adopt combined reporting. In Massachusetts, combined reporting remains under consideration by a business taxation study commission that is expected to issue its recommendations before the end of 2007.

There has also been serious discussion or consideration of combined reporting in a number of other states in recent years:

- The 2003 Blue Ribbon Tax Reform Commission in New Mexico recommended that the state adopt combined reporting.¹
- In a November 2003 report, the Florida Senate Committee on Finance and Taxation wrote: “There are several changes in the Florida Income Tax Code that the legislature should consider to prevent further erosion from tax

avoidance strategies by corporations that are taxable under current law: 1. Adopt combined reporting to nullify the use of passive investment companies and other corporate tax avoidance strategies. . . .”²

- In a March 2003 report, the Ohio Committee to Study State and Local Taxes identified combined reporting as a policy option for the state worthy of further consideration. It stated: “Unitary taxation [another term for combined reporting] is a constitutionally sanctioned tax system that treats corporate groups as a single business enterprise for income tax purposes. The result is a more fair tax picture for a business enterprise. This approach reduces many of the tax planning opportunities that affect the current Ohio tax.”³
- Bills to mandate the use of combined reporting were introduced in 2007 legislative sessions in at least two states in addition to the six in which the governor recommended it, Maryland (HB 553/SB 393) and New Mexico (HB 535).

III. Corporate Tax Shelters and the Need for Combined Reporting

Renewed discussion of combined reporting was sparked approximately five years ago by a rash of court cases in which non-combined reporting states sought to nullify an abusive corporate tax shelter to which they are vulnerable. That tax shelter is frequently referred to as the “Delaware Holding Company” or “Passive Investment Company” (PIC). It is based on a corporation’s transferring ownership of its trademarks and patents to a subsidiary corporation located in a state that does not tax royalties, interest, or similar types of “intangible income,” such as Delaware and Nevada. Profits of the operational part of a business that otherwise would be taxable by the state(s) in which the company is located are siphoned out of such states by having the tax-haven subsidiary charge a royalty to the rest of the business for the use of

the trademark or patent. The royalty is a deductible expense for the corporation paying it, and so reduces the amount of profit such a corporation has in the states in which it does business and is taxable. Moreover, the profits of the Passive Investment Company often are loaned back to the rest of the corporation, and a secondary siphoning of income occurs through the payment of deductible interest on the loan. Of course, the royalties and interest received by the PIC are not taxed; Delaware has a special income tax exemption for corporations whose activities are limited to owning and collecting income from intangible assets, and Nevada does not have a corporate income tax at all.

Combined reporting nullifies the PIC tax shelter because the profits of the subsidiary are added to the profits of the operational part(s) of the corporate group, eliminating any tax benefit of shifting profits on paper from the latter to the former. Only Vermont, Texas, New York, and West Virginia chose to address the PIC problem through combined reporting, however. All of the remaining states that enacted legislation to attack PICs chose limited, targeted approaches focusing on just this particular tax shelter. Many of those bills were so watered-down in the legislative process by business objections that there is a real question as to whether they will be effective at all. The answer to this won't be known for several years until state corporate tax audits covering the years when the laws went into effect reveal whether corporations have, as the laws require, stopped deducting their royalty payments to their PICs.⁴

A recent front-page article in the *Wall Street Journal* underscores the need to take a comprehensive rather than piecemeal approach to the corporate tax avoidance strategies to which non-combined reporting states are vulnerable.⁵ The article discusses a tax shelter established by Wal-Mart that is analogous to the PIC but that would not be nullified by the targeted anti-PIC legislation that some states enacted. Indeed, the article revealed that Wal-Mart set up this shelter, known as a "captive Real Estate Investment Trust" (REIT), at approximately the same time it was liquidating its conventional PIC (perhaps because PICs

had become a red flag for state auditors).⁶ Wal-Mart transferred ownership of all its stores to its REIT subsidiary, and the stores paid tax-deductible rent to the REIT for use of the buildings they occupied. As with royalty payments for the use of trademarks, the rent payments had the effect of reducing taxable profits of the stores and shifting the profits to the REIT. Virtually all states effectively treat the REIT as a tax-exempt entity — just as the federal government does. And the other Wal-Mart subsidiary that owned the REIT was only taxable in the state in which it was based, so the states where Wal-Mart's stores were located couldn't reach the REIT's profits when those were passed on in the form of dividends to the REIT's owner, either.

The Wal-Mart REIT example suggests that when the comprehensive solution of combined reporting is available, it is simply not optimal for states to seek to shore-up their corporate income taxes through targeted attacks on specific tax shelters. The case-by-case approach is inferior to combined reporting for at least three reasons:

- Highly-skilled and highly-compensated tax attorneys and accountants are likely to remain at least one step ahead of understaffed state revenue departments in devising new mechanisms multistate corporations can use to minimize their state income taxes in non-combined reporting states. For example, a recent newsletter from the BDO Seidman accounting firm that discussed a (rare) New York State court victory against a PIC assured its clients that:

BDO Seidman can facilitate the replacement of your current Delaware Holding Company with state tax reducing strategies to fit naturally around your business operations. Examples of BDO Seidman's most popular state tax reducing strategies include:

- 197 Strategy,
- Embedded Royalty Company, and

- Effective Use of Transfer Pricing.⁷
- It is labor-intensive, time-consuming, and costly for states to address these problems on a case-by-case basis. For example, after the Wisconsin legislature rejected the 1999 call by former Governor Tommy Thompson to mandate combined reporting, the state revenue department was compelled to engage in a four-year-long (and still ongoing) process of auditing and then negotiating individual agreements with 175 banks to stop tax avoidance based on the use of PICs located in Nevada.⁸
- Some of the targeted legislation aimed at nullifying particular tax shelters that non-combined reporting states are vulnerable to may be subject to legal challenge. Several articles have been written by corporate tax attorneys advising their clients how to attack these laws on the grounds that they discriminate against interstate commerce; a test case in Alabama already went against that state.⁹ In contrast, the legality of combined reporting has been upheld twice by the U.S. Supreme Court.¹⁰

The corporate income taxes of states that do not mandate combined reporting are fundamentally flawed because they permit intra-corporate transactions to affect how much income tax a corporation owes to a particular state. Attacking specific tax shelters that exploit this flaw is akin to treating the symptoms of a disease rather than the underlying defect that causes it.

IV. State Corporate Tax Experts and Newspaper Editorial Boards Support Combined Reporting

In giving serious consideration to combined reporting, states are following advice long offered by state corporate tax policy experts. For example:

- Economist Charles McLure,

Deputy Assistant Secretary of the Treasury Department in the Reagan Administration, has written: "Failure to require unitary combination is an open invitation to tax avoidance. (Or — to the extent transfer prices are misstated — is it tax evasion?) The advent of electronic commerce exacerbates the potential problems of economic interdependence and manipulation of transfer prices."¹¹

- In a recent paper, George Washington University professors David Brunori and Joseph J. Cordes wrote: "Our research shows that requiring combined reporting would help the corporate income tax become a more significant source of revenue. . . The combined reporting requirement would severely limit the ability of corporations to use tax planning techniques such as creating nowhere income and establishing passive investment companies to avoid state corporate tax liability. . . ."¹²
- In an article in the prestigious *National Tax Journal*, Economists William F. Fox, Matthew N. Murray, and LeAnn Luna wrote: "[W]e argue for combined reporting in all states. This conclusion is based in part on economic considerations that are independent of any tax planning opportunities, such as the practical problems associated with measuring economies of scope across related firms. But combined reporting can also lessen tax planning distortions based only on corporate form that waste resources through avoidance and government oversight activities."¹³

Major newspapers have also editorialized in support of combined reporting. For example:

- According to the *Wisconsin State Journal*: "Wisconsin should require combined reporting, which demands that a corporation add together the profits of all subsidiaries in one report so that taxable profits can be attributed to the states where they belong. Seventeen states, including neighboring Minnesota

and Illinois, require combined reporting. It's time for Wisconsin to update its tax laws so that the state budget is not again left with a multi-million-dollar hole.¹⁴

- According to the *Des Moines Register*: "The appropriate tax rate of business certainly is debatable, but everyone should agree those companies should pay the full taxes they owe, and multistate corporations shouldn't have a tax advantage over wholly local corporations. Last year [former Governor] Vilsack proposed combined reporting to lawmakers, but it didn't get anywhere. . . . That's unfortunate. . . . Ensuring taxes are collected by closing a loophole that's unfair to Iowa-based businesses should be a bipartisan no-brainer."¹⁵

V. Combined Reporting Is Primarily About Fairness, Not Revenue

The *Des Moines Register* editorial just cited alludes to an important issue. The primary goal of combined reporting is to create a level playing field for all businesses. It seeks to ensure that large multistate corporations cannot end up paying income tax at a lower effective tax rate than small businesses by subdividing themselves into separate corporations and then manipulating transactions within the overall corporate group.

Because such manipulations appear to be widespread and because combined reporting nullifies their tax effects, most states that have studied the fiscal impact of combined reporting have concluded that its adoption would raise some additional revenue. In states that need new revenue sources, requiring combined reporting could certainly make a modest contribution toward that objective. Most states that have prepared estimates conclude that the adoption of combined reporting would increase corporate income tax receipts on the order of 10 to 25 percent.

If a state is considering combined reporting at a time when it does not need additional revenue, and if it wishes to maintain the

current balance of taxes between businesses and households, it can use the revenue gained from combined reporting to make offsetting changes in other business tax provisions to ensure that the overall impact is revenue neutral. Even if other business tax changes are made to keep combined reporting revenue-neutral in the short run, its adoption will help to preserve the long-run revenue-generating capacity of the corporate income tax by nullifying a wide variety of corporate tax-avoidance techniques.

VI. Combined Reporting and State Economic Development

As is often the case when changes in tax policy are put forward that would have the effect of increasing tax payments by some businesses, the widespread consideration of combined reporting that is now occurring has brought forth warnings from corporate interests that implementing the policy would harm the economic prospects of any state doing so.

In fact, combined reporting states are well-represented among the most economically-successful states in the country. Since 1990, for example, only 10 states that levy corporate income taxes have managed to achieve net positive growth in manufacturing employment. Nine of those ten states — Arizona, Idaho, Kansas, Montana, Minnesota, Nebraska, North Dakota, Oregon, and Utah — had combined reporting in effect throughout the 1990-2006 period. The governor of the tenth state, Iowa, has proposed adoption of combined reporting.

Being the state that has used combined reporting the longest and enforces it most aggressively was not a barrier to California's giving birth to Silicon Valley in the 1990s. The presence of combined reporting has not been a barrier to Intel Corporation's maintenance of its headquarters in California and its decision to place the bulk of its expensive chip fabrication plants in Oregon, Arizona, and Colorado — all combined reporting states. Such anecdotes and the data on manufacturing employment cited above suggest that the burden of proof ought to lie with combined reporting opponents to demonstrate that the policy has a negative

impact on state economic growth.

All state and local taxes paid by corporations represent approximately two to four percent of their expenses on average, and the state corporate income tax represents on average less than 10 percent of that 2-4 percent. A state's decision to adopt combined reporting increases that small corporate tax load only slightly. The potential influence on corporate location decisions of state corporate tax policies is simply overwhelmed in most cases by interstate differences in labor, energy, and transportation costs, which comprise a much greater share of corporate costs than state corporate income taxes do and often vary more among the states than effective rates of corporate taxation. It comes as no surprise, then, that a recent study by economists Robert Tannenwald and George Plesko, which measured interstate differences in overall state and local tax costs for corporations in a particularly rigorous way, found that there was not a statistically-significant (inverse) correlation between those costs and state success in attracting business investment.¹⁶ In other words, higher state and local taxes did not impede business investment.

VII. Making the Transition to Combined Reporting

Adopting combined reporting is a significant change in corporate tax policy and necessitates some effort to educate state personnel and taxpayers alike in the ways in which it differs from the "separate entity" approach to corporate taxation that still prevails in a majority of states.¹⁷ Fortunately, assistance is available to states that wish to make the change to combined reporting from the Multistate Tax Commission. The MTC is an organization of state revenue departments whose members include most of the existing combined reporting states. In recent years, the MTC has promulgated a model statute for the implementation of combined reporting and a model regulation spelling out in considerable detail which corporate subsidiaries do and do not constitute parts of a "unitary business" that therefore must be included in a combined report.¹⁸ The MTC also has a staff of corporate

income tax auditors who audit large multistate corporations on behalf of numerous states simultaneously. They are quite familiar with auditing under combined reporting regimes. A state new to combined reporting could supplement its auditing efforts with MTC auditors as its audit staff familiarizes itself with the new approach. States do not need to be members of the MTC to participate in its Joint Audit Program.

VIII. Conclusion

With six governors simultaneously recommending the adoption of combined reporting and three states enacting it, 2007 could be a breakthrough year in state corporate tax reform efforts. As policymakers in non-combined reporting states ponder their states' ongoing vulnerability to a variety of aggressive corporate tax shelters — such as Wal-Mart's "captive REIT" — and objectively examine the decades-long experience of 16 states with this policy, the number of states requiring combined reporting seems likely to grow.

(Footnotes)

¹New Mexico Blue Ribbon Tax Reform Commission, table of recommendations, available at legis.state.nm.us/LCS/bluetaxdocs/BTRCTableofRecommendations.pdf

²Florida Senate Committee on Finance and Taxation, Why Did Florida's Corporate Income Tax Revenue Fall While Corporate Profits Rose? Available at www.flsenate.gov/data/Publications/2004/Senate/reports/interim_reports/pdf/2004-137ft.pdf

³Report of the Committee to Study State and Local Taxes, March 1, 2003. Available at tax.ohio.gov/channels/research/documents/CSSLT%20Final%20Draft.pdf. The Ohio corporate income tax is scheduled to be phased out.

⁴Some 100 corporations were still deducting royalty payments to PICs more than two years after a Maryland law clamped down on the deductions. See: Kathleen Johnston Jarboe, "Loophole Still Used Even After Closure," Daily Record, May 6, 2006.

⁵Jesse Drucker, "Wal-mart Cuts Taxes by Paying Rent to Itself" Wall Street Journal, February 1,

2007.

⁶According to the article cited in the previous note, Wal-Mart set up its captive REIT structure in the second half of 1996 and liquidated its PIC in February 1997.

⁷BDO Seidman, LLP, State Tax Alert, May 2005.

⁸Paul Gores, "Bankers Fear Doyle Cold Shoulder, Some Still Smarting Over Tax Shelter Issue," Milwaukee Journal Sentinel, November 15, 2006.

⁹See, for example: Thomas H. Steele and Pilar M. Sansone, "Surveying Constitutional Theories for Challenges to Add Back Statutes," web site of the Morrison and Foerster law firm, February 23, 2005. The Alabama case, which was not decided on constitutional grounds, is discussed in Matthew S. Houser, Christopher R. Grissom, and Bruce P. Ely, "Alabama Judge Rules for Jeans Manufacturer in Addback Case," State Tax Notes, January 29, 2007.

¹⁰The cases were Container Corporation of America v. California Franchise Tax Board (1983) and Barclays Bank v. California Franchise Tax Board (1994).

¹¹Charles E. McLure, "The Nuttiness of State and Local Taxes and the Nuttiness of Responses Thereto," State Tax Notes, September 11, 2002, p. 851.

¹²David Brunori and Joseph J. Cordes, "The State Corporate Income Tax: Recent Trends for a Troubled Tax," unpublished paper submitted to the American Institute of Tax Policy, August 15, 2005.

¹³William F. Fox, Matthew N. Murray, and LeAnn Luna, "How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?" National Tax Journal, March 2005.

¹⁴"Heed Warning to Update Tax Laws," Wisconsin State Journal, February 2, 2007.

¹⁵"First, Close Loopholes," Des Moines Register, February 20, 2004.

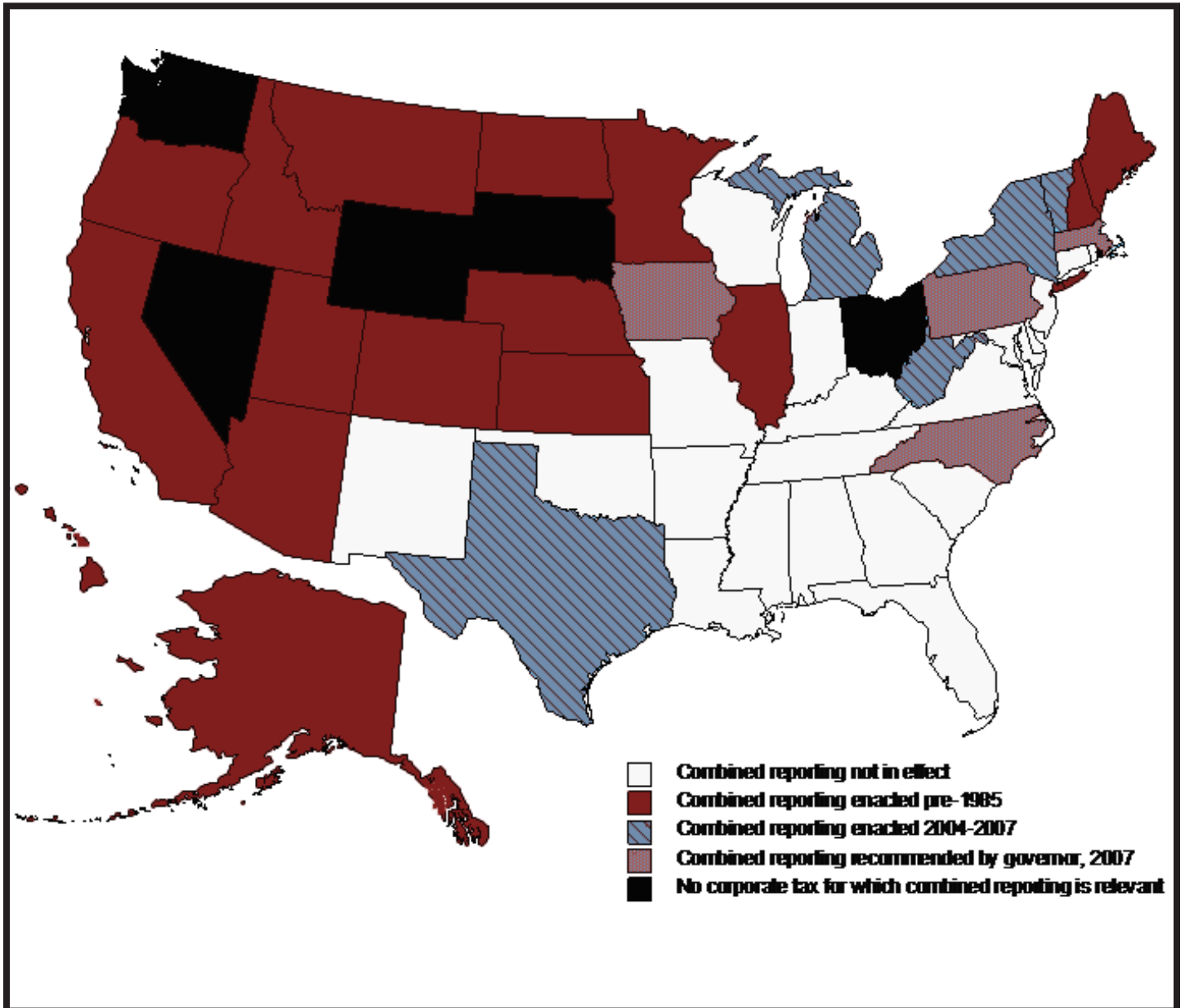
¹⁶George A. Plesko and Robert Tannenwald, Measuring the Incentive Effects of State Tax Policies Toward Capital Investment, Federal Reserve Bank of Boston Working Paper 01-4, December 3, 2001.

¹⁷The key differences between combined reporting and the "separate entity" approach to state corporate income taxation are discussed in Appendix B of Michael Mazerov, State Corporate Tax Disclosure: The Next Step in Corporate Income Tax Reform, February 2007. Available at www.cbpp.org/2-13-07sfp.pdf.

¹⁸The MTC's model combined reporting statute is available at www.mtc.gov/uploadedFiles/Multistate_Tax_Commission. The MTC's model

definition of a "unitary business" for combined reporting purposes is available on pp. 5-14 of the following document www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/

Figure 1
Current Status of Combined Reporting



MTC Training Supports the Professional Development of State Personnel

Ken Beier, Director of Training

Student evaluations have been very positive for all recent MTC training courses: Nexus Schools (in Arkansas, Michigan, Colorado and Connecticut), the corporate income tax course (in Oregon and Oklahoma), sampling courses (in Oklahoma and Louisiana), and computer assisted audit techniques (in Oklahoma).

Additional information on MTC training, including complete course descriptions, scheduled courses, tuition, and registration can be found in the Training Programs page (under Events and Training) of our website at www.mtc.gov.

The objective of **Nexus Schools** is to provide participants with a detailed understanding of the constitutional principles and limitations for establishing nexus for corporate business taxes and sales/use taxes. Participants also learn current investigative approaches and audit techniques, including the types of information used to prove nexus. The primary audience for these classes is state revenue department auditors and attorneys who have had limited exposure to nexus issues, but are not experts in the area.

State and local sales & use tax auditors, supervisors and review section personnel can benefit from the sampling courses – **Statistical and Basic Random Sampling** offered by the MTC. Participants gain understanding of basic random sampling and more sophisticated sampling techniques and how these techniques are used in sales and use tax audits.

The **Corporate Income Tax** course is designed to accomplish two complementary goals: 1) to educate state revenue representatives concerning the basic laws relating to the apportionment of corporate income taxes; and 2) to train state auditors in the application of those laws for purposes of auditing multistate businesses. Part

One (2 days) is for any state revenue employee (lawyer, auditor, policy analyst or other) and can be taken on a stand-alone basis. Part Two (2 days) is primarily for state auditors or those who support state audit work. Part Two students also take Part One of the course.

The **Computer Assisted Audit Techniques** course provides participants with the confidence and skills to conduct an audit using electronic records. The primary audience for this course is state auditors who have a need to process electronic records in an audit environment.

The following training courses are scheduled at this time:

Nexus Schools

October 29-30, 2007 in Nashville, TN
Hotel Deadline: Friday, September 28, 2007

April 8-9, 2008 (tentative) in Baltimore, MD

The MTC encourages states to consider hosting a course—the host state guarantees a portion of the course enrollment and receives a credit against the tuition for its students. Please contact MTC Training Director Ken Beier at 954-630-2540 with any questions about hosting a course or suggestions for training activities.



The Multistate Tax Commission is registered with the National Association of State Boards of Accountancy (NASBA), as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be addressed to the National Registry of CPE Sponsors, 150 Fourth Avenue North, Suite 700, Nashville, TN, 37219-2417. Website: www.nasba.org.

Calendar of Events

Fall Program Committee Meetings

November 5-8, 2007
New Orleans, LA

Winter Program Committee Meetings

March 11-14, 2008
Tucson, AZ

MTC 41st Annual Conference and Committee Meetings

July 27-31, 2008
Santa Fe, NM

For further details of these and future meetings, please visit our website at www.mtc.gov.