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# SHOULD NEW LIMITS ON STATE CORPORATE PROFITS TAXES BE A *QUID PRO QUO* FOR THE STATES' ABILITY TO TAX INTERNET SALES?

## The "Business Activity Tax Nexus" Issue

by Michael Mazerov

There appears to be growing support in Congress for some type of legislation that would authorize states to require businesses without a physical presence within their borders to collect and remit sales taxes on sales made to state residents.[1] This new authority would be provided in exchange for states' simplification and standardization of their diverse sales tax rules. The tradeoff would provide a solution to the long-standing problem of states' inability to collect sales tax on mail-order catalog sales and the more recent and growing problem of collecting sales tax on Internet sales.

While apparently agreeing with the emerging compromise, some major corporations and trade associations in the Internet commerce, entertainment, and financial services industries nonetheless are seeking to block proposed legislation that would implement it.[2] These businesses are insisting that language be added to the bill that would require an out-of-state business to have a "*substantial* physical presence" within a state before the state could tax the corporation's *profits*.

Specifically, these businesses are seeking a federally-established "nexus" threshold for state "business activity taxes" (BATs). State taxes on corporate profits are the most widely-levied state business activity taxes. The term also encompasses such broad-based business taxes as the Michigan Single Business Tax (a form of value-added tax) and the Washington Business and Occupations Tax (a state tax on a business' gross sales). The "nexus" threshold is the minimum amount of activity a business must have in a particular state to become subject to taxation in that state.

Currently, nexus thresholds are established primarily by state law. The federal nexus law sought by some business leaders would invalidate any portion of a state's existing nexus law that imposes a business activity tax on a business with less than a "substantial physical presence" within the state. (See the Appendix for a more detailed description of the proposed legislation in the House and Senate.) The effort to replace state laws with a federal nexus law would lead to a reduction in corporate profits tax revenues in a number of states and also block states from enforcing their corporate taxes against companies that are not currently complying with state law. Because this is unacceptable to the states, business' insistence on adding the BAT nexus language seems likely to derail the emerging consensus on taxation of mail-order and Internet sales.

## Enacting a "Substantial Physical Presence" Nexus Threshold Would Immediately Reduce State Corporate Profits Tax Receipts

The opposition of such organizations as the National Governors' Association and the National Conference of State Legislatures to a federal BAT nexus threshold is not surprising. Permanently enshrining in federal law a "substantial physical presence" threshold for the imposition of state corporate profits taxes would have an adverse impact on the ability of states to finance critical education, health, and public safety services — both immediately and over the long term.

- Enactment of a "substantial physical presence" nexus threshold would immediately reduce corporate profits tax revenues in many states.

  Many state laws provide that something less than a *substantial* physical presence obligates an out-of-state corporation to pay tax on the share of its profit attributable to the state. For example, the laws of at least 20 states provide that out-of-state computer manufacturers like Gateway and Dell that use independent in-state firms to provide warranty repair services at their customers' residences or places of business are obligated to pay some corporate profits tax or other BAT to the state.[3] Similarly, the laws of many states would obligate an out-of-state bank to pay some corporate profits tax if it regularly sent loan officers into the state to solicit borrowing by major in-state businesses or made mortgage loans secured by in-state property. It is reasonable to assume that many corporations are complying with these laws, which would be voided by the "substantial physical presence" nexus standard sought by industry. If some out-of-state corporations were no longer obligated to pay tax on their profits, states would lose business tax revenues. It could be quite difficult politically to make up these lost business activity tax revenues by raising taxes on other individuals or businesses.

- A "substantial physical presence" nexus threshold would interfere with current efforts by states to shut down an abusive corporate profits tax avoidance strategy implemented by many multistate corporations.

  An increasing number of corporations are implementing a corporate profits tax avoidance strategy based on transferring ownership of the corporation's trademarks and patents to a subsidiary corporation in a state that does not tax royalties, interest, or similar types of "intangible income." Otherwise taxable profits are then siphoned out of all other states by having the tax-haven subsidiary charge a royalty to the rest of the business for the use of the patent or trademark.[4] The royalty is a deductible expense for the corporation paying it, and so reduces the amount of profit such a corporation has in the states in which it does business and is taxable. Moreover, the "profits" of the trademark-owning subsidiary often are loaned back to the rest of the corporation, and a secondary siphoning of income occurs through the payment of deductible interest on the loan. Many states take the position that the out-of-state corporation that owns the patents and trademarks is itself subject to the state's corporate profits tax notwithstanding its lack of a direct physical presence within the state; many of these states currently are engaged in audits and litigation to enforce this position. Federal imposition of a "substantial physical presence" threshold would stop these enforcement efforts in their tracks by exempting the tax-haven subsidiary from direct state taxation of its profits. Litigation and political pressure from multistate corporations has been highly successful in blocking alternative mechanisms available to states for neutralizing this tax shelter, so the closing of the remaining avenue by federal legislation would adversely affect state corporate tax collections.[5]

## A "Substantial Physical Presence" Threshold Would Reverse U.S. Supreme Court Decisions Upholding "Nexus by Attribution" — Leading to a "Stampede of Tax Avoidance"

Proponents of federal nexus legislation allege that "substantial physical presence" is already the nexus threshold for state corporate profits taxes established by U.S. Supreme Court decisions. They argue that a federal statute spelling out a comprehensive "substantial physical presence" standard is needed because states are ignoring these decisions and are unfairly and illegally seeking to force corporations with no physical presence in a state to pay corporate profits taxes.

In fact, the Supreme Court has *not* held that physical presence is required to establish business activity tax nexus; if anything, the weight of its decisions arguably suggests the opposite conclusion.[6] The debate is largely academic, however, because the examples of illegitimate action by states most often cited by proponents of federal legislation are cases in which the business arguably *had* a substantial physical presence in the state seeking to enforce the tax, albeit through surrogates. In cases such as *Tennessee v. America Online*, *Tennessee v. J.C. Penney National Bank*, and *South Carolina v. Geoffrey, Inc.*, the states sought to require out-of-state corporations to pay taxes on profits that were clearly attributable to customers located within the state and arguably could not have been earned without activity conducted on behalf of the out-of-state corporation by related and unrelated *in-state* corporations. If federal BAT nexus legislation were to nullify the positions states took in these cases with respect to corporate nexus, state taxes on corporate profits could be eviscerated in the long run.

- In its ongoing case against American Online, for example, Tennessee is seeking to require AOL to pay tax on profits attributable to sales of Internet access services to Tennessee residents. Tennessee's claim is based on the fact that AOL leases hundreds of thousands of dollars worth of modems and other computer equipment located in Tennessee from its own subsidiary and unrelated telecommunications service providers.

- BAT nexus legislation proponents argue that it is fair to impose a corporate profits tax only if a business has property and/or workers in a state benefitting directly from state services. Even if one accepts that argument, it makes no policy sense to allow a corporation to avoid nexus for the out-of-state part of its business simply by "housing" its in-state property/workers in a subsidiary corporation. Nor is it reasonable to enable a corporation to avoid nexus in a state by hiring a third party to perform activities on its behalf within a state.

- The U.S. Supreme Court has upheld this common-sense notion in two clear-cut decisions bearing on both sales taxes and business activity taxes.[7] The Court held that a corporation cannot avoid nexus in a state by hiring a third party to conduct activities on its behalf in the state that would establish nexus if conducted by its own employees. The Court affirmed the principle that "the crucial factor governing [the creation of] nexus is whether the activities performed in [a] state on behalf of the [out-of-state] taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in [the] state for [its] sales."

- Further, the Court held that the technical legal relationship between the in-state and out-of-state businesses had no bearing on whether such "attributional nexus" had been established by the activity of the in-state representative. The Court realized that to allow the precise legal relationship between the parties to affect the determination of whether nexus existed "would open the gates to a stampede of tax avoidance" as corporations moved to establish their contractual relationships in a manner that avoided nexus.

- Far from seeking to "codify" an existing "substantial physical presence" nexus standard for BATs, the preeminent goal of advocates of federal BAT nexus legislation is to *nullify* these two Supreme Court nexus decisions. Reversing these decisions would make it possible for multistate corporations to shelter substantial portions of their profits from taxation — by avoiding nexus in states in which they hire their own subsidiaries or unrelated businesses to perform activities on their behalf .

- The "substantial physical presence" nexus standard sought by business would effectively reverse the Supreme Court decisions by forcing states to establish that an in-state business is the actual legal "agent" of the out-of-state corporation upon which the state seeks to impose a BAT. "Agency" is a very high threshold that requires the "principal" to exercise significant direct control over how the "agent" carries out its activities on the principal's behalf. The creation of an agency relationship could be easily avoided in most instances by careful drafting of the service contract between the in-state and out-of-state business.

Elevating the threshold for "attributional nexus" from conducting activities on behalf of an out-of-state corporation that are "significantly associated" with its ability to make sales — the legal standard under current Supreme Court doctrine — to "agency" would indeed open up vast new opportunities for unfair corporate tax avoidance. For example:

- A retail store chain could place computer kiosks in all its stores. The kiosks could be linked over the Internet to its "dot-com" affiliate.[8] The stores could even accept merchandise returns on behalf of the dot-com affiliate. Despite this critical sales assistance provided by the stores to the dot-com affiliate, the affiliate likely would have no obligation to pay tax on its profit to any state except the one(s) where it has offices, warehouses, or similar facilities.[9]

- The QVC television home shopping network is available on virtually all local cable television systems in the United States. QVC apparently acknowledges that by carrying its programming, these local cable systems are effectively its in-state representatives in its customers' states; the company currently collects sales taxes in all states. (Whether QVC currently acknowledges it also has corporate profits tax nexus in all states is not publicly-available information.) Were the attributional nexus standard for corporate profits taxes raised to "agency," however, QVC likely could avoid paying corporate profits tax in all states except those in which QVC itself owned property or had employees. Under the "agency" nexus threshold sought by proponents of federal BAT nexus legislation, the local cable television systems that carry its programming — including those owned by its parent Comcast — likely would not be considered the legal agents of QVC merely by virtue of such contracts.[10]

Due to tax avoidance scenarios such as these, the enactment of a federal "substantial physical presence" BAT nexus threshold could reduce state BAT collections significantly. (The corporate profits tax alone currently generates more than $30 billion for the states each year.) Repealing the physical presence nexus threshold for *sales* taxes would avoid a state/local revenue loss from untaxed remote sales estimated to reach $10 billion annually within 2-3 years.[11] The state revenue loss resulting from a permanent "substantial physical presence" nexus threshold applicable to state *business activity taxes* could offset a substantial portion of the revenues states would "gain" from the elimination of the physical presence nexus threshold for *sales tax* imposition.

## A "Substantial Physical Presence" Nexus Threshold Could Harm the Economy

Enacting a new federal law establishing "substantial physical presence" as the threshold for state authority to impose corporate profits taxes on out-of-state corporations also could have a number of adverse impacts on the U.S. economy.

- A new federal BAT nexus law would stimulate even greater amounts of nexus-related litigation than is occurring at present because "*substantial* physical presence" is inherently even less of a "bright line" nexus threshold than is "physical presence." Courts in different states almost inevitably would reach different conclusions on what constitutes a "substantial physical presence," increasing rather than decreasing businesses' uncertainty about their profits tax obligations. Such uncertainty could stifle business investment decisions, and the additional litigation itself would waste significant private sector resources.

  The Supreme Court's stated goal in its 1992 *Quill* decision was to establish a "bright line" physical presence nexus threshold for sales taxes. Surveying the widespread sales tax nexus litigation that has occurred subsequent to *Quill*, a leading expert on Internet tax-related issues has stated flatly: "The current physical-presence standard for sales and use tax nexus has not created a bright-line test but instead has resulted in jurisdictional rules that are frequently ambiguous and inconsistent."[12] Whatever ambiguity may lie in a "physical presence" nexus standard, a "*substantial* physical presence" standard by definition opens even more room for disagreement and, hence, litigation. As discussed in the Appendix, the proposed federal nexus legislation not only states affirmatively that a business must have an *undefined* "substantial physical presence" in a state to be subject to tax on its profits, but both the House and Senate bills contain numerous "nexus carve-outs" — types and quantities of physical presence that are deemed *not* to be "substantial." A 1959 law creating just one such nexus carve-out has generated constant litigation for more than 40 years.[13] Not only does the proposed federal nexus law extend this carve-out to the entire service sector of the economy — to which it currently does not apply — but all of the additional carve-outs contain numerous undefined terms that would be likely to spark considerable additional litigation. As just one example, litigation would be almost inevitable over whether an out-of-state corporation's use of an independent entity's in-state property — such as AOL's use of a third party's modems — constituted a "lease" (nexus-creating under the proposed legislation) or a purchase of services (arguably nexus-avoiding under the legislation). In sum, more, not less, BAT nexus-related litigation would be the likely result of enacting a federal "substantial physical presence" nexus statute.

- A "substantial physical presence" threshold for corporate tax nexus would result in significant differences in effective state corporate profits tax rates — "tilting the playing field" to the competitive advantage of some corporations and the disadvantage of others.

  A "substantial physical presence" nexus threshold would reward with the lowest state corporate tax liability those corporations willing to implement the most aggressive corporate restructuring and tax avoidance strategies. Large corporations with multistate operations would have much greater opportunities to implement these strategies than would small, family-owned corporations serving a local market. The current physical presence threshold for *sales tax* nexus distorts the allocation of resources in the economy by providing a price advantage to tax-exempt remote sellers as compared with Main Street businesses who must charge sales tax. Analogously, a "substantial physical presence" threshold for corporate tax nexus would create disparate effective tax rates on corporate profits — favoring some corporations and disfavoring others.

- A "physical presence" nexus threshold for any type of tax may interfere with the efficient allocation of economic resources by creating an artificial disincentive for the placement of facilities in states where fundamental economic considerations might dictate they should be located.

  As the Chair of the Multistate Tax Commission has argued:

  > [I]n an era when companies can make substantial quantities of sales and earn substantial income within a state from outside that state, the concept of "physical activity" as a standard for state taxing authority [nexus] is inappropriate. . . . If a company is subject to state and local taxes only when it creates jobs and facilities in a state, then many companies will choose not to create additional jobs and invest in additional facilities in other states. Instead, many companies will choose to make sales into and earn income from the states without investing in them. If Congress ties states to physical activity concepts of taxing jurisdiction, Congress will be choosing to freeze investment in some areas and prevent the flow of new technology and economic prosperity in a balanced way across the nation.[14]

- By depriving states of corporate profits tax revenues, federal imposition of a "substantial physical presence" nexus threshold could impair their ability to provide services that are a critical foundation of a healthy national economy — such as high-quality K-12 and university education and transportation infrastructure.

## A Clear Business Activity Tax Nexus Standard Is Desirable — But It

## — Need Not Be Imposed on the States by the Federal Government
## — Should Not Be Allowed to Hold Up Action on the Taxation of Internet Sales

The preceding discussion has demonstrated that congressional enactment of a "substantial physical presence" BAT nexus threshold likely would have a serious adverse impact on state revenues. State representatives are likely to oppose such legislation fiercely, with the outcome uncertain. Nevertheless, if there were a constructive dialogue on the nexus issue involving state policymakers and business representatives, there is a reasonable prospect for a compromise that would advance the legitimate interests of both states and multistate corporations.

- State tax officials are just as dissatisfied as taxpayers are with enforcing nexus law in the current climate of uncertainty, conflict, and litigation. Tax administrators almost unanimously would agree that a clear, statutory nexus threshold for the corporate profits tax and other BATs is desirable.

- State legislators also should be receptive to working with other states to negotiate the specifics of such a threshold with the multistate business community — just as many states currently are working to develop and implement a uniform sales tax law.[15]

- State policymakers understand that the compliance costs entailed in becoming subject to a business activity tax in an additional state are not trivial for a business. They appreciate that a reasonable balance therefore needs to be struck between those costs and the tax revenue generated by subjecting a corporation with relatively little activity in a state to a BAT.

If discussions over BAT nexus do get underway, most state policymakers probably would argue for a law providing that BAT nexus is established once a corporation's sales in a particular state exceed a reasonable dollar amount. Industry would be free, however, to continue making its case for a threshold based on physical presence. Business might even carry the day on this position — especially if it proposed a very limited set of objectively measurable indicia of "physical presence" and addressed the legitimate concerns of the states about circumventing such a standard through the use of third parties and a corporation's own subsidiaries.

Whatever its substantive provisions might turn out to be, there is no reason that a uniform business activity tax nexus threshold could not be adopted through voluntary, cooperative action by the states. But if federal involvement should prove necessary, the model for a process that could address the multistate business community's legitimate desire for clarity concerning BAT nexus is the one that led to last year's enactment of the Mobile Telecommunications Sourcing Act (P.L. 106-252). In that case, rather than immediately go to Congress seeking federal preemption of state tax laws it found problematic, the cellular telephone industry reached out to the states. Armed with detailed documentation of conflicting state approaches to the taxation of "roaming" mobile phone calls yet acknowledging the legitimacy of state taxation of the service, the industry convinced the states to accept a uniform policy that preserved state revenues while reducing business compliance burdens. At the end of the negotiation process, the states and the industry *both* supported federal legislation requiring all states to implement the compromise if they wished to continue taxing roaming calls — with an adequate lead time that recognized the political realities of the state legislative process.

Congress may eventually conclude that a uniform, federally-sanctioned nexus standard for the imposition of state business activity taxes would be an appropriate exercise of its authority to regulate interstate commerce. But it should not jump to that conclusion without careful study, given the enormous potential impact on state tax revenues. Neither should Congress develop such a law in haste. The sales taxation of Internet and mail-order purchases has received years of careful deliberation by private and federally-sponsored study commissions and numerous congressional committees; it is ripe for congressional action. Action on an issue of such critical importance to states and to Main Street retailers should not be held hostage to last-minute demands that business activity tax nexus also be addressed — regardless of where Congress ultimately may decide the merits lie.

## Appendix: What Is "A Substantial Physical Presence"?

Major segments of the Internet commerce, financial services, and entertainment industries are insisting that a federally-mandated "substantial physical presence" nexus threshold for state business activity taxes be included in any federal legislation renewing the Internet Tax Freedom Act or addressing Internet sales tax collection. The definition of "substantial physical presence" they would like to see enacted is embodied — in slightly different form — in S. 664, the "New Economy Tax Fairness Act" (Gregg-Kohl) and H.R. 2526, the "Internet Tax Fairness Act of 2001" (Goodlatte-Boucher).

Both bills provide that neither a state nor a local government "shall have power to impose . . . a business activity tax on any person unless such person has a substantial physical presence in such State" or locality.[16] Each bill then goes on to enumerate a number of "nexus carve-outs" — types and quantities of physical presence a business can have in a state that in essence are defined as not substantial *enough* to obligate the business to pay a business activity tax to the state.

### Extending Federal Public Law 86-272 to the Service Sector

One of the nexus carve-outs contained in both S. 664 and H.R. 2526 is a re-enactment of Public Law 86-272. P.L. 86-272 was enacted in 1959 and intended to be a temporary moratorium on the ability of states to impose corporate profits taxes on certain out-of-state corporations; however, the law was never repealed. P.L. 86-272 provides that a state cannot impose a corporate profits tax on an out-of-state corporation if the corporation's only activity within the state is soliciting orders for the sale of physical goods, provided the orders are approved at an out-of-state office of the seller and the goods are shipped into the purchaser's state from an out-of-state location. P.L. 86-272 represents a carve-out from a physical presence nexus threshold because corporations may have an unlimited number of salespeople in a state at all times yet remain exempt from tax, provided the salespeople work out of home offices. (A company-owned office, even if used just for solicitation of orders, is not protected by Public Law 86-272, and so a state is free to impose a corporate income tax on an out-of-state corporation with such an office within its borders.)

Both S. 664 and H.R. 2526 not only reenact P.L. 86-272, but they modify it to protect from taxation corporations selling both services and intangible property (such as computer software) to which P.L. 86-272 currently does not apply. Under both bills, for example, a Delaware bank could send any number of loan officers into Maryland to visit Maryland businesses and encourage them to borrow from the bank, yet incur no obligation to pay a tax to Maryland on the portion of the bank's profit attributable to its interest earnings on such loans.[17]

### Blocking States from Asserting a Corporation Has "Attributional Nexus" in the State

In a key 1987 decision, the U.S. Supreme Court held that a state could impose a business activity tax on an out-of-state corporation that had contracted with an in-state business to conduct activities that were “significantly associated with the [out-of-state corporate] taxpayer’s ability to establish and maintain a market in [the] state for [its] sales.” When states impose a tax on an out-of-state corporation based on the in-state activities on its behalf of another corporation, this is referred to as “attributional nexus.” The aim of most of the carve-outs in both the House and Senate versions of the proposed legislation is to interfere with the ability of states to impose corporate profits taxes on out-of-state corporations based on an attributional nexus approach — particularly corporations involved in Internet commerce. In essence, both bills seek to block the ability of states to impose a profits tax on an out-of-state corporation when it contracts with an in-state corporation to provide facilities or engage in activities that would create nexus for the out-of-state corporation if conducted using its own property and employees.

For example, both bills provide that to impose a corporate profits tax or other BAT based on an attributional nexus approach, the in-state corporation must be the actual legal “agent” of the out-of-state corporation. Meeting this “agency” standard requires that the out-of-state “principal” exert significant direct control over how the in-state agent conducts its activity on a day-to-day basis — a much more restrictive standard than that the in-state business’ activity be “significantly associated” with the ability of the out-of-state corporation to make sales in the state. Both bills also provide that this agency standard even applies to a corporation’s own subsidiary; that is, an out-of-state corporation can have a subsidiary in a state conducting activities on its behalf yet not establish nexus for BAT purposes if the in-state subsidiary is not the legal agent of its out-of-state parent.

In addition to imposing an over-arching “agency” standard for attributional nexus in all instances, both bills enumerate a number of specific types of activities that even could be conducted by an in-state agent without creating BAT nexus for the out-of-state business. For example, an out-of-state corporation could have an agent in the state performing warranty repairs on goods it has sold without establishing nexus. This is aimed at voiding state laws that obligate out-of-state computer manufacturers like Dell and Gateway to pay some corporate profits tax to the state because they use in-state firms to do warranty repairs on computers at the customer’s home or place of business. Similarly, the bill provides that “the use of any service provider for transmission of communications” does not constitute “substantial physical presence.” This language would block the efforts of states like Tennessee to require America Online to pay some corporate profits tax to the state based on the fact that AOL contracted both with independent telecommunications companies and with its own subsidiaries to provide AOL’s Tennessee “points of presence” — the banks of modems and associated computer equipment to which its Tennessee subscribers connect.

### Not Just Nexus Carve-outs, but an *Affirmative* “Substantial Physical Presence” Nexus Requirement as Well

Most of the discussion of the proposed BAT nexus legislation has focused on the nexus-carve-outs and their potential consequences. Almost completely forgotten is the fact, noted at the beginning of this Appendix, that the legislation also states *affirmatively* that a corporation must have a "*substantial* physical presence" within a state before that state can impose a corporate profits tax or other BAT upon it. The carve-outs describe many activities and types of physical presence that are *not* "substantial physical presence"; however, what *is* "substantial physical presence" for purposes of this *affirmative* nexus standard is nowhere defined in either the House or Senate bill. Many corporations not protected by a "carve-out" will have some type of physical presence in a state short of a brick-and-mortar facility; such corporations could argue this physical presence is not "substantial" were S. 664 or H.R. 2526 to be enacted.

For example, so that sales can be more quickly delivered to customers, corporations frequently store inventory in warehouses throughout the country managed by other e-commerce companies, Federal Express, and businesses in the "logistics industry." Under current nexus law, it would be quite difficult for the corporation owning the inventory to claim that it does not have corporate income tax nexus in the state where such property is stored. Were the undefined "*substantial* physical presence" standard in S. 664 or H.R. 2526 to be enacted, however, such a corporation would be highly tempted to forego filing a corporate profits tax return with a state in which its inventory is stored and gamble that a court would rule that the presence of the inventory did not constitute "substantial physical presence."

It should be apparent from this discussion that enactment of S. 664 or H.R. 2526 could have an enormous impact on the ability of states to impose corporate profits taxes and other BATs on many out-of-state corporations. The body of this report discusses some of the less obvious corporate tax-avoidance possibilities that enactment of a "substantial physical presence" BAT nexus threshold would open up.

## Notes

1. The need for a federal law authorizing a state to require an out-of-state business to charge sales tax arises from the U.S. Supreme Court's 1992 *Quill* decision. The Court held in *Quill* that absent such a federal law, a business must have a "physical presence" in a customer's state before the business can be required by that state to charge sales tax on the customer's purchase and remit the tax to that state's treasury. The *Quill* decision protects many mail-order catalog and Internet merchants from an obligation to collect and remit sales taxes in most states, because such companies often can serve a nationwide market from a few physical locations.

2. The lead Senators seeking to craft a compromise on Internet sales taxes have been Dorgan, Hollings, McCain, and Wyden. The sales tax-related provisions are intended to be included in a larger package that would also renew the "moratorium" on state taxation of Internet access services imposed by the Internet Tax Freedom Act (1998). There has been relatively little activity in the House aimed at reconciling the different bills addressing the Internet sales tax issue.

3. See: Multistate Tax Commission National Nexus Program Bulletin 95-1. Reprinted in *State Tax Notes*, December 20, 1995.

4. The best-known example of this type of tax shelter was the transfer of Toys R Us' trademarks to its Delaware subsidiary, Geoffrey, Inc.. See: *South Carolina v. Geoffrey, Inc*., South Carolina Supreme Court, 1993.

5. Several years ago, New York attempted to neutralize the use of Delaware trademark subsidiaries by The Limited retail store conglomerate through "discretionary combination" of the subsidiaries' profits with the profits of the stores. (Discretionary combination effectively seeks to treat the stores and the Delaware companies as one corporation for tax purposes; it is an alternative to asserting that the Delaware subsidiaries themselves had corporate profits tax nexus in New York.) The case revealed that more than $400 million in profits that otherwise would have been taxable by the states in which the conglomerate's stores were located were transferred to the Delaware subsidiaries in just one four-year period. (Some states may have succeeded in taxing a share of the Delaware subsidiaries' profits.) New York lost the litigation. The Limited appears to be pursuing a multi-pronged strategy to hamstring state efforts to neutralize its use of the Delaware trademark company tax shelter; it is also a member of the "Coalition for Rational and Fair Taxation," which is lobbying for enactment of federal BAT nexus legislation.

6. See: Jerome Hellerstein, "*Geoffrey* and the Physical Presence Nexus Requirement of *Quill*," *State Tax Notes*, February 13, 1995. One significant way that a corporation can earn income in a state without being physically present within its borders is to own intangible property that is used in the state. As previously discussed, a common example is a trademark that is licensed for use in a state to generate royalty income for the out-of-state trademark owner. On the question of whether "physical presence" of the out-of-state trademark owner is required to impose a corporate profits tax on its royalty income, Hellerstein concluded: "The U.S. Supreme Court has made it clear that the presence of the recipient of income from intangible property in a state is *not* essential to the state's income tax on income of a nonresident [individual or corporation]." (Emphasis added.)

The late Jerome Hellerstein is widely recognized as a preeminent expert on constitutional law bearing on state taxing authority. The fact that he concluded that "physical presence' is not required in all instances to establish corporate income tax nexus under existing U.S. Supreme Court jurisprudence should be given great weight.

7. See: *Scripto v. Carson* (sales tax, 1960) and *Tyler Pipe v. Washington* (business activity tax, 1987).

8. Kmart already has placed in most of its stores kiosks that are linked to its Bluelight.com affiliate. (See: "Bluelight.com and Kmart Launch Kiosks," company press release, January 10, 2001.) Bluelight.com advertises on its Web site that its customers may return unwanted merchandise to any Kmart store. Bluelight.com apparently does not acknowledge that the presence of the kiosks and the acceptance of its returned merchandise are "significantly associated" with its ability to make sales; Kmart has stores throughout the United States, but Bluelight.com charges

sales tax only to customers in California and Ohio at the present time. Were the standard for attributional nexus raised to "agency," it seems likely that many more "clicks-and-mortar" companies like Kmart/Bluelight would be encouraged to use their stores to facilitate sales of their Internet subsidiaries because the profits of the subsidiaries likely would be shielded from taxation.

9. In addition to establishing an overarching "agency" standard for attributional nexus in all instances, a second provision of the proposed federal nexus legislation states that nexus is not created "by the use of an Internet service provider. . . to take and process orders via a . . . site on a computer that is physically located in such State." Thus, if a brick-and-mortar retailer contracted with an Internet service provider like the Microsoft Network to place computer kiosks in its stores which its out-of-state Internet sales affiliate uses "to take and process orders," states could not assert nexus over the retailer's Internet affiliate based on the presence within their borders of the kiosks. Moreover, since "Internet service provider" is not defined in the legislation, the retailer arguably could even incorporate its own, separate "Internet service provider" subsidiary to own the kiosks and link them to the Internet affiliate, while still claiming the same corporate tax immunity for the affiliate in most states where the kiosks are located.

10. In addition to the protection from corporate profits tax nexus for QVC provided by raising the attributional nexus threshold to "agency," an explicit provision of the pending BAT nexus legislation provides that nexus cannot be created by "the use of any service provider for transmission of communications. . . by cable." Thus, even if a local cable television system were determined by a court to be QVC's "agent," this additional language would protect QVC from establishing corporate income tax nexus by virtue of its reliance on local, physically-present cable television systems to carry its programming.

11. Donald Bruce and William F. Fox, "E-Commerce in the Context of Declining State Sales Tax Bases," *National Tax Journal*, December 2000, pp. 1373-88.

12. Karl Frieden, *Cybertaxation* (Arthur Anderson/CCH, Inc.), 2000, p. 356.

13. Public Law 86-272 was enacted in 1959 as a temporary limitation on the right of states to impose corporate profits taxes on out-of-state manufacturers and retailers of tangible goods whose activity within the state is limited to the "solicitation of orders." (See the Appendix for a more detailed discussion of P.L. 86-272.) More than 30 years of constant litigation ensued until the U.S. Supreme Court finally accepted a case that provided any guidance concerning what activities are and are not encompassed in the term "solicitation of orders" — which Congress failed to define. Litigation continues to this day regarding the interpretation of P.L. 86-272.

14. Statement of MTC Chair Elizabeth Harchenko before the Senate Committee on Commerce, Science, and Transportation, March 14, 2001.

15. The National Conference of State Legislatures has expressed a willingness to take up the issue of BAT nexus and explore with the private sector whether there are ways to change state nexus laws to provide more certainty to multistate corporations. See: Alison Bennett, "NCSL Working on Recommendations to Give Businesses More Certainty on Activity Taxes," *BNA Daily Tax Report*, June 18, 2001; Doug Sheppard, "NCSL Task Force May Take Up Business Activity Tax Issue," *State Tax Notes*, June 22, 2001.

16. Although the term "person" is not defined in the bill, it undoubtedly is intended to include corporations, partnerships, and other legal forms in which businesses are organized.

17. These loan officers arguably also would be free to solicit *deposits* from the Maryland businesses, since another carve-out in the bill states that the presence of employees to purchase goods and services also does not constitute a "substantial physical presence." Deposits could be characterized as intangible goods or services purchased by banks through the payment of interest.