State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective

John A. Swain
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INTRODUCTION

One of the most contentious issues in state taxation is the reach of the states' jurisdiction to tax net income. The failure to resolve this issue is a leading cause of the recent dramatic decline in state corporate income tax revenues.1 Familiar forces of change are at work: the ongoing shift from a mercantile to a service economy,2 the increasing mobility of capital,3 electronic commerce,4 and the "coming of age" of state tax planning techniques aggressively promoted by the national accounting firms.5 These forces allow corporations to do (or appear to do) business in a state from afar. Thus, traditional markers of nexus to tax—such as physical presence—are absent.

Unfortunately, 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. Students of the

1. Corporate income tax revenues declined over thirty percent relative to gross state product between 1995 and 2002. Michael J. McIntyre, Thoughts on the Future of the State Corporate Income Tax, 25 ST. TAX NOTES 931, 944 fig.1, 945 fig.2 (2002). "The Multistate Tax Commission (MTC) has estimated that between 1980 and the year 2000, the effective rate of state corporate income taxes declined nearly by half from 9.6 percent to approximately 5.2 percent...." Dan Bucks & Frank Katz, Explanation of the Multistate Tax Commission's Proposed Factor Presence Nexus Standard, 25 ST. TAX NOTES 1037, 1039 (2002). The MTC "further estimates that it is possible to account for only about 20 percent of that decline as having arisen from explicit statutory decisions of state legislatures ... to cut rates or grant credits or other reductions ... leaving roughly 80 percent of the decline that is unexplained by legislative action." Id. The MTC has suggested that one of the "likely candidates for the cause[] of that decline" is state-level "tax sheltering activity," whereby taxpayers shift income into no or low tax states. Id. See also infra Part III.B.1-2 (explaining income-shifting opportunities created by a physical presence nexus test).

2. "In 1960, 42 percent of U.S. wages and salaries were earned in the goods-producing sector" of the economy. Robert Tannenwald, Are State and Local Revenue Systems Becoming Obsolete?, 24 ST. TAX NOTES 143, 146 (2002). In 2000, the share had fallen to twenty-four percent. The portion of personal consumption dollars spent on services rose during this same period, however, from forty-one percent to fifty-eight percent. Id.

3. See id. at 155.


Court's due process jurisprudence may find this surprising. The Court held long ago that economic presence is sufficient for a plaintiff to hale a foreign corporation into court or for a state to assert its regulatory jurisdiction.\(^6\) The Court's state tax jurisprudence has taken a different tack, however, riding the winds of the dormant Commerce Clause into "uncharted and treacherous" waters.\(^7\)

The voyage began in 1967, when the Court held in *National Bellas Hess v. Department of Revenue*\(^8\) that a physical presence was required for a state to impose a use tax collection obligation on a mail-order company.\(^9\) Curiously, the *Bellas Hess* Court took no note of its earlier due process decisions affirming state regulatory jurisdiction based solely on economic presence.\(^10\) Twenty-five years later in *Quill Corp. v. North Dakota*, under essentially identical facts, the Court conceded that due process could be satisfied by economic presence alone.\(^11\) Nevertheless, the Court reaffirmed the physical presence test on Commerce Clause grounds alone.\(^12\)

Until that time, the Court had not indicated that the Due Process and Commerce Clause nexus standards diverged in any meaningful way.\(^13\) By removing state tax nexus from its due process moorings, the Court seems to have discarded the traditional source of content for nexus inquiries (tax or otherwise).\(^14\) Its replacement—the

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9. Id. at 758.

10. See *Bellas Hess v. Dept' of Revenue*, 386 U.S. 753 (1967) (failing to reference either *Travelers Health Ass'n* or *McGee*). See supra note 6 and accompanying text.

11. *Quill*, 504 U.S. at 307-08.

12. See id. at 309-19.

13. For example, whether *Bellas Hess* rested on Due Process or Commerce Clause grounds was not a matter of dispute before the *Quill* decision. See infra note 37 and accompanying text.

14. Of course a state tax must still satisfy due process, but *Quill* held that an economic presence is enough to satisfy this requirement. See supra note 11 and accompanying text. Accordingly, if a state can source income to it, due process usually will be satisfied. A major exception might be the "inadvertent presence" that could arise, for example, in the case of remote lessors of tangible personal property, or remote licensors of intangible property, who
Commerce Clause prohibition against undue burdens—is not well adapted for this purpose, and offers no rich nexus jurisprudence that it can call its own.  

Like the *Bellas Hess* decision, *Quill* did not expressly address income tax nexus. Indeed, dictum in *Quill* suggests that the nexus standard for taxes other than sales and use taxes may not be physical presence. Thus, *Quill* seems only to add to the uncertainty surrounding state income tax jurisdiction. These uncertainties have materialized in post-*Quill* state court litigation. Less than a year after the *Quill* decision, the South Carolina Supreme Court held that *Quill*'s physical presence test was not applicable to state income taxes. Courts since then have split. Again, uncertainty prevails.

There is no line of Supreme Court income tax nexus decisions parallel to *Quill*. The Court's exploration of the constitutional limits of income tax jurisdiction has been stymied by the affirmative
exercise of Congress's Commerce Clause powers. In 1959, Congress statutorily curtailed the states' power to impose a net income tax on sellers of tangible personal property whose in-state activities do not exceed mere "solicitation." Though intended as a temporary measure—allowing Congress to study the ramifications of several judicial decisions that were perceived to have expanded state income tax jurisdiction—the statute remains on the books to this day. Indeed, state and local tax professionals still refer to the

   (a) Minimum standards
   No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
   (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
   (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).
   (c) Sales or solicitation of orders for sales by independent contractors
   For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance, of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

Id. See id. In Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959), the Court sustained the states' power to impose a non-discriminatory, fairly apportioned net income tax on exclusively interstate businesses. Id. at 452. In response:

[There was] widespread alarm and protest among businesses. There were predictions of the most dire consequences to business and, indeed, the entire nation. Two Senate Committees promptly held hearings, and there was vociferous demand for immediate congressional action. Congress reacted with astonishing speed and, for the first time in its history, adopted an act restricting the states' power to tax interstate businesses.

HELLERSTEIN & HELLERSTEIN, supra note 14, ¶ 6.16 (citations omitted). The House Committee on the Judiciary formed the Special Subcommittee on State Taxation of Interstate Commerce, commonly known as the Willis Committee, to study the issue, but the Willis Committee's report resulted neither in further legislation nor the repeal of P.L. 86-272. See H.R. REP. NO.
measure as P.L. 86-272, despite having been incorporated into the United States Code.\textsuperscript{23}

P.L. 86-272 provides a safe harbor for sellers of tangible personal property, but it says nothing about services or intangibles.\textsuperscript{24} Thus, as the service sector of the economy continues to expand, so too does corporate concern about exposure to state income taxes. Further, as technological advances permit more businesses to provide goods and services from remote locations, policymakers fear that jurisdictional rules based on an anachronistic physical presence test threaten the tax base and provide inappropriate tax avoidance opportunities.\textsuperscript{25} At the same time, many of the growing number of firms that do business remotely resist the notion that they should be liable for taxes imposed by geographically distant jurisdictions.\textsuperscript{26}

Two conflicting proposals reflect this resurgence of concern over the state income tax. Taxing authorities have proposed a “factor presence standard” that would allow a state to tax an economically present business so long as the business’ in-state sales meet a certain threshold.\textsuperscript{27} Business taxpayers, on the other hand, are backing legislation that would expand P.L. 86-272’s safe harbor to cover services, intangibles, and numerous other in-state contacts.

\textsuperscript{23} See infra notes 194-200 and accompanying text.

\textsuperscript{24} See infra note 21.

\textsuperscript{25} See, e.g., Bucks & Katz, supra note 1, at 1010 (arguing that “t]he extent of corporate tax sheltering is a major problem in our society”).

\textsuperscript{26} See, e.g., Scott D. Smith & Sharlene Amitay, Economic Nexus: An Unworkable Standard for Jurisdiction, 25 ST. TAX NOTES 787, 787 (2002) (contending that economic nexus is “incompatible with fundamental constitutional requirements”).

\textsuperscript{27} See infra notes 194-200 and accompanying text.
that go far beyond the “mere solicitation” protection of the current statute. Sparks have flown.

28. See Internet Tax Fairness Act of 2001, H.R. 2526, 107th Cong. (2001). In addition to the in-state activities protected by P.L. 86-272, it would exclude:

(3) The presence or use of intangible personal property in such State or subdivision, including patents, copyrights, trademarks, logos, securities, contracts, licenses and permits issued by any governmental agency or authority authorizing the holder to conduct any business activity, money, deposits, loans, electronic or digital signals, and web pages, whether or not subject to licenses, franchises, or other agreements.

(4) The use of the Internet to create or maintain a World Wide Web site accessible by persons in such State or subdivision.

(5) The use of an Internet service provider, on-line service provider, internetwork communication service provider, or other Internet access service provider, or World Wide Web hosting services to maintain or take and process orders via a web page or site on a computer that is physically located in such State or subdivision.

(6) The use of any service provider for transmission of communications, whether by cable, satellite, radio, telecommunications, or other similar system.

(7) The leasing or owning of substantial property in such State or subdivision for less than 30 days. Property in such State or subdivision for purposes of being assembled, manufactured, processed, or tested by a person or persons within such State or subdivision for the benefit of the owner or lessee, or used to furnish a service by a person or persons within such State or subdivision to the owner or lessee, shall be disregarded in determining whether such 30-day limit has been exceeded.

(8) The assigning of employees, representatives, or agents in such State or subdivision for less than 30 days. Presence of employees, representatives or agents for purposes directly relating to the purchasing goods or services, gathering news and covering events, meeting with government officials, attending conferences, seminars and similar functions, and participating in charitable activities shall be disregarded in determining whether such 30-day limit has been exceeded.

(9) The affiliation with another person located in the State or subdivision, unless—

(A) the other person located in the State or subdivision is the person's agent under the terms and conditions of subsection (d); and

(B) the activity of the other person in the State or subdivision constitutes substantial physical presence under this subsection and is performed to establish, enhance, or maintain the market in the State or subdivision for the person.

(10) The use of an unaffiliated representative or independent contractor in such State or subdivision for the purpose of performing warranty or repair services with respect to tangible or intangible personal property sold by a person located outside the State or subdivision.

Id. at 4-6 (emphasis added) (internal quotations omitted). The proposed legislation would also include special rules preventing the attribution of certain activities of third parties to the taxpayer and would extend the coverage of P.L. 86-272 beyond net income taxes to all "business activity taxes." See id. at 3.

29. The passions that the nexus controversy arouses confirm that the stakes are indeed
The purpose of this Article is twofold: first, to identify the constitutional nexus standard for state income tax; second, to evaluate whether the constitutional standard reflects good tax policy. Part I discusses the relevant authorities and constitutional framework. The centerpiece of the discussion is Quill. In recognition of the varied approaches that commentators have taken to Quill, “Burdens Quill,” “Stare Decisis Quill,” and “Disappearing Ink Quill” interpretations are developed. Of equal importance are the income tax nexus cases that preceded Quill. The Court’s combined reporting cases also provide some illumination, and the post-Quill state court income tax decisions are briefly discussed.

Part II applies the authorities discussed in Part I to the question of state income tax jurisdiction. Are they controlling? Are they relevant, and how? Is physical presence required? If not, then what is the Commerce Clause standard? The constitutional inquiry is based on existing precedent. The authorities are critiqued as well as explained, but it is the explanations on which the legal reasoning is grounded.

Part III applies the basic tenets of good tax policy—equity, efficiency, and administrability—to the competing nexus standards of economic and physical presence. This normative inquiry is important because Congress has the authority to establish a nexus standard by exercise of its affirmative Commerce Clause powers, and because tax policy norms should inform the dormant Commerce Clause analysis of future Courts.
I. THE AUTHORITIES

A. The Complete Auto Test and Substantial Nexus

The Court has held that a state tax passes dormant Commerce Clause muster if it (1) is assessed against a taxpayer with whom the state has substantial nexus,\(^30\) (2) is "fairly apportioned,"\(^31\) (3) is non-discriminatory, and (4) is "fairly related to the services provided by the State."\(^3\) The elements of this test were articulated in Complete Auto Transit, Inc. v. Brady, although it took later decisions to enshrine Complete Auto as the definitive four-pronged test for the validity of a state tax under the dormant Commerce Clause.\(^33\) Further, none of these elements were new to the Court's state tax jurisprudence at the time Complete Auto was decided, although earlier treatments of the nexus, fair apportionment, and fairly related prongs of the test were often rooted in Due Process rather than dormant Commerce Clause analysis.\(^34\)

The focus of this Article is the nexus prong of the Complete Auto test. However, "nexus" carries two distinct meanings for state tax jurisdiction: (1) nexus with the taxpayer and (2) nexus with the income, transaction, activity or property sought to be taxed.\(^35\) It is probably more analytically precise to treat the second nexus definition—nexus with the income or transaction sought to be

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30. Sometimes the nexus prong of the test is articulated in a way suggesting that it addresses both nexus with the taxpayer and nexus with the income, activity, property or transaction sought to be taxed. For the sake of analytical clarity, and because this Article focuses on jurisdiction over the taxpayer, the nexus test is restated here to capture only the idea of taxpayer nexus. In Quill, discussed at length below, the Court seized upon Complete Auto's occasional, though inconsistent, reference to the nexus requirement as "substantial nexus" as a means to distinguish "the due process 'minimum contacts' test" from "the Commerce Clause 'substantial nexus' test." See Quill Corp. v. North Dakota, 504 U.S. 298, 312-13 (1992). Complete Auto is dubious authority for that leap—nexus was not an issue in Complete Auto because the taxpayer plainly was doing business in the state. See Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 276-78 (1977). Nonetheless, the Court has spoken.

31. Complete Auto, 430 U.S. at 279.
32. Id.
33. See Quill, 504 U.S. at 311.
35. HELLERSTEIN & HELLERSTEIN, supra note 14, ¶ 6.01.
taxed—as a fair apportionment issue.\textsuperscript{36} This Article specifically addresses jurisdiction over the taxpayer, and so references to “nexus” mean “nexus with the taxpayer” unless otherwise indicated.\textsuperscript{37}

\section*{B. Quill and Its Implications for State Income Tax Jurisdiction}

Although a sales and use tax case, \textit{Quill Corp. v. North Dakota}\textsuperscript{38} takes center stage because (1) it is the Supreme Court’s most recent pronouncement on state tax jurisdiction and (2) the Court decoupled Due Process Clause nexus from Commerce Clause nexus. In \textit{Quill}, the Court revisited the question it had addressed twenty-five years earlier under substantially identical facts: May a state compel a mail-order company to collect use tax from its customers if the company’s contacts with the state are limited to the use of the U.S. mail and common carriers?\textsuperscript{39} In the earlier case, \textit{National Bellas Hess, Inc. v. Department of Revenue},\textsuperscript{40} the Court answered in the negative, citing both the Due Process and Commerce Clauses.\textsuperscript{41} In \textit{Quill}, the Court again answered in the negative, but on Commerce Clause and stare decisis grounds alone.\textsuperscript{42}

\textsuperscript{36} For example, the state of Arizona may have nexus with Acme Copper Company, but it could not impose a severance tax measured by the copper that Acme extracts in Chile. The question in this example is not whether Acme has Arizona nexus—it clearly does—but whether the object or measure of the tax may be fairly apportioned to Arizona, i.e., whether the severance of Chilean copper has an Arizona nexus. \textit{See id.} (treating nexus with income as an apportionment issue for analytical and organizational clarity).

\textsuperscript{37} Still, the concepts are closely related. If the income or activities of a taxpayer have nexus with a state then the probability that the taxpayer also has nexus increases greatly.

\textsuperscript{38} 504 U.S. 298 (1992).

\textsuperscript{39} \textit{Id.}

\textsuperscript{40} 386 U.S. 753 (1967).

\textsuperscript{41} \textit{See id.} at 756. The taxpayer challenged the tax on both Due Process and Commerce Clause grounds. Whether the Court relied on both clauses is unclear, though it appears that the Court treated these considerations as essentially identical. \textit{See Quill}, 504 U.S. at 305 (treating \textit{Bellas Hess} unequivocally as both a Commerce Clause and a Due Process Clause authority).

\textsuperscript{42} \textit{See Quill}, 504 U.S. at 318.
1. Due Process Quill

Regarding due process, the Court observed that its "jurisprudence has evolved substantially in the 25 years since Bellas Hess."43 In a modern economy "it matters little that [] solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: The requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State."44 The Court then expressly overruled its earlier cases "to the extent that [they] have indicated that the Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax."45 In effect, the Court applied the minimum contacts test found in International Shoe v. Washington46 and its progeny.

2. Quill and the Commerce Clause

Quill Corporation fared better under the Commerce Clause. The Court held that the North Dakota use tax collection statute imposed an unconstitutional burden on commerce because Quill did not have a physical presence in the state.47 Obviously, the Court then felt obliged to distinguish Due Process Clause nexus from Commerce Clause nexus, although three concurring justices were content to adhere to Bellas Hess on stare decisis grounds alone.48

43. Id. at 307.
44. Id. at 308.
45. Id.
46. 326 U.S. 310 (1945). It was in International Shoe that the Court first clearly enunciated the modern due process test for personal jurisdiction: a defendant must have "minimum contacts" with the forum such that assertion of jurisdiction "does not offend 'traditional notions of fair play and substantial justice.'" Id. at 316 (quoting Milliken v. Meyer, 311 U.S. 457, 463 (1940)). Interestingly, International Shoe was a tax case involving the power of the State of Washington to assert its unemployment compensation tax. The concurring justices in Quill caution that the standard for "legislative (or prescriptive) jurisdiction" may not be the same as the standard for judicial jurisdiction, but agree that physical presence is not required for either. Quill, 504 U.S. at 319-20 (Scalia, J., concurring). See Richard D. Pomp, Are the Standards for Tax Jurisdiction and Personal Jurisdiction Identical?, 54 TAX NOTES 333, 333 (1992) (discussing this distinction in anticipation of the Quill decision).
47. Quill, 504 U.S. at 317-18.
48. Justices Kennedy and Thomas joined the concurrence written by Justice Scalia. Id. at 319-21 (Scalia, J., concurring).
The Commerce Clause portion of the decision has been the focus of intense analysis and debate. Here, we begin by summarizing the Court's two principal rationales for its Commerce Clause ruling: (a) stare decisis and (b) burden on interstate commerce. Next, the direct applicability of Quill to state corporate income tax nexus is addressed. Finally, a critique of Quill is offered in which the "Three Faces of Quill" are identified.

a. Quill's Commerce Clause Rationales

(1) Stare Decisis and the Court's Apologetic Tone

For many commentators, stare decisis is the crux of the Quill decision. They caution that the Court's other rationales should not "be taken very seriously." Indeed, the three concurring justices seem to take us aside and whisper this sentiment.


50. See Quill, 504 U.S. at 317-18. The Court also discusses the value of a bright-line test. Much of this discussion is connected either with its burdens analysis or its stare decisis analysis, and so the bright-line test will be addressed in connection with those rationales. At times, the Court appears to treat the bright-line test as intrinsically valuable. See infra Part I.B.2.

51. The application of the rationales of Quill to state corporate income tax nexus is considered in Part I.B.2.b.

52. See infra Part I.B.2.c.

53. See Hellerstein & Hellerstein, supra note 14, ¶ 6.02(2) (arguing that the Court relied on stare decisis rather than defending the physical presence test on the merits); Pomp & McIntyre, supra note 49, at 179-80 (quoting Charles Rothfield, Quill: Confusing the Commerce Clause, 3 St. Tax Notes 111, 115 (1992)) (arguing that Quill is essentially "a political decision" responding to concerns about retroactivity and the practical consequences of overruling Bellas Hess).

54. Rothfield, supra note 53, at 115.

55. See supra note 48 and accompanying text (noting that the concurrence would have decided Quill on stare decisis grounds alone).
The doctrine of stare decisis provides that courts will adhere to existing precedent and not disturb settled points. This is a bedrock principle of law. If the rules determined in earlier disputes were not applied to subsequent disputes, then people would have little guidance on how to structure their affairs. Applying this doctrine to Quill, the result was inevitable, given that in Bellas Hess the Court had previously decided a case that was practically indistinguishable on the facts.

Of course, the law must also allow for change. Even the most casual observer knows that the Supreme Court will overrule existing precedent. But how does the Court decide when a change in the law is appropriate? The Court has identified four factors that it considers: (1) whether there has been significant change in related principles of law; (2) whether there has been a change in the factual milieu (social, economic, cultural, technological, and so on); (3) whether the old rule has become unworkable; and (4) whether there are strong reliance interests in the old rule that would be harmed by a change. No one factor is controlling.

The first two factors might be called the “legal factors.” All first year law students know that cases are decided by the law and the facts. If these remain unchanged, reliance on earlier authority is plainly appropriate. The second two factors—the workability of the old rule and reliance interests—might be called the “pragmatic factors,” and reliance on these factors alone might be called “naked stare decisis.” When these two factors are in play, pragmatism and conservatism are balanced against strict adherence to the “right” legal result.

In overruling the due process aspect of Bellas Hess, the Court relied on the legal factors. Bellas Hess had been “superceded by developments in the law of due process.” The Court also acknowledged that there had been substantial changes in the nation’s economy since Bellas Hess was decided. Because Quill ultimately retained the old rule—now on Commerce Clause grounds alone—the Court had no cause to consider the pragmatic factors (the

57. Quill, 504 U.S. at 308.
58. Id.
59. See id.; see also supra note 44 and accompanying text.
workability of the physical presence test and the reliance interest of the mail-order industry) in rendering its due process decision.

Predictably, the pragmatic factors spearheaded the Court's refusal to upset the Commerce Clause aspect of *Bellas Hess*. First, the Court endorsed the continued workability of the old rule. Retaining the bright-line physical presence test "establishes the boundaries of legitimate state authority," "reduces litigation," "encourages settled expectations," and "fosters investment by businesses." Second, the Court found that "the *Bellas Hess* rule has engendered substantial reliance and has become part of the basic framework of a sizeable industry." Moreover, overruling *Bellas Hess* "might raise thorny questions concerning the retroactive application of those taxes and might trigger substantial unanticipated liability for mail-order houses." Accordingly, "the doctrine of *stare decisis* ... counsels adherence to settled precedent."

Because of its reliance on "naked stare decisis," the *Quill* decision took on an apologetic tone. The Court acknowledged that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today." Specifically, "our Commerce Clause jurisprudence now favors more flexible balancing analyses," and the bright-line *Bellas Hess* test "appears artificial at its edges." The Court concluded that it may be best to leave the issue for Congress to resolve under its affirmative Commerce Clause powers "even if we were convinced that *Bellas Hess* was inconsistent with our Commerce Clause jurisprudence." Thus, by removing any due process barriers to

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60. *Quill*, 504 U.S. at 315.
61. *Id.*
62. *Id.* at 316.
63. *Id.*
64. *Id.* at 317.
65. *Id.* at 318 n.10.
66. *Id.* at 317.
67. *Id.* at 311.
68. *Id.* at 314.
69. *Id.* at 315.
70. *Id.* at 318.
Congressional action in the first part of the opinion, the Court left the matter at Congress's doorstep, "at least for now."\textsuperscript{71}

\textit{(2) Undue Burden on Interstate Commerce}

Three concurring justices would have left matters there, declining to "revisit the merits of [Bellas Hess], but ... adher[ing] to it on the basis of \textit{stare decisis}."\textsuperscript{72} The majority, however, sought to develop an independent jurisprudential rationale for the rule.

The Court observed that "the nexus requirements of the Due Process and Commerce Clauses ... are animated by different constitutional concerns,"\textsuperscript{73} though it conceded that "we have not always been precise in distinguishing between the two."\textsuperscript{74} Due process is informed by concerns about "fair warning" and "notice."\textsuperscript{75} In contrast, the Commerce Clause addresses "structural concerns about the effects of state regulation on the national economy."\textsuperscript{76} Accordingly, "[a] tax may be consistent with due process and yet unduly burden interstate commerce."\textsuperscript{77} The Court then reifies the phrase "substantial nexus," which appeared inconsistently in \textit{Complete Auto}, and distinguished it from the "minimum contacts" required by due process.\textsuperscript{78} Substantial sales and use tax nexus requires a physical presence; minimum contacts analysis does not.\textsuperscript{79}

The \textit{Quill} Court's explanation of how a physical presence test furthers Commerce Clause values was thin. It did not claim that sales and use taxes themselves are burdensome. The Court was concerned with the administrative costs of tax compliance. The Court explained in a footnote:

North Dakota's use tax illustrates well how a state tax might unduly burden interstate commerce. On its face, North Dakota law imposes a collection duty on every vendor who advertises in

\textsuperscript{71} Id.
\textsuperscript{72} Id. at 320 (Scalia, J., concurring).
\textsuperscript{73} Id. at 312.
\textsuperscript{74} Id. at 305.
\textsuperscript{75} Id. at 312.
\textsuperscript{76} Id.
\textsuperscript{77} Id. at 314 n.7.
\textsuperscript{78} Id. at 313.
\textsuperscript{79} See id. at 308.
the State three times in a single year. Thus, absent the *Bellas Hess* rule, a publisher who included a subscription card in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, all would be subject to the collection duty. *What is more significant*, similar obligations might be imposed by the Nation’s 6,000-plus taxing jurisdictions. See *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 759-60 (1967) (noting that the “many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle [a mail-order house] in a virtual welter of complicated obligations”).

How a physical presence test reduces the burden is not apparent from the Court’s discussion. It is difficult to argue, for example, that Quill Corporation’s compliance burden would be less if it periodically sent sales representatives into the state, or had a small office in Sioux Falls. Physical presence marks *how* one does business in a state, not *how much*.

Perhaps sensing this problem, most of the Court’s discussion centers on the value of a bright-line test. Many of the bright-line test justifications focused on stare decisis concerns, already considered above. Remarkably, the Court also championed the bright-line test because it “demar[ks] ... a discrete realm of commercial activity that is free from interstate taxation.” However, the free trade zone approach to Commerce Clause jurisprudence had long since been rejected by the Court: “It was not the purpose of the Commerce Clause to relieve those engaged in interstate commerce from their just share of [the] state tax burden even though it increases the cost of doing business.” Another value of the bright-line test posited by the Court is that it gives clear notice to taxpayers that they are subject to a state’s jurisdiction to tax.

80. *Id.* at 313 n.6 (alteration in original) (emphasis added).
81. See *id.* at 314-17.
82. See *supra* Part I.B.2.a.1.
83. Quill, 504 U.S. at 315.
84. *Id.* at 310 n.5 (alteration in original) (quoting *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 623-24 (1981)).
85. See *id.* at 315 (“Such a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning
However, this has the ring of a due process notice concern, and the Court had already satisfied itself that physical presence is not required for adequate notice.

Though not clearly stated, the Court’s underlying concern seems to be that businesses with a low sales volume in multiple states may have compliance costs that are excessive compared to the amount of business done in those states and to the taxes that would be collected. “[M]ore significant[ly],” this problem is compounded by the multiplicity of taxing jurisdictions and the lack of uniformity in the tax rules and their administration. Manifesting this concern is the Court’s focus on “the little guy”—businesses that meet the bare minimum of solicitations (with presumably a correspondingly small sales volume)—and the Court’s acknowledgment that state sales and use taxes are not unconstitutionally burdensome as applied to all taxpayers, merely remote vendors. The Court acknowledged that physical presence is “artificial at its edges,” but the Court indicated its belief that the test will have the effect of protecting smaller vendors. That it may, but it also protects large vendors who are not unduly burdened. Artificiality emerges here, although more than around the “edges.”

We might sympathize with the Court because it is not well equipped to make quantitative distinctions. The Court could not reasonably adopt a rule under the dormant Commerce Clause that provides, for example, that a vendor with fewer than fifteen sales or a sales volume of less than $1000 in a state is not required to collect sale or use tax. This is a legislative rule. Instead, courts usually are limited to using qualitative or linguistic distinctions (for example, physical presence) as surrogates for more finely tuned legislation. The Court acknowledges these limitations by referring the matter to Congress.

86. Id. at 313 n.6.
87. See id.
88. See id. at 313. The Court acknowledged this concern in its holding, which allowed sales and use taxation of physically present vendors, but not remote vendors. Id.
89. Id. at 315.
90. See id.
91. Courts also use the “de minimis” concept—a quantitative idea—to draw lines.
92. By removing the Due Process Clause objection to taxing remote vendors, the Court believed it had cleared the way for Congress to exercise its affirmative Commerce Clause
b. Applicability to Corporate Income Taxes

Quill's holding does not apply directly to corporate income taxes:

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. To the contrary, the continuing value of a bright-line rule in this area and the doctrine and principles of stare decisis indicate that the Bellas Hess rule remains good law.\(^3\)

In addition, the Court painstakingly limited its analysis throughout the opinion to sales and use taxes. For example, early in the Commerce Clause portion of the opinion, the Court used language almost identical to that of its holding: "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."\(^4\) Of course the failure to articulate a physical presence test in connection with other taxes does not mean that one might not be found. But neither the Bellas Hess rule nor Quill's reaffirmation of that rule resolved this issue.

Still, Quill is relevant to the income tax nexus inquiry. Quill's decoupling of the nexus requirements for the Due Process and Commerce Clauses, its discussion of the values underlying the substantial nexus test, and its grounding in stare decisis all inform this inquiry. The applicability of the rationales of Quill to corporate income tax nexus is considered in Part II.

c. The Three Faces of Quill: A Critique

Because the focus of this Article is on identifying the nexus standard for corporate income taxes under existing law, a complete

\(^3\) Id. at 317 (emphasis added).
\(^4\) Id. at 314.
critique of Quill is not offered here. Nevertheless, a critical evaluation of Quill assists in assessing the applicability of the case and its substantial nexus requirement to state corporate income tax nexus.

For the purposes of analysis, “Three Faces of Quill” are posited: (1) Stare Decisis Quill, (2) Burdens Quill, and (3) Disappearing Ink Quill. These approaches are not mutually exclusive, and the three faces of Quill must be considered in unison in the final analysis. Nevertheless, the practical implications of Quill for future nexus disputes hinge largely on which face is found to predominate.

(1) Stare Decisis Quill

As noted, many commentators believe that stare decisis is the true face of Quill.95 The Court was concerned about the reliance interest of the mail-order industry and found workable the rule on which that industry had relied. The Court’s emphasis of these pragmatic stare decisis factors is subject to criticism. Most obviously, by emphasizing the pragmatic factors it necessarily de-emphasized the two stare decisis factors that pulled in the opposite direction—“wholesale changes’ in both the economy and the law.”96 The Court’s apologetic tone is the result of this tug of war.

The weight the Quill Court gave to the reliance and bright-line test factors can also be questioned. For example, does the mail-order industry truly have a reasonable reliance interest in not collecting or paying a tax that competitors are required to pay? In addition, the Court observed that the mail-order industry had experienced “dramatic growth over the last quarter century.”97 Was special tax treatment, therefore, necessary to the continued survival of a vibrant industry, however helpful such treatment may have been in its infancy98 More generally, do taxpayers have a reliance interest in tax laws not changing, at least prospectively? Finally, though the Court expressed concern over the retroactive effects of overruling

95. See supra notes 53-54 and accompanying text.
96. Quill, 504 U.S. at 303 (quoting the North Dakota Supreme Court’s decision below, 470 N.W.2d 203, 213 (N.D. 1991)).
97. Id. at 316.
98. An infant industry would seem to have a greater claim to detrimental reliance concerns than would an established, vibrant industry.
Bellas Hess, legal doctrines are available to prevent such harm when the law changes unexpectedly. The remedy is not to perpetuate an antiquated rule.

The bright-line physical presence test is indeed workable for the mail-order industry. The Quill opinion, however, fails to consider the negative consequences of the rule for competing businesses and for state governments. These countervailing burdens are considerable. The physical presence test puts physically present businesses at a competitive disadvantage by tilting the economic playing field in favor of mail-order businesses. Further, the test reduces state tax collections and encourages businesses to artificially structure themselves to avoid tax, harming the overall efficiency of the national economy—certainly a Commerce Clause consideration. Moreover, the Court probably overstated the extent to which the bright-line test decreases uncertainty over tax jurisdiction and resulting litigation. In the mail-order context, due process and existing sales and use tax statutes would require payment of taxes to the jurisdiction where the goods are shipped. This is a fairly bright-line rule itself, and comports more with economic reality.

(2) Burdens Quill: Is Quill a Tax Case?

Despite the admonition of the concurring justices, the majority sought to offer a substantive jurisprudential rationale for adhering to the Bellas Hess rule. In order to do so, it had to sever Due Process Clause nexus from Commerce Clause nexus. It is here that the doctrinal contortionism begins.

Recall the four-pronged Complete Auto test: (1) nexus, (2) fair apportionment, (3) non-discrimination, and (4) fair relation to benefits afforded by the state. An attorney or law school student

99. See Chevron Oil Co. v. Huson, 404 U.S. 97, 105-06 (noting that a "new principle of law" may be denied retroactive effect to avoid injustice or hardship). See generally Tribe, supra note 56, at 218-27 (discussing retroactivity of judicial decisions).

100. See infra Part I.A (discussing tax policy goals of horizontal equity, neutrality, and efficiency).

101. See infra Part III.B.2.

102. Compare a destination-based sales and use nexus test with the MTC's income tax factor nexus proposal. See infra note 340 and accompanying text.

uninitiated in the niceties of Commerce Clause tax jurisprudence would quickly ask two questions: First, are not the nexus, fair apportionment, and fair relation prongs largely due process concerns? Second, where is the prohibition against undue, but non-discriminatory, burdens?

These questions would arise because, outside the state tax area, the Court has held that the dormant Commerce Clause limits state regulation of interstate commerce by prohibiting undue burdens. Burdens are of two general types: discriminatory and non-discriminatory. Issues of nexus, fair apportionment, and benefits received are usually relegated to due process analysis.

The prohibition against discriminatory regulation operates much the same as in Commerce Clause tax jurisprudence: Facial discriminatory statutes are almost automatically struck down, and litigants also may show that the suspect regulation is discriminatory in effect. The Court's regulatory dormant Commerce Clause jurisprudence also allows litigants to challenge a state regulation that is unduly burdensome on interstate commerce even though residents are subject to the same regulation. Here, however, the Court weighed the legitimate benefits of the regulation to the state against the burdens on interstate commerce. Lack of uniformity is often a concern, although not the sort of uniformity that concerned the Quill Court. Rather, regulatory burdens cases typically involve a state regulation that is out of sync with neighboring states, or with states nationwide. A leading case involved an Iowa statute limiting semi-trailers to a length that was

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104. It might be explained to the "novice" at this point that fair apportionment serves to prevent multiple taxation, an obvious burden on interstate commerce. Still our novice might insist that this concern would be covered by a prohibition against undue burden or discrimination.


106. See Quill Corp. v. North Dakota, 504 U.S. 298, 312 (1992) (noting that the dormant Commerce Clause "prohibits discrimination against interstate commerce and "bars state regulations that unduly burden interstate commerce").

107. See supra note 34 and accompanying text.

108. See Bittker, supra note 105, § 6.06.

109. Often the language of discrimination is used in these cases as well, but it is the "discrimination" caused by the burden on interstate commerce, not by disparate treatment.

not customary elsewhere. The effect of this regulation was to cause trucks on interstate journeys to circumnavigate Iowa. The Court found that the Iowa statute burdened interstate commerce and provided no offsetting benefit to the state other than certain inappropriate local advantages.

These regulatory cases have been all or nothing propositions: either the statute is burdensome or it is not. The Court has not, in these cases, tried to create a safe harbor for smaller players while leaving the regulation in effect for others. Further, the Court has not generally struck down a state statute because the laws of all states are in discord. Statutory variation has been accepted as a natural consequence of our federal system. Problems of this nature can be (and have been) addressed by Congress's affirmative Commerce Clause powers.

Returning to our "uninitiated" attorney or law student, their questions would have been answered before the Quill decision as follows: Regarding the constitutional underpinnings of the nexus prong, not to worry, the Court has treated the Due Process and Commerce Clause concerns as essentially equivalent. Regarding the absence of a rule prohibiting a burdensome but non-discriminatory tax, the Court has implicitly determined that there is no such thing. The Court is not in the business of evaluating the economic burden of a state tax liability.

With this reconciliation of the pre-Quill regulatory and tax dormant Commerce Clause jurisprudence in mind, we now turn to Quill. Here, the Court is not concerned with the economic impact of the tax liability, but with the compliance burden of reporting tax to multiple jurisdictions with non-uniform tax rules. Strictly speaking, Quill is a regulatory burdens case, not a tax case. Indeed, because due process jurisprudence would no longer countenance the Bellas Hess physical presence rule, the Court was compelled to consider

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112. Kassel, 450 U.S. at 678.
113. Id. at 678-79.
114. See Commonwealth Edison Co. v. Montana, 453 U.S. 609, 617-29 (1981) (declining to undertake factual inquiry into the relationship between the benefits provided by the state and the burdens of a tax in order to provide a mechanism for judicial disapproval of excessive state taxes under the Commerce Clause).
whether its regulatory burdens jurisprudence would offer some protection or insight. Here it faced a problem, at least from the perspective of the majority. First, it would have had to balance the state's interests with the burden on the taxpayer. Second, the finding that a tax compliance system is burdensome would seem to apply to all taxpayers. State sales and use taxes would have to be stricken altogether. Burden cases are usually all or nothing propositions.

How then could the Court accommodate its apparent desire to protect a taxpayer that has due process connections with a state but whose economic presence is so small as to make the cost of tax compliance burdensome? Or, more cynically, how could the Court find a substantive law justification for allowing the doctrine of stare decisis to control the outcome of the case? It takes three awkward (or elegant) steps. First, it decouples Commerce Clause nexus from Due Process nexus. Second, it shoehorns its Commerce Clause burden concerns into the nexus prong of the Complete Auto test rather than applying regulatory Commerce Clause precedents. Third, it pulls the old due process physical presence nexus test out of the dust heap and gives it Commerce Clause burdens duty.

The problem with this approach is twofold. First, as discussed, the physical presence test is not an effective tool for sorting out relative burdens among taxpayers. A large mail-order house could comply easily, while a small business with a physical presence might have a much greater burden. The physical presence test is "artificial through and through."\(^1\)\(^\text{16}\) It takes legislation to sort out these distinctions. Second, to add a Commerce Clause burdens component to the concept of nexus, and to suggest that it has a meaning different from due process nexus, makes it difficult to know how to fill Commerce Clause nexus with content. Most of the nexus "burdens" that come to mind are also due process concerns: notice, foreseeableability, fundamental fairness, and the like.

To its credit, implicit in the Burdens Quill reasoning is that the nexus rule could be different for a tax that has lower burdens. Indeed, if a more uniform sales and use tax regime were in place, or

\(^{115}\) "Perspective is everything." See generally WILL DURANT, THE PLEASURES OF PHILOSOPHY (1953).

\(^{116}\) Robert D. Plattner, Quill: Ten Years After, 25 ST. TAX NOTES 1017, 1020 (2002).
if the specter of thousands of local jurisdictions were removed, then
the Commerce Clause nexus standard would approach the due
process standard, and the physical presence test would not apply
even to sales and use taxes.117

(3) Disappearing Ink Quill

The Quill Court left open the possibility that it might someday
revisit the Bellas Hess rule. By removing the due process obstacle
to more expansive sales and use tax jurisdiction, Congress has
become “free to decide” the appropriate nexus standard.118 Thus, the
Court chose to “withhold[] our hand, at least for now.”119 Indeed, Quill’s
holding emphasizes its temporal nature: “[O]ur reasoning ... does not compel that we now reject”120 the Bellas Hess rule, and “we disagree ... that the time has come to renounce the bright-line test
of Bellas Hess.”121

A twenty-five year gap spanned the original Bellas Hess decision
and Quill. More than ten years have passed since the Quill decision.
If the rate of change in our society is exponential, then at least
the same amount of change has occurred in the past ten years
as occurred in the twenty-five years prior to Quill.122 Recent

117. This insight is the major impetus behind the Streamlined Sales Tax Project (SSTP). This state-initiated project has approved a final draft of a Streamlined Sales and Use Tax Agreement that is now being presented to state legislatures for approval. The Agreement does not require that states adopt a uniform tax base, but it does require that the states use uniform definitions, such as for “food” or “clothing,” in defining their taxable base. Further, the Agreement provides for uniform administrative and procedural rules and calls for the creation of approved tax reporting software on which taxpayers can fully rely. See generally Streamlined Sales Tax Project, at http://www.streamlinedsalestax.org (last visited Apr. 11, 2003) (official website of the SSTP). The Agreement does not purport to overrule Quill, but the states hope that Quill will be either judicially or legislatively overruled once the Agreement is adopted by a sufficient number of states. See Streamlined Sales Tax Project Res. No. 05-02 (Nov. 13, 2002), at http://www.streamlinedsalestax.org/resolutions.html. The business community has been generally supportive of this effort. See Council on State Taxation, Report Card on Streamlined Sales Tax Implementing States’ Agreement, 26 ST. TAX NOTES 407 (2002) (“T]he Agreement would represent a major step toward a uniform and simpler sales and use tax structure.”).
119. Id. (emphasis added).
120. Id. at 317 (emphasis added).
121. Id. at 317-18 (emphasis added).
122. Assuming the exponent is greater than or equal to two. This is an empirical question.
developments bear this out. The advent of the Internet and e-commerce since the Quill decision has made geography and physical presence irrelevant in ways that the Quill Court could not have contemplated.

In short, the Court may now be ready to revisit and overrule the Quill decision. Of course, this is speculative. Congressional inaction, for example, could be taken as acquiescence in, or endorsement of, the Quill rule. Nevertheless, Quill’s apologetic tone, together with its indication that the Court may revisit the issue in the future, suggest that the opinion was that could not have been contemplated by the Quill Court.

C. State Income Tax Jurisdiction: Theoretical Underpinnings and Authorities

Having examined the Court’s most recent pronouncement on state tax nexus, we now turn to an analysis of the principles and cases directly relevant to state corporate income tax nexus.

1. Theoretical Underpinnings

It is well-settled that state power to tax can arise both from residence and source. Regarding residence, “[t]hat the receipt of income by a resident of the territory of a taxing sovereignty is a taxable event is universally recognized.” Regarding source, the Court “deem[s] it clear, upon principle as well as authority, that just as a State may impose general income taxes upon its own citizens and residents ... it may ... levy a duty of like character ... upon incomes accruing to non-residents from their property or business within the State.”

123. More specifically, I am referring to the use of the Internet by the general public for commercial purposes.
124. Also suggesting that the Court may reverse Quill is that the Court felt it appropriate to clear the way for Congress to act by removing the Due Process Clause barrier to legislatively overruling the physical presence test. See Quill, 504 U.S. at 318. If the “proper” policy determination would be to retain the physical presence test, then judicial road clearing would not have been needed. Congress could have crafted nexus rules under existing jurisprudence.
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The fundamental rationale for allowing states to tax income with an in-state source is that the state provides benefits and protections that allow the income to arise in the first instance.\textsuperscript{127} As stated expansively by the Court, “[t]he simple but controlling question is whether the state has given anything for which it can ask return.”\textsuperscript{128}

When source and domicile rules conflict, source generally prevails. Professor Hellerstein observes:

[W]hen both the state of domicile and the state of source have a legitimate claim to tax income, the state of domicile ordinarily yields to the state of source to avoid double taxation. This is true both as a matter of national and international practice, and as a matter of federal constitutional law.\textsuperscript{129}

That income may be sourced to a state—thereby becoming subject to the state’s taxing jurisdiction—does not necessarily mean that the state has jurisdiction to tax the non-resident who earned the income. Recall that nexus with income is distinct from nexus with the taxpayer.\textsuperscript{130} If only modern due process standards were implicated, then jurisdiction over income would usually result in jurisdiction over the taxpayer. Income in a jurisdiction generally arises only when a taxpayer has “purposefully availed” him or herself of the state and has created “minimum contacts.”\textsuperscript{131}

Possibly only the odd case of inadvertent income would make the distinction between nexus with income and nexus with the taxpayer meaningful.\textsuperscript{132} The Quill Court’s decoupling of Commerce Clause and Due Process Clause nexus, however, prevents one from leaping to this conclusion. The sales and use tax physical presence test gives rise to numerous instances in which the distinction between nexus with the taxpayer and nexus with the transaction has tremendous import, insulating remote sellers from tax collection obligations despite clear transactional nexus with a state. If the Commerce

\textsuperscript{127} See generally Hellerstein & Hellerstein, supra note 14, ¶ 6.04 (recognizing that the Court has adopted a broad view of source by tying state taxing power to benefits and protections afforded).

\textsuperscript{128} Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940).

\textsuperscript{129} Hellerstein & Hellerstein, supra note 14, ¶ 6.03 (citations omitted).

\textsuperscript{130} See supra notes 35-37 and accompanying text.

\textsuperscript{131} See supra note 46 and accompanying text.

\textsuperscript{132} See Hellerstein & Hellerstein, supra note 14, ¶ 6.02(1).
 Clause nexus test for income taxes were also physical presence, the consequences would be similar.

The severance of Commerce Clause and Due Process Clause analysis complicates the interpretation of several of the seemingly relevant income tax cases. The Court decided these cases on due process grounds alone. Accordingly, one could argue that *Quill*'s Commerce Clause holding renders these cases irrelevant. However, grounded as it was in stare decisis, *Quill* did not raise the Commerce Clause nexus bar. Instead, *Quill* lowered the due process bar to the level that the Court's non-tax due process jurisprudence had reached long before. Until *Quill*, the Due Process and Commerce Clause tax nexus standards were essentially identical, and many cases treated them as interchangeable, even failing to precisely identify which standard was being applied. 133 *Quill* simply retained the old Due Process/Commerce Clause physical presence test for sales and use tax, but removed the due process label. Thus, pre-*Quill* Due Process Clause nexus cases are relevant to post-*Quill* Commerce Clause nexus analysis.

Of even greater relevance may be the Due Process nexus cases that pre-date the Court's 1945 landmark opinion in *International Shoe Co. v. Washington.* 134 In *International Shoe*, the Court shifted the focus of judicial jurisdiction away from geographic presence to a more pragmatic "minimum contacts" analysis. 135 Because pre-*International Shoe* due process tax nexus cases were decided when the focus of jurisdictional inquiry was on corporate presence, these cases would seem to have special relevance to a Commerce Clause standard that also demands presence for sales and use taxes. For example, if we find that these early income tax cases are based on economic substance rather than formal labels despite the jurisprudential milieu in which they were decided, we would expect a similar approach today.

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133. See *supra* note 13 and accompanying text. See also *HELLERSTEIN & HELLERSTEIN*, *supra* note 14, ¶ 19.02(3)(c)(ii) (noting that the Court "had never indicated that there was any distinction in the meaning of the nexus requirement under either clause").
134. 326 U.S. 310 (1945).
135. *Id.* at 316.
2. The Income Tax Authorities


In Whitney v. Graves,\textsuperscript{136} a 1937 decision, the Court held that New York could tax a non-resident on the gain from the sale of a membership (or seat) in the New York Stock Exchange without running afoul of the Due Process Clause.\textsuperscript{137} The taxpayer had no physical presence in the state—membership in the Exchange was intangible personal property.\textsuperscript{138} The Court analyzed the issue in terms of "business situs."\textsuperscript{139} Normally intangibles are treated as located in the owner's state of residence. However, intangibles can obtain a business situs in another jurisdiction if the rights associated with the intangibles are sufficiently localized.\textsuperscript{140} The Court found that the "dominant attribute" of the membership—a right to buy and sell securities on the floor of the NYSE—was sufficiently localized in the situs of the Exchange to "bring it within the taxing power of New York."\textsuperscript{141} Accordingly, "the Court held that in laying the tax upon the profits derived by the relator from the sale of the ... membership the State did not exceed the bounds of its jurisdiction."\textsuperscript{142}

Whitney is a clear, early example of the Court upholding an income tax even though the taxpayer had no physical presence in the state. Indeed, the Court merely applied a well-settled rule for establishing the situs of intangibles.\textsuperscript{143} Importantly though, the Court did not find it necessary to find a separate physical presence to assert jurisdiction over the taxpayer.\textsuperscript{144}

Several objections might be raised to the contention that Whitney v. Graves is good authority for the absence of a state income tax

\textsuperscript{136} 299 U.S. 366 (1937).
\textsuperscript{137} Id. at 374.
\textsuperscript{138} Id. at 371.
\textsuperscript{139} Id. at 372.
\textsuperscript{140} See id.
\textsuperscript{141} Id. at 374.
\textsuperscript{142} Id.
\textsuperscript{143} See, e.g., City of New Orleans v. Stemple, 175 U.S. 309, 322-23 (1899) (upholding a local property tax on notes and mortgages belonging to a person whose only contact with the jurisdiction was the presence of those intangibles).
\textsuperscript{144} See Whitney, 299 U.S. at 372.
physical presence test. First, the decision has a "quasi in rem" jurisdiction feel, and the Court later rejected this approach to jurisdiction in favor of the uniform application of minimum contacts analysis. However, the close relationship between the intangible and the cause of action—taxation of the gain from the sale of the intangible—would be clear grounds for asserting jurisdiction under the latter standard as well. Second, the precedential value of Whitney might be limited to cases involving intangibles that acquire a business situs in the state of source. Even if limited in this way, however, its reach could be extensive. For example, remote sellers or lenders might still fall within the Whitney rule to the extent they can be found to acquire in-state intangible contract rights.

Third, membership in the New York Stock Exchange might be likened to a partnership interest. Thus, the owner of the membership could be treated as having a physical presence in New York by attribution of the physical presence of the New York Stock Exchange to the owner. Fourth, a narrow, literal reading of the holding suggests that the Court only addressed jurisdiction over the income, not the taxpayer. Although it appears that the Court treated the two as going hand in hand, one must concede that a more vigorously litigated case might have drawn out this distinction. Finally, the case was decided on Due Process Clause rather than Commerce Clause grounds. We have already addressed why this distinction may not be significant, particularly for cases like Whitney that were decided before International Shoe.

In summary, the Court held in Whitney v. Graves that a state has jurisdiction to impose its income tax despite the absence of taxpayer

145. See Walter Hellerstein, State Taxation of Corporate Income from Intangibles: Allied-Signal and Beyond, 48 TAX L. REV. 739, 824 n.446 (discussing jurisdictional aspects of taxing income from intangibles).
146. An example of such in-state intangible contract rights is business receivables.
147. Partners, limited liability company members, and subchapter S corporation shareholders often are treated as being present and taxable through the in-state presence of the entity. See Bruce P. Ely, State Taxation of Limited Liability Companies and Limited Liability Partnerships: Background and Recent Developments, in POMP & OLDMAN, supra note 20, at 10-57, 10-59.
148. See Whitney, 299 U.S. at 374 (holding that the state did not exceed its jurisdiction in laying tax upon the profits derived from the sale).
149. See id. at 370.
150. See supra Part I.C.1.
Still, its holding might be limited to income from certain well-defined intangibles, and its relevance to the Commerce Clause substantial nexus requirement can be challenged, however weakly.

b. Taxing Non-Resident Shareholders: International Harvester Co. v. Wisconsin Department of Taxation

In *International Harvester*, a due process challenge, the Court upheld the constitutionality of a Wisconsin tax on International Harvester shareholders measured by the Wisconsin portion of dividend distributions. The Wisconsin portion of the dividends was measured by using an apportionment formula essentially identical to the formula used to allocate International Harvester's income for corporate income tax purposes. Although the tax was collected through a withholding obligation imposed on the distributing corporation, the Wisconsin Supreme Court had clarified that the legal incidence of the tax was on the shareholders. The Supreme Court's opinion in *International Harvester* was based expressly on this determination. Indeed, the basis of the plaintiffs' claim was that the tax violated the due process rights of the "stockholder-taxpayers." Further,

151. As noted, the case might be distinguished by arguing that the physical presence of the NYSE was attributable to the seat holder, but the Court did not offer this as a rationale for its decision. See *supra* notes 136-42 and accompanying text.
152. *Int'l Harvester Co. v. Wis. Dep't of Taxation*, 322 U.S. 435 (1944).
153. *Id.* at 445.
154. 1935 Wis. Laws 505 § 3.
156. *Id.* at 441.
157. *Id.* at 445.
158. *Id.* at 443 (footnote omitted).
[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. A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers.159

This is a ringing endorsement of the theoretical underpinning of tax jurisdiction over non-residents: source and benefits conferred by the state.

*International Harvester*’s strength as an authority for state income tax jurisdiction based on economic presence alone is weakened by several factors. First, the opinion does not unequivocally state that Wisconsin has jurisdiction over *the stockholders* and not merely jurisdiction over their income. The holding of the case specifically referred to the constitutionality of the withholding of tax by *International Harvester*, an entity physically present in the state.160 While the opinion referred to the tax being imposed against both the shareholders and their income, the Court was never really compelled to reach the nexus *with the taxpayer* question. It noted that withholding is a “practically effective device ... necessary in order to enable the state to collect its tax.”161 We cannot be certain, however, whether the withholding tax is “necessary” only as a “practical[]” administrative matter, or is “necessary” because of the lack of jurisdiction over the ninety-eight percent of *International Harvester*’s 32,000 shareholders who resided outside Wisconsin.162

Second, as Justice Jackson’s dissent pointed out, the decision may have been based on a false analogy between corporate income and dividend distributions to shareholders.163 Given this false analogy,
International Harvester looks very much like a pass-through entity case. For example, states have subjected partners, limited partners, and S corporation shareholders to the income tax jurisdiction of the state in which the pass-through entity does business. Arguably, this is consistent with a physical presence test if we treat the pass-through entity's presence in the taxing jurisdiction as attributable to the owners.

Finally, International Harvester is a due process case, so arguably it does not speak directly to the Commerce Clause nexus issue. Again, however, pre-Quill and especially pre-International Shoe due process nexus cases are relevant because the due process tax nexus standards during those periods reflect the current Commerce Clause standard.

In his analysis of International Harvester, Professor Hellerstein concludes:

[There is no denying the fact that the Court's opinion in International Harvester lends powerful support to those who argue that a state has constitutional power to impose a tax on a nonresident based solely on the fact that the source of the nonresident's income is derived from activities conducted in the state, regardless of whether the nonresident has any physical presence in the state.]

He clarifies, however, that International Harvester may only support jurisdiction over the income, not the nonresident.

164. See supra note 147 and accompanying text. Otherwise, unless the state imposes an entity level tax—contrary to the pass-through treatment for federal income tax purposes—the income escapes taxation in that state.

165. However, if one makes this argument under the International Harvester facts, one would seem also to accept a theory of shareholder nexus or affiliate nexus (where the shareholder is a controlling corporation). Taxpayers have opposed these theories of jurisdiction on the state court level with some success. See generally John A. Swain, Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?, 75 S. Cal. L. Rev. 419 (2002) (arguing that affiliate nexus is a viable theory for asserting jurisdiction over Internet subsidiaries of physically present brick-and-mortar retailers).

166. See Int'l Harvester, 322 U.S. at 439-40.


168. Hellerstein & Hellerstein, supra note 14, ¶ 6.04(1).

169. "Needless to say, if the nonresident is not physically present in the state and owns no property there, it may be difficult to enforce any tax liability that is established on the basis..."
c. Provoking Congressional Action: Northwestern States
Portland Cement Co. v. Minnesota

Northwestern States involved both Due Process and Commerce Clause claims.\(^{170}\) The taxpayer was a company incorporated and headquartered in Iowa.\(^{171}\) Though its manufacturing facilities were located in Iowa, it regularly and systematically solicited orders for the sale of its product in Minnesota.\(^{172}\) Forty-eight percent of its sales were made in Minnesota, and it had a physical presence in Minnesota consisting of a leased sales office and several salespersons.\(^{173}\) Minnesota sought to tax its income on an apportioned basis as determined by a three-factor apportionment formula of sales, property and payroll.\(^{174}\)

The primary question before the Court was whether the Commerce Clause permitted Minnesota to tax income derived from exclusively interstate activities.\(^{175}\) The Court upheld the tax because it was fairly apportioned, non-discriminatory, imposed no undue burden, and did not result in multiple taxation.\(^{176}\) The Court also addressed nexus, treating it as a due process concern. It found that "it strains reality" to say that the taxpayer has no due process nexus.\(^{177}\)

In reaching its decision, the Court examined the decision of the California Supreme Court in West Publishing Co. v. McColgan.\(^{178}\) In West Publishing, the Court, per curiam, sustained an income tax levy where the taxpayer solicited orders for law books published out-of-state and shipped to customers from out-of-state locations.\(^{179}\) The

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\(^{171}\) Id. at 453.

\(^{172}\) Id. at 454.

\(^{173}\) Id.

\(^{174}\) Id. at 453-54.

\(^{175}\) Id. at 452.

\(^{176}\) Id. at 461-62.

\(^{177}\) Id. at 464.

\(^{178}\) 166 P.2d 861 (Cal. 1946) (en banc), aff'd per curiam, 328 U.S. 823 (1946).

\(^{179}\) West Publ'g Co. v. McColgan, 328 U.S. 823 (1946) (per curiam); see West Publ'g, 166 P.3d at 862.
taxpayer employed four in-state salespersons that used office space provided by certain attorneys in exchange for making available some of the legal publications the salespersons kept on hand and used in connection with soliciting orders. 180

Two aspects of the Court's discussion of West Publishing in Northwestern States are particularly relevant to the issue of income tax nexus. First, the Court stated that "it is significant ... that West had not qualified to do business" in the taxing state. 181 Second, the Court approvingly observed that the California Supreme Court's opinion "was not grounded on the triviality that office space was given West's solicitors by attorneys." 182 As Professors Rotunda and Nowak conclude: "On the basis of Northwestern States, it is reasonably clear that mere solicitation of business by a foreign corporation in a state ... provides a sufficient nexus to warrant apportionment of net income to the market state." 183

Unfortunately, the Court did not tell us if it would adhere to this conclusion if the taxpayer were not physically present. 184 Interstate businesses (and Congress), however, clearly thought that this might be the natural consequence of the Northwestern States decision. Soon after the Court released the Northwestern States decision, Congress enacted P.L. 86-272. P.L. 86-272 created an income tax nexus safe harbor for sellers of tangible personal property whose only activity in the state is the solicitation of orders, provided that the orders are forwarded out-of-state for acceptance and the goods are shipped from an out-of-state location. 185 As noted at the outset of this Article, P.L. 86-272 has stunted the development of a constitutional income tax nexus standard. 186

A separate aspect of Northwestern States is worthy of note. Justice Frankfurter's dissent demonstrates that the Court

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180. West Pub'l', 166 P.2d at 862.
182. Id.
183. RONALD D. ROTUNDA & JOHN E. NOWAK, 2 TREATISE ON CONSTITUTIONAL LAW: SUBSTANCE AND PROCEDURE § 13.4 (3d ed. 1999). Again, however, nexus with the taxpayer does not necessarily follow from nexus with the income.
184. At least it has not done so in a case decided explicitly under the dormant Commerce Clause. In both International Harvester and Whitney, the Court did not find that physical presence was required under the Due Process Clause. See supra Part I.C.2.a-b.
185. See supra notes 21-26 and accompanying text (discussing the safe harbor provisions of P.L. 86-272).
186. See supra note 21 and accompanying text.
considered, but rejected, compliance burden concerns. Justice Frankfurter discussed the practical compliance problems for small interstate businesses at length:

[T]here are thousands of relatively small or moderate size corporations doing exclusively interstate business spread over several States. To subject these corporations to a separate income tax in each of these States means that they will have to keep books, make returns, store records, and engage legal counsel, all to meet the divers and variegated tax laws of forty-nine States, with their different times for filing returns, different tax structures, different modes for determining "net income," and different, often conflicting, formulas of apportionment. This will involve large increases in bookkeeping, accounting, and legal paraphernalia to meet these new demands. The cost of such a far-flung scheme for complying with the taxing requirements of the different States may well exceed the burden of the taxes themselves, especially in the case of small companies doing a small volume of business in several States.

However, he acknowledged:

These considerations do not at all lead to the conclusion that the vast amount of business carried on throughout all the States as part of what is exclusively interstate commerce should not be made to contribute to the cost of maintaining state governments which, as a practical matter, necessarily contribute to the conduct of that commerce by the mere fact of their existence as governments.

Justice Frankfurter concluded that these concerns were best addressed by Congress. Indeed, this is what occurred shortly thereafter.

Importantly, Justice Frankfurter did not see compliance burdens as a nexus problem. Similarly, he did not see compliance as a burden hinging on whether an interstate business is physically

187. See Northwestern States, 358 U.S. at 474 (Frankfurter, J., dissenting).
188. Id.
189. Id. at 475. Along with compliance burden, he raised a second and related concern about litigation over the validity of various apportionment formulas. Id.
190. Id. at 476.
present in the taxing state. Instead, he saw the issue as one for “small companies doing a small volume of business,”\textsuperscript{191} surmising that the costs of compliance for these companies may exceed the benefit of revenue raised by the States. Finally, he saw the solution as legislative.\textsuperscript{192}

Obviously, the majority was not persuaded that Justice Frankfurter’s concerns have constitutional import, although the majority did not confront those concerns directly. Justice Harlan’s concurrence addressed the burdens issue, but treated it as solely one of fairness in apportioning the burden of the tax liability (not compliance costs). Justice Harlan observed that income taxes proportionally apply to the profits of local and interstate businesses alike.\textsuperscript{193}

\textit{d. The Court’s Contemporary Income Tax Cases}

After the Court’s decision in \textit{Northwestern States} and the Congressional response, the corporate income tax spotlight turned toward formulary apportionment, the unitary business principle, and combined reporting. Still, elements in these cases and developments are relevant to the nexus inquiry. First, nearly contemporaneous with \textit{Northwestern States} was the adoption by the National Conference of Commissioners on Uniform State Laws of the Uniform Division of Income for Tax Purposes Act (UDITPA).\textsuperscript{194} As its name suggests, UDITPA contains a uniform set of rules for the allocation and apportionment of income for state corporate income tax purposes. Of the states that impose a corporate income tax, about one-half “have adopted the essential features of UDITPA and most of the others have statutes that are consistent with UDITPA’s basic approach.”\textsuperscript{195} Very generally, UDITPA apportions business income based on the average of three factors: sales, property, and payroll.\textsuperscript{196} The sales factor, for example, is measured

\textsuperscript{191} Id. at 474.
\textsuperscript{192} Id. at 476.
\textsuperscript{193} See \textit{Northwestern States}, 358 U.S. at 469 (Harlan, J., concurring).
\textsuperscript{195} \textit{POMP & OLDMAN, supra note 20, at 10-1.}
\textsuperscript{196} See \textit{id. at} 10-11 to 10-12.
by the ratio of in-state sales to sales everywhere. The property and payroll factors are computed similarly. Although the Court has allowed states wide latitude in adopting apportionment formulas, it has recognized UDITPA's three-factor formula as "something of a benchmark against which other apportionment formulas are judged." There is no comparable uniform state sales and use tax act.

A second modern development is that the Court has expressly allowed states to require multi-corporate enterprises to report on a combined basis to the extent the combined group is conducting a unitary business. One consequence of combined reporting is that a member of a combined group that has no in-state physical presence nonetheless has its income included in the "apportionment base"—the amount of taxable income of the combined group to which the apportionment formula is applied. Moreover, if this non-physically present member has in-state sales, then its sales may be required to be included in the numerator of the sales factor. As a result, combined reporting and formulary apportionment—both constitutionally blessed by the Court in the face of Commerce Clause challenges—can have the practical effect of taxing the income of a non-physically present corporation. Although the Court has not had occasion to go so far as to hold that a state has jurisdiction over the taxpayer as well as the income in these situations, the gap between nexus with the income and nexus with the taxpayer has narrowed significantly.

197. See id. at 10-10 to 10-11.
198. See id.
200. But see supra note 117 and accompanying text (noting that the Streamlined Sales Tax Agreement, though in its infancy, is a significant step toward the creation of a uniform sales and use tax act).
201. See Container Corp., 463 U.S. at 168; see also infra notes 352-53 and accompanying text (giving an explanation of the unitary business principle).
202. See Barclays Bank v. Franchise Tax Bd., 512 U.S. 298, 304-07 (1994) (noting income of more than 220 affiliate corporations apportioned to California even though only two affiliates had California operations).
203. See generally POMP & OLDMAN, supra note 20, at 10-31 (discussing "pure" versus "nexus" combined reporting).
204. See Barclays Bank, 512 U.S. at 311-12, 311 n.10 (holding the taxable income of far flung combined group created a tax liability for only the two in-state affiliates, therefore nexus defense did not lie).
205. A fair reading of the Court's most recent corporate income tax cases is that nexus with
Third, the post-Quill case of Barclays Bank v. Franchise Tax Board raised the issue of compliance burdens. In Barclays Bank, the taxpayer claimed, among other things, that California’s worldwide combined reporting scheme violated the anti-discrimination prong of the Complete Auto test. Barclays argued that a foreign taxpayer filing a California tax return is “forced to convert its diverse financial and accounting records from around the world into the language, currency, and accounting principles of the United States’ at ‘prohibitiv[e]’ expense.” Barclays estimated, and the trial court found, that the start-up cost of creating the necessary accounting system would be more than five million dollars, and that it would cost more than two million dollars annually to maintain. However, the California Court of Appeals found that Barclays’ actual compliance cost ranged from $900 to $1,250 for one of its two combined groups.

The Court acknowledged that a compliance burdens claim could lie, citing a regulatory burdens case in which the Court applied its standard balancing test—weighing the burden on interstate commerce against the benefit to the state. The Court, however, rejected Barclays’ claim, noting that “reasonable approximations” allowed under the California regulations prevent the sort of burden of which Barclays complained.

The significance of Barclays Bank for Commerce Clause nexus analysis is twofold. First, a post-Quill Court seemed to know where burdens analysis belonged. Second, the Court held that a complex

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the taxpayer and nexus with the income remain separate, though obviously related inquiries. See, e.g., Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 778 (1992) (“[T]here must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax ....”), see also supra note 183 and accompanying text.


207. See id. at 312-13. Presumably, a nexus argument was not available to Barclays because two of its affiliates were physically present and doing business in California. See id. at 311 n.10.

208. Id. at 313 (alteration in original).

209. Id. at 313 n.11.

210. Id. at 314 n.13.

211. Id. at 313 (citing Hunt v. Washington State Apple Adver. Comm’n, 432 U.S. 333, 350-51 (1977)). In Hunt, the Court held that the increased costs imposed by a North Carolina statute on out-of-state producers “would tend to shield the local apple industry from the competition of Washington apple growers.” Hunt, 432 U.S. at 351.

212. Barclays Bank, 512 U.S. at 314.

213. The Court recognized that the burdens analysis belonged under the discriminatory
worldwide combined corporate income tax reporting obligation was not burdensome. Of course, a nexus challenge was not available to Barclays, and it is not suggested that Quill would be overruled simply because a later Court examined compliance burdens under another prong of the Complete Auto test. Nonetheless, Barclays Bank may demonstrate an increasing sophistication of the Court in dealing with claims of undue tax compliance burden. Indeed, it might suggest how the Court would rule with respect to corporate income tax nexus when the Court is unencumbered by naked stare decisis concerns.

e. Post-Quill State Court Decisions: A Divergence of Opinions

Soon after Quill was decided, the South Carolina Supreme Court held that Quill's physical presence test was inapplicable to income tax. In Geoffrey, Inc. v. South Carolina Tax Commission, Toys R Us had transferred its trademarks and related intangibles to Geoffrey, Inc., a wholly owned subsidiary corporation located in Delaware. Toys R Us then paid Geoffrey a royalty for the use of these trademarks in South Carolina. This had the effect of reducing the taxable income of Toys R Us in South Carolina, while Geoffrey's corresponding income went untaxed in Delaware. In auditing Toys R Us, South Carolina initially tried to disallow the deduction for the royalty to Geoffrey, claiming that it was an arbitrary shift of income and expenses between Geoffrey and Toys R Us. The state subsequently abandoned this position and took the straightforward approach of assessing Geoffrey on the royalty income attributable to the use of its trademarks and related intangibles in South Carolina. Along with a due process claim, Geoffrey argued that it had no physical presence in South Carolina

burden prong of the Complete Auto test, rather than under the nexus prong.

214. See supra note 188 and accompanying text.
216. Id. at 15.
217. See id.
218. See id. Delaware, a well-known corporate haven, exempts from income taxation a corporation whose in-state activities are limited to the maintenance and management of its intangible assets. DEL. CODE ANN. tit. 30, § 1902(b)(8) (1974 & Supp. 2002).
220. Id.
and was therefore protected from taxation by the dormant Commerce Clause and the Quill physical presence test.\(^{221}\)

The South Carolina Supreme Court rejected both of Geoffrey’s constitutional defenses. Due process was not offended because Geoffrey had purposefully directed its economic activities toward the state and had benefitted from government protections.\(^{222}\) Additionally, its intangibles were “present” in the state.\(^{223}\) Regarding the dormant Commerce Clause, the court found that Quill’s physical presence test was limited to sales and use taxes.\(^{224}\) Moreover, it found ample Commerce Clause nexus based on the presence of Geoffrey’s intangible property in the state and on the provision of state-provided protections and benefits—essentially the same reasons the court gave in rejecting Geoffrey’s due process challenge.\(^{225}\)

Some commentators bitterly attacked Geoffrey as a renegade decision,\(^{226}\) and most others were disappointed by the perfunctory treatment that the court gave to Quill—dismissing its relevance in a footnote.\(^{227}\) Nevertheless, a number of state courts have agreed with Geoffrey.\(^{228}\) In what initially was seen as a taxpayer victory, the

\(^{221}\) Id. at 16.
\(^{222}\) Id. at 16-17.
\(^{223}\) Id. at 17.
\(^{224}\) Id. at 18 n.4.
\(^{225}\) Id. at 18 & n.5 (citing Int’l Harvester Co. v. Wis. Dep’t of Taxation, 322 U.S. 435, 441-42 (1944)).
\(^{226}\) See David Cowling, Nexus From Intangibles—Geoffrey, 10 ST. TAX NOTES 129, 131 & n.16 (1996) (citing highly critical commentary of Geoffrey that describes the decision as “intellectually dishonest”).
\(^{227}\) See, e.g., HELLERSTEIN & HELLERSTEIN, supra note 14, ¶ 6.11(2) (criticizing the court for its perfunctory treatment of some of the issues and its failure to address others, though this “does not necessarily mean that Geoffrey was wrongly decided”); POMP & OLDMAN, supra note 20, at 11-127 to 11-128 (criticizing Geoffrey as lacking “intellectual rigor” and noting the divergence of subsequent state court opinions). But see Michael T. Fatale, Geoffrey Sidesteps Quill: Constitutional Nexus, Intangible Property and the State Taxation of Income, 23 HOFSTRA L. REV. 407, 411 (1994) (supporting cogently the Geoffrey decision).
\(^{228}\) See Borden Chems. & Plastics, L.P. v. Zehnder, 726 N.E.2d 73, 80 (Ill. App. Ct. 2000) (physical presence not applicable to income taxes); Truck Renting & Leasing Ass’n, Inc. v. Comm’r of Revenue, 746 N.E.2d 143, 149 n.13 (Mass. 2001) (citing Geoffrey and noting that neither party claimed that a physical presence test was applicable to the Massachusetts corporate excise tax); Mayer & Schweitzer, Inc. v. Div. of Taxation, 20 N.J. Tax 217, 231 (N.J. Tax. Ct. 2002) (implying that the physical presence test is not applicable to state income taxes); Kmart Props., Inc. v. Taxation and Revenue Dep’t, No. 21,140 (N.M. Ct. App. Nov. 27, 2001) (holding that the physical presence test is not applicable to income taxes), available at LEXIS 2001 STT 233-18, cert. granted, 40 P.3d 1008 (N.M. 2002); Couchot v. State Lottery
Tennessee Court of Appeals in *J.C. Penney National Bank v. Johnson*\(^\text{229}\) invalidated a franchise and excise tax assessment against a credit card company that did not have a physical presence in the state.\(^\text{230}\) While being careful not to decide whether a physical presence was required, the court noted that the Commissioner of Revenue cited no authority in which the United States Supreme Court had “upheld a state tax where the out-of-state taxpayer had absolutely no physical presence.”\(^\text{231}\) The court then expressed concern that “we would be unjustifiably overlapping the [Due Process and Commerce] clauses” if the court were to uphold the tax assessment.\(^\text{232}\) The court acknowledged that the *Quill* Court had expressed “some reservations about the vitality of the *Bellas Hess* decision,”\(^\text{233}\) but it believed that it was not in a position to speculate as to how the Supreme Court might decide future cases.\(^\text{234}\) A few state tax courts have extended *Quill’s* physical presence test to other taxes.\(^\text{235}\)

A careful reading of *J.C. Penney* reveals that while the court was reluctant to find that physical presence is required for franchise tax nexus, it believed that the taxing authority was asking it to merge the Due Process and Commerce Clause tests under *Quill*.\(^\text{236}\) The court seemed to say that *Quill’s* substantial nexus analysis was applicable to the instant case, and that the taxing authority had offered no separate Commerce Clause substantial nexus analysis as
a substitute for the sales and use tax physical presence test.\textsuperscript{237} In the court's view, substantial nexus was due process minimum contacts "\textit{plus} something,"\textsuperscript{238} and the only "\textit{plus} something" offered to the court was physical presence.

This cautious view of \textit{J.C. Penney} was confirmed in \textit{America Online, Inc. v. Johnson},\textsuperscript{239} in which the Tennessee Court of Appeals reversed a summary judgment in favor of the taxpayer, America Online, and remanded the case for further discovery regarding the taxpayer's contacts with the state.\textsuperscript{240} In reaching its decision, the court cautioned that \textit{J.C. Penney} did not "\textit{simply substitute 'physical presence' for 'nexus.'}"	extsuperscript{241} It reemphasized: "What we actually said in \textit{J.C. Penney} was, 'It is not our purpose to decide whether 'physical presence' is required under the Commerce Clause."\textsuperscript{242} Nevertheless, elsewhere in \textit{America Online} the court drew a line between businesses whose only contacts with a state are by "Internet, mail, and common carriers" and those whose contacts include relationships with in-state businesses and persons who facilitate their exploitation of the local market.\textsuperscript{243} Proponents of an economic nexus standard for state income taxes would not make this distinction.\textsuperscript{244}

In summary, post-\textit{Quill} state court income tax nexus decisions do more to illustrate the uncertainty and divergence of opinion regarding the appropriate test than to add clarity. Though the greater weight of authority supports an economic nexus standard,
the applicability of *Quill* to income tax nexus is still vigorously litigated. Undoubtedly, most non-physically present taxpayers still take the reporting position that they are not subject to tax, and taxing authorities have been generally timid in testing the limits of *Quill* in the income tax context.  

II. DETERMINING THE STATE CORPORATE INCOME TAX JURISDICTIONAL STANDARD

The authorities discussed in Part I can now be applied to the questions of whether state corporate income tax nexus demands a taxpayer's physical presence, and, if not, what are the nexus requirements?

**A. The Income Tax Authorities**

*International Harvester* and *Whitney* lend strong support to the proposition that taxpayer physical presence is not required for state income tax jurisdiction. *International Harvester* says as much, and the facts of *Whitney* make clear that lack of physical presence was no barrier to jurisdiction. The Court's dictum in *International Harvester* is emphatic on this point. The Court's expansive view of income tax jurisdiction, at a time when "presence" was the touchstone of jurisdictional analysis, buttresses this conclusion. Further, the doctrinal milieu in which the Court decided these cases blunts the objection that they are "merely" due process cases. If today's Commerce Clause nexus standard is today's due process standard "plus something," the due process standard at the time of *International Harvester* and *Whitney* was today's due process standard "plus something" as well.

This is not to say that *International Harvester* and *Whitney* are unequivocally controlling. There are lingering doubts about whether

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245. Cf. Cowling, supra note 226, at 141 (advising that some taxing authorities are approaching the *Geoffrey* decision with caution, and that although risks may be involved, taxpayers should not necessarily change their reporting positions in light of this single state court opinion).

246. See supra notes 158-59 and accompanying text.

247. See supra Part I.C.2.a.


249. See supra note 238 (explaining limits of the "plus something" metaphor).
they address nexus with income or nexus with the out-of-state taxpayer. They also might be considered crude pass-through entity cases, implicitly grounded on the attribution of the physical presence of an in-state entity (the NYSE in one case and International Harvester in the other). Furthermore, even if controlling, Whitney might be limited to cases involving the in-state business situs of a well-defined intangible.250

Regardless of whether one views International Harvester and Whitney as directly controlling, one can draw two powerful and unequivocal conclusions. First, whatever these cases might have done, they, nor any other pre-Quill Supreme Court income tax decision, did not establish a physical presence test for state income taxation. Nor did any other pre-Quill Supreme Court income tax decision. There is no “Bellas Hess” of corporate income tax jurisdiction. Accordingly, to the extent Quill is grounded in stare decisis and concerns about reliance interests, it has little application to state income tax jurisdiction.

Second, the Court in International Harvester and Whitney strongly adhered to the principle of source taxation, and, more generally, to acknowledging the primacy of economic substance in income tax matters. This adherence contrasted with the formalism that permeates the Court’s sales and use tax decisions, including Quill with its bright-line test. For example, International Harvester was decided fourteen days after the Court had decided that, on the one hand, a state could not impose a sales tax on certain sales by an out-of-state seller that had physical contacts with the state, but, on the other hand, a state could assess a use tax collection obligation on a similarly situated out-of-state seller.251 In a well-known concurring opinion, Justice Rutledge criticized the formalistic approach of the majority in these cases.252 To support his argument, Justice


251. Compare McLeod v. J.E. Dilworth Co., 322 U.S. 327 (1944) (holding that the state court does not have jurisdiction to impose sales tax), with Gen. Trading Co. v. State Tax Comm’n, 322 U.S. 335 (1944) (holding that the state court does have jurisdiction to impose use tax collection obligation).

252. Intl Harvester, 322 U.S. at 352 (Rutledge, J., concurring in part and dissenting in part). The Rutledge concurrence is treated as a separate “case” in both of the leading state and local tax casebooks. See JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION: CASES AND MATERIALS 804 (7th ed. 2001); POMP & OLDMAN, supra note 20, at 9-27. Rutledge articulated, among other things, the practical rationale for taxing sales in
Rutledge cited the majority opinion in *Wisconsin v. J.C. Penney*,\(^{253}\) an earlier case upholding the same tax that was upheld in *International Harvester*, for the proposition that the validity of a state tax should not "turn on" formal labels.\(^{254}\) The point here is that the Court's income tax decisions have recognized economic substance in a way that its sales and use tax cases have not.

*Northwestern States* represents the last step in a thwarted journey that might have tested fully the limits of state income tax jurisdiction under the Commerce Clause. Because the taxpayer in that case was physically present, it does not tell us with certainty how far the Court will go. What is certain, however, is that the "triviality" of physical presence was not treated as a touchstone in reaching the conclusion that mere solicitation of business was a sufficient predicate for a state to assert its income tax.\(^{255}\) Obviously, *Northwestern States* established neither a physical presence test nor a reliance interest therein.\(^{256}\) To the contrary, it prompted Congressional action in response to taxpayer insecurities about the possible reach of the decision.\(^{257}\) Finally, *Northwestern States* also is a case in which a tax compliance burden argument, very similar to that raised in *Bellas Hess* and *Quill*, was implicitly rejected.\(^{258}\)

The Court's unitary business and combined reporting cases are not dispositive of the nexus issue. They focused instead on the fair apportionment prong of the *Complete Auto* test. These cases nevertheless have blessed UDIPTA's three-factor apportionment as "something of a benchmark," implying that a state may properly source income based on in-state sales alone.\(^{259}\) To be sure, income nexus and taxpayer nexus remain separate inquiries, but the close connection between the two is evident from the Court's decisions. On a more general level, the unitary business/combined reporting

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the destination state while allowing a credit for taxes paid to the state of origin. See *Int'l Harvester*, 322 U.S. at 359-61. Rutledge explained that other alternatives, such as apportioning the tax, would be impractical. Id.

253. 311 U.S. 435 (1940).
254. *Int'l Harvester*, 322 U.S. at 352.
255. See supra note 182 and accompanying text.
256. See supra note 184 and accompanying text.
257. See supra note 185 and accompanying text.
258. See supra Part I.C.2.c. *Northwestern States*, however, is not conclusive on this point because the court rejected the compliance burdens argument in the context of a case involving a physically present taxpayer.
259. See supra note 199 and accompanying text.
The Court of the need to focus on economic substance in the income tax area. The Court also has demonstrated in these cases an appreciation of the complexity inherent in maintaining fidelity to economic realities. In recognizing the complexity, the Court has not been dissuaded from upholding economically sound tax reporting principles in the face of alleged undue burdens.  

**B. Income Tax Nexus and the Three Faces of Quill**

As noted in Part I, the Commerce Clause portion of the *Quill* decision has stare decisis, undue burdens, and disappearing ink faces.  

*Quill*'s relevance to income tax nexus depends largely on which face predominates. This Article will discuss each approach separately, and then will draw the approaches together in a concluding section.

1. *Stare Decisis* *Quill*

For many observers, *Quill* is about naked stare decisis: reliance interests in an outdated but still workable rule. Implicit in this view is that if *Quill* had been a case of first impression, then the physical presence test would not have been established. The state of the law and the modern economy when *Quill* was decided would not have countenanced it.

Under this view of *Quill*, there is no physical presence test for corporate income taxes because there was no bright-line income tax nexus test at the time *Quill* was decided. Further, and for this same reason, there is no reliance interest in a bright-line physical presence test for corporate income taxes. If there is no rule, there can be no reliance on it. The absence of a pre-existing physical presence test became abundantly clear after *Quill*, when several state courts ruled that *Quill* did not apply to income taxes, and commentators agreed that *Quill* left the income tax nexus question unresolved.  

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260. See supra Part I.C.2.d.
261. See supra Part I.B.2.c.
262. See supra Part I.C.2.e.
petitions for certiorari in the Geoffrey and J.C. Penney National Bank cases was that Quill left unresolved the nexus standard for state franchise and income taxes.263 Put differently, there is no antecedent “Bellas Hess” of income tax jurisdiction unless it is International Harvester or Whitney, both of which reject a physical presence requirement.264 Stare Decisis Quill required following the Court’s decision in Bellas Hess. Otherwise, the outcome would have been different.

Stare Decisis Quill also concerned itself with the retroactive application of a use tax collection obligation. This consequence of reversing a settled rule clearly troubled the Court.265 Assuming, arguendo, the validity of this concern, use tax collection is different from income tax reporting. Use tax collectors have the opportunity to pass on the tax in the first instance by collecting it from customers. The retroactive application of a use tax collection obligation generally denies use tax collectors this opportunity. The result can be harsh. For this reason, the rule of thumb for use tax collectors is “when in doubt, collect the tax.”

Income tax liabilities are different. Income tax collectors have no opportunity to pass the tax on to the consumer in the first instance.266 Accordingly, income taxpayers are more likely to avoid paying tax when there is only a good faith or substantial basis for the position taken—why pay now when the worst case scenario is to pay later, albeit with interest?267 Moreover, if a state determined that a multistate taxpayer had nexus with it and the taxpayer had not reported income, the taxpayer ordinarily would have the opportunity to amend the returns that had erroneously reported the income to other jurisdictions. Theoretically, expanding nexus does not necessarily result in increased income tax liability, either prospectively or retroactively. This is admittedly a gross oversimplification.268 Nevertheless, income taxpayers probably would be harmed less by “retroactive” application of an economic nexus rule

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263. See supra text accompanying notes 16-20.
264. See supra Part I.C.2.a-b.
265. See supra note 67 and accompanying text.
266. Of course, part of the income tax burden may be passed on as an economic, as opposed to a contractual matter.
267. A penalty risk also exists, depending on the statutory penalty standard.
268. See infra notes 300-03 and accompanying text (discussing the conditions for an income tax system that would apportion precisely 100% of taxpayer income among the states).
than would be use tax collectors. Moreover, legal theories are available that allow taxpayers to avoid or cushion the retroactive application of a new rule.  

In summary, income tax nexus is, at best, a case of first impression. Since Quill was decided, the law, buttressed by technological and economic developments, has trended further away from the notion that physical presence is a necessary condition to the assertion of jurisdiction. If Quill has nothing more to show us than its stare decisis face, then physical presence is not required for income tax nexus.

2. Burdens Quill

Of course, the Quill Court does offer a substantive legal justification for maintaining the physical presence test. Although businesses that exploit a state’s market without having a physical presence have no due process objection to taxation, taxation of such entities is an undue burden on interstate commerce. The rationale is twofold: First, asking these businesses to comply with the non-uniform sales and use tax rules of over 6,000 state and local jurisdictions is unduly burdensome. Second, a bright-line physical presence test relieves the burden caused by the uncertainty of determining when one has sufficient tax nexus.

Burdens Quill focuses on a particular type of compliance burden: the burden caused by numerous jurisdictions adopting non-uniform tax rules and procedures. Implicit in this rationale is that the burden on commerce decreases as uniformity increases and the number of jurisdictions decreases. Indeed, if there were only fifty taxing jurisdictions and one set of sales and use tax rules, then the

269. See infra notes 305-06 and accompanying text. The argument here is that a decision upholding economic income tax nexus would not constitute a change in the law. It is not beyond the realm of possibility, however, that the Court would adopt a prospective-only remedy as a means of reaching a just result. See James B. Beam Distilling Co. v. Georgia, 501 U.S. 529, 546 (1991) (White, J., concurring) (noting that no one can “sensibly insist on automatic retroactivity for any and all judicial decisions in the federal system”); supra note 99.

270. See supra note 80 and accompanying text.

271. See supra note 77 and accompanying text.

272. See supra notes 60-64 and accompanying text.
unconstitutional burden identified in Quill undoubtedly would be relieved.

Because the compliance burden can vary from tax to tax, comparing sales and use tax compliance burdens with state income tax compliance burdens is important under Burdens Quill. This is an empirical question. This Article does not claim to report the results of an empirical study. Interested states and taxpayers are encouraged to conduct such a study, which is highly relevant if one takes Burdens Quill seriously. Nevertheless, several key features of state corporate income taxes suggest that they are significantly less burdensome in the ways that concerned Burdens Quill: First, most state corporate income taxes use federal income tax measures of net income as a starting point in calculating taxable income.\textsuperscript{273} States have no corresponding pre-determined starting point for sales and use tax calculations. Second, unlike sales and use taxes, most state corporate income taxes use UDITPA, or formulas based on UDITPA, to allocate and apportion income.\textsuperscript{274} States have no analogous uniform state sales and use tax act.\textsuperscript{275} Third, significantly fewer jurisdictions impose a net income tax than impose a sales and use tax.\textsuperscript{276} Fourth, income tax returns typically are filed annually while sales and use tax returns are filed monthly.\textsuperscript{277} Fifth, income tax returns are prepared based on financial and tax accounting records and do not involve the collection and payment of a tax on each retail purchase or sale transaction. Thus, the infrastructure and data collecting costs for sales and use taxes may be greater. Sixth, in the sales and use tax context, remote sellers often complain that their

\textsuperscript{273} According to one treatise:
The outstanding characteristic of state corporate net income taxes is their broad conformity to the federal corporate income tax....
Pressure from taxpayers for easing compliance and auditing burdens has been the prime force responsible for the very wide conformity of the state corporate income tax base to the federal corporate income tax base....

\textsc{Hellerstein & Hellerstein, supra note 14, § 7.02.}

\textsuperscript{274} \textit{Supra} notes 195-99 and accompanying text.

\textsuperscript{275} \textit{But see supra} note 117 (discussing the ongoing State Streamlined Sales Tax Project).

\textsuperscript{276} Most state income taxes are imposed only at the state level. \textit{Cf. Hellerstein & Hellerstein, supra note 14, § 6.11(1)} (explaining that South Carolina wished to tax income on South Carolina sales in Geoffrey).

customers are more likely to refuse to pay tax than are customers in face-to-face retail transactions. This is not an issue for income taxpayers because the income tax is not a tax collected from customers. Seventh, typically, income taxpayers are not required to obtain separate tax licenses for each jurisdiction in which they do business, as is often the case for sales and use taxpayers. Again, the burdens question is largely empirical.

There are indications that the Court indeed may view income tax compliance burdens differently from sales and use tax burdens. For example, the Court in both Barclays and Northwestern States failed to find that income tax compliance burdens were unduly burdensome. However, these cases do not yield a conclusive indication of what the Court would find absent such presence because both cases involved a physically present taxpayer.

The second burdens consideration is the value of a bright-line test. The bright-line test does both stare decisis and compliance burdens duty—under the former because of the reliance interest in the existing rule, and under the latter as a tool to define a class of burdened taxpayers. Stare decisis and compliance burdens caused by non-uniform rules and multiple jurisdictions have already been addressed. The Court goes further, however, and claims that a bright-line test has intrinsic value because it reduces taxpayer uncertainty about the reach of a state’s taxing authority. Accordingly, the absence of a bright-line test may arguably increase income tax compliance uncertainty (i.e., burden), and so adoption of the physical presence test is warranted.

278. See Eugene F. Corrigan, Searching for the Truth, 26 ST. TAX NOTES 677, 677-78 (discussing the difficulty of collecting sales tax from remote customers). This was probably more of a problem when true mail-order sales were more common. Modern buyers placing orders by credit card over the phone or on the Internet have less opportunity to rebel.
279. Of course, customers may bear partially the economic burden of the tax.
280. See, e.g., ARIZ. REV. STAT. ANN. § 42-5005 (West 1999 & Supp. 2002) (requiring persons conducting business in two or more locations to procure a separate license for each location).
281. In doing a comparative compliance burdens study it would be important to isolate those burdens of Commerce Clause concern: e.g., burdens caused by lack of uniformity among the various jurisdictions, by the number of jurisdictions nationwide that impose separate income taxes, and by the number of returns required to be filed, rather than simply lump all tax compliance burdens together.
282. See supra notes 176, 212 and accompanying text.
283. See supra Part I.B.2.c.(2).
284. Quill, 504 U.S. at 315; see also supra notes 60-63 and accompanying text.
There are two basic responses to this argument. First, the Court does not treat a bright-line test as a necessary condition for relieving undue Commerce Clause burdens. Indeed, the Court reminds us that modern jurisprudence has moved away from such tests. Second, there are other "bright-line" tests that suggest themselves in the context of state corporate income taxes. Most obvious is the three-factor UDITPA apportionment formula. If, by application of these factors, we can identify income that has nexus with a jurisdiction, then it is a small step to find Commerce Clause nexus with the income-producing taxpayer, provided that the taxpayer also has due process nexus. One of the attractions of this bright-line test is that a sizeable body of case law has evolved around these apportionment principles, and the Court recognizes the three-factor formula as "something of a benchmark."

Often it is naive to think that a so-called bright-line will eliminate gray areas and the litigation that results. Lawyers and law students understand that it is often the courts that resolve the inevitable gray area questions by building a body of case law. If one is looking for a bright-line for state income tax nexus, the well-worn path of apportionment factors may be more brightly illuminated than a physical presence test. Indeed, when tax advisors are asked to give state income tax nexus opinions they typically fall back on the UDITPA factors as a safe harbor.

In sum, income tax compliance burdens may not be undue, and to the extent that the Quill Court endorses the value of a bright-line rule, it does not necessarily follow that the bright-line for corporate income tax nexus should be physical presence.

285. Quill, 504 U.S. at 314 ("Our Commerce Clause jurisprudence now favors more flexible balancing analyses."). See id. at 305-08.
286. See supra notes 196-99 and accompanying text.
287. See infra note 338 and accompanying text (discussing proposal to equate income tax nexus with existence of an apportionment factor of greater than zero).
288. See generally Hellerstein & Hellerstein, supra note 14, ¶ 9.18 (discussing UDITPA sales factor and associated case law).
289. See supra note 199 and accompanying text.
290. See infra notes 385-87 and accompanying text (discussing the Multistate Tax Commission's factor nexus proposal).
291. This statement is based on the author's own experience as a tax attorney as well as off-the-record conversations with other tax attorneys specializing in-state and local taxation.
3. Disappearing Ink Quill

Eventual abandonment of the physical presence test is implicit in Disappearing Ink Quill. Under this view, the Court will re-examine Commerce Clause nexus as a matter of first impression. The apologetic tone of Quill signals the probable result under this scenario: a decision acknowledging that economic exploitation of a state’s marketplace is ample grounds for imposing a tax.

4. Integrating the Faces of Quill

The relevant income tax authorities, along with a synthesis of the three faces of Quill, strongly suggest that physical presence is not required for corporate income tax nexus. The income tax cases that preceded Quill did not establish a physical presence test, and so the stare decisis rationale of Quill has no application. Further, Quill itself did not establish an income tax nexus rule.

Without a stare decisis backdrop, Burdens Quill loses much of its authority. The Quill Court made it clear that the case may have been decided differently had it been one of first impression. Thus, Burdens Quill is a second-best solution, doing rear guard duty to protect an antiquated bright-line test and the reliance interests of the mail-order industry. While we cannot quarrel with the Burdens Quill observation that the Due Process and Commerce Clauses are animated by differing constitutional considerations, the Court turns to the physical presence test largely because of stare decisis considerations.

Even if we take Burdens Quill at face value, Burdens Quill implies that the substantial nexus required will vary depending on the burden imposed by the lack of uniformity among state tax rules and, more importantly, by the sheer number of jurisdictions imposing the tax at issue. There are strong reasons to believe that

292. See supra Part I.A.
293. Quill, 504 U.S. at 311.
294. Id. at 312.
295. Both the Bellas Hess and Quill Courts seem to be particularly troubled by the number of jurisdictions to which a remote taxpayer might have to report. See Hellerstein & Hellerstein, supra note 252, at 274 (emphasizing that the burdens' bugaboo is the number of jurisdictions implicated).
state corporate income taxes are less burdensome than sales and use taxes on both counts. 296

Finally, Disappearing Ink *Quill* is not a remote possibility, although the analysis in this Article is not predicated on that view of *Quill*. The jurisprudential "megatrend" is away from bright-line jurisdiction tests. 297 *Quill* is now more than ten years old. Accordingly, the Court quite possibly could reverse *Quill*. If we combine the Disappearing Ink qualities of *Quill* with the absence of stare decisis considerations for income tax nexus, there is an even greater likelihood that the *Quill* physical presence test will not be adopted for corporate income tax nexus purposes.

C. Substantial Nexus and Minimum Contacts: Giving Content to a Corporate Income Nexus Standard

The central conclusion of this Article is that physical presence is not an income tax nexus requirement. Accordingly, substantial nexus for income taxes may approach the due process minimum contacts standard. This is not inconsistent with *Quill*. *Quill* does not hold that the Commerce Clause threshold is higher or lower than the due process threshold. It says that the thresholds are different. They are different because they reflect different values and concerns. 298 Due process concerns itself with "notice" and "fair warning" while the Commerce Clause concerns itself with burdens on interstate commerce. 299 The labels placed on these distinct tests—"minimum contacts" and "substantial nexus"—do not so much have intrinsic meaning to be divined, say, from an inquiry into the meaning of "substantial," as they are shorthand for the values that underlie the constitutional provisions which they mark. Thus, even under the strongest view of *Quill*—Burdens *Quill*—the income tax nexus test will approach the "minimum contacts" test to the extent state income tax compliance burdens are less than comparable sales and use tax burdens. 300

296. See supra notes 273-81 and accompanying text.
298. *Quill*, 504 U.S. at 312.
299. See id.
300. While it has been suggested that substantial nexus is minimum contacts "plus something," a more precise statement is that of the *Quill* Court: "[A] corporation may have
I will make two final observations before turning to our tax policy inquiry. First, if tax rules allow us to structure our affairs to achieve the same economic result at a lower tax cost, we generally will do so. The physical presence test is a rule that allows this type of “planning” in ways unanticipated by the Quill Court. These planning opportunities might be even greater if the Court adopted the physical presence test for corporate income taxes.\textsuperscript{301} In future Supreme Court litigation, taxing authorities would be well-advised to create a record that demonstrates this cost of adopting a physical presence test for income tax nexus.

A second and related observation is that income tax rules tend to track economic substance more than sales and use tax rules.\textsuperscript{302} The reasons for this are not entirely clear and may be as much historical as logical. Nevertheless, Quill’s physical presence test and the distinction between a use tax collection obligation and a direct sales tax liability are prime examples of sales and use tax formalism at work. In contrast, the income tax cases reflect a certain fidelity to economic substance. The Court might get it wrong from time to time, as do we all, but it does appear to struggle toward an economically substantive result. Accordingly, it is reasonable to expect a similar approach to the problem of state corporate income tax jurisdiction.

\textbf{III. Economic Nexus and Tax Policy: Should States Assert Their Power to Tax Corporations that Have “Mere” Economic Presence?}

The conclusion so far has been constitutional/legal: states have jurisdiction to impose an income tax on corporations that have an in-state economic presence even though they may not have a physical presence. The public policy question remains: *should* states exercise this power?

\textsuperscript{301} See generally Pomp, supra note 5, at 50-53 (describing ascendancy of the state and local tax planning profession in the past decade). \textit{See also infra} notes 354-55, 359-68 and accompanying text (explaining common income-shifting techniques).

\textsuperscript{302} Supra notes 259-65 and accompanying text.
A. The Economic Goals of Tax Policy: Equity, Efficiency, and Administrability

Questions of tax policy are generally addressed with reference to three overarching values: equity, efficiency, and administrability.\(^{303}\) In turn, each of these values invokes various sub-themes. For example, there are several approaches to equity. One approach is "benefits-received" taxation, which is based on the notion that a tax should be a price paid for a government service rendered.\(^{304}\) A weakness of this approach is that what often makes a government service a government service (i.e., a public good) is the difficulty of measuring or pricing the benefit provided to each individual or entity.\(^{305}\) Further, benefits-received taxes cannot be used to finance government's distributional programs. Asking transfer payment recipients to finance their own payments would result in a pointless circularity.\(^{306}\)

Early theorists such as Adam Smith and John Stuart Mill recognized these limitations of the benefits-received model and took the pragmatic view that taxes are a necessary evil: a sacrifice we make for the common good, to support desired public expenditures, and, more generally, to live in a civilized society.\(^{307}\) Under this view,

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\(^{303}\) See generally RICHARD W. TRESCH, PUBLIC FINANCE: A NORMATIVE THEORY 332-33 (2d ed. 2002). Tresch subdivides efficiency considerations into static efficiency (minimizing deadweight loss) and dynamic efficiency (promoting long-run growth), and he adds a flexibility objective, which is usually associated with macro-economic planning and stabilization policies at the national level. Id. See also JOHN L. MIKESELL, FISCAL ADMINISTRATION: ANALYSIS AND APPLICATIONS FOR THE PUBLIC SECTOR 278 (4th ed. 1995) (paying attention also to revenue raising potential); John A. Swain, The Taxation of Private Interests in Public Property: Toward a Unified Theory of Property Taxation, 2000 UTAH L. REV. 421, 435-40 (2000) (synthesizing approaches of several economic texts).


\(^{305}\) See UTZ, supra note 304, at 29 (summarizing practical and theoretical hurdles to implementing benefit taxation).

\(^{306}\) TRESCH, supra note 303, at 180. This being said, public finance theorists generally agree that state and local governments are less capable of implementing distributional policies because of the relative openness of their economies and the consequent ability of people and capital to "vote with their feet." See, e.g., PAUL E. PETERSON, CITY LIMITS 104-06 (1981) (describing limits of urban fiscal policies and the competition among suburban localities).

\(^{307}\) JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY 167-68 (Oxford Univ. Press 1998) (1848); RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND
the sovereign has clear normative authority to impose broad-based
taxes to fund its operations—it is not a mere seller in a marketplace
of public goods. Thus, the fundamental question is "how the
government should ask people to sacrifice?" By their ability to pay
is the dominant view.

The ability to pay approach to tax equity is usually addressed by
reference to horizontal equity and vertical equity. Horizontal
equity is achieved when persons with the same ability to pay indeed
do pay the same taxes. Similarly, the principle of vertical equity
allows persons with unequal abilities to pay to bear unequal tax
burdens.

The exploration of the tax policy goal of economic efficiency can
be quite complex. Economists generally view taxes as necessarily
distorting economic behavior and resulting in economic in-
efficiencies. Thus, the goal of good tax policy is to minimize the
interference of a tax with the economic decisions that would be
made in an otherwise efficient market.

An example of tax inefficiency is the predominant state sales and use tax pattern of

\[\text{PRACTICE 228-32 (4th ed. 1984); ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 361-62 (Encyclopedia Britannica 1952) (1776).}\]

\[\text{308. See supra note 307.}\]

\[\text{309. TRESCH, supra note 303, at 334.}\]

\[\text{310. Id. at 334-35.}\]

\[\text{311. Id.; see also RICHARD D. POMP & OLIVER OLDMAN, 1 STATE AND LOCAL TAXATION 6-9 to 6-12 (4th ed. 2001) (discussing vertical and horizontal equity in context of consumption taxes, which, along with the income tax, is a quintessential ability to pay tax).}\]

\[\text{312. Determining the proper measure of who has an equal ability to pay is challenging, complex, and controversial. The best candidates are income and consumption. See TRESCH, supra note 303, at 338.}\]

\[\text{313. Again, who should bear a greater tax burden, and how much, is a topic fraught with complexity and disagreement. See, e.g., MUSGRAVE & MUSGRAVE, supra note 307, at 240-43 (explaining that the case for progressive tax rates is "quite inconclusive"; there is "no intuitive conclusion" about whether and to what degree progressive tax rates are desirable; and "[m]atters are even less predictable under the equal proportional sacrifice rule").}\]

\[\text{314. This is the primary focus of the major public finance texts. For exhaustive discussions, see MIKESELL, supra note 303; MUSGRAVE & MUSGRAVE, supra note 307; TRESCH, supra note 303. For a discussion directed toward law students and lawyers, see UTZ, supra note 304.}\]

\[\text{315. See MIKESELL, supra note 303, at 294-95. Taxes are almost always inefficient because they impose an added cost on economic activity. See id. One exception might be a property tax measured solely by land value, because the supply of land is completely inelastic. Owners of land are compelled to put land to its most economically efficient use regardless of the level of taxation. See generally HENRY GEORGE, PROGRESS AND POVERTY ch. IV (1887) (advocating land taxation as a panacea to social and political ills).}\]

\[\text{316. See MUSGRAVE & MUSGRAVE, supra note 307, at 225.}\]
taxing sales of goods but not services.\textsuperscript{317} This creates an artificial preference for services, distorting otherwise efficient economic behavior.\textsuperscript{318} This aspect of efficiency is sometimes called neutrality.\textsuperscript{319} Horizontal equity and neutrality are closely related.\textsuperscript{320} Taxing like persons and transactions differently usually will violate both horizontal equity and neutrality.\textsuperscript{321} Tax rules that give rise to tax motivated transactions and alter the method by which people would otherwise do business also hamper efficiency.\textsuperscript{322} A simple example is the inefficiency of a person driving an extra five miles to cross a state line to avoid sales tax. A physical presence nexus standard encourages similarly inefficient corporate behavior.\textsuperscript{323}

Administrability is probably the most easily understood tax policy value.\textsuperscript{324} A tax should be easy to administer and pay.\textsuperscript{325} As the difficulty of either increases, so too do efficiency losses, losses from tax avoidance behavior, and losses from the inability of the tax collector to effectively collect revenue. But note the trade-off between equity

\begin{itemize}
\item \textsuperscript{317} See John F. Due & John L. Mikesell, Sales Taxation: State and Local Structure and Administration 83-85 (1983).
\item \textsuperscript{318} See Pomp & Oldman, supra note 311, at 6-21 to 6-24 (exploring lack of normative foundation for sales tax exemption for services).
\item \textsuperscript{319} The decision to impose any tax usually violates the neutrality principle. A tax on income favors leisure; a tax on consumption favors savings. However, once the decision is made to impose, say, an income tax, the tax should be designed to interfere as little as possible with how income is earned unless a conscious policy choice has been made to do so (e.g., to favor capital gains over current income to encourage savings and investment). Pomp & Oldman, supra note 311, at 6-12 to 6-13.
\item \textsuperscript{320} Id.
\item \textsuperscript{321} For example, violating neutrality would be a nexus rule that allows state A to tax businesses with substantial sales to state A customers but denies state A the power to tax similar businesses simply because the business lacks the physical presence of an employee or leased office. See infra Part III.B.1 (presenting more precise case for this example).
\item \textsuperscript{322} Mikesell, supra note 303, at 294-95. Although the individual taxpayer is economically motivated to engage in tax avoidance planning, the devion of economic resources to these activities and the associated opportunity costs are wasteful and decrease overall wealth and welfare.
\item \textsuperscript{323} See infra Part III.B.2.
\item \textsuperscript{324} The "transaction costs" of tax administration to both the tax collector and the taxpayer have long been recognized. Adam Smith admonished that the levying of a tax should not "require a great number of officers, whose salaries may eat up the greater part of the ... tax." Smith, supra note 307, at 362. From the taxpayer's perspective, Smith observed: "Bly subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation, and oppression." Id.
\item \textsuperscript{325} Tresch, supra note 303, at 332.
\end{itemize}
and administrability. A complex set of rules is often required to accurately delimit a class of similarly situated taxpayers or transactions. The Internal Revenue Code is replete with examples of the complexity caused by trying to ensure that only the "right" person or transaction is taxed. Complexity leads to collection and compliance difficulties. Compliance and enforcement costs, of course, cannot be entirely eliminated, but they should be reduced so long as equity and efficiency are not too greatly compromised.

B. The Tax Policy Benefits of Economic Nexus

1. Equity: Ensuring that All Corporations Benefitting from a State's Market Are Subject to Tax

An economic presence test promotes equity by ensuring that all corporations that benefit from a state's market are subject to tax on their income from that market. Persons with income sourced to a state are, indeed, taxed by the state. All persons selling goods or services to in-state customers are subject to the state's income tax regardless of the essentially arbitrary marker of an in-state office or employee. To be sure, under the prevalent state apportionment formulae, the presence or absence of in-state property or personnel would affect the percentage of income sourced to the state, but absence of these factors would not deny the state jurisdiction to tax


327. See, e.g., id. §§ 1.05-06 (demonstrating complexity of targeting earned income and child credit to low income individuals).

328. As Professor Popkin observes:

In some situations ... complexity can so befuddle the IRS that taxpayers with good tax advisors can avoid taxes, either because government auditors are no match for taxpayer counsel or there is no audit in the first place. The result is tax inequity, as the rules are avoided by some but not all taxpayers.

329. Quill can be criticized on tax policy grounds because it merely substituted one administrative issue (taxpayer compliance burden) for another (impracticality of enforcing the use tax against each individual purchaser), while rendering the sales tax non-neutral and horizontally inequitable by creating a de facto exemption for remote sellers. The Court chose to leave tax policy to Congress, because Congress could enact legislation that would preserve the states' power to tax remote sellers (and thus promote equity and efficiency) while reducing compliance burdens. See Quill Corp. v. North Dakota, 504 U.S. 298, 318 (1992).
if the taxpayer has in-state sales. Thus, similarly situated businesses are taxed, but the amount of income that is taxed is still determined by the level of in-state presence.

Lobbyists for corporate interests sometimes object that non-physically present taxpayers receive no benefits from the state. See, e.g., COUNCIL ON STATE TAXATION, JURISDICTION TO TAX—CONSTITUTIONAL, POLICY POSITION OF 2001-2002, Mar. 1, 2001, at http://www.statetax.org/ (suggesting that businesses not “present” in a jurisdiction and “therefore not receiving any benefits and or protections from the jurisdiction, should not be required to pay tax to that jurisdiction.”). The policy statement clarifies that “present” means “physically present.” Id. The Council on State Taxation (“COST”) is the leading state tax organization representing business taxpayers. See also Internet Tax Fairness Act of 2001: Hearing Before the Subcomm. on Commercial and Admin. Law of the Comm. on the Judiciary, 107th Cong. 6-13 (2001) (statement of Arthur R. Rosen, Chairman, Coalition for Fair and Rational Taxation) [hereinafter Statement of Rosen]. Rosen attempts to refute the notion that states are providing benefits to remote sellers. First, he suggests that the benefits provided to the remote seller are limited to highways, police protections, and the like. Id. at 12. Rosen argues that because the immediate beneficiaries of these services are the seller’s delivery media (e.g., telecommunications or trucking companies) and because these media are in-state taxpayers, it would be duplicative to tax the out-of-state seller. Id. An obvious flaw in Rosen’s argument is that it ignores that the out-of-state seller receives benefits in excess of what is provided to its delivery media. For example, not only does the state protect the trucks, it protects the remote seller’s goods. Further, the state provides a legal system that allows the remote seller to enforce the trucking company’s obligation to deliver goods rather than abscond with them. This same legal system protects the seller’s right to enforce the obligations of its customers. Numerous other protections and benefits could be identified that extend beyond mere delivery of the product. Second, Rosen argues that both buyers and sellers benefit and are burdened from their transactions in equal proportions (buyers part with money and sellers part with goods or services). Id. at 12-13. Accordingly, there is no “balance due” at the end of the transaction to either the buyer’s state or the seller’s state. Id. If there were, he argues, then states could ask buyers to pay tax to the state of origin because they benefit from the remote state’s maintenance of an orderly society that allows goods and services to be produced for export. Id. Thus, it is implied, the benefits argument proves too much because we do not treat buyers as taxpayers in the state of origin. The refutation of this argument is threefold. First, there is a “balance due” to government. Taxes are what we pay to live in a society that allows a market to operate in the first instance. Like it or not, the government is a “silent partner” in the economy (one that often is not appreciated until it ceases to function). Second, the benefits argument does not prove too much. In the context of taxes on either net income or business receipts, which is what Rosen is addressing, customers in the state of destination would not be taxpayers in the seller’s state simply because the customers have no net income or business activity sourceable to that state. In the sales and use tax context, it indeed would be constitutionally permissible for the state of origin to impose a sales tax on the transaction, which the seller would pass on to the buyer,
Although this point of view may have some political cache, it is factually unsupported and has not been voiced by disinterested observers.\textsuperscript{332} Simply put, a remote seller could not do business in a lawless society. Indeed, a seller in a lawless society would be compelled to be physically present to enforce the obligations of the buyer and to ensure the safe delivery of its product. Remote commerce can only exist in an orderly society in which government has undertaken these functions on behalf of all beneficiaries of that orderly society, including remote sellers.\textsuperscript{333}

Sometimes the "no state benefit" argument seems to take the form of a strict benefits-received theory of taxation.\textsuperscript{334} The corporate interest lobbyists do not so much argue that no benefits are received, but that the benefits are disproportionate to the tax that would be imposed; that because the seller has provided a valuable good in exchange for the money received by the customer, the seller has already paid for these benefits; that because the common carrier delivering the goods and the customers are local taxpayers, taxing but most states choose not to do so. Sales and use taxes are consumption taxes, and so the state of consumption is usually considered the proper jurisdiction to impose the tax. Third, note how the argument has shifted from "no benefits are received" to "yes, benefits are provided, but this is not a sufficient basis to impose a tax in all instances." Agreed. Usually it is the tax policy criterion of administrability that prevents us from pushing the benefits notion to the outer limits. So we have come full circle. The claim that the state provides no benefits is really a specie of the tax policy (and Burdens Quill) concern of the compliance costs. It is not that no benefits are provided, it is that the administrative burdens can sometimes outweigh the benefits. Reasonable minds can disagree on where the line is drawn, but the claim that a state provides no benefits to a remote seller is without merit. See infra note 332 (the Quill Court dismisses this argument in holding that the state taxation of remote sellers did not violate due process, finding that remote sellers benefit from the market state).

Finally, Rosen argues that states misunderstand federalism. See Statement of Rosen, \textit{supra}, at 11-12. States are responsible for "state-level" issues and the federal government is responsible for issues that affect "the American economy as a whole." Rosen implies that if a party receives benefits from the American economy as a whole then any related obligations are owed to the federal government and not the states. See \textit{id}. This is simply another version of the no benefits argument addressed above. It presupposes that remote sellers do not benefit from the market state. As demonstrated, this is not the case.

332. As a legal matter, the lack of benefit claim is primarily a due process challenge that the Quill court unequivocally answered in favor of the state. \textit{Quill}, 504 U.S. at 308. The Court held that there is "no question" that economic exploitation of the state's market provides adequate due process grounds for the imposition of tax, in part because of "the benefits [the taxpayer] receives from access to the State." \textit{Id}.

333. See \textit{supra} notes 331-32 (refuting the "no state benefits" argument).

334. See \textit{supra} note 331 and accompanying text.
the seller company would be duplicative; or some similar *quid pro quo* analysis.335

Even if these objections were supportable, which is doubtful,336 the simple answer is that the normative basis for corporate income taxation is ability to pay, not benefits received. Income taxes are a quintessential ability to pay tax.337 Accordingly, the corporate income tax need not be justified on the grounds that it is a reasonable approximation of a purchase price for government services.338 The taxpayer’s exploitation of the state’s market is sufficient justification. If it is, then it is benefitting from the state’s government and the state can legitimately ask it to pay taxes on the net income earned in the jurisdiction.339 If proponents of the benefits-received argument persist by claiming that benefits-received rather than ability to pay is the proper normative basis for the state-level corporate income tax, then they prove too much. If their argument had merit then it would be grounds to object to the corporate income tax generally, physical presence or not.340

335. *See supra* note 381.
336. *See supra* notes 273-80 (explaining fallacies of these various objections to the income taxation of remote sellers).
337. *See TRESCH, supra* note 303, at 338-52 (noting that income and consumption taxes are the “two main contenders” for the measuring ability to pay as measured by utility).
338. It is probably more accurate to say that the corporate income tax is a “second-best” solution to inequities in the individual income, which is an ability to pay tax. Thomas F. Pogue, *State and Local Business Taxation: Principles and Prospects, in THE FUTURE OF STATE TAXATION* 95 (David Brunori ed., 1998). It is axiomatic that taxes on businesses are ultimately borne by individuals: employees, customers, suppliers, and owners. Under our current tax system, retained corporate earnings are not taxed to shareholders until the shares are sold, and shareholders escape taxation entirely if the shares are held at death. *Id.* at 96. Immediately taxing corporate earnings tends to iron out this anomaly. Ideally, corporate earnings would be taxed to shareholders in the year they accrue, as occurs, for example, in the case of partnerships, limited liability companies, and subchapter S corporations. This system would avoid the double taxation of dividends for companies that annually pay out a portion of their earnings. *See generally id.* at 95-97 (explaining the role of business taxes in augmenting direct taxes).
339. *See supra* note 331 (discussing the benefits-received argument in greater detail). As a constitutional matter, such taxes must meet the four-pronged *Complete Auto* test. *See supra* Part I.A. However, apart from the issue of nexus, addressed in Parts I and II, there is no serious claim that state corporate income taxes violate this test. The Court acknowledged, in effect, the ability to pay rationale of taxation in *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 623-24 (1981). *See also supra* note 85 and accompanying text; *supra* note 332 (discussing the *Quill* Court’s holding that a remote mail-order company benefits from the state whose market it exploits).
340. A meaningful challenge of economic presence based on benefits-received grounds
The other possible counterargument is that equity is not enhanced by an economic presence rule because this rule only determines to which states a corporation pays tax, not the overall state tax income tax liability of the multistate corporation. Every corporation arguably will pay its fair share in the aggregate under either nexus test, although an individual state might still claim that it is not getting its fair share of tax. The difference between economic and physical nexus is simply where the tax is paid. Thus, horizontal equity among taxpayers is preserved under either nexus test. This counterargument is plausible only if the heroic assumption were true that all states have identical and complementary income tax rules. Perhaps sadly, this is not the case.

State income tax rates vary, some states do not impose a corporate income tax, many states do not require combined reporting, and some states do not have throwback rules.

To illustrate, assume that Xco has neither property nor payroll in state A but makes thirty percent of its sales to customers in state A. All of Xco’s property and payroll are in state B, and it makes seventy percent of its sales to customers in state B. State B does not require Xco to throwback its sales in non-nexus jurisdictions to the

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341. If all states apportioned income solely based on the UDITPA three-factor apportionment formula then the sum of the apportionment ratios would be 1.0. The total receipts, property and payroll would, in the aggregate, be the numerators of these factors as well as the denominators (assuming no foreign activities). See infra notes 342-45 and accompanying text, for a discussion of how receipts from non-nexus jurisdictions would have to be “thrownback” to nexus jurisdictions to reach this result under a physical presence test.

342. The Court has called such state tax rules “internal[ly] consisten[ts].” Container Corp. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983). At minimum this would require that all states have the same rate and base, combined reporting, and rules that throwback receipts in non-nexus jurisdictions to the numerators of receipts factors in states that the taxpayer has a physical presence.

343. See generally HELLERSTEIN & HELLERSTEIN, supra note 14, ¶ 9.01 (discussing state variation from UDITPA); POMP & OLDMAN, supra note 20, at 10-18 (explaining throwback rules and state variations).

344. Id.
state $B$ receipts factor numerator. State $B$ uses the traditional three-factor apportionment formula, and physical presence is required for a state to impose its income tax. In this example, $Xco$ would pay no tax to state $A$ because it is not physically present in state $A$ and would apportion ninety percent of its income to state $B$ ($\left(0.7 \text{ receipts factor} + 1.0 \text{ property factor} + 1.0 \text{ payroll factor}\right) ÷ 3$). This would leave ten percent of its income untaxed.

This is just the tip of the iceberg. A sizeable industry has developed around exploiting the differences among state income tax rules. Setting aside, for the moment, the inefficiencies of this tax motivated planning and the overall loss of state revenue, such “planning” undoubtedly affects horizontal equity adversely. Some taxpayers will be able to exploit these seams in the state corporate income tax fabric while others will not. Indeed, often the larger, more highly capitalized businesses have the resources and expertise to engage in such planning. Thus, those with the most ability to pay may pay the least.

Economic nexus helps to minimize these manipulations because changing where wealth is consumed is much more difficult than changing where it is produced. In other words, moving property or payroll around is easier than dictating the location of customers. A corporation will rarely employ a tax planning strategy designed not to make a sale. Thus, assuming that sales of goods and services are sourced to the destination, an economic presence test will

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345. See supra notes 196-98 and accompanying text (explaining the UDITPA three-factor income apportionment formula).


347. On the other hand, many smaller closely held companies are organized as pass-through entities such as subchapter $S$ corporations or limited liability companies. See supra notes 163-64 and accompanying text. Therefore, these companies are not subject to entity level income taxation. Even closely held subchapter $C$ corporations often avoid corporate level tax through salary or leasing arrangements.

348. Professor Fox demonstrates that under a physical presence nexus standard “firms are encouraged ... to reduce their sales tax liability by concentrating their activities in a limited number of low or zero tax rate states.” Fox, supra note 4, at 42. Therefore, “[n]eutral equality can be achieved only with an economic exploitation” sourcing rule. Id. at 41.

349. While regulations promulgated under UDITPA by the Multistate Tax Commission generally source sales of tangible personal property to the destination state, services are generally sourced to the jurisdiction where the “greater proportion of income producing activities [occurred] ... based on costs of performance.” MULTISTATE TAX COMM’N, ALLOCATION AND APPORTIONMENT REGULATIONS reg. IV.17 (2001), at http://www.mtc.gov/UNIFORM/General_72701.pdf [hereinafter MTC]. Compare MTC, supra,
ensure that the destination state will be able to tax income attributable to those sales. Planning around that tax consequence normally will be impossible or impractical. If income is only taxed where a business has a physical presence, however, then taxpayers will be motivated to limit their physical presence to tax havens. Thus, taxpayers will apportion a greater amount of their income to tax havens, and even throwback rules will simply throwback receipts to low tax jurisdictions.

In sum, equity is enhanced by economic nexus because economic nexus ensures that similarly situated taxpayers are treated the same, both within each state and nationally. Further, if a state’s right to impose a tax can be based on the ability to pay principle (which is one aspect of equity analysis); and if the ability to pay principle is predicated, in turn, on a state’s entitlement to tax those who benefit from the existence of that state government; then the economic nexus argument receives high marks because entities exploiting a state’s market fall within the class of benefitted, and therefore taxable, participants in that political community.

2. Efficiency: Minimizing Efficiency Losses and Discouraging Tax Avoidance Transactions

As noted, equity and neutrality are closely correlated.\textsuperscript{350} Failure to treat similarly situated taxpayers the same violates the neutrality principle and thus distorts economic behavior. Further, efficiency losses result if tax rules encourage firms to engage in the economically wasteful enterprise of rearranging their operations or corporate structure solely to minimize their tax liability.\textsuperscript{351} The previous section demonstrated that economic presence nexus rules,

\textsuperscript{350} See supra note 320 and accompanying text.

\textsuperscript{351} See supra note 322 and accompanying text; see also Fox, supra note 4, at 42 (explaining that efficiency losses result from tax motivated manipulation of business activities and location).
coupled with a destination based receipts factor, minimize the potential for these inefficient tax avoidance behaviors. This section explores this strength of the economic presence test in greater detail.

A single business can be organized as one corporation or it can be multicorporate. If the economic activity of the business is the same, then ideally it would be taxed the same regardless of the business' formal structure. Some states recognize this economic reality by requiring combined reporting: a multicorporate business engaged in a "unitary business" files a combined return and reports income as a single entity, essentially ignoring its formal corporate structure. A majority of states, however, only provide for separate entity reporting. One of the many defects of separate entity reporting, particularly if coupled with a physical presence nexus rule, is that it allows taxpayers to structure their operations to artificially minimize net income in high tax states and to maximize income in tax havens.

The Geoffrey case illustrates both this tax planning technique and how economic nexus thwarts it. Recall that Toys R Us created an

352. A constitutional predicate to the use of formula apportionment is that a multistate business must be "unitary." See Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 439 (1980) ("[T]he lynchpin of apportionability... is the unitary-business principle."). This is true whether the business is multicorporate or single entity. Thus, even a single corporation could be operating two or more unitary businesses, in which case a separate return would be filed for each unitary business for the purpose of formulary apportionment. See POMP & OLDMAN, supra note 20, at 10-21, 10-30. The precise contours of a unitary business are much disputed. In general terms, the Court has characterized a unitary business as one involving "functional integration, centralization of management, and economies of scale." Mobil Oil Corp., 445 U.S. at 438 (citing Butler Bros. v. McColgan, 315 U.S. 501, 508-09 (1942)).

353. See generally POMP & OLDMAN, supra note 20, at 10-30 to 10-37 (explaining combined reporting); HELLERSTEIN & HELLERSTEIN, supra note 14, ¶ 8.11 (explaining combined reporting, its distinction from consolidated reporting, and its relationship to the unitary business principle).

354. See POMP & OLDMAN, supra note 20, at 10-32.

355. A related problem is the administrative difficulty of establishing and policing transfer pricing among corporate affiliates. For example, in Geoffrey, if the taxpayer had been successful, his savings would have been measured by the price it set for the licensing of intangibles to the South Carolina affiliate. See infra notes 356-63 and accompanying text for explanation of Geoffrey.

intangibles holding company in Delaware ("Geoffrey"). Delaware does not tax the income of intangibles holding companies. Geoffrey then licensed the use of its intangibles to Toys R Us operating affiliates, including the affiliate located in South Carolina, a separate entity to the state. The payment by the South Carolina operating entity to the Delaware holding company was intended to reduce South Carolina income by the amount of the payment. Moreover, the taxpayer hoped that South Carolina would apply a physical presence nexus test, thereby finding that Geoffrey was outside its jurisdiction to tax. Thus, Geoffrey's royalty income would only be subject to tax in Delaware; therefore, it would not be taxed at all.

In Geoffrey, however, the South Carolina Supreme Court dashed the taxpayer's tax avoidance hopes by applying the economic presence test, coupled with a destination-based sales factor. The court held that Geoffrey was taxable in South Carolina despite its lack of physical presence. Further, the court held that Geoffrey's licensing receipts were attributable to South Carolina, the state in which Toys R Us used the intangibles. Thus, the payment to Geoffrey did not have the effect of exporting income—the income stayed in South Carolina and was taxable to the economically present entity that earned it.

Unfortunately, not all post-Quill state court decisions have adopted the Geoffrey view, and several state courts have upheld the intangibles holding company tax avoidance technique. Indeed, the

357. Geoffrey, 437 S.E.2d at 15. "Geoffrey" is the name of a fanciful giraffe that Toys R Us uses to promote its stores.
359. Geoffrey, 437 S.E.2d at 15. This is one sophisticated giraffe.
360. See id.
361. See id. at 18.
362. Id.
363. Id. at 19.
364. See, e.g., Sherwin-Williams Co. v. Comm'r of Revenue, 778 N.E.2d 504 (Mass. 2002) (holding that the transaction had economic substance); ACME Royalty Co. v. Dir. of Revenue, 96 S.W.3d 72 (Mo. 2002) (en banc) (holding royalty payments received by out-of-state licensor from affiliated Missouri licensee were not derived from Missouri sources under applicable Missouri income tax statute). The ACME Royalty Court split 4-3 and its decision contains a well-reasoned dissent criticizing the intangible holding company tax avoidance scheme:

The Missouri Director of Revenue aptly describes this recent trend in tax avoidance: "[A] bare corporate change can make income that is taxable today not taxable tomorrow." The result is the creation of so-called "nowhere
use of intangibles holding companies in this fashion has become a
common state tax planning device notwithstanding the Geoffrey
ruling. 365

This tax avoidance opportunity would not have arisen if South
Carolina had been a combined reporting state. 366 In a combined
reporting state, the holding company and the operating entity would
have been part of the larger Toys R Us combined group, and so the
inter-affiliate licensing transaction would have been ignored. 367
Further, the amount of income apportioned to Delaware (and thus
away from other states) as a result of the creation of the holding
company would have been minimal because the Delaware receipts,
property, and payroll of the holding company would have been
relatively inconsequential.

The adoption by all states of combined reporting would be a
significant step toward reducing state tax motivated transactions,
but it would not obviate the need for an economic presence juris-
dictional standard. Even under a universal combined reporting
regime, the physical presence nexus test motivates taxpayers to
avoid physical presence in some jurisdictions while shifting property

income."—income that is taxed in no state.

"Nowhere income," it might be noted, is not just affecting individual states.
The Wall Street Journal reports that the Internal Revenue Service is also
concerned about loss of federal income tax. Companies set up offshore
subsidiaries so they can transfer royalties from sales of products made outside
the United States to places like Bermuda. Glenn R. Simpson, A New Twist in
Tax Avoidance: Firms Send Best Ideas Abroad, WALL ST. J., June 24, 2002, at
A1. The Journal reports that more than two dozen pharmaceutical and computer
companies have set up subsidiaries in Bermuda. Id. "The transfer of intellectual
property—such as trademarks and patents—has become so widespread that it
has prompted an aggressive crackdown by the Internal Revenue Service on
alleged abuses that one IRS consultant says could eventually involve tax claims
in the tens of billions of dollars." Id.

By moving their profits to places where such income is not taxable, companies
are avoiding taxation in places such as Missouri where those profits were
derived.

ACME Royalty, 96 S.W.3d at 78 (Wolff, J., dissenting).

365. See ACME Royalty, 96 S.W.3d at 75-81; POMP & OLDMAN, supra note 20, at 10-33 to
10-35 (describing tax avoidance use of Delaware holding companies).

366. See Charles E. McLure, Jr., Legitimacy, Fairness, and Equity of State and Local Taxes
on Interstate Commerce, 22 ST. TAX NOTES 49, 50 (2001); supra notes 352-53 and
accompanying text.

367. See supra note 353 and accompanying text.
and payroll to tax havens. Of course, regardless of the applicable nexus standard, differing tax rates will continue to create incentives to locate tax liability increasing activities into low tax jurisdictions. The economic presence test, coupled with a destination-based receipts factor, dampens the effect of shifts in property and payroll because the receipts factor ensures that at least some income is apportioned to jurisdictions exploited by economically present taxpayers. As noted, altering where goods are produced is much easier than altering where they are consumed. Thus, employing inefficient tax motivated strategies is both more difficult and less rewarding when economic presence is the nexus standard.

Some might applaud the physical presence test as promoting beneficial tax competition among the states. Without entering into

368. See supra note 348 and accompanying text. Combined reporting, in effect, converts a multicorporate unitary business to a single entity for tax reporting purposes. See supra notes 352-53 and accompanying text. Thus, all of the tax avoidance opportunities available to a single entity (without separately reporting affiliates) are still available to a combined group. Combined reporting takes away a potent weapon in the taxpayer's arsenal—the shifting of income to affiliates in low tax jurisdictions and the separate incorporation of nexus creating assets—but it does not take away the incentive to move productive assets to low tax jurisdictions. Economic efficiency is not enhanced by production decisions motivated by tax, rather than economic factors. See Fox, supra note 4, at 40-42.

369. A destination-based receipts factor rule is required so that receipts are attributed to the market that the taxpayer is exploiting. If receipts were attributable to the state of origin, then the receipts factor would be duplicative of the payroll and property factors, resulting in the same distortive incentive to shift payroll and property into low tax jurisdictions. See supra note 348 and accompanying text.

370. See supra note 348 and accompanying text.

371. Multistate businesses have been tremendous beneficiaries, at least in the short term, of interjurisdictional tax competition. The "race to the bottom"—in which states compete by offering tax incentive packages to businesses shopping for places to locate or relocate—has been subject to extensive documentation and criticism. See generally Peter D. Enrich, Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business, 110 HARV. L. REV. 377 (1996); Walter Hellerstein, Commerce Clause Restraints on State Tax Incentives, 82 MINN. L. REV. 413 (1997); Walter Hellerstein & Dan T. Coenen, Commerce Clause Restraints on State Business Development Incentives, 81 CORNELL L. REV. 789 (1996). On balance, commentators see this phenomenon as harmful to the general welfare, as businesses make location decisions based on noneconomic criteria and overall state revenue collection is driven downward in a "negative sum" game. See, e.g., Melvin L. Burstein & Arthur J. Rolnick, Congress Should End the Economic War for Sports and Other Businesses, THE REGION, June 1996, at 35, 35-36, reprinted in 11 ST. TAX NOTES 111 (1996); McIntyre, supra note 1, at 944-45 (referring to Figure 1, which documents recent "decline in-state corporate tax revenues as a percentage of gross state product" and surmising that this trend may be attributable in part to the "hollow[ing] out" of the base through companies' "tax maneuvers").
the complex debate of whether tax competition among jurisdictions is beneficial,\textsuperscript{372} it can be demonstrated that the physical presence test does not enhance the sort of interjurisdictional competition that might be claimed to be salutary. The basic argument for interjurisdictional tax competition is that competition compels state and local governments to be more efficient service providers. It allows persons to "vote with their feet"\textsuperscript{373} and be present only in those jurisdictions that offer the desired mix of government services and taxes.\textsuperscript{374} The competition argument has two responses relevant to nexus. On the one hand, even with an economic presence test, taxpayers have an incentive to shift their presence to low tax jurisdictions.\textsuperscript{375} Thus, interjurisdictional competition still exists as long as there are differentials in effective tax rates and there are mobile factors of production. Perhaps this would promote that "moderate" level of competition that some economists believe is

\textsuperscript{372} Modern speculation on the value of fiscal competition began with Charles Tiebout. See Charles M. Tiebout, A Pure Theory of Local Expenditures, 64 J. Pol. Econ. 416 (1956). Tiebout, "the founding father of the mobility literature," speculated that our federal system would allow individuals to "vote with their feet" and live in jurisdictions that offer a combination of services and taxes that would maximize individual utility and general welfare. Tresch, supra note 303, at 855-56. Tresch notes that "[t]he literature on mobility ... is among the largest in all of public sector economics," but that literature "has generally not supported Tiebout's conjecture." Id. at 856. As a constitutional, political, and historical matter, the destructive consequences of fierce competition among the states was a prime impetus for the formation of the United States and the adoption of a federal constitution. See Utz, supra note 304, at 221 (recognizing the limits of the Tiebout conjecture and exploring a middle ground approach modeled by the European Community.). Id. at 219-22; see also infra note 374.

\textsuperscript{373} Tresch, supra note 303, at 856.

\textsuperscript{374} See Tannenwald, supra note 2, at 154-56 (summarizing both the deleterious effects of interjurisdictional tax competition and the academic arguments supporting competition "in moderation"). One interesting counterargument to the benefits of competition is that public goods by definition extend beyond goods and services that can be sold to each beneficiary for a discrete "price" while excluding from those services persons who do not pay for them. Further, government necessarily must pursue some distributive tax and spending policies, and these by definition cannot be "charged back" to the beneficiaries. See supra notes 304-05 and accompanying text (explaining the challenges to state and local governments of imposing taxes based on benefits received). Thus, taking the competitive model to its logical conclusion would result in state and local governments being reduced by competition to becoming sellers of private goods and services, left unable to do those things that are essentially governmental. Furthermore, governments require somewhat of a captive audience to remain governments and retain their sovereignty. The author is grateful to Professor Michael McIntyre for this suggestion.

\textsuperscript{375} See supra note 368 and accompanying text.
beneficial. On the other hand, the benefits (if any) of inter-jurisdictional tax competition are not supported by a rule (the physical presence test) that denies states the power to tax economically present entities. Allowing a taxpayer to lurk in tax haven A while exploiting the economy of state B makes the taxpayer a free-rider in state B. This cannot be supported by a theory extolling the competitive market-like benefits of tax competition on the premise that taxpayers are making choices about which mix of government services to purchase. The prevention of shoplifting is what makes a market work, and the associated compliance costs are a necessary evil.


Administrability has two components, ease of enforcement and ease of taxpayer compliance. Taxpayer compliance burdens are by now an old friend, being a focus of our earlier constitutional analysis. However, the conclusion that corporate income tax compliance burdens do not conflict with the dormant Commerce Clause does not fully answer our tax policy inquiry. Meeting minimum constitutional standards does not, per se, result in the best tax policy.

Compliance burdens are the last refuge for those who advocate a bright-line physical presence test. The fewer the jurisdictions with taxing authority, the less the compliance burden, and the bright-line of physical presence undoubtedly aids in determining whether a

376. See supra note 374 and accompanying text.
377. Cf. Fox, supra note 4, at 47 n.19 (arguing that the public choice argument is not implicated when there is simply a shift in “tax structure,” not “the overall tax level”).
378. See TRESCH, supra note 303, at 332. The focus in state tax constitutional litigation is largely on the compliance costs to the taxpayer, but the tax enforcement side of the coin is equally important from a policy perspective. Recall, for example, that the use tax collection obligation challenged in Quill arose because of the administrative impracticality of enforcing the use tax against each in-state purchaser. See supra note 38-39. It is worth considering whether an economic nexus test would facilitate tax enforcement by reducing the tax avoidance opportunities that arise under a physical presence test. See supra notes 322, 367-68 and accompanying text. This having been said, this section focuses on the taxpayer compliance side of the coin.
379. See supra Parts I.B and II.B.
taxpayer has nexus with a state. The problem with this argument is that the physical presence test completely sacrifices the other tax policy values of equity and efficiency and makes states vulnerable to numerous accounting "shenanigans." Tax compliance always has costs. The tax policy question is how to minimize these costs while furthering the other tax policy values of equity and efficiency? At the margin, this requires trade-offs among these values. Complicating the analysis is the constitutional and political value of federalism. If one were creating a corporate income tax system from scratch and aware that many corporations do business nationally and internationally, one would probably propose a national or international tax collection system rather than fifty or more state systems. Our federal political structure, however, is one of the immutable restraints on any tax compliance mechanism that is proposed.

Those serious about easing compliance burdens should look for rules that preserve the benefits of economic presence while minimizing the costs. The most sensible approach lies in seizing upon the obvious connection between nexus with the taxpayer and nexus with the income. The three-factor UDITPA formula is a time-honored and constitutionally blessed approach to income allocation. If a taxpayer has in-state receipts, property, or payroll, then its income is apportionable to the state. The obvious next step 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. The only exceptions would be (1) the rare instances in which due process is offended, and (2) where the
amount of income apportionable to the state is de minimis, causing the costs of collection and compliance to exceed the revenue that the state would generate. Under this approach, a taxpayer with mere economic presence (i.e., in-state receipts, but no property or payroll) would have income tax nexus.

Economist Charles McLure has proposed such a factor presence rule, and the Multistate Tax Commission (MTC) has drafted a detailed “factor presence nexus standard” for practical application. Under the MTC proposal, a taxpayer would be presumed to have nexus with a state if the taxpayer has in-state receipts, property, or payroll exceeding certain de minimis thresholds. The thresholds are either (a) $50,000 of in-state property, $50,000 of in-state payroll, or $500,000 of in-state receipts; or (b) a property, payroll, or receipts factor of greater than twenty-five percent. A

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385. McLure, supra note 366, at 49 (arguing that more than a de minimis amount of sales, payroll or property should create nexus).


387. Id. The MTC's proposed factor nexus standard provides, in pertinent part:

A. (1) Individuals who are residents or domiciliaries of this State and business entities that are organized or commercially domiciled in this State have substantial nexus with this State.

(2) Nonresident individuals and business entities organized outside the State that are doing business in this State have substantial nexus and are subject to [list appropriate business activity taxes for the state, with statutory citations] when in any tax period the property, payroll or sales of the individual or business in the State, as they are defined below in Subsection C, exceed the thresholds set forth in Subsection B.

B. (1) Substantial nexus is established if any of the following thresholds is exceeded during the tax period:

(a) a dollar amount of $50,000 of property; or

(b) a dollar amount of $50,000 of payroll; or

(c) a dollar amount of $500,000 of sales; or

(d) twenty-five percent of total property, total payroll or total sales.

C. Property, payroll and sales are defined as follows:

(1) Property ....

(2) Payroll ....

(3) Sales counting toward the threshold include the total dollar value of the taxpayer's gross receipts, including receipts from entities that are part of a commonly owned enterprise as defined in [Subsection D(2)].

D. (1) of which the taxpayer is a member, from
factor nexus rule would create a bright-line nexus test based on economic reality rather than on an arbitrary physical presence.\textsuperscript{388} This test would also remove the objection that an economic presence

(a) the sale, lease or license of real property located in this State;
(b) the lease or license of tangible personal property located in this State;
(c) the sale of tangible personal property received in this State as indicated by receipt at a business location of the seller in this State or by instructions, known to the seller, for delivery or shipment to a purchaser (or to another at the direction of the purchaser) in this State; and
(d) The sale, lease or license of services, intangibles, and digital products for primary use by a purchaser known to the seller to be in this State. If the seller knows that a service, intangible, or digital product will be used in multiple States because of separate charges levied for, or measured by, the use at different locations, because of other contractual provisions measuring use, or because of other information provided to the seller, the seller shall apportion the receipts according to usage in each State.
(e) If the seller does not know where a service, intangible, or digital product will be used or where a tangible will be received, the receipts shall count toward the threshold of the State indicated by an address for the purchaser that is available from the business records of the seller maintained in the ordinary course of business when such use does not constitute bad faith. If that is not known, then the receipts shall count toward the threshold of the State indicated by an address for the purchaser that is obtained during the consummation of the sale, including the address of the purchaser's payment instrument, if no other address is available, when the use of this address does not constitute bad faith.

(4) Notwithstanding the other provisions of this Subsection C, for a taxpayer subject to the special apportionment methods under [Multistate Tax Commission Regulations IV.18.(d) through (j)], the property, payroll and sales for measuring against the nexus thresholds shall be defined as they are for apportionment purposes under those regulations.\textsuperscript{...}

E A State without jurisdiction to impose tax on or measured by net income on a particular taxpayer because that taxpayer comes within the protection of Public Law 86-272 (15 U.S.C. § 381) does not gain jurisdiction to impose such a tax even if the taxpayer's property, payroll or sales in the State exceeds a threshold in Subsection B. Public Law 86-272 preempts the state's authority to tax and will therefore cause sales of each protected taxpayer to customers in the State to be thrown back to those sending States that require throwback. If Congress repeals the application of Public Law 86-272 to this State, an out-of-state business shall not have substantial nexus in this State unless its property, payroll or sales exceeds a threshold in this provision.

\textsuperscript{388} The factor nexus proposal acknowledges that some multistate businesses will still be protected by P.L. 86-272. \textit{Id. at 4}; see also \textit{supra} note 21 and accompanying text (reproducing and explaining P.L.86-272). Repeal of this federal statute would be necessary to fully implement an economic nexus approach to state corporate income jurisdiction. See MTC, \textit{FACTOR PRESENCE NEXUS STANDARD, supra} note 386, at 4.
STATE INCOME TAX JURISDICTION

Although the adoption of factor nexus rules would significantly reduce the administrative costs of determining jurisdiction to tax, it would not address the difficulty of complying with the non-uniform substantive tax rules of multiple jurisdictions. UDITPA has been an important uniformity cornerstone for many years, but more could be done. Perhaps the resurgence of interest in sales and use tax uniformity reflected by the Streamlined Sales Tax Project will provoke renewed efforts to achieve even greater corporate income tax uniformity. Lack of uniformity strengthens the hand of opponents of a sensible income tax nexus rule, who are urging Congress to adopt even greater restrictions on state income tax nexus.

CONCLUSION

For more than a decade, state tax policy has been frozen in the Quill headlights. Passing by in the fast lane have been relentless economic and technological changes, followed closely by corporate taxpayers and their clever tax planners. Change may be afoot. If widely adopted, the Streamlined Sales Tax Agreement will bring needed sales and use tax uniformity, and perhaps the judicial or Congressional overruling of Quill. This Article has shown that corporate income tax does not require such radical road clearing. Quill's physical presence test is not a constitutional barrier to corporate income tax jurisdiction, and the state income tax already underwent its own "streamlining" years ago with the adoption of UDITPA. State income tax authorities should confidently assert their jurisdiction to tax economically present businesses. The Constitution allows it, and good tax policy demands it.

But good tax policy demands more. Congress should repeal P.L. 86-272. Its safe harbors have no place in a modern economy. In

389. See Bucks & Katz, supra note 1, at 1038 (arguing that the proposal provides taxpayers with "certainty" and "clarity" when determining whether they are subject to state income tax).
390. See supra note 117 and accompanying text (discussing the Streamlined Sales Tax Project's attempt to create more uniform sales and use tax rules).
391. See supra note 28 and accompanying text (providing a discussion of business-backed legislation that would extend the nexus protections of P.L. 86-272).
exchange for repeal of P.L. 86-272, states should adopt uniform nexus guidelines and more uniform substantive income tax rules. The modern global economy and the political landscape demand minimizing the compliance burden of reporting to multiple jurisdictions. So too may the political landscape. Corporate taxpayers have cautiously endorsed the Streamlined Sales Tax Agreement, acknowledging the value of tax uniformity and conceding that widespread adoption of the Agreement may be the demise of the physical presence nexus test for sales and use taxes. However, the *quid pro quo* for this endorsement is a demand for the radical expansion of P.L. 86-272. Finding a logic behind these inconsistent positions is challenging, apart from the logic of horse trading. The only plausible justification for expanding P.L. 86-272 is to protect taxpayers from the compliance burden of state income tax reporting. Thus, states would be wise to call the corporate bluff and further enhance the uniformity of the state corporate income tax system. Paradoxically, it is only by working together that states can preserve their sovereign power to tax.

392. *See supra* note 117.

393. *See* Council on State Taxation, *supra* note 117, at 408 (conditioning support for expanded sales tax nexus on further income tax nexus restrictions).