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## THE ILLUSORY PROMISE OF ECONOMIC NEXUS

by

*Adam B. Thimmesch*\*

### ABSTRACT

The economic nexus standard has gained significant support during the last decade as the proper standard for determining the scope of states' taxing powers under the Dormant Commerce Clause. Unfortunately, however, despite the widespread acceptance of that standard in the abstract, there is no uniform understanding of what economic nexus actually means. State courts that have adopted that standard have generally failed to explain its parameters, and those few courts that have actually addressed the scope of economic nexus have adopted artificially high standards that severely restrict its reach. Actions by state legislatures and revenue authorities have been much the same. Uncertainty reigns, yet those disparate approaches to the same constitutional standard have yet to receive scholarly attention. This Article seeks to fill that void by analyzing state actions in this area and by evaluating how states' different formulations for economic nexus will likely develop over time. Such an analysis shows that states' economic nexus formulations have little theoretical or jurisprudential grounding and will necessarily change and deteriorate over time. As a result, states' actions in this area will be non-uniform and will maintain the significant uncertainty that currently exists. Federal attention to economic nexus is thus warranted to prevent state actions from undermining the goals of the Dormant Commerce Clause. This Article analyzes several potential federal responses and concludes that Congress should intervene and adopt a federal factor nexus standard based on the Multistate Tax Commission's model formulation.

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\* Assistant Professor of Law, University of Nebraska College of Law. I want to thank Steve Bradford, Brian Lepard, Bill Lyons, and Richard Moberly for their review and comments on prior drafts. All errors and omissions are my own.

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*“Our new constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes!”<sup>1</sup>*

## I. INTRODUCTION

Ben Franklin’s observation about the inevitability of death and taxes is likely known by most. We understand that individuals can attempt to cheat both for short periods of time, but few have illusions of winning the battle altogether. Upon venturing into the corporate world, however, the rules change. Perpetual existence is likely a birthright for a firm.<sup>2</sup> Further, while federal taxation tends to follow any domestic profits, a corporation’s obligations regarding *state* taxation are much less certain. Contrary to Mr. Franklin’s declaration, firms may find that they can generate significant income on which they are not forced to suffer the burden of state taxation. Such firms’ benefactor on this front is the Dormant Commerce Clause and its limitations on state taxing power.

Under the Dormant Commerce Clause, a state can only tax a business that has a “substantial nexus” within it.<sup>3</sup> If a business’s presence in a state falls short of that standard, the state simply lacks the jurisdiction to compel the business to pay its tax. But what is a substantial nexus? How is it generated?

When evaluating state sales and use taxes, the Supreme Court has repeatedly held that the substantial nexus requirement can only be met where

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1. Benjamin Franklin. Letter from Benjamin Franklin to Jean Baptiste Le Roy (Nov. 13, 1789), *in* *Memoirs of Benjamin Franklin* 619 (1834).

2. *See, e.g.*, DEL. CODE. ANN. tit. 8, § 102(b)(5) (2012) (providing a default rule of perpetual existence for corporations formed under Delaware law).

3. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

a taxpayer has a physical presence in the taxing state.<sup>4</sup> The Court has remained silent, however, as to whether this physical presence rule is limited only to those taxes or whether it applies to state business activity taxes, such as corporate income taxes, as well.<sup>5</sup> In the absence of guidance from the Court, commentators have widely lauded an economic nexus standard<sup>6</sup> as the appropriate standard for business activity tax purposes.<sup>7</sup> That standard allows states to tax businesses that do not have a physical presence within their boundaries as long as those businesses have sufficient economic contacts with the state. For example, imagine a software company that has all of its employees, offices, and physical assets located in California. Due to aggressive marketing on the Internet, the business has secured several lucrative contracts with companies in New Jersey. Under an economic nexus standard, New Jersey could tax that business based on its economic connection to the state regardless of its distant physical footprint. Such taxation would not be permissible under a physical presence rule.

Academic support of the economic nexus standard has focused almost exclusively on its permissibility under the Dormant Commerce

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4. *Quill Corp. v. North Dakota*, 504 U.S. 298, 311–13 (1992); *Nat'l Bellas Hess, Inc. v. Dep't of Rev. of Ill.*, 386 U.S. 753 (1967), *overruled by Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

5. “Business activity taxes” refer to taxes that are not transaction based, like sales taxes, but rather are measured by net income, profits, or receipts. They include income taxes, franchise taxes, gross receipts taxes, and business and occupation taxes, among others. The discussion in this Article applies equally to all types of business activity taxes.

6. The use of the term “standard” here does not necessarily imply a subjective standard rather than a rule (although that issue is discussed later herein). The term “standard” in this context merely refers to which economic nexus “test” should govern, whether expressed as a rule or as a standard. For a summary of the conceptual difference between rules and standards and for a good sample of the literature in this area, see Scott Dodson, *The Complexity of Jurisdictional Clarity*, 97 VA. L. REV. 1, 15–20 (2011).

7. See, e.g., Christina R. Edson, *Quill's Constitutional Jurisprudence and Tax Nexus Standards in an Age of Electronic Commerce*, 49 TAX LAW. 893, 942–47 (1995) [hereinafter Edson, *Quill's Constitutional Jurisprudence*]; Michael T. Fatale, *Geoffrey Sidesteps Quill: Constitutional Nexus, Intangible Property and the State Taxation of Income*, 23 HOFSTRA L. REV. 407, 447–52 (1995); Michael T. Fatale, *State Tax Jurisdiction and the Mythical “Physical Presence” Constitutional Standard*, 54 TAX LAW. 105 (2000); Craig J. Langstraat & Emily S. Lemmon, *Economic Nexus: Legislative Presumption or Legitimate Proposition?*, 14 AKRON TAX J. 1 (1999); John D. Sneathen & Andrew A. Swain, *Paying Their Fair Share: The Hidden Lessons of Complete Auto and Quill*, 46 ST. TAX NOTES 749 (December 11, 2007); John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 373–93 (2003) [hereinafter Swain, *A Jurisprudential and Policy Perspective*].

Clause. Only limited attention has been given to defining what economic nexus actually means. This limited attention has resulted in a range of proposals — from a heightened qualitative formulation that requires significant economic exploitation,<sup>8</sup> to a formulation that requires only minimal levels of economic contact,<sup>9</sup> to a federal quantitative standard.<sup>10</sup> What is missing from the literature, however, is a significant discussion about how individual states have defined economic nexus and whether those state definitions are suitable or sustainable.<sup>11</sup>

This Article fills that gap by providing a comprehensive review of states' actions regarding economic nexus and by evaluating how their different formulations will likely evolve over time. Such a discussion will show that state authority regarding economic nexus largely follows the academic literature. That is, state courts evaluating economic nexus have focused nearly all of their energies on justifying their support of that standard. They have given almost no attention to determining what economic nexus means.<sup>12</sup> Further, even where states have adopted particular formulations, they have not acted uniformly. States' formulations have taken both qualitative and quantitative forms, and within those forms, significant variations already exist. This Article shows that those variations will continue and that states' current economic nexus formulations will ultimately suffer from significant erosion.

In light of these problems, a federal economic nexus standard is warranted. Without federal action, the great variety and instability of state formulations will create impermissible burdens on interstate commerce, regardless of the impact of any one formulation. Although such intervention would certainly weaken state taxing autonomy and could be challenged on

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8. Edson, *Quill's Constitutional Jurisprudence*, *supra* note 7.

9. Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7.

10. Charles E. McLure, Jr., *Implementing State Corporate Income Taxes in the Digital Age*, 53 NAT'L TAX J. 1287, 1295–97 (2000) [hereinafter McLure, *Implementing*].

11. *But see* Julie Roman Lackner, Note, *The Evolution and Future of Substantial Nexus in State Taxation of Corporate Income*, 48 B.C. L. REV. 1387 (2007) (providing a limited overview of the variety of state judicial economic nexus formulations at the time). This note provides a good positive analysis of the various judicial formulations that had been announced through 2007, but further work is obviously required. This Article thus discusses the additional judicial standards that have been adopted since that time, reviews the states' legislative approaches to economic nexus, analyzes how those judicial and legislative approaches will develop over time, and provides a normative assessment of economic nexus.

12. Further, the few economic nexus formulations that states have adopted have yet to be reviewed by the Supreme Court, which has maintained indifference towards this issue for nearly twenty years. *See infra* Part II.B.1 (listing a series of economic nexus cases in which the Supreme Court has denied certiorari).

federalism grounds, it would infringe on state authority in a way that is limited to the federal interests underlying the Commerce Clause. Federal regulation in this area would intervene at a jurisdictional level and would leave states free to adopt varying substantive taxing structures to serve their local interests.

This Article offers and evaluates four potential approaches for a federal economic nexus standard and concludes that the best option — considering both tax and constitutional policy — is for Congress to adopt a quantitative standard based on the Multistate Tax Commission’s model formulation. That approach would provide bright-line guidance, comport with normative tax principles, and provide adequate constitutional protection for interstate commerce.

To form the groundwork for that proposal, Part II of this Article provides a history of the economic nexus standard, from Supreme Court authority to state judicial and legislative actions. Part III then evaluates how states’ current economic nexus formulations will likely evolve without federal intervention. Part IV analyzes four potential federal approaches to the economic nexus standard and determines that Congress should adopt a federal factor nexus standard. Part V briefly concludes.

## II. THE HISTORY OF ECONOMIC NEXUS

The “nexus” concept in state taxation has a long and detailed history. However, the modern era of nexus can be traced to the United States Supreme Court’s 1977 enunciation of a four-part test for evaluating state taxes under the Dormant Commerce Clause in *Complete Auto Transit, Inc. v. Brady*.<sup>13</sup> For a tax to be upheld under that test, it must: (1) be “applied to an activity with a substantial nexus with the taxing state;”<sup>14</sup> (2) be “fairly apportioned;” (3) “not discriminate against interstate commerce;” and (4) be “fairly related” to the benefits afforded to the taxpayer by the state.<sup>15</sup> In turn, the concept of economic nexus has developed under the first prong of *Complete Auto*, which explicitly sets forth a “substantial nexus” requirement.

Interestingly, the only real guidance that the Court has provided regarding the substantial nexus requirement has involved use tax collection

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13. 430 U.S. 274, 279 (1977).

14. Less than one month after *Complete Auto*, the Court clarified that this substantial nexus requirement necessitates only a nexus between the taxing state and the taxpayer (or tax collector in the case of a use tax collected by an out-of-state merchant), not the particular activity being taxed. *Nat’l Geographic Soc’y v. Cal. Bd. of Equalization*, 430 U.S. 551, 560 (1977).

15. *Complete Auto*, 430 U.S. at 279, 287. Of course, the *Complete Auto* Court did not create this four-factor test out of whole cloth but simply joined the elements together from the Court’s long history of Commerce Clause analysis. *See id.* at 279.

obligations rather than direct impositions of tax. A use tax is complementary to a state's sales tax. Whereas sales taxes are generally imposed on retail transactions that occur within a state, use taxes are imposed on the use or consumption of taxable property within a state.<sup>16</sup> Such taxes are designed to compensate states for the tax revenues that are lost when taxpayers make purchases without paying sales tax.<sup>17</sup> This occurs, for example, when a person buys an item online — or in a neighboring state — without paying sales tax.<sup>18</sup> Absent a use tax on that person's use of the goods in his or her home state, the person would avoid paying any sales or use tax on that purchase merely by making the purchase online (or across the border).

The principal problem for states with use taxes has been collecting them. It is not practical — or politically expedient — for states to take enforcement actions against individual consumers for small sums.<sup>19</sup> States have thus responded by imposing use tax collection obligations on certain out-of-state vendors (*e.g.*, catalog or internet businesses). Those vendors naturally resist those obligations, often arguing that those requirements violate the Due Process and Commerce Clauses.

The Court upheld one state's collection obligations against those challenges less than one month after *Complete Auto*.<sup>20</sup> In that case, the National Geographic Society argued that the Due Process and Commerce Clauses barred California from requiring it to collect a use tax on sales to California customers because its mail-order business did not have any physical connection to the state.<sup>21</sup> The Court rejected that challenge because one of the Society's other business lines — within the same legal entity — did have a physical presence in California.<sup>22</sup> The Court did not evaluate the case under *Complete Auto*'s substantial nexus prong, but it did hold that the

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16. See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 12.01 (3d ed. 1998 & Supp. 2010) [hereinafter HELLERSTEIN, STATE TAXATION].

17. *Id.* ¶ 16.01[2].

18. Residents of Iowa, for example, can travel to Minnesota to purchase clothing, which is exempt from Minnesota sales tax. MINN. STAT. § 297A.67, subd. 8 (2012).

19. States have attempted to encourage voluntary compliance with their use taxes by putting use-tax remittance lines on their income tax returns. See Nina Manzi, *Use Tax Collection on Income Tax Returns*, 36 ST. TAX NOTES 25 (July 2, 2012) (evidencing that twenty-five states currently provide for use-tax reporting on their states' individual income tax returns). Voluntary compliance in those states appears to be low. *Id.* at 26 (showing that the percentage of income tax returns that actually report use tax due ranges from 0.2 percent to 9.8 percent).

20. Nat'l Geographic Soc'y v. Cal. Bd. of Equalization, 430 U.S. 551, 560 (1977).

21. *Id.*

22. *Id.* at 562.

Society's "continuous presence in California . . . provides a sufficient nexus to justify the State's imposition"<sup>23</sup> of use taxes. That physical presence analysis was consistent with the Court's pre-*Complete Auto* decision in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, which explicitly recognized a physical presence rule under both the Due Process and Commerce Clauses.<sup>24</sup>

*National Bellas Hess* also involved a use-tax collection obligation imposed on a remote vendor. In that case, however, the vendor did not have a physical presence in the taxing state. The Court found that factor to be determinative in upholding the vendor's challenge, noting the "sharp distinction . . . between mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business."<sup>25</sup>

Fifteen years after *Complete Auto* the Court was presented with another of these cases in *Quill Corporation v. North Dakota*.<sup>26</sup> The State of North Dakota's unilateral determination that *National Bellas Hess* was no longer valid law and its adoption of a statute that imposed a use-tax collection obligation on out-of-state vendors that merely advertised in the state precipitated this case.<sup>27</sup> *Quill* challenged the tax-collection obligation as a violation of both the Due Process and Commerce Clauses. The *Quill* Court made two very important determinations with respect to the substantial nexus prong of *Complete Auto*.

First, the Court recognized that its Due Process jurisprudence since *National Bellas Hess* had abandoned a bright-line physical presence rule in favor of a minimum contacts standard.<sup>28</sup> The Court thus determined to extend that lower threshold to its Due Process Clause analyses of state tax statutes.<sup>29</sup> The *Quill* Court's second important determination was to retain its more exacting physical presence standard for purposes of the Commerce Clause.<sup>30</sup>

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23. *Id.*

24. *Nat'l Bellas Hess, Inc. v. Dep't of Rev. of Ill.*, 386 U.S. 753, 758 (1967).

25. *Id.*

26. 504 U.S. 298 (1992). *Quill*'s physical presence in the state was limited to a few floppy diskettes over which it retained title. *Id.* at 315 n.8.

27. *Id.* at 302–04.

28. *Id.* at 307 (citing *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945)). The Court recognized that the Due Process inquiry was satisfied if the out-of-state actor "purposefully avail[ed] itself of the benefits of an economic market in the forum state" regardless of the actor's physical presence there. *Id.*

29. *Id.* at 308.

30. The Court noted that it might not have adopted this test had it been asked to do so for the first time in that case but that its determination was not inconsistent with *Complete Auto*. *Id.* at 311. Further, the Court acknowledged that it

The combination of those two decisions operated to create a “gap” between the protections afforded to taxpayers under these two constitutional provisions. The Court justified this disconnect by discussing the difference in their purposes:

Despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical. The two standards are animated by different constitutional concerns and policies.

Due process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual’s connections with a State are substantial enough to legitimate the State’s exercise of power over him. We have, therefore, often identified “notice” or “fair warning” as the analytic touchstone of due process nexus analysis. In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy. Under the Articles of Confederation, state taxes and duties hindered and suppressed interstate commerce; the Framers intended the Commerce Clause as a cure for these structural ills. It is in this light that we have interpreted the negative implication of the Commerce Clause. Accordingly, we have ruled that that Clause prohibits discrimination against interstate commerce . . . and bars state regulations that unduly burden interstate commerce . . . .

The *Complete Auto* analysis reflects these concerns about the national economy. The second and third parts of that analysis, which require fair apportionment and nondiscrimination, prohibit taxes that pass an unfair share of

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had applied the physical presence test after *Complete Auto* (in *Nat’l Geographic*). *Id.* The Court then proceeded to defend the physical presence test on several grounds, including stare decisis. For a complete discussion of *Quill* and its reasoning for upholding the physical presence test, see Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 328–29. For a discussion supporting *Quill*’s ongoing validity as a positive matter, see Adam B. Thimmesch, *The Fading Bright Line of Physical Presence: Did KFC Corporation v. Iowa Department of Revenue Give States the Secret Recipe for Repudiating Quill?*, 100 KY. L.J. 339 (2012) [hereinafter Thimmesch, *The Fading Bright Line*].



the tax burden onto interstate commerce. The first and fourth prongs, which require a substantial nexus and a relationship between the tax and state-provided services, limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce. Thus, the “substantial nexus” requirement is not, like due process’ “minimum contacts” requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce. Accordingly, contrary to the State’s suggestion, a corporation may have the “minimum contacts” with a taxing State as required by the Due Process Clause, and yet lack the “substantial nexus” with that State as required by the Commerce Clause.<sup>31</sup>

This discussion is of paramount importance when analyzing nexus cases under the “substantial nexus” requirement of *Complete Auto*. The Court made it very clear that the Due Process and Commerce Clauses protect different interests and that a taxpayer’s actions in a state could constitutionally satisfy the former without satisfying the latter.

*Quill* represents the Court’s last guidance regarding the jurisdictional limitations reflected in the substantial nexus prong of *Complete Auto*. However, despite the Court’s affirmation of the physical presence rule, there has been considerable conflict regarding whether this rule applies to taxes other than sales and use taxes. That debate has been aided principally by the tone and language of *Quill*, which indicates a less-than-enthusiastic adherence to the rule.<sup>32</sup> Indeed, the *Quill* Court explicitly stated that it had not, “in [its] review of other types of taxes, articulated the same physical presence requirement” and that it may not have adopted such a test if it were being offered as a matter of first impression.<sup>33</sup> Consequently, taxpayers and state revenue authorities have debated whether — for purposes of taxes *other than* sales and use taxes — a taxpayer must have a physical presence in a state or whether an “economic” presence suffices.<sup>34</sup>

This Article does not attempt to address the underlying question of whether *Quill* compels a physical presence test for all state taxes or whether it should be limited to state sales and use taxes.<sup>35</sup> Rather, this Article focuses

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31. *Quill*, 504 U.S. at 312–13 (citations omitted).

32. See HELLERSTEIN, STATE TAXATION, *supra* note 16, ¶ 6.02[2] (labeling the *Quill* Court’s affirmation of the physical presence test “almost apologetic”).

33. *Quill*, 504 U.S. at 314.

34. A discussion of state-court determinations on this issue is discussed in Part II.B.1.

35. A great amount of attention has already been given to this debate. See *supra* note 7 and accompanying text.

on the proper formulation for economic nexus once it is accepted as an appropriate standard under the Dormant Commerce Clause. Part II.A begins this discussion by providing background on the economic nexus concept and its place in the Court's nexus jurisprudence. Part II.B and II.C then provide an overview of the various state judicial and legislative adoptions of economic nexus.

A. *A Conceptual and Jurisprudential Introduction to Economic Nexus*

Before discussing how states have defined what economic nexus means, it is important to understand the conceptual structure under which nexus issues arise. Nexus, of course, refers to a person's connection with a state and that state's concomitant power to impose a tax — or tax-collection obligation — on that person. Walter Hellerstein has identified nexus as being comprised of two elements: (1) substantive jurisdiction and (2) enforcement jurisdiction.<sup>36</sup> The former refers to a state's substantive connection with an item of income, while the latter refers to the state's power over the taxpayer.<sup>37</sup>

Substantive jurisdiction itself is considered to have two bases: residence and source.<sup>38</sup> Residence-based jurisdiction allows a state to tax the income of persons who reside within the taxing state.<sup>39</sup> In contrast, source-based jurisdiction gives a state jurisdiction over income that is attributable to sources within the taxing state without regard to the residence of the recipient.<sup>40</sup> Substantive jurisdiction thus gives states power over the income of nonresidents who economically exploit state markets. Of course, this expanded reach over the income of non-residents raises questions regarding a state's ability to actually collect the tax it imposes on that income. That concern is encompassed by the concept of enforcement jurisdiction.

As indicated above, the boundaries of a state's enforcement jurisdiction dictate the extent to which that state can collect tax on income over which it has substantive jurisdiction. Under current law, states' enforcement and substantive jurisdictions are not coterminous. Rather, states' enforcement jurisdiction has been limited by both judicial<sup>41</sup> and

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36. Walter Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 GA. L. REV. 1, 3–4 (2003) [hereinafter Hellerstein, *Jurisdiction to Tax Income*].

37. *Id.*

38. *Id.* at 4; HELLERSTEIN, STATE TAXATION, *supra* note 16, ¶ 6.03.

39. *See, e.g.*, *Shaffer v. Carter*, 252 U.S. 37, 57 (1920).

40. Hellerstein, *Jurisdiction to Tax Income*, *supra* note 36, at 6–8.

41. The *Quill* physical presence test discussed above is an example of a judicial limitation on enforcement action. Although a state may have substantive jurisdiction over the income derived from a sale made to an in-state resident, the

legislative<sup>42</sup> action. Thus, due to tax-specific jurisdictional rules, a state can have jurisdiction over a taxpayer's income without actually having the ability to require the taxpayer to remit the tax.<sup>43</sup>

With this framework in mind, *Complete Auto* reveals itself as addressing both enforcement and substantive jurisdiction. First, the requirement of nexus with the taxpayer under *Complete Auto*'s substantial nexus prong evidences a concern for the state's connection to that person (i.e., its ability to enforce an assessment of tax — its enforcement jurisdiction). Second, the requirement that income be fairly apportioned under *Complete Auto*'s second prong speaks to a particular state's right to tax only the income that is fairly attributable to it. This test reflects a concern that states have an underlying substantive right to the income being taxed — in other words, substantive jurisdiction.<sup>44</sup>

Current debate regarding the efficacy and scope of economic nexus occurs within the purview of an enforcement jurisdiction analysis or whether a state has sufficient authority over the person to require its payment of tax

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state does not have enforcement jurisdiction over the remote vendor if that vendor does not have a physical presence in the state.

42. See, e.g., 15 U.S.C. §§ 381–84 (2012) (restricting state enforcement power over taxpayers with only limited physical presence in a state) [hereinafter P.L. 86-272]. P.L. 86-272 was enacted by Congress after the Court's decision in *Northwestern States Portland Cement Co. v. Minnesota*. In that case, the Court upheld the imposition of state income taxes on companies whose only presences in the taxing states were in-state salespersons who solicited orders for fulfillment from outside the states in which they solicited orders. *Nw. States Portland Cement*, 358 U.S. 450, 454–56, 465 (1959). Congress reacted swiftly to the decision and adopted P.L. 86-272 within the year. Pub. L. No. 86-272, 73 Stat. 555 (1959); see HELLERSTEIN, STATE TAXATION, *supra* note 16, ¶ 6.16. P.L. 86-272 limits states' enforcement jurisdiction over remote vendors that sell tangible personal property and that only have limited activities within their boundaries, including solicitation activities. 15 U.S.C. § 381(a).

It is important to note at the outset of this Article that the discussion of economic nexus here is limited to taxpayers that are not protected by P.L. 86-272. Regardless of the proliferation and scope of economic nexus among the states, P.L. 86-272 limits its impact to those who do not fall within its protections. For a full discussion of the scope and impact of P.L. 86-272, see HELLERSTEIN, STATE TAXATION, *supra* note 16, ¶¶ 6.16–6.18.

43. This disconnect can be remedied if the state has enforcement jurisdiction over a third party who controls the out-of-state person's funds. For example, a state can impose a withholding requirement on in-state persons who make payments to out-of-state businesses that do not have a nexus with the state. See *infra* notes 65–74 and accompanying text.

44. Bradley W. Joondeph, *Rethinking the Role of the Dormant Commerce Clause in State Tax Jurisdiction*, 24 VA. TAX REV. 109, 118–20 (2004); Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 328–29.

(i.e., the substantial-nexus prong of *Complete Auto*).<sup>45</sup> In this light, it is safe to say that the Supreme Court has never explicitly recognized economic nexus as a legitimate basis for the imposition of a state business activity tax under the Dormant Commerce Clause.<sup>46</sup> This lack of direct guidance, however, has not prevented states from arguing that the Supreme Court has recognized the validity of economic nexus for purposes of enforcement jurisdiction analyses.<sup>47</sup> Two cases generally form the basis for such arguments: *New York ex rel. Whitney v. Graves*<sup>48</sup> and *International Harvester Co. v. Wisconsin Department of Taxation*.<sup>49</sup>

*Whitney* involved a Due Process challenge to the imposition of New York state income tax on gains received by an out-of-state taxpayer from the sale of a fractional membership on the New York Stock Exchange.<sup>50</sup> Whitney's membership on the Exchange gave him rights to trade on the Exchange and access to certain other benefits, including an insurance fund and access to reduced commissions for transactions undertaken on his behalf.<sup>51</sup>

Whitney challenged the imposition of New York income tax on his gains from the sale of his fractional membership as a violation of the Due Process Clause, arguing that the membership did not have a business situs in New York.<sup>52</sup> The Supreme Court evaluated the rights to which Whitney's membership entitled him and determined that the very nature of the asset was that it was "localized" at the Exchange.<sup>53</sup> The Court noted that wherever the

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45. This is not to say that the concept of economic nexus does not apply to substantive jurisdiction. To the contrary, economic nexus is the heart of substantive jurisdiction. That inquiry focuses solely on the source of income without regard for presence of the income earner. Economic nexus for purposes of substantive jurisdiction is thus on sound footing, so to speak. The discussion in this Article therefore discusses economic nexus in the context of enforcement jurisdiction and *Complete Auto*'s substantial nexus requirement.

46. See Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 328–29 (stating that "the Supreme Court has not directly answered the question of whether mere economic presence is a sufficient ground for a state to assert its income tax jurisdiction"). State courts have pointed to many Supreme Court decisions to justify the adoption of economic nexus. However, for reasons discussed below, those decisions are less than definitive with respect to the scope of states' enforcement jurisdiction.

47. See, e.g., *KFC Corp. v. Iowa Dep't of Rev.*, 792 N.W.2d 308, 314 (Iowa 2010); *Kmart Prop., Inc. v. Tax'n and Rev. Dep't of N.M.*, 131 P.3d 27, 36 (N.M. Ct. App. 2001); *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13, 23 (S.C. 1993).

48. 299 U.S. 366 (1937).

49. 322 U.S. 435 (1944).

50. *Whitney*, 299 U.S. at 367.

51. *Id.* at 370–71.

52. *Id.*

53. *Id.* at 372–73.

owner of a membership right resides, “he must go to the Exchange to exercise his privilege to trade upon its floor.”<sup>54</sup> In turn, the Court held that “the dominant attribute of relator’s membership in the New York Stock Exchange so links it to the situs of the Exchange as to localize it at that place and hence bring it within the taxing power of New York.”<sup>55</sup>

*Whitney* arguably provides support for an economic nexus standard under the Commerce Clause.<sup>56</sup> First, the Court upheld the New York income tax based solely on its analysis of the business situs of Whitney’s intangible asset. That analysis rings of an economic nexus — rather than a physical presence — analysis. Further, although *Whitney* involved a Due Process challenge, the Court’s Due Process standard for purposes of state taxation had not yet been lowered pursuant to *Quill*.<sup>57</sup> *Whitney* may therefore signal how the Court would analyze an economic nexus dispute today.

Despite the foregoing, *Whitney* falls short of being dispositive on the economic nexus inquiry for many reasons. First, the decision’s singular focus on the presence of an asset in the state suggests that the Court may have been focused on a quasi in rem jurisdiction theory,<sup>58</sup> which the Court later rejected.<sup>59</sup> Second, the Court’s focus on a business situs analysis may indicate that, even if economic nexus is accepted, it is bound by business-situs analyses.<sup>60</sup> Third, Whitney’s membership in the New York Stock Exchange could be likened to an interest in a pass-through entity, which can generate a physical presence for its owners where the entity operates.<sup>61</sup> Fourth, despite the recognition above — that then-current Due Process analysis was similar to present-day Commerce Clause analysis — the decision was a Due Process decision. Applying *Whitney* for Commerce

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54. *Id.*

55. *Whitney*, 299 U.S. at 372–73.

56. For a discussion of those arguments, see Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 347–49.

57. See *supra* notes 26–29 and accompanying text; see also Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 347–49 (discussing how *Whitney* could be instructive on this point).

58. Quasi in rem jurisdiction refers to a state’s jurisdiction over a person’s property that is located in the state. See BLACK’S LAW DICTIONARY 689 (7th ed. 2000).

59. *Shaffer v. Heitner*, 433 U.S. 186, 207–12 (1977); Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 347–48.

60. Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 348.

61. *Id.*; see also *Borden Chems. & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73, 81 (Ill. App. Ct. 2000) (“Certainly, the physical presence in the taxing state of the partnership that generates the income suffices as a physical presence of the nonresident partner in the state.”).

Clause purposes can be problematic to the extent that the Due Process and Commerce Clauses are focused on different concerns.<sup>62</sup>

Finally, *Whitney* could have been decided on physical presence grounds. The Court has repeatedly recognized that the physical presence of a taxpayer's agents can be attributed to the taxpayer so long as the activities of the agents are "significantly associated with the taxpayer's ability to establish and maintain a market" in the taxing state.<sup>63</sup> In *Whitney*, the Court explicitly noted that the taxpayer's right to trade on the market could only be exercised by a member physically present at the Exchange.<sup>64</sup> As a result, if *Whitney* himself were not physically present in New York, to exercise his right would have required the use of an agent acting on his behalf in the state. Thus, *Whitney* appears to be as easily reconcilable with a physical presence standard — with attribution principles — as with an economic nexus standard.

*International Harvester* provides similarly mixed signals. That case involved a challenge to the imposition of a Wisconsin tax on dividends paid from a corporation doing business in the state.<sup>65</sup> Two shareholder-recipients who had no personal connection to Wisconsin challenged the imposition of the tax as a violation of the Due Process Clause.<sup>66</sup> The tax was collected by the state through a withholding obligation imposed on the corporation making the distribution.<sup>67</sup>

The appellants challenged the imposition of the tax on their dividend distributions as a violation of the Due Process Clause because they had no

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62. See *supra* note 31 and accompanying text.

63. *Tyler Pipe Indus., Inc. v. Wash. Dep't of Revenue*, 483 U.S. 232, 249–50 (1987) (quoting *Tyler Pipe Indus., Inc. v. Wash. Dep't of Revenue*, 715 P.2d 123, 126 (Wash. 1986)); see also *Scripto, Inc. v. Carson*, 362 U.S. 207, 211–13 (1960). For a full discussion of these "agency nexus" cases, see Mark Cowan, *Tax Planning Versus Business Strategy: The Rise and Fall of Entity Isolation in Sales and Use Taxes*, 44 IDAHO L. REV. 63, 93–109 (2007); Andrew Haile, *Affiliate Nexus in E-Commerce*, 33 CARDOZO L. REV. 1803, 1811–13 (2012); John Swain, *Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus*, 75 S. CAL. L. REV. 419, 433–35 (2002); Thimmesch, *The Fading Bright Line*, *supra* note 30, at 345–48.

64. *New York ex rel. Whitney v. Graves*, 299 U.S. 366, 373 (1937) ("Wherever the owner may reside he must go to the Exchange to exercise his privilege to trade upon its floor. If he prefers to have his customers' orders executed through other members, still they must execute these orders on the Exchange under its rules.").

65. *Int'l Harvester Co. v. Wis. Dep't of Tax'n*, 322 U.S. 435, 437–38 (1944). The Wisconsin tax at issue applied to the portion of a corporation's dividend distribution that was attributable to the corporation's income earned in Wisconsin. *Id.* at 438.

66. *Id.*

67. *Id.* at 437. Despite this mechanism for collecting the tax, the incidence of the tax was on the shareholders. *Id.*

connection with Wisconsin, nor were the dividends declared or paid from within the state.<sup>68</sup> The Court rejected that challenge,<sup>69</sup> noting that “[p]ersonal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation’s Wisconsin earnings as is distributed to them.”<sup>70</sup> The Court went on to note that “[a] state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation.”<sup>71</sup>

The *International Harvester* Court’s analysis may seem to lend credence to an economic nexus concept. The Court certainly was unimpressed by the taxpayers’ lack of physical connections to the taxing state. However, several factors weigh against viewing this opinion as direct support for economic nexus under *Complete Auto*’s first prong. First, the opinion seems to focus on substantive jurisdictional grounds rather than on enforcement jurisdictional grounds.<sup>72</sup> This is highlighted principally where the court recognizes that “[s]o long as the earnings actually arise [in Wisconsin] . . . the conditions of state power to tax are satisfied . . . even though some practically effective device be necessary in order to enable the state to collect its tax.”<sup>73</sup> The latter portion of this statement speaks directly to enforcement jurisdiction, a concern that was alleviated by the state’s use of a taxpayer with a physical presence in the state — the dividend issuer — to collect the tax.<sup>74</sup>

The Court may have also inappropriately attributed the source of the corporation’s income (and its activities) directly to the shareholders — as in the case of a flow-through entity.<sup>75</sup> That analysis would be inappropriate because it would ignore the separate legal existence of the corporation. If

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68. *Id.* at 439–40.

69. *Id.* at 445 (“We conclude that appellants’ stockholders can have no constitutional objection to the withholding by Wisconsin of a tax measured by their dividends distributed from Wisconsin earnings.”).

70. *Id.* at 441. The Court also noted that “the fact that the stockholder-taxpayers never enter Wisconsin and are not represented in the Wisconsin legislature cannot deprive it of its jurisdiction to tax.” *Id.* at 443.

71. *Id.* at 441–42.

72. For a similar critique, see Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 350 (stating that “the opinion does not unequivocally state that Wisconsin has jurisdiction over the stockholders and not merely jurisdiction over their income”).

73. *Int’l Harvester*, 322 U.S. at 443–44.

74. See HELLERSTEIN, *STATE TAXATION*, *supra* note 16, ¶ 6.04 n.66 (recognizing the questions regarding enforcement jurisdiction presented by the *Int’l Harvester* decision).

75. Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 350–51.

accepted, however, such an analysis would be consistent with a physical presence standard (i.e., the shareholders would have been physically present through attribution).

Finally, one can limit the relevancy of *International Harvester* to the economic nexus debate by limiting that case to its Due Process roots. (Recall that the taxpayers in the case challenged the Wisconsin tax solely on that ground.) In fact, the Court nearly compels this limitation with its clear statement that its Due Process jurisprudence did not prohibit “unfair or burdensome taxes, merely because they are unfair or burdensome.”<sup>76</sup> This statement is in direct conflict with the *Quill* Court’s declaration of the purpose for the Commerce Clause’s enforcement jurisdiction bar. As noted above, the *Quill* Court characterized the substantial nexus prong of *Complete Auto* as “limit[ing] the reach of state taxing authority so as to ensure that state taxation does not *unduly burden interstate commerce*.”<sup>77</sup> The *International Harvester* Court’s express rejection of that concern undercuts an extension of that case to the substantial nexus inquiry under the Commerce Clause.

Beyond *Whitney* and *International Harvester*, *Quill* itself perhaps can be viewed as supporting an economic nexus standard for purposes of state business activity taxation. The Court’s opinion in *Quill* explicitly (and repeatedly) noted that it had not adopted a physical presence rule for the purpose of evaluating impositions of taxes other than sales and use taxes.<sup>78</sup> The Court thus could be viewed as implying that an economic nexus standard suffices for those purposes. The problem with relying on this analysis, of course, is that the Court did not say that the standard was proper. It only implied that it was.

As this discussion evidences, the Court’s nexus jurisprudence may provide some indirect support for an economic nexus standard for enforcement jurisdiction purposes, but that support falls short of being definitive on several grounds. As a result, it has fallen upon state courts and state legislatures to determine the extent to which an economic nexus satisfies *Complete Auto*’s substantial nexus prong.

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76. *Int’l Harvester*, 322 U.S. at 444.

77. *Quill Corp. v. North Dakota*, 504 U.S. 296, 313 (1992) (emphasis added).

78. *Id.* at 314 (“Although we have not, in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule.”); *id.* at 317 (“In sum, although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes.”).



B. *Economic Nexus as Adopted by State Courts*

1. *State Judicial Acceptance of the Economic Nexus Standard*

The Supreme Court's lack of direction regarding economic nexus has not prevented states from adopting that standard when analyzing the imposition of state income taxes. Indeed, less than a year after the *Quill* decision, the South Carolina Supreme Court accepted the validity of the economic nexus standard for income taxes in *Geoffrey, Inc. v. South Carolina Tax Commission*.<sup>79</sup> The taxpayer in this case was an out-of-state company (Geoffrey) whose only connection to the state was that it licensed intellectual property to a related entity (Toys-R-Us) operating in the state.<sup>80</sup> The state asserted that Geoffrey was subject to the state's tax because it earned income from the use of its intellectual property in the state under its licensing agreements with Toys-R-Us. Geoffrey challenged the imposition of the tax as a violation of both the Due Process and Commerce Clauses.

The South Carolina Supreme Court found that neither clause was violated by the state's imposition of tax on Geoffrey. With respect to the Due Process Clause, the court found that "Geoffrey purposefully directed its activities towards South Carolina," that it had the required minimum connection with the state, and that "South Carolina ha[d] conferred benefits upon Geoffrey to which the challenged tax [was] rationally related."<sup>81</sup>

Turning to Geoffrey's Commerce Clause challenge, the court stated: "[I]t is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there."<sup>82</sup> The court dismissed Geoffrey's argument that *Quill*'s physical presence standard applied by use of a mere footnote, stating that the *Quill* decision itself had "noted that the physical presence requirement had not been extended to other types of taxes [beyond sales and use taxes]."<sup>83</sup> Geoffrey petitioned the Supreme Court to review the case, but the Court denied the request.<sup>84</sup>

*Geoffrey* stands as the starting point for state assertions that an economic nexus standard for income taxes is permissible after *Quill*.

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79. 437 S.E.2d 13 (S.C. 1993).

80. *Id.* at 16–17.

81. *Id.* at 19–22.

82. *Id.* at 23. The *Geoffrey* court's sole supporting citation from the Supreme Court was a reference to *Int'l Harvester, Inc.* As discussed earlier, the South Carolina court's reference is unsatisfactory for many reasons. See *supra* notes 65–77 and accompanying text.

83. *Geoffrey*, 437 S.E.2d at 23 n.4.

84. *Geoffrey, Inc. v. S.C. Dep't of Rev. & Tax'n*, 510 U.S. 992 (1993). The *Geoffrey* court's limited Commerce Clause analysis and subsequent determination are subject to critique on several grounds. See, e.g., HELLERSTEIN, STATE TAXATION, *supra* note 16, ¶ 6.11[2].

Initially, however, other states were not overwhelmingly convinced that *Geoffrey* was correct; in the next decade, many cases were decided on each side of the issue. Courts in Illinois,<sup>85</sup> New Mexico,<sup>86</sup> North Carolina,<sup>87</sup> Ohio,<sup>88</sup> and Washington<sup>89</sup> agreed with the South Carolina court and held that *Quill* did not foreclose an economic nexus standard outside of sales and use tax cases. In contrast, cases in Tennessee,<sup>90</sup> Texas,<sup>91</sup> and New Jersey<sup>92</sup> held that *Quill* prohibited the use of an economic nexus standard for state income taxes.

State courts began to approve economic nexus standards with increasing regularity and unity beginning in 2005. In June 2005, a West Virginia circuit court determined that MBNA Bank, an out-of-state credit card company, had a sufficient nexus with the state based merely upon its solicitation of, and business with, West Virginia customers.<sup>93</sup> The West Virginia Supreme Court affirmed this decision in 2006, and the U.S. Supreme Court declined to review the case in 2007.<sup>94</sup>

The West Virginia experience played out almost simultaneously in New Jersey. In 2005, the Appellate Division of the New Jersey Superior Court held that an out-of-state intangible holding company had a nexus with New Jersey for income tax purposes simply based upon its receipt of royalty income from its related-party licensor in the state.<sup>95</sup> The Supreme Court of

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85. *Borden Chems. & Plastics v. Zehnder*, 726 N.E.2d 73 (Ill. App. Ct. 2000).

86. *Kmart Props., Inc. v. Tax'n & Rev. Dep't of N.M.*, 131 P.3d 27 (N.M. Ct. App. 2001), *cert. granted*, 40 P.3d 1008 (N.M. 2002), *cert. dismissed, aff'd in part, rev'd in part sub nom. Kmart Corp. v. Tax'n & Rev. Dep't of N.M.*, 131 P.3d 22 (N.M. 2005).

87. *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004).

88. *Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225 (Ohio 1996), *cert. denied*, 519 U.S. 810 (1996). The *Couchot* court expressed support for an economic nexus standard, but the taxpayer in that case had a physical presence in the taxing state. *Id.* The income at issue was lottery winnings from a ticket that the taxpayer purchased and redeemed while physically present in Ohio. *Id.* at 1230–31.

89. *Gen. Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001), *cert. denied*, 535 U.S. 1056 (2002).

90. *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999).

91. *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000).

92. *Lanco, Inc. v. Dir., Div. of Tax'n*, 21 N.J. Tax 200 (N.J. Tax Ct. 2003), *cert. denied*, 551 U.S. 1131 (2007).

93. *Tax Commissioner of W. Va. v. MBNA Am. Bank, N.A.*, No. 04-AA-157, (W. Va. Cir. Ct. June 27, 2005), *aff'd*, 640 S.E.2d 226 (W. Va. 2006).

94. *Tax Commissioner of W. Va. v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 236 (W. Va. 2006), *cert. denied*, 551 U.S. 1141 (2007).

95. *Lanco, Inc. v. Dir., Div. of Tax'n*, 879 A.2d 1234, 1242 (N.J. Super. Ct. App. Div. 2005).

New Jersey affirmed that decision in 2006, and the U.S. Supreme Court declined to review the case in 2007.<sup>96</sup>

In 2005, the Oklahoma Court of Civil Appeals also held that no physical presence was required under the Commerce Clause for the state to impose its income tax on an out-of-state intangible-holding company.<sup>97</sup> The New Mexico Supreme Court followed that decision just six days later with its rejection of the extension of the physical presence rule in *Kmart Corporation v. Taxation & Revenue Department of New Mexico*, another case involving an intangible-holding company structure.<sup>98</sup>

These developments that began in 2005 have set the stage for an overwhelming state rejection of a physical presence test for purposes of state income taxes. In addition to the above-referenced decisions, cases and administrative rulings in Arizona,<sup>99</sup> Florida,<sup>100</sup> Indiana,<sup>101</sup> Iowa,<sup>102</sup> Louisiana,<sup>103</sup> Massachusetts,<sup>104</sup> Missouri,<sup>105</sup> Ohio,<sup>106</sup> and Washington<sup>107</sup> have

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96. *Lanco, Inc. v. Dir., Div. of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007). The New Jersey Supreme Court reiterated its economic nexus holding in *Praxair Tech., Inc. v. Dir., Div. of Tax'n*, 988 A.2d 92 (2009).

97. *Geoffrey, Inc. v. Okla. Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005) (*Geoffrey Okla.*).

98. *Kmart Corp. v. Tax'n & Rev. Dep't of N.M.*, 131 P.3d 22, 23 (N.M. 2005). For a discussion of the unique procedural history of the *Kmart Corp.* case, see Walter Hellerstein, *Green Light, Red Light, or Blue Light: New Mexico Supreme Court Sends Mixed Signals With Kmart Decision*, 39 ST. TAX NOTES 141 (Jan. 16, 2006).

99. Decision of Hearing Officer, No. 200700083-C, Ariz. Dep't of Rev., Mar. 28, 2008, <http://www.azdor.gov/LinkClick.aspx?fileticket=9ZY8i7xZVNE% d&tabid=105&mid=474>.

100. Fla. Technical Assistance Advisement 07C1-007 (Oct. 17, 2007), <https://taxlaw.state.fl.us/wordfiles/CIT%20TAA%2007C1-007.doc>.

101. *MBNA Am. Bank, N.A. v. Ind. Dep't of State Rev.*, 895 N.E.2d 140 (Ind. T.C. 2008) (*MBNA Ind.*).

102. *KFC Corp. v. Iowa Dep't of Rev.*, 792 N.W.2d 308 (Iowa 2010).

103. *Bridges v. Geoffrey, Inc.*, 984 So. 2d 115 (La. Ct. App. 2008) (*Geoffrey La.*).

104. *Geoffrey, Inc. v. Commissioner of Rev.*, 899 N.E.2d 87 (Mass. 2009), *cert. denied*, 129 S. Ct. 2853 (2009) (*Geoffrey Mass.*); *Capital One Bank v. Commissioner of Rev.*, 899 N.E.2d 76 (2009), *cert. denied*, 129 S.Ct. 2827 (Mass. 2009).

105. *Acme Royalty, Co. v. Dir. of Rev.*, Case No. 99-2839 RI, 2002 WL 200921 (Mo. Admin. Hearing Comm'n Jan. 3, 2002), *rev'd on other grounds*, 96 S.W.3d 72 (Mo. 2002); *Gore Enter. Holdings, Inc. v. Dir. of Rev.*, Case No. 99-2856 RI, 2002 WL 200918 (Mo. Admin. Hearing Comm'n Jan. 3, 2002), *rev'd on other grounds*, 96 S.W.3d 72 (Mo. 2002).

106. *Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225 (Ohio 1996).

107. *Lamtec Corp. v. Dep't of Rev.*, 246 P.3d 788 (Wash. 2011).

all rejected the application of the physical presence test to taxes other than sales and use taxes. State revenue authorities also indicate broad acceptance of an economic nexus standard.<sup>108</sup> In contrast, only a few state courts have held that a physical presence is required for taxes other than sales and use taxes.<sup>109</sup> The great weight of the authority has thus rejected the application of *Quill* outside of those taxes. As discussed below, however, states have varied greatly in their explanation of the standard that applies in the absence of a physical presence rule.

## 2. State Judicial Economic Nexus Formulations

Although state courts have readily accepted the validity of economic nexus, they have given very little attention, if any, to what economic nexus actually means.<sup>110</sup> Their decisions have focused almost exclusively on justifying the adoption of that standard and the rejection of the physical presence standard of *Quill*.<sup>111</sup> Many of those courts have simply found that an economic nexus existed based on the particular facts presented without explaining what standard they applied. For example, in cases involving intangible-holding-company structures,<sup>112</sup> many courts have stated only that deriving income from licensing intangible property for use in the state is sufficient to establish an economic nexus with the state.<sup>113</sup> Those cases do

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108. See generally BNA 2012 State Tax Department Survey Results, <http://www.riacheckpoint.com> (State & Local Tax Library).

109. See, e.g., *Innova Diagnostics, Inc. v. Strayhorn*, 166 S.W.3d 394 (Tex. App. 2005); *In re Wascana Energy Mktg. Inc.*, DTA No. 817866, 2002 WL 1726832 (N.Y. Div. Tax App. July 18, 2002); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000).

110. This Article will take the opposite approach. While one can debate whether state-court adoptions of an economic nexus concept are on firm footing, this Article is aimed at evaluating the meaning of economic nexus. For writings evaluating the former issue, see *supra* note 7.

111. See, e.g., *MBNA Am. Bank, N.A. v. Ind. Dep't of State Rev.*, 895 N.E.2d 140 (Ind. T.C. 2008); *KFC Corp. v. Iowa Dep't of Rev.*, 792 N.W.2d 308, 324–28 (Iowa 2010); *Capital One Bank v. Commissioner of Rev.*, 899 N.E.2d 76, 83–86 (Mass. 2009); *Lanco, Inc. v. Dir., Div. of Tax'n*, 908 A.2d 176, 176–77 (N.J. 2006); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 193–95 (N.C. Ct. App. 2004); *Geoffrey, Inc. v. Okla. Tax Comm'n*, 132 P.3d 632, 635–38 (Okla. Civ. App. 2005); *Tax Commissioner of W. Va. v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 230–34 (W. Va. 2006).

112. For a description of the intangible holding company structure, see Sheldon Laskin, *Trademark Royalties, Nexus, and Taxing That Which Enriches*, 22 AKRON TAX J. 1, 5–7 (2007) [hereinafter Laskin, *Trademark Royalties*].

113. See *Geoffrey, Inc. v. Commissioner of Rev.*, 899 N.E.2d 87, 92 (Mass. 2009) (“[S]ubstantial nexus can be established where a taxpayer domiciled in one

not discuss whether the first dollar of such income created that economic nexus or whether some higher amount of income was required.

One line of cases does, however, provide an actual formulation for economic nexus — a substantial economic presence standard. This standard was first adopted by the West Virginia Supreme Court in *Tax Commissioner of West Virginia v. MBNA America Bank, N.A.*, a case addressing the taxation of MBNA America Bank, a Delaware corporation in the principal business of issuing and servicing VISA and MasterCard credit cards.<sup>114</sup> MBNA solicited customers in West Virginia through mail and telephone solicitations.<sup>115</sup> During the two tax years at issue, those efforts resulted in gross receipts attributable to West Virginia customers of approximately \$8.4 million and \$10 million.<sup>116</sup> The West Virginia Tax Commissioner asserted that MBNA was subject to the state’s corporate income tax because it regularly engaged in business in West Virginia.<sup>117</sup> MBNA challenged that assertion, arguing that the Commerce Clause barred the state’s imposition of tax because MBNA did not have a physical presence in the state.<sup>118</sup>

The *MBNA W. Va.* court carefully evaluated *National Bellas Hess* and *Quill* and determined that their physical presence requirement applied only to state sales and use taxes.<sup>119</sup> The court concluded that “[r]ather than a physical presence standard . . . a significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes.”<sup>120</sup> The court cited to a 1995 article as “suggesting” this test and providing its bounds:

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State carries on business in another State through the licensing of its intangible property that generates income from the taxpayer.”); *Kmart Props., Inc. v. N.M. Tax’n & Rev. Dep’t*, 131 P.3d 27, 36 (N.M. Ct. App. 2001) (“[T]he use of KPI’s marks within New Mexico’s economic market, for the purpose of generating substantial income for KPI establishes a sufficient nexus”); *A & F Trademark*, 605 S.E.2d at 195 (“Rather, we hold that under facts such as there where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause.”); *Geoffrey, Inc. v. S.C. Tax Comm’n*, 437 S.E.2d 13, 18 (S.C. 1993) (“We hold that by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a ‘substantial nexus’ within South Carolina.”); see also *KFC*, 792 N.W.2d at 328 (“We hold that, by licensing franchises within Iowa, KFC has received the benefit of an orderly society within the state and, as a result, is subject to the payment of income taxes that otherwise meet the requirements of the dormant Commerce Clause.”).

114. *MBNA W. Va.*, 640 S.E.2d at 227.

115. *Id.*

116. *Id.* at 227–28.

117. *Id.* at 228.

118. *Id.*

119. *MBNA W. Va.*, 640 S.E.2d at 232.

120. *Id.* at 234.

According to this commentator, a substantial economic presence standard incorporates due process purposeful direction towards a state while examining the degree to which a company has exploited a local market. Further, a substantial economic presence analysis involves an examination of both the quality and quantity of the company's economic presence. Finally, under this test, purposeful direction towards a state is analyzed as it is for Due Process Clause purposes and the Commerce Clause analysis requires the additional examination of the frequency, quantity and systematic nature of a taxpayer's economic contacts with a state.<sup>121</sup>

The court in turn found this test "persuasive" and determined to apply it to the case at hand.<sup>122</sup>

The taxpayer raised two principled objections to the adoption of an economic nexus standard. It first argued that the court should apply a more onerous nexus standard for purposes of direct taxes (i.e., income taxes) than for purposes of indirect taxes (i.e., sales and use taxes). MBNA argued that direct taxes create a greater burden on interstate commerce because they require not only administrative efforts, but they also take money directly from the corporate coffers.<sup>123</sup> Second, it argued that the adoption of a substantial nexus requirement, which does not require a physical presence, would be tantamount to adopting a Due Process minimum contacts standard.<sup>124</sup>

The court quickly disposed of MBNA's concerns. With respect to MBNA's "burden" argument, the court relied on the *National Bellas Hess* and *Quill* Courts' focus on the "substantial compliance burdens attached to the collection of sales and use taxes."<sup>125</sup> The court then simply decided to "reject MBNA's claim that the imposition of direct taxes is a greater burden than the duty of collecting taxes."<sup>126</sup>

This reasoning is unsatisfying. The court made no attempt to compare the burdens of sales and use tax compliance with those of state income tax compliance. Perhaps the burdens of the former are more onerous

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121. *Id.* (citations omitted).

122. *Id.*

123. *Id.* at 234. Of course, one can debate how different those are. The burden of administrative efforts can be boiled down to the costs that they impose as well.

124. *MBNA W. Va.*, 640 S.E.2d at 235.

125. *Id.*

126. *Id.*

than the latter, but the court did not undertake that analysis. Instead, the court relied on the fact that the *National Bellas Hess* and *Quill* Courts focused on sales and use taxes — an unsurprising focus given the issue presented in those cases.

The court's reliance on that analysis also failed to take into account the additional burdens of actually funding those taxes. Sales and use taxes are collected from a customer, whereas income taxes must be paid from the corporation's funds. As noted above, compliance burdens are not a unique exaction. They are simply the cause for additional capital outlays. The funding of a tax thus imposes the same type of burden on taxpayers as do pure compliance costs, and that burden must be taken into account.

The court addressed MBNA's concerns about the convergence of the Commerce and Due Process inquiries with similar brevity. The court simply disagreed with MBNA's assertion and explained that the Commerce Clause requires "that an entity's contacts with the taxing state be more frequent and systematic in nature" and that a taxpayer's "exploitation of the market must be greater in degree than under the Due Process standard so that its economic presence can be characterized as significant or substantial."<sup>127</sup> The court thus expressed that "although a substantial economic presence standard is by nature more elastic than the bright-line physical presence test, . . . when properly applied, a greater nexus is required under the substantial economic presence standard than under the minimum contacts analysis."<sup>128</sup>

After a relatively brief explanation of its new economic nexus standard, the *MBNA W. Va.* court gave an equally brief application of that test. The court looked to both MBNA's activities directed at West Virginia and its economic returns from those efforts. With respect to the former, the court noted that MBNA had "continuously and systematically engaged in direct mail and telephone solicitation and promotion in West Virginia."<sup>129</sup> With respect to the latter, the court focused on MBNA's derivation of revenue from West Virginia customers in amounts ranging from eight to ten million dollars during the two years at issue. The court labeled those amounts "significant gross receipts."<sup>130</sup> In sum, the court held that MBNA's "systematic and continuous business activity in this State produced significant gross receipts attributable to its West Virginia customers which indicate[d] a significant and economic presence sufficient to meet the substantial nexus prong of *Complete Auto*."<sup>131</sup>

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127. *Id.*

128. *Id.*

129. *MBNA W. Va.*, 640 S.E.2d at 235.

130. *Id.* at 236.

131. *Id.*

The *MBNA W. Va.* analysis has been utilized, to one degree or another, by a variety of courts since 2006.<sup>132</sup> In *Bridges v. Geoffrey, Inc.*, for example, the Court of Appeals of Louisiana discussed the *MBNA W. Va.* case and its significant economic presence test in the context of analyzing whether *Quill* applied to the state's income tax.<sup>133</sup> After determining that *Quill* did not so apply, the court made its economic nexus determination by focusing on the taxpayer's licensing agreements with "eight to eleven stores in Louisiana" and its receipt of "significant royalty income from the use of its trademarks in th[e] state."<sup>134</sup>

In 2009, the Supreme Judicial Court of Massachusetts gave a similar analysis in its decision in *Capital One Bank v. Commissioner of Revenue*.<sup>135</sup> In the course of its examination of whether the physical presence rule applied to the state tax at issue, the court discussed the *MBNA W. Va.* court's analysis and found it to be "persuasive."<sup>136</sup> The court's limited economic nexus analysis then focused on Capital One's lending activities in the state, its solicitation and conduct of "significant" business with "hundreds of thousands of Massachusetts residents," and its receipt of "millions of dollars in income" from the state.<sup>137</sup> The court also expressly addressed the relationship between its economic nexus standard and the Due Process standard, stating that "[w]hile the concept of 'substantial nexus' is more elastic than 'physical presence,' it plainly means a greater presence, both qualitatively and quantitatively, than the minimum connection between a State and a taxpayer that would satisfy a due process inquiry. Simply put, the test is 'substantial' nexus, not 'minimal' nexus."<sup>138</sup>

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132. Although none of those courts have explicitly adopted the *MBNA W. Va.* test, they have issued opinions that apply the same analysis.

133. *Bridges v. Geoffrey, Inc.*, 984 So. 2d 115, 126–27 (La. Ct. App. 2008).

134. *Id.* at 126–28.

135. 899 N.E.2d 76 (Mass. 2009).

136. *Id.* at 86.

137. *Id.* The court also noted that the taxpayer had made use of the state's Attorney General's office and court system. *Id.* at 86–87. The *MBNA Ind.* court also looked to this factor in a footnote in its analysis. *MBNA Am. Bank, N.A. v. Ind. Dep't of State Rev.*, 895 N.E.2d 140, 144 n.4 (Ind. T.C. 2008) ("MBNA admits that during the years at issue, it had pending in Indiana's court system debt collection actions also exceeding a 'de minimis' number.").

138. *Capital One Bank*, 899 N.E.2d at 86; see also *Kmart Props., Inc. v. N.M. Tax'n & Rev. Dep't*, 131 P.3d 27, 36 ("Although *Quill* did establish that 'substantial nexus' under *Complete Auto Transit* has more than the minimum contacts required of due process . . . we need not quantify that difference here."). These courts' limited discussions provide a uniform interpretation of economic nexus as a standard that is more exacting than the Supreme Court's Due Process requirements. They fail, however, to provide any precise guidance on the quantum of difference between the two.



Other courts have provided similar analyses without specifically mentioning the *MBNA W. Va.* test. Those courts have focused on the taxpayers' systematic and continuous solicitation in the taxing states and their receipt of significant revenue from customers in those states without explicitly setting forth any "test."<sup>139</sup> Those cases can be interpreted consistently with the substantial economic presence test but still provide no explicit guidance on what standard for economic nexus actually applies.

The import of this discussion is that most state courts adopting the economic nexus standard have failed to provide any formulation for how that test is to be applied. Additionally, those courts that have provided some formulation have adopted heightened qualitative standards that require "substantial" economic presences in their state. Those standards purposefully require a market exploitation that is more significant than that required under the Due Process Clause, but they provide little additional guidance on their boundaries.

### C. *State Economic Nexus Legislation*

State legislatures have been mindful of economic nexus, and many have enacted (or retained) legislation that imposes a business activity tax on out-of-state parties based simply on their economic contacts with the taxing state.<sup>140</sup> That economic nexus legislation has taken both qualitative and quantitative forms.

#### 1. *Qualitative Economic Nexus Standards*

States legislatures have adopted a variety of qualitative economic nexus standards. Those standards reflect two distinct interpretations of economic nexus. The first follows the *MBNA W. Va.* model and recognizes economic nexus as a heightened jurisdictional bar on state taxation. The second simply applies a pure substantive jurisdiction analysis, which looks only to a taxpayer's derivation of revenue from sources within a state.

New Hampshire has adopted the former approach and imposes its business profits tax on every organization "carrying on any business activity

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139. See, e.g., *MBNA Ind.*, 895 N.E.2d at 144 (looking at the regular solicitation of business from Indiana customers and the receipt of "significant gross receipts" from Indiana customers); *Geoffrey, Inc. v. Commissioner of Rev.*, 899 N.E.2d 87, 93 (Mass. 2009) (focusing on the taxpayer's extensive contacts with customers in the state and the annual royalty income that it received therefrom).

140. Undoubtedly, not all of the statutes discussed below were passed with conscious thought towards the current economic nexus debate. However, as discussed herein, many of the recent statutory enactments directly incorporate standards from this debate.

within the state.”<sup>141</sup> The term “business activity” is defined to mean “a substantial economic presence evidenced by a purposeful direction of business toward the state examined in light of the frequency, quantity, and systematic nature of a business organization’s economic contacts with the state.”<sup>142</sup> This statute thus directly incorporates the *MBNA W. Va.* standard for economic nexus.<sup>143</sup>

The State of Connecticut has adopted a similar approach. Connecticut General Statutes section 12–216a provides:

Any company that derives income from sources within this state and that has a substantial economic presence within this state, evidenced by a purposeful direction of business toward this state, examined in light of the frequency, quantity and systematic nature of a company’s economic contacts with this state, without regard to physical presence, and to the extent permitted by the Constitution of the United States, shall be liable for the tax imposed under this chapter.<sup>144</sup>

This statute, like that adopted by New Hampshire, adopts the heightened *MBNA W. Va.* standard for economic nexus.<sup>145</sup>

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141. N.H. REV. STAT. ANN. §§ 77-A:1(I), 77-A:2 (2012).

142. *Id.* § 77-A:1(XII). *See also* OR. ADMIN. R. 150-317.010(2) (2012) (proving that substantial nexus exists with the state “where a taxpayer regularly takes advantage of Oregon’s economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in the state.”).

143. Despite this qualitative standard, New Hampshire does not require corporations to file income tax returns in the state unless their “gross business income” exceeds \$50,000. N.H. REV. STAT. ANN. § 77-A:6(I). This return-filing threshold gives the look of a quantitative test, but it is implemented through an administrative provision rather than a nexus provision. The threshold is also significantly lower than other states’ quantitative nexus thresholds, which are discussed below.

144. *See* 2011 CONN. PUB. ACTS 100, § 55 (June Spec. Sess.). Prior to this legislation, Connecticut law imposed the state’s corporate income tax on companies that either derived income from the state or that had a substantial economic nexus in the state. *Id.* Under that statute, the substantial economic nexus portion of the statute was seemingly subsumed by the source prong of the state’s disjunctive statute. The apparent heightened *MBNA W. Va.* standard of the second prong was rendered irrelevant by less exacting, source-based first prong.

145. The Connecticut Department of Revenue Services supplemented the state’s qualitative economic nexus provision with an Information Publication indicating that a corporation will not be deemed to have an economic nexus with the state if its activities have resulted in less than \$500,000 of Connecticut sales during the tax year. State of Connecticut Department of Revenue Services, Informational Publication 2010(29.1) (Dec. 28, 2010), *Q&A on Economic Nexus*

Other state statutes rely on source principles without requiring an *MBNA W. Va.* level of contacts with their state. Kentucky, for example, has defined “doing business” in the state to include “[d]eriving income from or attributable to sources within this state” and “[d]irecting activities at Kentucky customers for the purpose of selling them goods or services.”<sup>146</sup> This formulation contains both source principles (deriving income from sources in the state) and activity principles (directing activities at in-state customers). This is similar to the approach adopted in Minnesota. Minnesota Statutes section 290.015, subdivision 1(b) provides that a business is subject to the state’s income tax “if the trade or business obtains or regularly solicits business from within this state, without regard to physical presence in this state.” This formulation contains the same two elements, imposing tax on those who (1) obtain business from the state (a source concept) or (2) regularly solicit business from the state (an activity concept). Many state statutes adopt the same approach,<sup>147</sup> while some rely solely on source concepts.<sup>148</sup> Regardless of the approach, however, these states’ standards accept that the simple derivation of revenue from a state is sufficient for the imposition of the states’ business activity taxes without an inquiry into the level of that revenue or the level of the economic contacts that created those returns.<sup>149</sup>

The foregoing qualitative economic nexus formulations provide three principal lessons. First, even among states that have adopted such standards, there is significant variation in how they are structured. Second, only formulations like those adopted in Connecticut and New Hampshire

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(<http://www.ct.gov/drs/lib/drs/publications/pubsip/2010/ip2010-29.1.pdf>) [herein after Connecticut, *Q&A*]. Although this standard appears to set up a purely quantitative standard, the publication notes that taxpayers not meeting this threshold can still be assessed tax under other nexus standards. *Id.*

146. KY. REV. STAT. ANN. § 141.010(25)(f)-(g) (West 2012). Of course, this statute respects P.L. 86-272, providing that “[n]othing in this subsection shall be interpreted in a manner that goes beyond the limitations imposed and protections provided by the United States Constitution or Pub. L. No. 86-272.” *Id.* § 141.010(25).

147. *See, e.g.*, ALA. CODE § 40-18-2(a)(3) (2012); ARIZ. REV. STAT. ANN. § 43-102(A)(5) (2012); GA. CODE ANN. § 48-7-31(a) (2012); IOWA CODE § 422.33(1) (2012); KAN. STAT. ANN. § 79-32, 110(c) (2012); N.J. ADMIN. CODE § 18:7-1.6(a)(2) (2012); N.M. STAT. ANN. § 7-2A-3(A) (2012); S.C. CODE ANN. § 12-6-530 (2012).

148. *See, e.g.*, IND. CODE § 6-3-2-2(a)(5) (2012); LA. REV. STAT. ANN. § 47:31(3) (2012); ME. REV. STAT. tit. 36 § 5102(6), (10) (2012); OR. ADMIN. R. § 150-318.020(2)(1) (2012); UTAH CODE ANN. § 59-7-201(1) (West 2012); VA. CODE ANN. § 58.1-400 (2012).

149. A lack of case law analyzing the boundaries of these standards suggests that states have not yet attempted to exercise their taxing powers to the full extent allowed by their statutes.

attempt to provide meaningful guidance on what actions constitute an economic nexus. Third, many of those formulations allow the imposition of tax based simply on source principles.

## 2. *Quantitative Tests for Economic Nexus*

Many states have eschewed qualitative economic nexus standards in favor of purely quantitative rules. Those rules are generally based upon a 2002 model statute promulgated by the Multistate Tax Commission.<sup>150</sup> Under that model legislation, a taxpayer has a sufficient nexus with a state if it has more than (1) \$50,000 of property; (2) \$50,000 of payroll; (3) \$500,000 of sales; or (4) 25% of its total property, payroll, or sales in the state.<sup>151</sup>

The model statute also provides for inflation adjustments to those threshold amounts<sup>152</sup> and provides model sourcing rules for determining the property, payroll, and sales factors.<sup>153</sup> Legislatures and revenue authorities in California,<sup>154</sup> Colorado,<sup>155</sup> Michigan,<sup>156</sup> Ohio,<sup>157</sup> Oklahoma,<sup>158</sup> and Washington<sup>159</sup> have adopted this factor nexus concept in some form.<sup>160</sup>

The California factor nexus standard follows the MTC model formulation's threshold amounts.<sup>161</sup> Like the MTC model, those amounts are

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150. Multistate Tax Commission, *Factor Presence Nexus Standard for Business Activity Taxes* (Oct. 17, 2002), [http://www.mtc.gov/uploadedFiles/Multistate\\_Tax\\_Commission/Uniformity/Uniformity\\_Projects/A\\_-\\_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf) [hereinafter MTC, *Factor*]. The MTC's factor nexus standard is based on a proposal by economist Charles McLure, Jr. See McLure, *Implementing*, *supra* note 10, at 1295–97.

151. MTC, *Factor*, *supra* note 150, § B(1).

152. *Id.* § B(2) (providing that the state tax administrator shall adjust those threshold amounts if the consumer price index has changed by 5 percent or more since the last adjustment”).

153. *Id.* § C.

154. CAL. REV. & TAX. CODE § 23101(b) (West 2012).

155. 1 COLO. CODE REGS. § 201-2:39-22-301.1 (2012).

156. MICH. COMP. LAWS ANN. § 206.621 (West 2012).

157. OHIO REV. CODE ANN. § 5751.01(I) (West 2012).

158. OKLA. STAT. tit. 68, § 1218(H)(3)–(6) (2012).

159. WASH. REV. CODE § 82.04.067(6) (2012).

160. A number of other states have adopted quantitative nexus standards specifically for financial institutions. See HELLERSTEIN, STATE TAXATION, *supra* note 16, at ¶ 6.29. Those statutes raise the same constitutional questions as do the broader factor nexus standards discussed herein. However, due to the limited scope of those statutes on one particular industry, they are not specifically discussed herein. Note, however, that attention will need to be paid to this issue if and when Congress evaluates a national nexus standard.

161. CAL. REV. & TAX. CODE § 23101(b).

also to be adjusted for inflation.<sup>162</sup> A taxpayer's sales, property, and payroll, however, are determined under California's general rules for apportionment rather than under specific formulas for purposes of factor nexus.<sup>163</sup> California also deviates from the MTC model in a significant way. The California Franchise Tax Board has recently indicated that the state's quantitative nexus standard is not necessarily a bright-line rule for nexus in the state. Rather, the Board has indicated that it can find that a taxpayer has nexus with the state if that taxpayer meets the state's factor nexus thresholds or if it "actively engages in any transaction for the purpose of financial or pecuniary gain or profit in California."<sup>164</sup> The ability to "opt out" of the factor nexus standard makes that standard nearly meaningless in determining the lower boundary of the state's reach under economic nexus.

The Michigan corporate income tax also utilizes a factor nexus standard based on the MTC model. Under this tax, a taxpayer has a substantial nexus with the state if it has a physical presence in the state for more than one day or if it actively solicits in the state and has Michigan gross receipts of at least \$350,000.<sup>165</sup> The Michigan statute does not include inflation adjustments or a unique provision for determining a taxpayer's Michigan gross receipts. Presumably, then, the state's general apportionment rule will apply to the factor nexus determination.<sup>166</sup>

Ohio adopted the MTC's factor nexus standard for purposes of its commercial activity tax in 2005.<sup>167</sup> The statute differs from the MTC model by providing neither an inflation-adjustment provision nor specialized apportionment rules for purposes of the factor nexus standard. Ohio law also provides an alternative rule under which a person has a substantial nexus with the state if the person "[o]therwise has nexus with the state to an extent that the person can be required to remit the tax [ ] under . . . the Constitution

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162. *Id.* §§ 23101(c); 17041(h).

163. *Id.* §§ 23101(b)(2)–(4); 25120(c), (e)–(f); 25129–25131; 25133.

164. State of California Franchise Tax Board, *General Information on New Rules for Doing Business in California*, [www.ftb.ca.gov/businesses/New\\_Rules\\_for\\_Doing\\_Business\\_in\\_California.shtml](http://www.ftb.ca.gov/businesses/New_Rules_for_Doing_Business_in_California.shtml) (last visited June 14, 2012) [hereinafter California, *General Information*].

165. MICH. COMP. LAWS ANN. § 206.621 (West 2012). This standard was previously incorporated into the Michigan business tax. That tax was repealed in favor of the corporate income tax on May 25, 2011. 2011 Mich. Pub. Acts 38. For a discussion of this bill and its effect, see Cara Griffith, *A Primer on the New Michigan Corporate Income Tax*, 60 ST. TAX NOTES 819 (June 13, 2011).

166. The Michigan provision is less closely related to the MTC model than other states' formulations because it includes only a sales factor and a *de minimis* physical presence factor. However, for purposes of this article, it is discussed with those other standards because it relies on a quantitative formulation.

167. OHIO REV. CODE ANN. § 5751.01(I) (West 2012).

of the United States.”<sup>168</sup> Oklahoma followed that model (including reserving the state’s right to impose its tax if the taxpayer otherwise has nexus sufficient under the U.S. Constitution)<sup>169</sup> with its enactment of a business activity tax in 2010.<sup>170</sup> The effect of the Ohio and Oklahoma opt-out provisions is the same as the effect of the opt-out policy adopted by the California Franchise Tax Board.

Finally, Washington has adopted a bifurcated approach for purposes of its business and occupations tax.<sup>171</sup> The state applies a factor nexus concept to out-of-state entities with respect to their service and royalty income. However, taxpayers with income from retailing, wholesaling, or other classifications are still subject to a physical presence standard.<sup>172</sup> For taxpayers engaged in activities subject to the factor nexus standard, Washington has adopted the MTC levels for the property and payroll factors, but it reduced the sales threshold to \$250,000 — one-half of the MTC model’s amount.<sup>173</sup> Those factors are adjusted for inflation consistent with the MTC’s model statute,<sup>174</sup> but they are determined under the state’s general apportionment rules.<sup>175</sup>

In addition to these state legislative factor nexus standards, two states have adopted factor nexus by administrative action. First, the Colorado Department of Revenue adopted a factor nexus standard by regulation in April of 2010.<sup>176</sup> The Colorado regulation follows the MTC model formulation’s threshold amounts and adopts the MTC’s factor calculation provisions, but it does not provide for inflation adjustments.<sup>177</sup> Connecticut revenue authorities similarly adopted factor nexus at the agency level, supplementing the state’s statutory qualitative economic nexus standard via publication. Under that agency guidance, a corporation has an economic

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168. *Id.* § 5751.01(H)(4).

169. OKLA. STAT. tit. 68, § 1218(H)(7) (2012).

170. *Id.* § 1218(H)(3)–(6).

171. The Washington business and occupations tax is a tax on the “value of products, gross proceeds of sales, or gross income of [a] business.” WASH. REV. CODE § 82.04.220(1) (2012).

172. *Id.* § 82.04.067(6).

173. *Id.* § 82.04.067(1).

174. *Id.* § 82.04.067(5).

175. *Id.* § 82.04.067(4).

176. 33 COLO. REG. 8 (April 2010), <http://www.sos.state.co.us/CCR/RegisterHome.do?pyear=2010>.

177. 1 COLO. CODE REGS. § 201-2:39-22-301.1(2)(c) (2012). Taxpayers subject to the Department’s special apportionment methods calculate their nexus factors consistent with those regulations as they were defined for tax periods prior to January 1, 2009. *Id.* § 201-2:39-22-301.1(2)(c)(iv).

nexus with Connecticut if its activities have resulted in at least \$500,000 of Connecticut sales during the tax year.<sup>178</sup>

These divergent legislative and regulatory actions show that states are keen to adopt quantitative economic nexus standards based upon the MTC model, but states are not limiting their reach to that set forth by the MTC. States have adopted widely divergent sales thresholds, many fail to provide for inflation adjustments, and some retain the right to tax businesses that do not meet their factor thresholds.

### III. EVALUATING STATE ECONOMIC NEXUS FORMULATIONS

The discussion above shows that significant variation exists among states' economic nexus standards, whether in qualitative or quantitative form. The most obvious variation is among states that have insisted on "heightened" economic nexus formulations and those that have either failed to address the scope of their formulations or those that simply rely on source principles.<sup>179</sup>

Evaluating the validity of source based economic nexus is straightforward<sup>180</sup> — its validity depends on whether the Commerce Clause requires something more than the simple derivation of revenue from a state.<sup>181</sup> Heightened economic nexus formulations present a much different inquiry. Such formulations purport to require heightened levels of connection to a state and, in doing so, attempt to avoid the more difficult constitutional question presented by economic nexus once it is accepted that physical presence is not required. Those heightened formulations thus serve to lessen the need for the Court to evaluate that issue and purport to provide a meaningful method for evaluating economic nexus disputes moving forward. But are those formulations likely to remain as restrictive as they are today? Do they rest on foundations that will stand firm in the face of continued evaluation and pressure for more state revenue? If the answers to these questions are "no," then states' current heightened economic nexus formulations provide only a snapshot of what economic nexus currently

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178. Connecticut, *Q&A*, *supra* note 145.

179. The term "heightened" in this sense refers to those economic nexus standards that require some level of economic connection to a state that is significantly higher than the minimum connections required by the Due Process Clause or the simple derivation of revenue from a state.

180. To call the evaluation "straightforward" is not to call it "easy." It is straightforward because it directly presents the fundamental constitutional question, not because that question is easily answered.

181. The initial step in determining the validity of those standards is thus determining whether *Quill* compels the conclusion that the Commerce Clause provides a higher jurisdictional bar on business activity taxes than does the Due Process Clause. *See infra* Part III.A.1.

means rather than formulations on which taxpayers can rely. Significantly, they would also lack meaning in the search for a rational economic nexus standard going forward. This section thus analyzes whether and how those formulations will develop over time.

A. *The Future of Qualitative Economic Nexus*

The discussion above evidences that states' qualitative economic nexus formulations have taken many forms, from the *MBNA W. Va.* substantial economic presence test to unarticulated standards providing no explicit bounds. It also shows that the courts that have evaluated the scope of their states' economic nexus formulations have indicated that those formulations provide heightened jurisdictional bars that are more onerous than that provided by the Due Process Clause. Those heightened standards require taxpayers to have "significant" or "substantial" economic connections with a state.<sup>182</sup> Constitutionally adequate economic nexus under those standards can thus only be found where a taxpayer has undertaken frequent, meaningful, and systematic efforts to exploit the market of the taxing state.<sup>183</sup>

Evaluation of those standards shows three fundamental weaknesses that call into question the sustainability of their heightened formulations. First, the U.S. Supreme Court's Commerce Clause jurisprudence does not compel elevation of those Commerce Clause standards over the Due Process Clause. Second, established precedent shows that the concept of substantiality has very little meaning for purposes of state tax nexus analyses. Third, those standards unnaturally elevate physical contacts over economic contacts.

1. *The Gratuitous Elevation of the Commerce Clause over the Due Process Clause*

As discussed above, state courts adopting heightened economic nexus standards have done so based on a belief that the Commerce Clause must restrict state power more than the Due Process Clause restricts state power.<sup>184</sup> Each of those courts has expressed support for this belief by

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182. Tax Commissioner of W. Va. v. MBNA Am. Bank, N.A., 640 S.E.2d 226, 235 (W. Va. 2006).

183. *Id.* at 234–35.

184. *Id.* at 235 ("exploitation of the market [under the Commerce Clause] must be greater in degree than under the Due Process standard"); *Capital One Bank v. Commissioner of Rev.*, 899 N.E.2d 76, 86 (Mass. 2009) (stating that the concept of substantial nexus "plainly means a greater presence, both qualitatively and quantitatively, than the minimum connection between a State and a taxpayer that



referencing *Quill* and its discussion regarding the purposes and requirements of the Commerce and Due Process Clauses.<sup>185</sup> The steadfastness of those heightened economic nexus standards thus depends on whether *Quill* actually commands that result. It does not.

Prior to *Quill*, the Court had held that both the Commerce and Due Process Clauses required that a remote vendor have a physical presence in a state before the state could require the business to collect its sales or use taxes.<sup>186</sup> The *Quill* Court, however, recognized that its general Due Process jurisprudence had evolved to reject the physical presence rule in favor of a minimum-contacts standard.<sup>187</sup> The Court thus agreed to “lower” its Due Process bar for purposes of analyzing state taxes. At the same time, the Court determined to maintain its physical presence rule under the Commerce Clause (at least for purposes of state sales and use taxes).<sup>188</sup> That simultaneous lowering of the Due Process bar and maintenance of a heightened Commerce Clause bar can be interpreted to mean that the Commerce Clause requires a “higher” jurisdictional bar than does the Due Process Clause, and states have certainly felt limited by that construction. Such a conclusion holds true, however, only as long as the Commerce Clause still imposes a physical presence requirement. Indeed, the comparison to be made in *Quill* is not between the Commerce and Due Process Clauses, but between the physical presence standard and the minimum contacts standard. If the Commerce Clause test is no longer one of physical presence (as is the case if one accepts an economic nexus standard), then that comparison is no longer relevant.<sup>189</sup>

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would satisfy a due process inquiry”); *Kmart Props., Inc. v. N.M. Tax’n & Rev. Dep’t*, 131 P.3d 27, 36 (N.M. 2001) (“Although *Quill* did establish that ‘substantial nexus’ under *Complete Auto Transit* has more than the minimum contacts required of due process . . . we need not quantify that difference here.”).

185. *MBNA W. Va.*, 640 S.E.2d at 235 (responding to the taxpayer’s argument that an economic nexus test was “in fact [] applying a Due Process minimum contacts standard in violation of *Quill*”); *Capital One*, 899 N.E.2d at 86 (citing back to the court’s discussion of *Quill*’s Commerce Clause discussion in a prior footnote); *Kmart Props.*, 131 P.3d at 36 (noting that *Quill* established that the Commerce Clause imposes a higher burden than the Due Process Clause).

186. *Nat’l Bellas Hess, Inc. v. Dep’t of Rev. of Ill.*, 386 U.S. 753, 758 (1967).

187. *Quill Corp. v. North Dakota*, 504 U.S. 298, 307 (1992).

188. *Id.* at 311.

189. For the mathematically inclined, assume that “PP” stands for the physical presence standard, that “MC” stands for the minimum-contacts standard, that “DP” stands for the Due Process Clause standard, and that “CC” stands for the Commerce Clause standard. Under *Quill*, it can be said that CC=PP and that DP=MC. It can also be said that PP>MC. It necessarily follows that CC>DP (i.e., that the Commerce Clause imposes a higher burden than the Due Process Clause). However, if a state accepts the validity of economic nexus, it necessarily believes

Quite simply, *Quill*'s concomitant lowering of its Due Process standard and its adherence to a physical presence rule under the Commerce Clause does not mandate that the Commerce Clause always be more restrictive than the Due Process Clause. It only does so as long as the Commerce Clause requires a physical presence standard. For states rejecting a physical presence rule, then, *Quill* provides a different lesson. Its only guidance is found in its discussion of the purposes for the jurisdictional requirements under the Due Process and Commerce Clauses.

The *Quill* Court very clearly explained that the constitutional protections provided under those clauses are based on different concerns and policies.<sup>190</sup> The Court also explained that "a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with the State as required by the Commerce Clause."<sup>191</sup> This statement reflects that the Commerce Clause can impose a higher jurisdictional bar on states' powers. However, it does not necessarily require that it do so. It also does not establish any required quantum of difference between the two or foreclose the possibility that a taxpayer could have a substantial nexus under the Commerce Clause without having the minimum contacts necessary for Due Process nexus.<sup>192</sup> The only true lesson that one can take from *Quill* is that the requirements under those constitutional provisions are truly "different."<sup>193</sup> A Commerce Clause inquiry must focus on the structural impacts of the state tax at issue, and a Due Process inquiry must focus on fairness to the individual taxpayer. This does not necessarily compel a heightened economic nexus standard, and courts' reliance on *Quill* to justify such standards is thus unwarranted. States' heightened economic nexus formulations thus have great latent structural

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that CC  $\neq$  PP. As a consequence, it does not follow that CC must necessarily be greater than DP.

190. *Quill*, 504 U.S. at 312 ("Despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical. The two standards are animated by different constitutional concerns and policies.").

191. *Id.* at 313.

192. Assume, for example, a customer from State A travels to State B and makes a significant purchase from B Corp. B Corp operates only in State B, limits its advertising to mailed advertisements within State B, and sends no personnel outside of the state. If State A sources B Corp's income from the customer to State A (because State A was the ultimate destination of the goods), B Corp could be subject to State A's income tax under an economic nexus standard. However, it is very likely that B Corp would lack the minimum contacts necessary to be subject to State A's tax under the Due Process Clause.

193. See Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 372.

weakness. If those standards are challenged as unduly restrictive, it is unlikely that *Quill* will compel their preservation.<sup>194</sup>

## 2. *The Insignificance of Substantiality*

Just as the prior analysis shows a jurisprudential weakness in the foundation of states' heightened economic nexus standards, current case law under the physical presence test shows a weakness in the principles used to frame those standards. Those standards have relied on formulations that require "substantial" or "significant" economic presences. Courts adopting those standards thus presume that those adjectives provide meaningful limitations on state power. Current nexus jurisprudence proves that to be untrue.

As previously discussed, the very basic standard under which Commerce Clause nexus disputes are evaluated is the *Complete Auto* standard, which requires that a taxpayer have a "substantial" nexus in a state.<sup>195</sup> Consequently, courts evaluating nexus disputes in sales tax cases have extensively evaluated the concept of substantiality. Those courts have been forced to determine how much of a physical presence is required to meet *Complete Auto*'s substantial nexus test.<sup>196</sup> The courts' decisions in those cases establish that the "substantial" qualifier is substantial only in name.

The most direct guidance from the Court on this question came in its decision in *National Geographic Society v. California Board of Equalization*.<sup>197</sup> As discussed above,<sup>198</sup> this case involved the question of

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194. Of course, *Quill* continues to compel a physical presence rule for sales and use taxes until the Court or Congress provides otherwise.

195. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

196. See HELLERSTEIN, STATE TAXATION, *supra* note 16, ¶ 19.02[4]. This continued debate has led some to question whether the *Quill* Court's bright-line test achieved its goal of reducing litigation. Laskin, *Trademark Royalties*, *supra* note 112, at 11 n.46. That critique, however, focuses on the area of continued debate rather than recognizing the certainty that *Quill* did provide. *Quill* did provide certainty and eliminate litigation for taxpayers with only an economic nexus in a state (for purposes of sales and use taxes). To ignore that benefit is akin to ignoring the number of fatalities that seat belts have prevented by focusing on the remaining number of traffic deaths. As the Michigan Court of Appeals aptly stated, "the 'bright-line' rule of *Quill* does not cut as cleanly on both sides. It definitively answers the question who cannot be taxed . . . but leaves somewhat open the question who may be taxed." *Magnetek Controls, Inc. v. Rev. Div., Dep't of Treasury*, 562 N.W.2d 219, 222 n.5 (Mich. Ct. App. 1997).

197. *Nat'l Geographic Soc'y v. Cal. Bd. of Equalization*, 430 U.S. 551 (1977). As noted previously, the Court issued that decision only three weeks after *Complete Auto*.

whether the National Geographic Society could be required to collect California sales and use tax where its only physical presence in California was its maintenance of two offices in the state.<sup>199</sup> The California Supreme Court upheld the imposition of that obligation on National Geographic, adopting a “slightest presence” test.<sup>200</sup>

The Supreme Court rejected California’s slightest presence test, but did not opine as to the proper level of contacts required. Rather, the Court simply noted that National Geographic’s actions in the state<sup>201</sup> established “much more substantial presence than the expression ‘slightest presence’ connotes”<sup>202</sup> and held that “the Society’s continuous presence in California in offices that solicit advertising for its magazine provides a sufficient nexus to justify” the state’s imposition of tax.<sup>203</sup> The *National Geographic* Court thus provided only minimal guidance on the magnitude of physical presence required under *Complete Auto*.

In the absence of further guidance from the Court, a number of states have interpreted its rejection of the slightest presence test to mean that a taxpayer’s physical presence in a state must be only somewhat greater than a slightest presence.<sup>204</sup> The seminal case in this regard is *In re Orvis Company Inc. v. New York*.<sup>205</sup> The *Orvis* court first determined that the substantial

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198. See *supra* notes 20–23 and accompanying text.

199. *Nat’l Geographic*, 430 U.S. at 552–54.

200. *Id.* at 555–56. The California court noted that “the slightest presence within such taxing state . . . will permit the state constitutionally to impose on the seller the duty of collecting the use tax from such mail order purchasers and the liability for failure to do so.” *Nat’l Geographic Soc’y v. State Bd. of Equalization*, 547 P.2d 458, 462 (Cal. 1976).

201. National Geographic’s physical presence in California consisted of the “maintenance of two offices in the State and solicitation by employees assigned to those offices of advertising copy in the range of \$1 million annually.” *Nat’l Geographic*, 430 U.S. at 556.

202. *Id.* Interestingly, the Court supported its conclusion in part by pointing to its earlier decision in *Standard Pressed Steel Co. v. Wash. Department of Revenue*, 419 U.S. 560 (1975), in which it upheld the imposition of a direct tax on a taxpayer that had only a single employee in the taxing state. *Nat’l Geographic*, 430 U.S. at 557. The Court found it “significant” that it had labeled the taxpayer’s nexus argument in that case “frivolous.” *Id.*

203. *Nat’l Geographic*, 430 U.S. at 562.

204. *Orvis Co. v. Tax Appeals Tribunal of N.Y. (In re Orvis Co.)*, 654 N.E.2d 954 (N.Y. 1995); *Magnetek Controls, Inc. v. Rev. Div., Dep’t of Treasury*, 562 N.W.2d 219, 224 (Mich. Ct. App. 1997); WASH. REV. CODE § 82.04.067(6) (2012).

205. 654 N.E.2d 954. *Orvis* involved two cases that were consolidated on appeal from the New York Appellate Division. In the first — *In re Orvis Co.* — the taxpayer’s physical presence in the state was limited to visits to as many as nineteen customers on average of four times a year. *Id.* at 962. In the other — *In re Vt.*

nexus requirement of *Complete Auto* did not require a taxpayer to have a substantial physical presence in the taxing state.<sup>206</sup> Instead, the court stated that the taxpayer's presence need only "be demonstrably more than a 'slightest presence.'"<sup>207</sup> The court then determined that the taxpayers' visits to nineteen customers four times per year and forty-one in-state visits over a three-year period, respectively, satisfied that standard.<sup>208</sup> The *Orvis* court's distillation of *National Geographic* down to a standard that requires only more than a slightest presence has been adopted by a number of other states.<sup>209</sup> The quantum of physical presence required to establish a substantial nexus under current law is thus fairly minimal — and certainly falls short of anything systematic or continual.

This discussion is not intended to intimate that states find a substantial nexus in each case where a taxpayer has any repeated or sustained physical presence in a state.<sup>210</sup> However, it does show that states do not feel

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*Informational Processing, Inc.* — the taxpayer had visited customers' locations in the state forty-one times during the three-year audit period. *Id.*

206. *Id.* at 959 ("Quill simply cannot be read as equating a substantial physical presence of the vendor in the taxing State with the substantial nexus prong of the *Complete Auto* test . . .").

207. *Id.* at 960–61.

208. *Id.* at 961–62. *Cf. In re* Petition of NADA Servs. Corp., No. 810592, 1996 WL 54197, \*15 (N.Y. Div. Tax App. Feb. 1, 1996) (holding that the slightest presence test was not met where the taxpayer's connection with the state consisted of twenty trips into New York and an unspecified number of trips in the state by independent contractors over the three-year audit period).

209. *See, e.g.*, WASH. REV. CODE § 82.04.067(6) (2012) ("a person is deemed to have a substantial nexus with this state if the person has a physical presence in this state, which need only be demonstrably more than a slightest presence"); *Brown's Furniture, Inc. v. Wagner*, 665 N.E.2d 795, 803 (Ill. 1996) (holding that the taxpayer had "established more than a slight physical presence within the [s]tate"); *Magnetek Controls*, 562 N.W.2d at 224 ("tax obligations may be imposed, consistent with the Commerce Clause, on taxpayers with 'demonstrably more than a 'slightest presence' in a state'); Comptroller of Maryland, *Nexus Information for Sales and Use Tax*, <http://business.marylandtaxes.com/taxinfo/salesanduse/nexus.asp> (last visited Oct. 5, 2012) ("All that is required is for the out-of-state vendor to demonstrate more than a 'slightest presence' in the taxing state."); State of Tennessee Office of the Attorney General, *Opinion 09-101*, (May 28, 2009), <http://www.tn.gov/attorneygeneral/op/2009/op/op101.pdf> ("By contrast, the Commerce Clause's 'substantial nexus' prong requires something more than the 'slightest presence' in the taxing jurisdiction.").

210. For example, the Kansas Supreme Court has held that the imposition of the state's use tax against an out-of-state vendor was not permissible based upon the vendor's eleven visits into the state over a forty-eight-month audit period. *In re* Appeal of Intercard, Inc., 14 P.3d 1111, 1113, 1122–23 (Kan. 2000). The Florida Supreme Court came to the same conclusion where the taxpayer was present in the state only three days a year. *Dep't of Rev. of Fla. v. Share Int'l, Inc.*, 676 So. 2d

bound to require an extensive exploitation of a state simply because the relevant standard incorporates the adjective “substantial.” Rather, once a physical presence of more than a slightest amount is established, a taxpayer is generally found to be subject to the state’s taxing authority. The concept of substantiality simply has very little meaning under current nexus jurisprudence.<sup>211</sup>

The totality of this authority calls into question the intractability of the substantial economic presence test. Just as relatively minimal levels of physical presence in a state appear to satisfy the substantial nexus requirement, it seems likely that increasingly lower levels of economic presence could satisfy the substantial economic presence test.<sup>212</sup> This conclusion is certainly supported by looking at the very authority that states and commentators cite as support for an economic nexus standard. Recall that in *International Harvester*, the taxpayers simply invested in a corporation that engaged in business in the taxing state. The court’s decision to uphold the tax in that case rested solely on the fact that the taxpayers derived income from Wisconsin, not on any showing of a heightened

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1362 (Fla. 1996), *cert. denied*, 519 U.S. 1056 (1997); *cf.* *Lamtec Corp. v. Dep’t of Rev.*, 246 P.3d 788, 790, 795 (Wash. 2011) (upholding the imposition of tax based on fifty to seventy in-state visits over the course of seven years); *Ariz. Dep’t of Rev. v. Care Computer Sys., Inc.*, 4 P.3d 469, 471–72, 474–75 (Ariz. 2000) (upholding the state’s imposition of tax on an out-of-state vendor whose sales personnel visited the state seven times and whose training personnel visited the state for eighty days during the seven year audit period); MICH. COMP. LAWS ANN. § 206.621 (West 2012) (imposing the state’s income tax on corporations that are physically present in the state for more than one day). For a detailed discussion of these cases and others, see HELLERSTEIN, STATE TAXATION, *supra* note 16, ¶ 19.02[4].

211. To be fair, the *MBNA W. Va.* economic nexus formulation does purport to require frequent or systematic economic contacts with a state. One could thus claim that substantial economic nexus is not subject to the same erosion as the physical presence standard. The answer to this claim is two-fold. First, not all heightened qualitative economic nexus standards contain these further qualifiers. Second, the terms “frequent” and “systematic” are not unlike the term “substantial” in that they do not have independent meaning. They must be measured against something. In that way, they are subject to the same pressures as the “substantial” qualifier of *Complete Auto*’s substantial nexus test.

212. *See supra* notes 65–74 and accompanying text. Of course, this discussion assumes that one can quantify and attribute economic contacts in the same way that one can quantify and attribute a taxpayer’s physical contacts. This type of inquiry may not be appropriate when discussing nexus in the context of electronic commerce. *See* Walter Hellerstein, *State and Local Taxation of Electronic Commerce: Reflections on the Emerging Issues*, 52 U. MIAMI L. REV. 691, 694–95, 701–702 (1998) (arguing that attempting to assign economic contacts to a particular jurisdiction “makes little sense in cyberspace” and presents questions “not worth answering”).

economic nexus. Thus, if that case is relevant to an enforcement jurisdiction analysis, it significantly undercuts the significance of substantiality as a requirement for economic nexus.<sup>213</sup>

3. *The Arbitrary Elevation of Physical Presence over Economic Presence*

Heightened economic nexus standards purport to require taxpayers to have much more meaningful economic contacts with a state than the physical contacts that are required to establish a substantial nexus under *Orvis*. Those standards therefore necessarily ascribe more constitutional significance to physical contacts than to economic contacts,<sup>214</sup> and their legitimacy — from a theoretical perspective — rests on whether that elevation of physical contacts is warranted.

Answering that question is a short task. Elevating physical contacts in that way would cut at the core of the rationale for an economic nexus standard as a matter of first import. The economic nexus standard is based in large part on states' recognitions of the great technological and social changes that have made economic exploitation the equal sister of physical exploitation in the modern economy. The emergence of the Internet, for example, has largely obviated the need for businesses in many industries to have physical storefronts. In addition, other businesses have developed solely in the digital realm — cloud computing or online-dating services for instance. It is now possible for a business to exploit a remote market more comprehensively with electronic methods than it can with a local physical presence. For example, would anyone argue that a shoe manufacturer in North Carolina could exploit the California market more fully as a transient vendor on a street corner in Berkeley than by setting up an Internet storefront and sending repeated e-mail solicitations to California customers? Certainly not. A heightened standard for economic exploitation simply does not comport with this economic reality.

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213. The preceding analysis of the insignificance of substantiality has been intended to show that states' limitations of economic nexus can effectively change without requiring changes to their current formulations — that is, that current formulations do not necessarily require a heightened economic nexus standard. It is a separate issue, however, to consider whether those standards will change. Will states push those standards ever lower? Will they seek to expand their power in that way? This issue is discussed below.

214. Michigan Compiled Laws § 206.621(1) clearly demonstrates this in the context of a heightened quantitative standard. That statute imposes tax on businesses that have gross receipts of \$350,000 or more sourced to Michigan or that have a physical presence in the state for a period of only more than one day. The significance of one day of physical presence over hundreds of thousands of dollars of gross receipts is remarkable.

A different standard for economic and physical presence would simply ignore the vast diversity of economic “experiences” that can occur in the modern economy. A physical presence can range from an unintended frolic across state lines in a company vehicle to the operation of multiple physical storefronts. Similarly, an economic presence can range from an undirected electronic communication to a significant portfolio of long-term licensing agreements with multiple businesses in a state. The constitutional protection afforded to taxpayers under the Commerce Clause cannot rest on a distinction as meaningless as whether they physically or economically exploit their markets. Rather, the quantity and quality of contacts must govern.

Of course, this equivalization of physical and economic presences conflicts with the Court’s personal jurisdiction jurisprudence, which does elevate physical presences over other presences to a certain extent.<sup>215</sup> Under that jurisprudence, a taxpayer that does not have a physical presence in a state needs to otherwise have “minimum contacts” with that state to be subject to its jurisdiction. The Court thus holds out physical presences as different, more meaningful, than other presences in that context. Why then can we limit the import of physical presences for purposes of a Commerce Clause analysis? Why can we be comfortable equating physical and economic contacts in that realm? The answer is twofold.

First, different purposes underlie the Court’s Due Process and Commerce Clause standards.<sup>216</sup> Due Process is concerned with fairness and notice whereas the Commerce Clause is concerned about economic factors — here, the impact of a state’s nexus standard on interstate commerce.<sup>217</sup> Thus, although physical presences are given some weight for purposes of personal jurisdiction, that factor alone is not sufficient to conclude that they should have the same relevancy under the Commerce Clause. The importance of physical presences for that purpose depends on the extent to which they impact the burdens of state taxation. Only if they lessen those burdens (as they lessen our concerns about fairness and notice for personal jurisdiction inquiries) should they have weight in the relevant Commerce Clause standard.

A quick analysis shows that physical presences do not lessen tax-compliance burdens such that they should be given weight for Commerce Clause purposes. Fundamentally, if an out-of-state business’s costs of

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215. *Int’l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945) (“due process requires only that in order to subject a defendant to a judgment in personam, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend ‘traditional notions of fair play and substantial justice’”).

216. *See supra* note 31 and accompanying text.

217. *See supra* note 31 and accompanying text.



compliance with a state's income tax laws are \$x, how would those costs be less than \$x if the business decided to have an employee attend a conference in the state or to retain title to inventory in the state? The business's burdens of compliance would be unrelated to those minimal physical connections. Rather, the burdens of the state's tax system would be related to the rate of the state's tax, the clarity and complexity of its reporting rules, the corporate structure of the taxpayer, and the taxpayer's economic returns from the state. The taxpayer's physical presence in the state would play no role in those costs.<sup>218</sup> For these reasons, physical presences should have a lesser role (if any) for purposes of the Commerce Clause than they do for purposes of analyzing personal jurisdiction.

Of course, to say that physical presences should play a lesser role for Commerce Clause purposes than for purposes of analyzing personal jurisdiction leaves them with little worth. The Court's personal jurisdiction standard already reflects little reverence for physical presences. The standard against which physical presences are measured is only one of "minimum" contacts. Thus, physical presences are only afforded more weight than economic contacts that are something less than minimum. That is not saying much. If we start with that limited elevation of physical presences and discount it further by the relative lack of importance of physical presences for Commerce Clause purposes, it is easy to justify putting physical presences and economic presences on the same plane, as suggested above.<sup>219</sup> Once that occurs, *Orvis* and its kin have considerable meaning when evaluating states' promises of heightened economic nexus. Just as a taxpayer's limited, but repeated physical presence in a state creates substantial nexus under the physical presence standard, so too will limited, but repeated economic exploitations likely create a substantial nexus under an economic nexus standard. There is simply no theoretical (or, as discussed above, jurisprudential) basis under which economic exploitation should be held to a meaningfully higher standard than physical exploitation.<sup>220</sup>

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218. It could be argued that a physical presence would actually increase those costs rather than decrease them. That would occur because the business's physical presence could generate an in-state property or payroll factor, which could increase the taxpayer's return-preparation difficulty and level of tax owed. Of course, these impacts suggest that out-of-state businesses may be more burdened if it has a minimal physical presence than if it has none.

219. One could go even further and argue that perhaps physical presence alone is insufficient under the Commerce Clause, but that goes beyond the bounds of this article.

220. Of course, it is much more difficult to accidentally find oneself physically present in a jurisdiction than economically present. However, a critique based on that rationale would speak more towards fairness concerns than it does to the difference between the quality of economic and physical contacts. That fairness concern would properly be analyzed under the Due Process Clause.

#### 4. Summary

The analysis above shows that states' heightened qualitative economic nexus formulations are not compelled by the Court's Commerce Clause jurisprudence, that the actual language of those formulations provides only limited practical limitations on states' applications of those formulations, and that there is no theoretical basis for those formulations' elevation of physical presence over economic presence. What, then, will actually happen to those standards? Will they necessarily weaken over time?

Of course, none of us can know the future. Nonetheless, a few factors indicate that states' expansion of their power is most likely. First, states have an obvious interest in expanding their taxing power to the greatest extent possible. Broad economic nexus standards would give states the flexibility to deal with new situations (or, perhaps more directly to the point, abusive tax structures) as they arise even if, as a matter of policy, states do not fully exercise their self-defined power. Second, and more fundamentally, states have little real reason to deny themselves that power. As shown above, there is little jurisprudential or theoretical basis for a restrictive economic nexus standard. The only reason for state restraint would be to avoid unintentionally inviting the Supreme Court to the party. However, given the Supreme Court's general lack of interest in reviewing nexus disputes (and given states' confidence in their power under the Dormant Commerce Clause), assuming restraint on this basis is suspect. To the contrary, states may wish to push the boundaries precisely to get the Supreme Court to look at the issue — and to support economic nexus directly.

The one potential obstacle to an expanded economic nexus standard, then, would appear to be state courts. Will state courts reject attempts by state legislatures and revenue authorities to expand economic nexus? Even if they felt so inclined, the analysis offered above suggests that state courts will have limited bases on which to require heightened economic nexus standards. Unless a physical presence rule is required, there is little jurisprudential basis for limiting economic nexus in that way. It is thus difficult to imagine that states' qualitative economic nexus formulations will not deteriorate over time.

#### B. *The Future of Quantitative Factor Nexus*

In lieu of the qualitative standards discussed above, a number of state legislatures and revenue departments have adopted quantitative factor nexus rules consistent with the MTC model formulation.<sup>221</sup> Those rules

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221. *See supra* Part II.C.2.

provide much needed certainty for taxpayers doing nexus analyses,<sup>222</sup> and they provide significant administrative benefits.<sup>223</sup> Unfortunately, however, state factor nexus formulations are inherently arbitrary and hence exceptionally malleable. Three forms of flexibility<sup>224</sup> prevent those standards from being suitable forms for economic nexus going forward: (1) magnitude flexibility; (2) definitional flexibility; and (3) application flexibility.

### 1. *Magnitude Flexibility*

Factor nexus operates by exempting from tax those businesses that do not exceed prescribed minimal levels of property, payroll, or sales in a state. The determination of the magnitude of those levels is thus of the utmost importance to both businesses and state revenue authorities. Unfortunately, however, the levels at which those thresholds are set is ultimately arbitrary. Nexus under the Commerce Clause has never been recognized as a purely quantitative inquiry. Thus, a state need only set its threshold amounts high enough to effectively eliminate any unreasonable risk that taxpayers will exceed them without having expended constitutionally significant efforts to exploit its market.<sup>225</sup> There is nothing that requires states to act uniformly. Indeed, significant variation already exists among the states that have adopted factor nexus standards.

As noted above, the MTC model sets the sales factor threshold at \$500,000.<sup>226</sup> Many states have also adopted that threshold, but not all states have been uniform. Michigan has adopted a sales threshold that is \$350,000

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222. *But see supra* notes 165 and 170 and accompanying text (discussing two states' provisions allowing them to opt out of their factor nexus provisions).

223. The standard also loosens the physical presence standard by allowing certain levels of property and payroll in the state without requiring the taxpayer to pay tax in that state.

224. Although flexibility is sometimes viewed as a valuable trait, it is not favorable in this context. Flexibility undermines the value of a factor nexus standard as providing certain, uniform, bright-line guidance.

225. In proposing a factor nexus standard, Professor McLure was very deliberate in noting that his standard would require "significant amounts" of activity in the taxing state. McLure, *Implementing, supra* note 10, at 1295–96 ("The repetition of the words 'significant amounts' in the previous paragraph is intended to prevent a finding of nexus where the economic activities of the corporation that could create nexus are *de minimis*."). There is not universal agreement that all states' factor nexus thresholds are currently set high enough. *See* Steven Roll, *States Take Contrasting Approaches to Implementing Economic Nexus Standards*, State Tax Blog [http://www.bna.com/blogs\\_post.aspx?id=2147484887&blogid=97](http://www.bna.com/blogs_post.aspx?id=2147484887&blogid=97) (last visited May 18, 2012) (noting that Fred Nicely, tax counsel for the Committee on State Taxation had expressed that Washington's \$250,000 threshold was impermissibly low).

226. *See* MTC, *Factor, supra* note 150.

— only 70 percent of the MTC model.<sup>227</sup> The sales threshold in Washington is even lower, at one-half of the MTC model — \$250,000.<sup>228</sup> This disparate practice is the result of using dollar values as a proxy for a real constitutional standard. Until a constitutional boundary is established, states will likely continue to adopt lower standards.<sup>229</sup> Further, states that have already adopted threshold amounts will be free to lower them. Magnitude flexibility will almost certainly lead to magnitude erosion over time.

Another less apparent way for factor thresholds to differ or erode over time is through the use or nonuse of inflation adjustments. The MTC model requires annual review and potential inflation adjustment of the factors,<sup>230</sup> and California and Washington have adopted that rule. Other states have not been uniform. As shown above, Colorado, Connecticut, Michigan, Ohio, and Oklahoma do not require inflation adjustments.<sup>231</sup> A necessary consequence of this lack of uniformity is that states' thresholds can vary from one another over time even if they were enacted at the same level.

## 2. *Definitional Flexibility*

Definitional flexibility refers to the fact that the determination of a taxpayer's factors is purely a matter of legislative (or perhaps administrative) discretion.<sup>232</sup> This manifests itself more clearly with respect to a taxpayer's sales factor than its property or payroll factors because attributing property or payroll to a state is generally self-evident. The sourcing of sales is much

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227. MICH. COMP. LAWS. ANN. § 206.621 (West 2012).

228. WASH. REV. CODE § 82.04.067 (2012).

229. This again assumes that states will utilize the current uncertainty regarding the bounds of economic nexus to lower their standards over time. It appears most reasonable to assume that states will seek to expand their taxing power as far as possible. Of course, this begs the question of why states have not already done so. The answer is two-fold. First, states have wisely chosen to litigate economic nexus disputes that involve taxpayers with very significant income from their states (and hence large potential tax liabilities). This has allowed state courts to adopt standards to meet those limited facts. Second, economic nexus is still in its relative infancy. States have been focused on obtaining widespread acceptance of that standard in the abstract. States thus have been justifiably cautious with their economic nexus standards to date. As the concept is more readily accepted, it seems safe to assume that the aforementioned expansion will begin.

230. MTC, *Factor*, *supra* note 150, § B(2).

231. *See supra* notes 166–179 and accompanying text.

232. *See* Charles E. McLure, Jr. & Walter Hellerstein, *Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals*, 31 ST. TAX NOTES 721, 733 (Mar. 1, 2004) [hereinafter McLure & Hellerstein, *Congressional Intervention*] (noting that the “choice of apportionment formulas . . . and the definition of each of the factors are, to some extent, arbitrary”).

more problematic. The revenue from a single sale of a service, for example, can be attributed to several states.

Assume that a lawyer in New York receives a call from an Illinois client that has a legal question related to a patent used in its manufacturing process in its Georgia facility. The lawyer undertakes her legal research in her New York office and calls the client in Illinois with her advice. The client immediately calls the facility manager in Georgia to implement the advice and eagerly awaits the lawyer's bill. The income that the lawyer receives from the client could be fairly sourced to at least three states: the state where the work was performed (New York), the state where the client received the advice and the bill for the lawyer's services (Illinois), or the state where the advice was ultimately used (Georgia). The sourcing of those receipts will depend on how the state legislatures or revenue authorities determine to define their sales factors.<sup>233</sup> As a result, unless states adopt the same methods for calculating taxpayers' factors, wide variations can exist regarding how those factors are calculated from state to state. This concern is not merely academic. As shown above in Part II.C.2, the MTC has issued model attribution rules, but states adopting a factor nexus standard have not uniformly adopted them.

Sales factors can also be manipulated due to concerns other than properly sourcing income. For example, significant attention has been paid to the potential for "nowhere" income that results from the apportionment of sales to states in which a business is not subject to tax —either due to jurisdictional reasons or because the state does not impose a corporate income tax.<sup>234</sup> States have responded to this concern by adopting throwout and throwback rules to further the goal that all of a taxpayer's income be subject to tax somewhere. Apportionment formulae thus represent not only a method for properly attributing income to its source state, but also a method

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233. For recent discussions of the sourcing of services income, see Cara Griffith, *Using Market-Based Sourcing for Service Receipts: The Difficulties*, 56 ST. TAX NOTES 387 (May 3, 2010); Giles Sutton, Jaime Yesnowitz, Chuck Jones & Terry F. Conley, *The Nuances of Market-Based Sourcing of Service Revenue: Not All Markets Look the Same*, 21 J. Multistate Tax'n & Incentives 2, 6 (May 2011); John A. Swain & Walter Hellerstein, *The Market State Approach to the Attribution of Receipts From Services*, 59 ST. TAX NOTES 331 (Jan. 31, 2011). Of course, the same issue can arise with respect to the sale of goods. Sales of goods can be attributed to the state where the items are sold, shipped, or put to use.

234. HELLERSTEIN, STATE TAXATION, *supra* note 16, ¶ 9.18[1][b]; Institute on Taxation and Economic Policy, *'Nowhere Income' and the Throwback Rule* (Aug. 2011), [www.itepnet.org/pdf/pb39throw.pdf](http://www.itepnet.org/pdf/pb39throw.pdf); Michal Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States*, (May 23, 2003), <http://www.union1.org/oip/PDF%20Files/Economics/Three%20loopholes.pdf>.

for ensuring that all of a taxpayer's income is subject to tax by at least one state.

Under a throwback rule for example, a taxpayer's sales are added back to their sales factor numerator<sup>235</sup> in a state if (1) the taxpayer is not subject to tax in the state to which the sale would otherwise be sourced and (2) the item sold originates from the taxing state.<sup>236</sup> The effect of a throwback rule is that the taxpayer's sales are attributed to the state from which the goods were shipped, rather than the state in which the taxpayer's customer consumes the goods. The rule thus ensures that "mismatches" between states' overall substantive jurisdiction and their enforcement jurisdiction do not arise.<sup>237</sup> It does not, however, reflect an increase in the origination state's enforcement jurisdiction. Throwback rules thus take on an uneasy tone when pulled into the enforcement jurisdiction inquiry. The purpose of factor nexus is not to ensure that a taxpayer's income is subject to tax somewhere, but rather to determine when a taxpayer's connection to a particular state is sufficient to meet the demands of the Commerce Clause. A throwback rule is thus unsuited to an economic nexus analysis. Throwing back sales for purposes of a factor nexus inquiry would improperly source sales to a state based not upon a taxpayer's actions with respect to that state, but with respect to another state's jurisdiction to tax. That focus is inappropriate when attempting to determine the scope of a state's enforcement jurisdiction.

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235. A taxpayer's sales factor numerator represents its sales that are attributable (under the states' particular rules) to the taxing state. State corporate income taxes make use of apportionment formulae to properly allocate income among the states in which a taxpayer does business. Historically, states have used three factors (the property factor, the payroll factor, and the sales factor) to develop an overall apportionment formula that is applied to the taxpayer's apportionable income. See HELLERSTEIN, STATE TAXATION, *supra* note 16, ¶ 8.05–8.06.

236. For a detailed discussion of throwback rules, see HELLERSTEIN, STATE TAXATION, *supra* note 16, ¶ 9.18[1][b]. The throwback rule is a component of the Uniform Division of Income for Tax Purposes Act ("UDITPA"), a model income tax act drafted by the National Conference of Commissioners on Uniform State Laws. UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT (1957). The UDIPTA throwback rule provides that "[s]ales of tangible personal property are in this state if . . . the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser." *Id.* § 16(b). A taxpayer is deemed to be taxable in the state of the purchaser if the taxpayer is either "subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax" in that state or "that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not." *Id.* § 3.

237. See William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 747–51 (1957).

A throwback rule is only one example of how a taxpayer's factors can be manipulated<sup>238</sup> to reflect aspects of its business operations other than its connection with a particular state.<sup>239</sup> Because the factors are ultimately subject to state legislative control, factor definitions can be shaped and changed in myriad ways.<sup>240</sup> That definitional flexibility calls into question the ability of state quantitative economic nexus standards to provide uniform or consistent guidance to taxpayers regarding their multi-state tax-compliance obligations.

### 3. Application Flexibility

The final weakness of current factor nexus standards is that nothing prevents states from adopting opt-out provisions like those enacted by the Ohio and Oklahoma legislatures and by the California Franchise Tax Board. As discussed above, the Ohio factor nexus provision provides an alternative rule under which a person has a substantial nexus with the state if the person “[o]therwise has nexus with the state to an extent that the person can be required to remit the tax [ ] under the Constitution of the United States.”<sup>241</sup> Oklahoma law similarly allows the state to impose its tax on a business that “[o]therwise has nexus with this state to an extent that the person can be required to remit the tax imposed under this act under the Constitution of the United States.”<sup>242</sup> The California Franchise Tax Board has also indicated that it can assert nexus over a taxpayer if that taxpayer actively engages in

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238. “Manipulated” is not used in a pejorative sense. Rather, it merely refers to the fact that states can change (or customize) their factors to take into account elements perhaps not previously contemplated or that cause the standard factor formulation to produce results that were not desired or anticipated.

239. Although the MTC formulation for calculating a taxpayer's sales for purposes of its factor nexus standard does not include a throwback rule, as show above in Part II.C.2, states have often relied upon their general apportionment provisions rather than the MTC's formulation. Most states' general apportionment provisions contain throwback rules. *See* HELLERSTEIN, STATE TAXATION, *supra* note 16, at ¶ 9.18[1][b][i].

240. The MTC's model regulations to the UDITPA include both a provision allowing the use of alternative apportionment formulas “where the apportionment an allocation provisions contained in Article IV produce incongruous results” and special rules that modify the normal apportionment rules in specific situations. *See* Multistate Tax Comm'n, Allocation and Apportionment Regulations §§ IV.18(a)-(c) (2010), [http://www.mtc.gov/uploadedFiles/Multistate\\_Tax\\_Commission/Uniformity/Uniformity\\_Projects/A\\_-\\_Z/AllocaitonandApportionmentReg.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocaitonandApportionmentReg.pdf). States have followed suit by adopting special apportionment rules. *See, e.g.*, CAL. REV. & TAX CODE § 25137 (West 2012); GA. COMP. R. & REGS. § 560-7-7-.03(5)(e) (2012); ILL. ADMIN. CODE tit. 86, § 100.3380(c) (2012).

241. OHIO REV. CODE ANN. § 5751.01(H)(4) (West 2012).

242. OKLA. STAT. tit. 68 § 1218(H)(7) (2012).

business transactions for profit in the state, regardless of whether those activities meet the state's factor nexus thresholds.<sup>243</sup>

These economic nexus "safety valves" undercut any potential for state-adopted factor nexus to provide uniformity or certainty. A taxpayer that does not meet a state's prescribed thresholds must still consider whether the state could argue that it has nexus under some non-defined, qualitative nexus standard. Application flexibility thus completely undermines the administrative and commercial benefits of factor nexus and is perhaps the most damning type of flexibility for state-adopted factor nexus. If factor nexus is to be accepted as an administrative proxy for economic nexus, states (just as taxpayers) should be bound to their choice.

#### 4. Summary

The sum of this discussion evidences that factor nexus (in its current form) does not provide any assurance of a consistent, uniform economic nexus standard. That approach to economic nexus certainly provides administrative benefits and may capture a good portion of taxpayers with an economic nexus in a taxing state. However, state factor nexus standards simply do not provide any guidance on the constitutional question — when does an economic nexus rise to the level of a substantial nexus? At best, those standards provide bright-line rules that create some level of certainty for states and taxpayers — at least with respect to a single state.<sup>244</sup> At worst, factor nexus represents a flexible system under which states can change and lower their nexus thresholds at will, requiring taxpayers to undertake a burdensome review of state standards each year even though their business activity is unchanged.

### IV. WHAT SHOULD BE DONE WITH ECONOMIC NEXUS?

The analysis above demonstrates that states' current economic nexus formulations are non-uniform, that those formulations lack concrete foundations, and that there is no direct Supreme Court authority requiring adherence to their forms. Taxpayers can thus fairly expect that current economic nexus formulations will change as states evaluate new applications of the economic nexus construct. Consequently, without a conscious effort to develop a unified approach to economic nexus, an unacceptable lack of uniformity and an unacceptable lack of certainty will result. That lack of uniformity and lack of certainty will create a state tax environment that is

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243. See California, *General Information*, *supra* note 164.

244. Of course, that certainly is maintained only as long as states do not change any of the variables that go into the calculation of a taxpayer's factors or retain the flexibility to assert nexus under other standards as well.



inconsistent with the purpose of the Court's Dormant Commerce Clause jurisprudence — to create structural protections against undue burdens on interstate commerce. Something must be done. It is no longer sufficient to discuss the efficacy of economic nexus. The dialog must evolve to more comprehensively discuss what economic nexus should mean.

A. *Potential Approaches for Economic Nexus*

In developing the ideal approach to economic nexus, two aspects must be evaluated: (1) what principles should guide the development of that approach and (2) who should develop or impose that approach. The answer to the first dictates the answer to the second. As a principal matter, the economic nexus “question” is one implicating the core concerns of the Dormant Commerce Clause — ensuring that state regulation (and specifically here state taxation) — does not unduly burden interstate commerce. To those ends, two guiding principles should govern: uniformity<sup>245</sup> and certainty.<sup>246</sup>

To the extent that states' rules are uniform, multistate taxpayers bear little marginal burdens when entering a new market (other than payment of the tax imposed), and interstate commerce is encouraged.<sup>247</sup> In contrast, a

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245. See, e.g., Hellerstein, *Jurisdiction to Tax Income*, *supra* note 36, at 67 (discussing a desire for a clarified, uniform standard for enforcement jurisdiction); W. Bartley Hildreth, Matthew N. Murray & David L. Sjoquist, *Interstate Tax Uniformity and the Multistate Tax Commission*, 58 NAT'L TAX J. 575, 581 (2005) (“Certainly uniformity of state corporate income taxes would be preferred to non-uniformity.”); Charles E. McLure, Jr., *The Difficulty of Getting Serious About State Corporate Tax Reform*, 67 WASH. & LEE L. REV. 327, 328 (2010) [hereinafter McLure, *The Difficulty*] (stating that “an ideal system of state corporate income taxes would exhibit uniformity in . . . standards for jurisdiction to tax”); McLure & Hellerstein, *Congressional Intervention*, *supra* note 232 (general extolling the benefits of uniformity).

246. There has been some discussion in recent tax scholarship regarding the potential benefits of uncertainty within the tax laws. See, e.g., Sarah B. Lawsky, *Probably? Understanding Tax Law's Uncertainty*, 157 U. PA. L. REV. 1017 (2009). Cf. Leigh Osofsky, *The Case Against Strategic Tax Law Uncertainty*, 64 TAX L. REV. 489 (2011). That discussion generally focuses on the potential benefits/detriments of uncertainty with respect to substantive tax provisions. The constitutional and jurisdictional dimensions of the issues discussed herein present a drastically different question.

247. For an article supporting the notion that the Court's Commerce Clause concerns about nexus stem from the marginal costs of tax compliance, see generally David Gamage & Devin J. Heckman, *A Better Way Forward for State Taxation of E-Commerce*, 92 B.U. L. REV. 483 (2012).

lack of uniformity causes increased burdens on interstate commerce through increased tax compliance costs.<sup>248</sup>

Certainty also significantly reduces the marginal burdens of compliance. Certainty for these purposes means that a state's nexus rule is available, easy to apply, and static. Where a state's rule does not meet those criteria, compliance costs are increased and interstate commerce is discouraged.

With these two principles in mind, it becomes clear that a federal "solution" for economic nexus is needed. Parts II.B–C, above, evidence the lack of uniformity among the states with respect to their economic nexus formulations. Wide variations already exist among current state standards, whether in qualitative or quantitative form. Indeed, even the states that have adopted the MTC's model factor nexus standard have failed to adopt it uniformly. Further, there is little reason to expect widespread uniform action among states in the future.<sup>249</sup> It is thus clear that state-adopted economic nexus is highly unlikely to satisfy the goal of uniformity.

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248. Sanjey Gupta & Lillian F. Mills, *Does Disconformity in State Corporate Income Tax Systems Affect Compliance Cost Burdens*, 56 NAT'L TAX J. 355, 357, 369–70 (2003); see also PricewaterhouseCoopers, *Total Tax Contribution: How Much do Large U.S. Companies Pay in Taxes?* (2009), at 5, [http://www.pwc.com/us/en/national-economic-statistics/assets/total\\_tax\\_contribution.pdf](http://www.pwc.com/us/en/national-economic-statistics/assets/total_tax_contribution.pdf) (noting that state and local tax compliance costs are more than double the study participants' federal tax compliance costs per dollar of taxes paid — suggesting that the lack of uniformity increases compliance costs). Two factors may mitigate the results of these studies. First, significant technological advances have certainly reduced compliance costs since the data used in the Gupta study. Second, the compliance costs in those studies undoubtedly include planning costs that firms "voluntarily" incur to lower their effective state tax rates. We can debate whether those costs should be charged to the states or to taxpayers. While those are voluntary costs in one sense, firms may be required to engage in those activities from a competitive standpoint. As much as a firm's tax personnel may dislike artificial state-tax-minimization strategies, the capital markets are not forgiving of lost opportunities to increase earnings per share.

249. See Charles E. McLure, Jr., *Understanding the Nuttiness of State Tax Policy: When States Have Both Too Much Sovereignty and Not Enough*, 58 NAT'L TAX J. 565, 570–72 (2005) [hereinafter McLure, *Understanding the Nuttiness*] (discussing the lack of uniform state action on tax matters); *State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues: Hearing Before the Subcomm. on Commercial and Admin. Law of the Comm. on the Judiciary*, 111th Cong. 25 (2010) (statement of Rep. Johnson, Jr., Member, House Comm. on the Judiciary) ("[T]here has never been an instance where all states have enacted a uniform tax law. They have gone as far — group states — agreeing to model uniform tax laws; but a minority of those states have enacted the various model laws.") The Streamlined Sales and Use Tax Agreement, for example, has developed for over a decade, yet only 24 states have adopted its basic structure. The

State economic nexus formulations also fail to provide any certainty. First, there is significant uncertainty in states whose courts have simply approved the concept of economic nexus without defining what it means. Further, in the states in which standards have been announced, the preceding analysis suggests that those standards will change and erode over time. State-adopted economic nexus thus provides little certainty to taxpayers.

The combination of these factors compels the conclusion that purposeful, proactive action by the Supreme Court or Congress<sup>250</sup> is warranted. The question, then, is what the ideal federal approach to economic nexus would be. There are four main options. First, the Court or Congress could adopt simple source-based economic nexus and effectively remove the substantial nexus prong of *Complete Auto* (at least for purposes of business activity taxation). Second, the Court or Congress could adopt a physical presence rule and reject economic nexus altogether. Third, the Court or Congress could adopt a heightened economic standard based on the *MBNA W. Va.* standard. Finally, Congress could adopt a federal factor nexus standard.<sup>251</sup>

#### B. *The Appropriate Approach For Economic Nexus*

Determining the best formulation for economic nexus requires that both tax and constitutional policy considerations be taken into account. This

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Streamlined Sales Tax Governing Board, *About Us*, <http://www.streamlinedsalestax.org/index.php?page=About-Us> (last visited Oct. 4, 2012).

250. To be sure, there may be concerns about Congress inserting itself in such a material way into state affairs. However, two factors mitigate those concerns. First, the intervention would be purely jurisdictional. A federal formulation would not change states' substantive tax rules. Rather, it would operate just as the Dormant Commerce Clause currently operates — as a pure jurisdictional threshold. Second, Congress has on many occasions promulgated jurisdictional rules for state taxation. (Perhaps most notably, its enactment of P.L. 86-272. *See supra* note 42.) States are even currently turning to Congress to expand their jurisdiction to impose use-tax collection requirements on remote vendors. *See, e.g.*, Main Street Fairness Act, H.R. 2701, 112th Cong. § 4(a)(1) (2011); The Marketplace Equity Act of 2011, H.R. 3179, 112th Cong. (2012). Congress also clearly has the constitutional authority to enact an economic nexus standard. PAUL J. HARTMAN & CHARLES A. TROST, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION 585–95 (Thompson West 2d ed. 2003); HELLERSTEIN, STATE TAXATION, *supra* note 16, ¶ 4.23.

251. These options necessarily exclude the option of the Court adopting a factor nexus standard. The Court simply is not a good body to develop a quantitative test. *See* John A. Swain, *State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century*, 38 GA. L. REV. 343, 364 (2003) (stating that the Court “is not well-equipped to make quantitative distinctions”); HELLERSTEIN, STATE TAXATION, *supra* note 16, ¶ 8.09[4][c] (stating that “[l]egislatures are far better equipped than courts to establish quantitative standards”).

is not only a tax issue, but a Commerce Clause (and hence commercial) issue as well. The determination of the ideal approach for economic nexus should thus be guided by the formulation that can best serve both masters. An evaluation of each proposal follows with that framework in mind.

### 1. *Source-Based Economic Nexus*

The first option discussed above was for the Supreme Court or Congress to adopt source-based economic nexus. That option would serve the goal of aligning states' enforcement and substantive jurisdiction and would perhaps best serve good tax policy.<sup>252</sup> However, the absence of a *de minimis* rule in a pure source-based standard likely makes that approach the least palatable option from a constitutional perspective. Recall that the Court's Dormant Commerce Clause jurisprudence is driven by concerns about the effects of state taxation on interstate commerce. Subjecting businesses to a state's tax regime based on the generation of minimal amounts of revenue from within that state would severely implicate that concern. For example, no business could operate on the Internet without opening itself to taxation in any (or every) state.<sup>253</sup> This failure counsels heavily against the adoption of pure source-based economic nexus.<sup>254</sup>

### 2. *A Physical Presence Standard*

The second option would be for the Court or Congress to reject economic nexus and to adopt a physical presence rule. From a constitutional perspective, this option has merit. A bright-line physical presence rule would provide clear guidance to taxpayers engaged in interstate commerce and

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252. See Hellerstein, *Jurisdiction to Tax Income*, *supra* note 36, at 47–49 (discussing two possible “solutions” to the misalignment of states' substantive and enforcement jurisdiction); Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 374–393 (discussing these issues and noting that the “next step” in this area “would be a rule providing that if there is nexus with the income (i.e., if the income is apportionable to the state), then there is nexus with the taxpayer.”). “Good tax policy” in this instance means that states have the power to tax all income over which they have substantive jurisdiction. That construct ensures that all income is subject to tax somewhere and that taxation does not depend on the type of commerce or corporate structure that generated that income.

253. Of course, Due Process considerations might counsel otherwise.

254. In advocating for source-based nexus, John Swain has noted that exceptions would be needed in two situations: (1) where taxation would violate the Due Process Clause and (2) where a taxpayer's income attributable to the state is *de minimis*. Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 390–91. The recognition of a need for a *de minimis* rule highlights the constitutional concerns raised by pure source-based nexus.

reduce litigation regarding the scope of state power. Businesses would not only save money by reducing their tax and return-preparation costs, but they would also save money by not having to research and evaluate as many as fifty different state standards.<sup>255</sup> A physical presence would thus provide the same benefits that the *Quill* Court noted with its enunciation of that rule for state sales and use taxes.<sup>256</sup>

Of course, where the physical presence rule shines for constitutional purposes, it is remarkably dull from a tax-policy perspective. Again, good tax policy would ensure that states have the power to collect tax on all of the income over which they have substantive jurisdiction.<sup>257</sup> Good tax policy does not allow for “nowhere income” (which results from a disconnect between substantive and enforcement jurisdictions) or a preference between types of economic actors (whether operating in tangible or digital form). Reliance on a physical presence rule would violate those ideals by preventing states from taxing income over which they had substantive jurisdiction and by ensuring that taxpayers that exploited a market through electronic or other non-physical means would have an advantage over those who did so physically. That standard would continue to exalt form over substance and place greater strains on state resources without a compelling policy justification. Consequently, although that standard might serve the goals of the Commerce Clause admirably, its failure to comport with good tax policy counsels against its adoption.<sup>258</sup>

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255. Assuming, of course, that all fifty states determined to implement a business activity tax.

256. See *Quill Corp. v. North Dakota*, 504 U.S. 298, 315–16 (1992) (noting that the artificiality of bright-line tests is “more than offset by the benefits of a clear rule,” including “firmly establish[ing] the boundaries of state authority . . . and reduc[ing] litigation”).

257. See *supra* note 252.

258. See McLure, *Understanding the Nuttiness*, *supra* note 249, at 569–70 (discussing how P.L. 86-272 is an example of Congress poorly legislating state tax policy); McLure & Hellerstein, *Congressional Intervention*, *supra* note 232, at 734–35 (noting the “opportunities for tax planning” and the revenue loss created by P.L. 86-272); Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 393 (“But good tax policy demands more. Congress should repeal P.L. 86-272. Its safe harbors have no place in a modern economy.”). Cf. Marjorie Gell, *Broken Silence: Congressional Inaction, Judicial Reaction, and the Need for a Federally Mandated Physical Presence Standard for State Business Activity Taxes*, 6 *PITT. TAX. REV.* 99, 119–29 (2009) (discussing economic, constitutional, administrative, and systematic concerns with an economic nexus standard and proposing a federal physical presence rule).

### 3. *A Qualitative Economic Nexus Standard*

The third option would be for the Court or Congress to adopt a qualitative economic nexus formulation in the form of the *MBNA W. Va.* test. From a tax-policy perspective, that option would be favorable because it would finally establish the validity of economic nexus. As discussed above, however, such a standard would improperly elevate physical contacts over economic contacts.<sup>259</sup> It would thus artificially limit economic nexus and would be internally inconsistent.

From a constitutional standpoint, a heightened, qualitative economic nexus standard would serve the goals of the Commerce Clause by protecting taxpayers from taxation in remote states unless they had significant economic presences in those states. Businesses considering expanding their marketing or distribution could thus do so without fear that their tax-compliance costs will outweigh their economic returns from that expansion. Despite those benefits, however, the soft, qualitative language of such a standard would invite continued controversy between taxpayers and taxing authorities and would not be easy to administer.<sup>260</sup> Those debates would ultimately generate the same litigation that is occurring today, and the Court would be solicited repeatedly to review that standard. Given the Court's general lack of interest in reviewing cases under the physical presence standard,<sup>261</sup> it is reasonable to assume that it would have a similar lack of interest in reviewing cases under a federal, qualitative economic nexus standard. The adoption of such a standard would thus lead, again, to significant debate and uncertainty unless Congress intervened to provide guidance.

In sum, a federal, qualitative standard for economic nexus would only marginally represent good tax policy, would fall short of providing adequate guidance for taxpayers, and would unnecessarily burden interstate commerce. That approach is consequently not ideal under either of the relevant benchmarks.

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259. *See supra* Part III.A.3.

260. Charles McLure recognized this point in initially proposing a factor nexus standard. McLure, *Implementing*, *supra* note 10, at 1296 (“It would not be satisfactory merely to specify in general terms that ‘significant amounts’ of in-state payroll, property, or sales would be required for nexus; that leaves too much uncertainty and too much room for litigation.”). It is also worth recognizing that disputes under a federal qualitative standard would naturally result in different state interpretations of the uniform federal standard. A lack of uniformity would again commence.

261. *See supra* Part II.B.1 (listing a long line of cases in which the Supreme Court has denied certiorari over state tax jurisdiction cases).

#### 4. Factor Nexus Legislation

The final option listed above would be for Congress to exercise its authority under the Commerce Clause and to adopt federal factor nexus legislation.<sup>262</sup> This option would be desirable from a constitutional perspective for two reasons. First, it would pay due accord to the goals of the Commerce Clause by providing a de facto *de minimis* rule through its minimum nexus thresholds. Consequently, businesses could expand their marketing efforts into new states without worrying that their marginal costs of tax compliance will exceed their monetary benefits from exploiting those markets.<sup>263</sup>

Additionally, from a constitutional policy perspective, the adoption of a federal “rule” rather than a “standard” would be appropriate in this area. While there has been vigorous debate regarding the benefits of rules versus standards,<sup>264</sup> the concerns of the Commerce Clause counsel towards a clear, bright-line rule. As the *Quill* court noted, a bright-line rule “firmly establishes the boundaries of legitimate state authority . . . and reduces litigation.”<sup>265</sup> The Court lauded such a rule because its law in the area of state taxation has been “something of a ‘quagmire’ and the ‘application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guidelines to the States in the exercise of their indispensable power of taxation.’”<sup>266</sup> Bright-line rules also “encourage[] settled expectations and, in doing so, foster[] investment by businesses and individuals” — core concerns underlying the Dormant Commerce Clause.<sup>267</sup> Federal factor nexus (appropriately structured) would provide all of those benefits.<sup>268</sup>

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262. A proper starting point for such legislation would be the MTC model discussed above. *See supra* Part III.C.1. A concomitant repeal of P.L. 86-272 would be ideal. That artificial limitation on states’ jurisdiction to tax would be inconsistent with the recognition of a federal economic nexus standard.

263. This assumes, of course, that the thresholds are set appropriately.

264. *See, e.g.*, Pierre Schlag, *Rules and Standards*, 33 UCLA L. Rev. 379 (1985) (discussing the perceived benefits and detriments of rules and standards); Seana Valentine Shiffrin, *Inducing Moral Deliberation: On the Occasional Virtues of Fog*, 123 HARV. L. REV. 1214 (2010) (discussing the potential benefits of standards over rules); Cass R. Sunstein, *Problems with Rules*, 83 CALIF. L. REV. 953 (1995) (discussing potential weaknesses with rules).

265. *Quill Corp. v. North Dakota*, 504 U.S. 298, 315 (1992).

266. *Id.* at 315–16.

267. *Id.* at 316.

268. Implicit in this discussion is that a federal factor nexus standard would provide standard definitions for determining taxpayers’ factors. That mandatory uniformity would alleviate the undue burdens created by a system that requires taxpayers to determine their tax obligations by applying a multiplicity of different

A federal factor nexus standard would also further good tax policy by relying on source principles rather than on artificial distinctions between economic and physical presences. The factor nexus thresholds could be set sufficiently low to avoid the conceptual problems that heightened economic nexus standards present.<sup>269</sup> Most importantly, federal factor nexus would eliminate nexus variability among states.<sup>270</sup> As discussed above, even among states that have adopted factor nexus standards, those standards are not uniform. They also have three weaknesses that effectively foreclose their potential for obtaining that uniformity: states' flexibility with respect to the magnitude of those thresholds, the uncertainty and flexibility with respect to how sales are actually sourced, and states' adoptions of opt-out provisions to those standards.<sup>271</sup> A federal factor nexus standard would solve each of those problems while serving the same policy goals.

The federal solution would eliminate magnitude variability because the magnitude of the factor threshold amounts would be set by Congress, and could only be changed through deliberation and debate at a national level. Further, that legislation would eliminate definitional flexibility by providing uniform apportionment rules (for purposes of the nexus determination).

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nexus rules. States would still be free, however, to apply their own apportionment formulae. There is no inherent need to unify a taxpayer's factors for purposes of nexus determinations and for purposes of apportioning their income.

This is different than the proposals of the Willis Committee and of Charles McLure. They each note the inherent inconsistency in using one rule for nexus purposes and another for apportionment purposes. H.R. REP. NO. 88-1480, pt. 1, at 485-87 (1964); McLure, *Implementing*, *supra* note 10, at 1297. While there is truth to their concerns, I believe that the need for a uniform nexus standard counsels towards as light of a touch as necessary. By adopting a broad economic nexus standard and allowing states to adopt their own apportionment formulae, states retain more flexibility and can reduce incidences of nowhere income to the greatest extent possible.

269. As previously discussed, heightened economic nexus standards have artificially limited scopes so as to avoid the appearance of overbreadth.

270. John Swain has also recently offered factor nexus as the preferred standard for addressing economic nexus. John A. Swain, *Misalignment of Substantive and Enforcement Jurisdiction in a Mobile Economy: Causes and Strategies for Realignment*, 63 NAT'L TAX. J. 925, 941 (2010) [hereinafter Swain, *Causes & Strategies*] (advocating for factor nexus standards as the ideal approach to factor nexus); *see also* Quinn T. Ryan, Note, *Beyond BATSA: Getting Serious About State Corporate Tax Reform*, 67 WASH. & LEE L. REV. 275, 307-20 (2010) (proposing a federal adoption of factor nexus and uniform apportionment rules). The major difference between Professor Swain's approach and that considered herein is that this Article advocates for a federal factor nexus standard. As described in the text, a federal standard would provide the uniformity and certainty that state factor nexus standards do not provide.

271. *See supra* Part III.B.



Finally, federal factor nexus would eliminate application flexibility by precluding states from adopting opt-out rules. The federal standard would be mandatory and exclusive.

Of course, this discussion assumes that a federal factor nexus standard would provide uniform thresholds for all states. This may seem problematic at first blush because it seems to ignore the very real differences between states' markets — \$250,000 of sales into Wyoming is very different than \$250,000 of sales into New York. This issue, like others, deserves to be considered in further scholarship. However, uniform standards for all states would be sensible. Interstate commerce is burdened if the costs of compliance overwhelm a taxpayer's returns from a state, regardless of the size of the market. Thus, the magnitude of the federal factors should be set at the point at which a taxpayer's returns from a state can be reasonably expected to overcome its costs of compliance with the state's income tax laws. A focus on market sizes is irrelevant to that question. If "indexing" the threshold amounts were desirable, the more compelling basis would be the level of complexity of that state's income tax (or perhaps its level of divergence from a standard system like the UDITPA). Of course, if a federal factor nexus standard were considered, Congress would resolve these issues with adequate input and guidance from the relevant constituencies.

In sum, federal factor nexus presents the option for economic nexus that would best serve both good tax and constitutional policy goals.<sup>272</sup> It would recognize the legitimacy of economic nexus without artificially limiting its scope and would provide a clear, uniform rule with built in *de minimis* protection.<sup>273</sup> Without more then, this Article could conclude.

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272. Once the idea of a federal factor nexus standard is accepted as worthy, a number of secondary issues would need to be considered. Do the property and payroll factors maintain relevance? Should certain industries have different formulations? These issues are beyond the scope of this article, but they deserve to be explored in further scholarship.

273. As noted at the outset, this proposal would also be consistent (in large part) with the recommendations of other prominent state tax scholars. *See, e.g.*, McLure, *Implementing*, *supra* note 10, at 1295–97; Swain, *A Jurisprudential and Policy Perspective*, *supra* note 7, at 390–93; Swain, *Causes & Strategies*, *supra* note 270, at 941. *See also* Tax Section, N.Y. State Bar Ass'n, *Nexus Requirements for Imposition of Business Activity Taxes* (Jan. 25, 2008), [http://www.nysba.org/AM/Template.cfm?Section=Tax\\_Section\\_Reports\\_2008&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=13360](http://www.nysba.org/AM/Template.cfm?Section=Tax_Section_Reports_2008&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=13360) (proposing a federal economic nexus standard that contains *de minis* thresholds). Of course, the proposal offered herein is different than prior proposals for two reasons. First, as previously noted, John Swain has advocated for factor nexus at the *state* level rather than at a federal level. Second, Charles McLure and others have proposed wider-reaching federal intervention that would include federal apportionment rules, for example. The proposal herein is thus more and less restrictive than prior proposals.

Congress could implement this proposal and clear the muddy waters. Of course, the world is not that simple, and several obstacles stand in the way of a federal factor nexus standard.<sup>274</sup>

The principal obstacle to the adoption of a federal factor nexus standard is that such a standard would not be ideal for either of the two constituencies that it would most directly impact — states and the business community. States would naturally prefer to retain their current (essentially unfettered) power, and business would prefer a physical presence rule.<sup>275</sup> Outside of a few interested academics, then, Congress is unlikely to find much support for extending its hand in this way. Not since the adoption of P.L. 86-272 in 1959 has Congress passed such expansive state tax legislation, and it is unlikely to do so without a request from at least one of the major interested parties.

As an additional complication, state tax nexus is as much of a political issue as it is a tax-policy issue. For those who believe that a physical presence rule currently governs, a federal factor nexus rule would be branded a tax increase (and a tax increase that did not inure to the benefit of Congress).<sup>276</sup> On the other hand, to states that believe that a federal factor nexus standard would limit their power, such a bill could be construed as another unfunded mandate stretching state resources. Each of these constructs is less than palatable for Congress.

The only realistic possibility that federal factor nexus has for enactment appears to be for the business community and states to adopt a unified front and to approach Congress to intervene. That unity would have to be fostered through serious discussion regarding the current state of the law and the potential benefits that a federal standard would provide. States would have to give up sovereign control of their standards in favor of a clear directive from Congress to taxpayers. That directive (in the form of factor nexus) would allow states to retain a significant level of power and would prevent states from having to litigate threshold economic nexus disputes in perpetuity. On the other side of the debate, taxpayers would have to abandon hope of a physical presence rule in favor of uniformity and a satisfactory *de minimis* rule. This will perhaps become more palatable as more states adopt broad economic nexus standards.

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274. See McLure, *The Difficulty*, *supra* note 245, at 338 (explaining why federal action on apportionment and nexus issues is unlikely).

275. Currently, Congress has before it a bill that would extend the protections of P.L. 86-272 to all vendors, whether of tangible personal property, intangible personal property, or services. Business Activity Tax Simplification Act of 2011, H.R. 1439, 112th Cong. (2011). That bill would provide business with the broad-reaching physical presence standard that it has sought for years.

276. Expanded state tax power would actually reduce federal revenues due to the federal income tax deduction for state income taxes paid or incurred. See I.R.C. § 164(a)(3).

The other potential room for agreement between states and the business community would be as part of a “package deal” on nexus for purposes of state sales and use taxes. As noted above, *Quill* currently imposes a physical presence rule for purposes of sales and use taxes. The losses to states from that rule have been estimated to be over ten billion dollars annually.<sup>277</sup> To the extent that the physical presence rule for purposes of state sales and use taxes protects a smaller subset of vendors than those that suffer from uncertainty or continued debate regarding economic nexus for purposes of business activity taxes, it may be possible to form an alliance of interests among business and states. If business feels that economic nexus is here to stay, and that states’ standards will be either unduly broad or uncertain, it may be willing to support a repudiation of *Quill* in exchange for federal factor nexus. States will be less inclined to make that deal, of course, if they feel that *Quill* is not on firm footing. However, given the current lack of interest by the Court and the lack of agreement in Congress in dealing with these nexus issues, a reversal of *Quill* does not seem imminent.<sup>278</sup> On the other hand, the revenue losses from the physical presence rule are current and very real. States accordingly may be willing to give some ground on economic nexus to see *Quill* abandoned once and for all. Finally, Congress could force compromise by refusing to adopt a bill addressing sales tax nexus unless that legislation included rules for business activity taxes as well. That approach would surely frustrate states, but might be the quickest way for Congress to resolve these issues. Congress should consider whether it wants to use the current momentum on sales tax nexus to encourage resolution of both issues in one fell swoop.

None of this is to say that compromise is likely in the short term. However, it will never happen if the dialogue regarding economic nexus does not evolve. For too long, the discussion has centered on the threshold issue of whether economic nexus is permissible. That focus has resulted in a multiplicity of varied standards that fail to provide the certainty or uniformity required by the Dormant Commerce Clause. It is time for states, the business

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277. See Donald Bruce, William F. Fox & LeAnn Luna, *State and Local Sales Tax Revenue Losses from E-Commerce*, 52 ST. TAX NOTES 537, 540 (May 18, 2009) (projecting losses of \$11.4 billion in 2011).

278. There has been recent optimism regarding the likelihood of a Congressional reversal of *Quill* as the House Judiciary Committee evaluates a new proposal — Marketplace Equity Act of 2011. H.R. 3179, 112th Cong. (2011). Laura Saunders, *Online Sales Tax is Coming!*, WALL ST. J., July 21, 2012, at B9. However, it is unclear whether that legislation will gain traction in the near future. John Buhl, *U.S. House Panel Undecided on Remote Sales Tax Legislation*, 65 ST. NOTES 299, 299–301 (July 30, 2012). This bill may fare the same as previous bills attempting to achieve similar ends. Of course, to the extent that this bill is either passed (or gains significant support), business’s ability to use *Quill* as a bargaining chip for a federal factor nexus standard would be eliminated.

community, the tax bar, and tax scholars to turn their attentions to developing a satisfactory federal factor nexus standard.

## V. CONCLUSION

Economic nexus is a doctrine that has no precise formulation. State courts adopting that standard have either ignored its boundaries or have adopted heightened standards that have questionable bases and that are subject to significant erosion. State legislatures have adopted more satisfactory approaches, but those standards will also be subject to erosion and will create undue compliance burdens on multi-state enterprises. Ultimately, then, the idea that “economic nexus” currently means something is illusory, and the Supreme Court or Congress will be required to intervene. A federal factor nexus standard is the most appropriate method for addressing economic nexus in a way that pays proper attention to both tax and constitutional policy considerations. At the very least, the discourse in this area should evolve to discussing how that standard should be formulated and how to achieve that goal. The current approach of simply adopting *ad hoc* economic nexus formulations cannot continue.