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INSIGHTS

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RINGING IN THE NEW YEAR: ISSUES FROM 2013 THAT WILL LIKELY IMPACT 2014

By R. Gregory Roberts and Rebecca M. Ulich

The past year brought many important judicial decisions across all areas of state and local taxation. In this article, we will focus on several of those decisions that we think are likely to have an impact beyond the jurisdictions in which they were decided and beyond the specific facts involved in the appeals. Accordingly, in this article we will analyze decisions from the past year that highlight: (1) the continued resurgence of the Due Process Clause as a viable limitation on state taxing authority; (2) the potential use of the federal Internet Tax Freedom Act as a tool against the states' ability to tax electronic commerce; and (3) the potential impact of challenges to state modifications to the Multistate Tax Compact.

The Due Process Clause

For many years the Due Process Clause was largely viewed as a feeble means of challenging a state's authority to assert tax against an out-of-state corporation. That began to change with the U.S. Supreme Court's decisions in Goodyear and J. McIntyre Machinery in 2011, in which the Court embraced a "purposeful availment"

continued on page 2

IN THIS ISSUE

standard for personal jurisdiction under the Due Process Clause.[1] Following closely thereafter, the Oklahoma and West Virginia Supreme Courts in *Scioto* and *ConAgra*, respectively, were the first state tax cases in years to be decided largely on due process grounds.[2] The resurgence of the Due Process Clause as a limitation on the states' taxing power continued in the past year with decisions from two federal courts in *In re Washington Mutual, Inc.* and *Gordon v. Holder*.[3]

In *In re Washington Mutual, Inc.*, the Bankruptcy Court found that Oregon's imposition of tax on Washington Mutual, Inc. ("WMI") was improper under the Due Process Clause.[4] WMI was a bank holding company that owned subsidiaries, including subsidiaries that conducted banking-related operations in Oregon. WMI and its subsidiaries filed consolidated federal tax returns as well as consolidated Oregon corporate excise tax returns. In 2008, as a result of downgrades in its credit ratings and the global credit crisis, WMI filed for bankruptcy. After WMI had filed for bankruptcy, Oregon issued an assessment against WMI and its subsidiaries asserting additional corporate excise taxes, interest and penalties.[5]

In reaching its determination, the court explained that "[t]he initial inquiry regarding due process . . . is whether a defendant had minimum contacts with the jurisdiction such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice," and that "[d]ue process is not satisfied unless, in addition to finding 'minimum contacts,' the court determines that the income a state seeks to tax relates to a benefit received from the state."[6]

The resurgence of the Due Process Clause as a limitation on the states' taxing power continued in the past year with decisions from two federal courts in *In re Washington Mutual, Inc.* and *Gordon v. Holder*.

Although WMI's subsidiaries conducted business in the State, the court found that WMI "was simply a parent holding company" that "conducted no business activity within or directed towards Oregon," and, therefore, WMI lacked the minimum contacts required by the Due Process Clause.[7] Further, the court explained that, in order for a subsidiary's use of intellectual property in the State to be imputed to the parent company, due process requires that the parent must derive substantial revenue from the intellectual property.[8] As WMI did not earn any income from the use of the intellectual property in the State, the court found that WMI received no benefits from Oregon for its subsidiaries' use of intellectual property in the State.[9] Thus, the court concluded that the assessed tax violated the Due Process Clause because WMI lacked the necessary minimum contacts and the asserted tax was not rationally related to values connected with Oregon.[10]

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The District of Columbia Circuit Court in *Gordon* similarly recognized the Due Process Clause as an important limitation on a jurisdiction's authority to tax.[11] In *Gordon*, Robert Gordon, who owned a business that sold tobacco products across state lines, requested a preliminary injunction against the enforcement of the provisions of the Prevent All Cigarette Trafficking Act ("PACT Act").[12] The PACT Act was enacted, in part, to prevent remote purchasers from avoiding state taxes and prohibits "delivery sales" of cigarettes and smokeless tobacco products unless all applicable state and local taxes are paid "in advance of the sale, delivery, or tender."[13] Moreover, under the PACT Act, delivery sellers "must collect any taxes that state or local laws require in-state retailers to collect," and "[t]hey are subject to federal criminal and civil penalties if the applicable taxes have not been paid in advance."[14] Among other arguments, Gordon argued that the taxing provisions violated the Due Process Clause.[15]

The Circuit Court found that Gordon presented two substantial and novel constitutional questions: (1) whether the Due Process Clause requires minimum contacts between the state or local taxing authority and the nonresident seller, even when the federal government is the source of the seller's duty to collect taxes; and (2) if due process requires minimum contacts with the state or local taxing jurisdiction, does a single delivery sale to a buyer in that jurisdiction create the requisite minimum contacts?[16] In affirming the District Court's injunction against the enforcement of the taxing provisions on due process grounds because it found the underlying constitutional questions to be "close," the Circuit Court noted that "[s]tates require retailers to collect applicable taxes from resident buyers and remit the receipts to the state," but that "[a] state may not . . . impose such an obligation on a retailer with whom the state lacks minimum contacts."[17] The court noted that "[t]he minimum contacts requirement derives from the Due Process Clause" and observed that "[t]his means that most out-of-state retailers operate beyond the state's regulatory reach."[18]

Upcoming Speaking Engagements

January 14

TEI State & Local Tax Luncheon
Dallas, Texas
- "East Coast/West Coast Update on Significant State and Local Tax Developments in the Eastern and Western States"
  Eric J. Coffill and Hollis L. Hyans

January 20

2013-2014 Lieb/Preis State Tax Study Group for CPAs
Chatham, New Jersey
- "New Jersey Update"
  Mitchell A. Newmark and Richard C. Call

January 26 – 31

COST 2014 SALT Basics School
Atlanta, Georgia
- "Constitutional Restrictions"
  Andres Vallejo

January 28 – 29

23rd Annual Ohio Tax Conference
Columbus, Ohio
- "Nexus… Are Bellas Hess and Quill Still the Law? Is Amazon the New Test?"
  Craig B. Fields
- "Current State of Apportionment including Elective Apportionment and Alternative Apportionment – Trends, Pitfalls & Opportunities"
  Mitchell A. Newmark
- "Preventing & Handling Procedural Problems in Tax Matters"
  Mitchell A. Newmark

February 5 – 7

The 2014 National Multistate Tax Symposium
Orlando, Florida
- "State Tax Implications of International Transactions"
  Craig B. Fields

March 31

2014 ABA/IPT Advanced Income Tax Seminar
New Orleans, Louisiana
- "Update on Economic Substance/Sham Transaction Doctrine"
  Hollis L. Hyans

May 14 – 16

TeleStrategies' Communication Taxation 2014
Lake Buena Vista, Florida
- "Sales and Excise Tax: Defense of Digital and 'Cloud' Products and Services from State Taxation"
  R. Gregory Roberts and Rebecca M. Ulich

In analyzing the underlying rationale of the Due Process Clause, the court explained that "due process jurisprudence ensures democratic legitimacy by relying on the mechanism of 'fair warning'" because, "[f]airly warned that a state might tax them, persons can participate, at least through petitioning and speech, in the political process that decides whether it will [tax them]."[19]

The *Washington Mutual* and *Gordon* cases continue the recent trend of decisions that look to whether a taxpayer has purposefully directed its economic activities at a particular jurisdiction so as to establish the requisite minimum contacts under the Due Process Clause.

The court also explained that "[a]nother simple but controlling question to test the lawfulness of an exercise of taxation power is whether the state has given anything for which it can ask return," because, "when minimum contacts with that state or locality are lacking, the state or locality offers no services or protections to justify the tax it receives."[20]

The *Washington Mutual* and *Gordon* cases continue the recent trend of decisions that look to whether a taxpayer has purposefully directed its economic activities at a particular jurisdiction so as to establish the requisite minimum contacts under the Due Process Clause. Taken together, these decisions highlight that the Due Process Clause is a viable means of challenging states' ever increasing attempts to tax activities with only the slightest connection to the state.

Taxpayers should also be aware of *DaimlerChrysler Ag v. Bauman*, which is pending before the U.S. Supreme Court.[21] *Daimler* presents the Court with an issue that was not addressed in *Goodyear*: Whether a state has jurisdiction over a parent company based on the activities of a subsidiary in the state.[22] Thus, *Daimler* has the potential to significantly impact state and local taxing authority, as the Court may be forced to address whether due process nexus can be established based on an "enterprise" theory, which entails an analysis similar to a unitary business analysis.[23]

Affiliate Nexus Provisions and the Taxation of Electronic Commerce

As in previous years, challenges to statutes involving affiliate or "click-through" nexus provisions (*i.e.*, the "Amazon" laws) have continued, with decisions rendered regarding such provisions in New York and Illinois and an appeal pending in Colorado.[24] In a unique twist on prior decisions, on October 18, 2013, the Illinois

Supreme Court, in *Performance Marketing Association v. Hamer*, found that Illinois' affiliate nexus provisions were "void and unenforceable" because they were "expressly preempted" by the federal Internet Tax Freedom Act ("ITFA").[25]

In 2011, Illinois amended its statutory definitions to impose use tax collection obligations on an out-of-state internet retailer or serviceman that contracts with a person in the State to refer potential customers to the retailer or serviceman's website with an internet link, if the gross receipts generated from such referrals exceed $10,000 during the preceding four quarters.[26] The Illinois Circuit Court found that the statute was invalid because it was (1) unconstitutional under the Commerce Clause and (2) expressly preempted by the ITFA. On appeal, however, the Illinois Supreme Court limited its decision to a finding that the provision was invalid under the ITFA and, therefore, did not decide whether the provision was also unconstitutional.

Among other restrictions, the ITFA prohibits a state from imposing "discriminatory taxes on electronic commerce."[27] A "discriminatory tax," is defined, in part, as "any tax imposed by a State or political subdivision thereof on electronic commerce that . . . imposes an obligation to collect or pay tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means."[28]

In reaching its determination, the court noted that "Illinois law does not presently require out-of-state retailers who enter into performance marketing contracts for 'offline' print or broadcast advertising which is disseminated nationally, or internationally, to collect Illinois use tax;" however, pursuant to the State's affiliate nexus provisions, "out-of-state retailers who enter into such contracts with Illinois Internet affiliates for the publication of online marketing—which is inherently national or international in scope and disseminated to a national or international audience—are required to collect Illinois use tax."[29] The court, therefore, found that the affiliate nexus provisions imposed discriminatory taxes within the meaning of the ITFA by "singling out retailers with Internet performance marketing arrangements for use tax collection."[30] The court also disagreed with the State's argument that a click-through link constitutes "active solicitation," which is similar to solicitation activity that would impose use tax collection obligations on offline affiliates.[31] The court found that, because

The court found that the affiliate nexus provisions imposed discriminatory taxes within the meaning of the ITFA by "singling out retailers with Internet performance marketing arrangements for use tax collection."

MOFO ATTORNEY NEWS

CONGRATULATIONS: On December 12, 2013, **Paul H. Frankel** received the 2013 Franklin C. Latcham Award for Distinguished Service in State and Local Taxation from Bloomberg BNA. The Award has been given to a distinguished state tax practitioner annually since 1996. George Farrah, Executive Editor of Bloomberg BNA's Tax & Accounting publications said that "Paul is truly a legend in the area of state and local taxation, providing leadership and guidance throughout his career and across a wide range of topics."

the parties had stipulated that "an Internet affiliate does not receive or transmit customer orders, process customer payments, deliver purchased products, or provide presale or postsale customer services" and because "an Internet affiliate displaying a link on its website does not know the identity of Internet users who click on the link, and after a user connects to the retailer's website, the affiliate has no further involvement with the user," it was "clear" that the Internet affiliate did not engage in "active" solicitation.[32]

The court concluded that the affiliate nexus provisions were discriminatory under the ITFA because "performance marketing over the Internet provides the basis for imposing a use tax collection obligation on an out-of-state retailer when a threshold of $10,000 in sales through the clickable link is reached."

Thus, the court concluded that the affiliate nexus provisions were discriminatory under the ITFA because "performance marketing over the Internet provides the basis for imposing a use tax collection obligation on an out-of-state retailer when a threshold of $10,000 in sales through the clickable link is reached" whereas, "national, or international, performance marketing by an out-of-state retailer which appears in print or on over-the-air broadcasting in Illinois, and which reaches the same dollar threshold, will not trigger an Illinois use tax collection obligation."[33]

Although *Performance Marketing Association* may well prove helpful in future challenges to affiliate nexus provisions, as one of the few published cases applying the ITFA and engaging in an analysis under the ITFA's prohibition on discriminatory taxes, *Performance Marketing Association* may also breathe new life into the ITFA as a means of challenging the imposition of other state taxes. As states continue to aggressively pursue the taxation of electronic commerce, for example, taxpayers should be cognizant of the analysis applied by the Illinois Supreme Court in *Performance Marketing Association* and the viability of the ITFA as a check on states' taxing authority.

Challenges to State Modifications under the Compact

Numerous important developments occurred in 2013 relating to the various challenges to state modifications to the three-factor apportionment formula of the Multistate Tax Compact (the "Compact"). 2014 promises more of the same, with cases currently pending in California, Michigan, Minnesota, Oregon and Texas.

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On January 16, 2013, the California Supreme Court granted the Franchise Tax Board's petition for review of the California Court of Appeal's decision in *The Gillette Co. v. Franchise Tax Board*.[34] In *Gillette*, the Court of Appeal held that member states to the Compact must permit taxpayers to use either the Compact's equally weighted three-factor formula or the state's own statutory apportionment formula.[35] In reaching its decision, the court found that: (1) the Compact specifically extended to taxpayers the option to elect to apportion their taxes under the Compact's formula and the taxpayers were entitled to enforce this right; and (2) the Compact is both a statute and a binding agreement among sovereign signatory states and, therefore, California cannot unilaterally alter or amend the terms of the Compact.[36]

On July 3, 2013, the Michigan Supreme Court granted IBM's application for leave to appeal the Michigan Court of Appeals' decision in *IBM Corp. v. Department of Treasury*.[37] In *IBM*, in a *per curiam* decision, the Michigan Court of Appeals held that the Business Tax Act repealed by implication the election provision found in the Compact and that the taxpayer was required to compute its tax liability pursuant to the single sales factor apportionment formula provided by the Business Tax Act.[38]

In contrast to the Michigan Court of Appeal's 2012 decision in *IBM*, on June 6, 2013, in *Anheuser-Busch, Inc. v. Dep't of Treasury*, the Michigan Court of Claims held that the Compact is a binding compact that cannot be repealed by a conflicting statute and, therefore, that a corporation may elect to apportion its income tax according to the Compact.[39] The court also found that the Michigan modified gross receipts tax is not an "income tax" under the Compact and, thus, cannot be apportioned according to the Compact.[40] On August 2, 2013, the Michigan Supreme Court denied the taxpayer's motion for immediate consideration and the case is now pending before the Court of Appeals.[41]

Additional actions challenging state modifications to the Compact are pending in Oregon, Minnesota and Texas.[42] As courts begin to issue decisions regarding the states' authority to unilaterally alter the Compact, taxpayers should be aware of the potential impact of these decisions on other state modifications to the Compact.

For example, numerous states that adopted the Compact have since changed their definitions of business income to provide that "business income" includes all income apportionable under the U.S. Constitution,[43] or have adopted disjunctive functional tests to provide that "business income" includes income from tangible and intangible property if the acquisition, management *or* disposition of the property constitutes integral parts of the taxpayer's regular trade or business.[44] If the apportionment factor challenges in the *Gilette*-line of cases are successful, taxpayers may be able to elect into the Compact and its traditional definitions of business and nonbusiness income. This option could prove especially fruitful in those states that modified their definitions of business income after courts found that a liquidation exception existed under the Compact's functional test.

As courts begin to issue decisions regarding the states' authority to unilaterally alter the Compact, taxpayers should be aware of the potential impact of these decisions on other state modifications to the Compact.

Similarly, many states changed the Compact's sourcing methodology to adopt market-based sourcing and, if taxpayers are successful in *Gillette* and similar cases, these changes to the Compact would also be ripe for challenge.

1 *Goodyear Dunlop Tires Operations, S.A. v. Brown*, 131 S. Ct. 2846 (2011) (engaging in an analysis under the Due Process Clause in finding that foreign subsidiaries of Goodyear that had no presence in North Carolina and did not take any affirmative action to cause their tires to be shipped to North Carolina were not subject to general jurisdiction by the State because "a small percentage" of their tires were distributed in the State by other Goodyear USA affiliates); *J. McIntyre Machinery, Ltd.v. Nicastro*, 131 S. Ct. 2780 (2011) (holding that, under the Due Process Clause, New Jersey courts

lacked jurisdiction over a foreign manufacturer that "at no time had [] advertised in, sent goods to, or in any relevant sense targeted the State").

2 *Scioto Ins. Co. v. Okla. Tax Comm'n*, 279 P.3d 782 (Okla. 2012) (stating that "[d]ue process is offended by Oklahoma's attempt to tax an out of state corporation that has no contact with Oklahoma other than receiving payments from an Oklahoma taxpayer . . . under a contract not made in Oklahoma"); *Griffith v. ConAgra Brands, Inc.*, 728 S.E.2d 74 (W. Va. 2012) (finding that "royalties earned from the nation-wide licensing of food industry trademarks and trade names [did not satisfy] . . . 'purposeful direction' under the Due Process Clause").

3 *In re Washington Mutual, Inc.*, 485 B.R. 510 (U.S. Bankr. Ct. Del. Dist., Dec. 19, 2012); *Gordon v. Holder*, 721 F.3d 638 (D.C. Ct. App. 2013), *affirming* 826 F. Supp. 2d 279 (2011), *on remand from* 632 F.3d 722 (D.C. Ct. App. 2011). Additionally, in *Linn v. Dep't of Revenue*, 2013 IL App. (4th) 121055 (Ill. Ct. App. 4th Dist. Dec. 18, 2013), the Illinois Court of Appeals held that imposition of Illinois income tax on an *inter vivos* trust violated the Due Process and Commerce Clauses and was, therefore, unconstitutional. The court found that the fact that the trust's grantor was an Illinois resident was "not a sufficient connection to satisfy due process." *Id.* The court further explained that taxation was improper under the Due Process Clause because the trust "receives the benefits and protections of Texas law, not Illinois law" and "no Illinois probate court has jurisdiction" over the trust. *Id.* Moreover, the court noted that the trust "had nothing in and sought not[h]ing from Illinois" and met none of the factors that would give the State personal jurisdiction over the trust in a litigation. *Id.*

4 485 B.R. 510. The court also found that WMI did not have nexus with Oregon under the Commerce Clause. *Id.* at 514.

5 Oregon assessed WMI on the basis that it was jointly and severally liable for the state corporate excise tax of its subsidiaries that did business in the State because WMI had filed an Oregon consolidated return. *In re Washington Mutual, Inc.*, 485 B.R. 510. Oregon argued that, pursuant to the State's statute, if WMI was not subject to tax by the State, the return should not have been filed in WMI's name and WMI should not have been included in the consolidated tax group. *Id.* at 514.

6 485 B.R. at 515.

7 *Id.* at 516.

8 *Id.*

9 *Id.*

10 *Id.*

11 721 F.3d 638 (D.C. Ct. App. 2013). Although the Circuit Court's decision is limited to the affirmance of a preliminary injunction by the District Court and, therefore, the Circuit Court did not reach any determinations on the merits, the court's recognition of the Due Process Clause as a limitation on state taxing authority is noteworthy.

12 721 F.3d at 641.

13 *Gordon* at 642. "Delivery sales" are "any sale[s] in which either the purchase or the delivery does not occur face-to-face." *Id.*

14 *Id.*

15 721 F.3d 638.

16 *Id.*

17 *Gordon* at 641 (citing *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)). The court also noted that "[u]nder the Due Process Clause, we treat an obligation to collect taxes the same as an obligation to pay taxes." *Gordon* at 645 (citing *Quill*, 504 U.S. at 319 (Scalia, J., concurring)).

18 *Gordon* at 641-42.

19 *Gordon* at 649 (citing *Quill*, 504 U.S. at 312).

20 *Gordon* at 650-51 (internal quotations and citation omitted).

21 133 S. Ct. 1995 (2013) (oral arguments heard Oct. 15, 2013).

22 *Id.*

23 The Ninth Circuit found that DaimlerChrysler AG ("DCAG") was subject to personal jurisdiction in California through the contacts of its subsidiary, Mercedes-Benz USA ("MBUSA"). *Bauman v. DaimerChrysler Corp.*, 644 F.3d 909 (9th Cir. 2011). In reaching its determination that DCAG had the requisite contacts with California, the court noted that "[s]elling Mercedes-Benz vehicles is a critical aspect of DCAG's business operations" and that "MBUSA's sales in California alone accounted for 2.4% of DCAG's total worldwide sales." *Id.* at 922. Further, the court found that DCAG had "the right to control nearly every aspect of MBUSA's operations." *Id.* at 921. The court also found that it was reasonable for California to assert jurisdiction over DCAG because "DCAG has purposefully and extensively interjected itself into the California market through MBUSA" by designing cars for California-specific purposes, initiating lawsuits in State courts, retaining permanent counsel in the State and being listed on the Pacific Stock Exchange located in San Francisco. *Id.* at 925.

24 On December 2, 2013, the U.S. Supreme Court's denial of certiorari in *Amazon.com LLC v. N.Y.S. Dep't of Taxation and Fin.*, No. 13-259 *cert. denied* (Dec. 2, 2013), and *Overstock.com Inc. v. N.Y.S. Dep't of Taxation and Fin.*, No. 13-252 *cert. denied* (Dec. 2, 2013), finalized the New York Court of Appeals' decision upholding the constitutionality of New York's affiliate nexus statute, which creates a rebuttable presumption that a vendor is doing business in the State when it solicits business through an in-state representative and compensates the representative with a commission. *Overstock.com Inc. v. Dep't of Taxation and Fin.*, 20 N.Y.3d 586 (2013). In Colorado, despite being dismissed from federal court under the Tax Injunction Act ("TIA"), the Direct Marketing Association ("DMA") has continued its challenge in state court by filing a complaint and a motion for a permanent injunction. *Direct Marketing Ass'n*, No. 10-cv-01546-REB-CBS (Col. Dist. Ct. Dec. 10, 2013) (dismissing Commerce Clause claims and dissolving the permanent injunction based on the decision of the U.S. Court of Appeals for the 10th Circuit in *The Direct Marketing Ass'n v. Brohl*, 735 F.3d 904 (10th Cir. 2013), *rehearing denied*, Oct. 1, 2013)); *see The Direct Marketing Ass'n v. Colo. Dep't of Revenue*, No. 13 CV 34855 (Denver Dist. Ct.) complaint and motion filed November 5, 2013.

25 *Performance Marketing Ass'n v. Hamer*, No. 114496 (Ill. Oct. 18, 2013). As the Illinois Supreme Court found that the provisions were void under federal preemption, the court did not consider whether the provisions violated the Commerce Clause of the U.S. Constitution. *Id.*

26 35 ILCS 105/2(1.1) and 110/2(1.1).

27 Section 1101(a)(2) of the ITFA (47 U.S.C. § 151); *Performance Marketing Ass'n*, No. 114496.

28 *Id.*

29 *Performance Marketing Ass'n*, No. 114496.

30 *Id.*

31 *Id.*

32 *Id.*

33 *Id.*

34 147 Cal. Rptr. 3d 603 (Cal. Ct. App. 2012).

35 *Id.* at 949.

36 *Id.*

37 *IBM Corp. v. Dep't of Treasury*, No. 306618 (Mich. Ct. App. Nov. 20, 2012), *leave to appeal granted*, 832 N.W.2d 388 (Mich. 2013).

38 *Id.*

39 No. 11-85-MT (Mich. Ct. Cl. June 6, 2013), *appeal docketed*, No. 316743 (Mich. Ct. App. June 12, 2013), *appeal docketed*, No. 316977 (Mich. Ct. App. June 27, 2013), *leave to appeal directly to the Michigan Supreme Court denied*, No. 147438-9 (Mich. Aug. 2, 2013).

40 *Id.*

41 No. 316743 (Mich. Ct. App. June 12, 2013), *appeal docketed*, No. 316977 (Mich. Ct. App. June 27, 2013), *leave to appeal directly to the Michigan Supreme Court denied*, No. 147438-9 (Mich. Aug. 2, 2013).

42 *Kimberly-Clark Corp. v. Comm'r*, No. 08670 (Minn. Tax Ct. Dec. 12, 2013); *Health Net, Inc. v. Dep't of Revenue*, TC 5127 (first amended complaint filed in Or. Tax Ct., Regular Div., Jan. 17, 2013); *Graphic Packaging Corp. v. Combs*, No. D-1-GN-12-003038 (petition filed in Travis County Dist. Ct. Sept. 27, 2012), *oral arguments heard on* December 19, 2013; *see also Revenews*, Multistate Compact Apportionment Election, Protective Refund Claim (Or. Dep't of Revenue Sept. 24, 2012) (acknowledging that the Compact apportionment election is being challenged in the Oregon Tax Court).

43 *See* D.C. Cd. § 47-1810.02 (eff. 2004); Iowa Cd. § 422.32(1)(b) (eff. May 1, 1995); 35 Ill. Comp. Stat. § 5/1501(a)(1) (eff. July 30, 2004); Kan. Stat. Ann. § 79-3271 (eff. Jan. 1, 2008); Minn. Stat. § 290.17 (eff. for tax years beginning after Dec. 31, 1998); N.C. Gen. Stat. § 105-130.4 (eff. Jan. 1, 2002); W.V. Cd. § 11-24-3a(a)(2) (eff. Mar. 10, 2007).

44 *See* Ala. Cd. § 40-27-1.1 (eff. for tax years beginning after Dec. 31, 2001); Miss. Cd. Ann. § 27-7-23(a)(2) (eff. for tax years beginning on or after Jan. 1, 2001); N.M. Stat. Ann. § 7-4-2(A) (eff. for the 1999 and subseq. tax years); Tenn. Cd. Ann. § 67-4-2004(4), *previously codified as*, Tenn. Cd. Ann. § 67-4-804(a)(1) (eff. for tax years ending on or after July 15, 1993).

DEFENDING AGAINST PENALTIES

By Craig B. Fields and Richard C. Call

Over the years, we have seen common scenarios where penalties should not be imposed, including the following:

1. When the taxpayer files in accordance with a statute, but the state taxing authority asserts additional tax based on alternative apportionment;
2. Where there is an honest difference of opinion on a position; and
3. When the taxpayer's position is based on the state taxing agency's prior conduct or statement.

We note that, in many instances, state taxing agencies faced with the above scenarios have taken the high road and either not imposed penalties or abated the penalties assessed. However, in some cases, taxpayers have been forced to litigate in order to eliminate penalties. In the following pages, we provide a few examples of taxpayers that successfully defended against penalties in such scenarios.

Background

Some of the common penalties that states use include late-filing, late-payment, and substantial understatement penalties.[1] The exact types of penalties, the language that states use to apply the penalties and the amount of the penalties vary. Furthermore, whether a state's statutes, regulations, cases or other authorities permit or require abatement of the penalties is a state-specific question. Practices also vary amongst state taxing agencies as to how and when to assert or abate penalties. The extent to which the below cited cases may be persuasive in other jurisdictions may vary.[2]

Alternative Apportionment

In *CarMax Auto Superstores West Coast, Inc. v. Department of Revenue*, an ongoing South Carolina case, the South Carolina Administrative Law Court ("Administrative Court") abated penalties in an alternative apportionment dispute.[3] The company ("CarMax") filed South Carolina returns using the statutorily prescribed three-factor double-weighted sales formula. Carmax included in its sales factor both its receipts from licensing and its receipts from its retail business. The South Carolina Department of Revenue asserted that the sales factor should be adjusted to exclude the retail income earned by CarMax because it was all earned outside of South Carolina. The Administrative Court held for the Department of Revenue on the apportionment issue, but the court did not uphold the Department of Revenue's assertion of negligence and substantial understatement penalties.

MOFO ATTORNEY NEWS

WELCOME: Morrison & Foerster's State + Local Tax Group would like to welcome **Daniel Lee Eggerman** and **Lisa Ma**. Mr. Eggerman and Ms. Ma join us as associates in the San Francisco office.

Regarding the negligence penalty, the South Carolina statute provided that a penalty may be assessed when underpayment of tax is due to "negligence or disregard of regulations."[4] "Negligence" was defined as a "failure to make a reasonable attempt to comply with the [statute]" and "disregard" was defined to include "careless, reckless, or intentional disregard."[5]

The Administrative Court found that:

> [CarMax] was not negligent in its reporting. It had no opportunity to report its tax liability under the alleged alternative self-designed apportionment method used by SCDOR. Such alternative method is unpublished and no notice has been given by SCDOR that such a method exists. It would have been impossible for a taxpayer to file its tax returns under the method of taxation that SCDOR has used in making the assessment of additional tax that is at issue in this case.[6]

The Administrative Court held for the Department of Revenue on the apportionment issue, but the court did not uphold the Department of Revenue's assertion of negligence and substantial understatement penalties.

Regarding the substantial understatement penalty, the Administrative Court indicated that the penalties were "*mandatory* . . . where a taxpayer substantially understates amounts owed."[7] However, the court explained that the statutes provided for a list of exceptions that also required "mandatory" reduction of the substantial understatement penalty.[8] Specifically, the penalty did not apply to:

1. Understatements that are attributable "to the tax treatment of an item:

   (i) by the taxpayer if there is or was substantial authority for that treatment, or

(ii) with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return and there is a reasonable basis for the tax treatment of the item by the taxpayer";[9] or

2. Understatements "if it is shown that there was a reasonable cause for the portion and that the taxpayer acted in good faith with respect to the [understatement]."[10]

The Administrative Court held that the substantial understatement penalties asserted against CarMax should be abated inasmuch as CarMax "filed in accordance with the statutory method as well as the tax return forms and instructions," noting that the tax return forms and instructions constituted substantial authority.[11] Additionally, the Administrative Court found that abatement of the penalty was proper because CarMax made "adequate disclosure" on its income tax returns.[12] The South Carolina Court of Appeals reversed the substantive decision regarding the use of alternative apportionment and the case is now pending in the Supreme Court of South Carolina.

The Michigan Tax Tribunal did abate late payment penalties because the taxpayer had an "honest difference of opinion" on the substantial nexus question.

Honest Difference of Opinion

In *Gear Research, Inc. v. Department of Treasury*, the Michigan Tax Tribunal held that penalties should be abated because the taxpayer had an "honest difference of opinion."[13] The substantive issue (which the taxpayer won fully on appeal) was whether certain of its sales made to states other than Michigan were required to be thrown back for purposes of computing the sales factor.

Whether sales were required to be thrown back turned on "whether [the taxpayer's] contacts with the foreign states in which it makes sales create a substantial nexus between Petitioner's activities and the foreign state."[14] The taxpayer argued that it had substantial nexus with other states because its employees were physically present and solicited sales in the other states and because it had independent contractors making sales calls in other states. The Department of Treasury argued that "in the absence of an office, a plant, or a small sales force establishing a physical presence in each foreign state no substantial nexus exist[ed]."[15]

The Michigan Tax Tribunal held that sales made to all but New Jersey and New York were required to be thrown back. It found that, unlike in *Magnetek Controls, Inc, v. Department of Treasury*, a Michigan Court of Appeals decision finding that a corporation had substantial nexus based on solicitation by its employees, the amount of the solicitation was not sufficient to justify a finding of substantial nexus.[16] The Michigan Tax Tribunal stated that "[the taxpayer's] sales activity followed by a two to four day visit by the company President does not constitute a sufficient physical presence to establish a nexus with the aforementioned states."[17]

The Michigan Tax Tribunal did, however, abate late payment penalties because the taxpayer had an "honest difference of opinion" on the substantial nexus question. The Michigan Tax Tribunal explained:

> [D]ue to the unclear nature of this issue and the threshold to be met, the Tribunal holds that, based on these facts, a penalty is inappropriate. . . . Considering that there was "an honest difference of opinion" imposition of a penalty is inappropriate. Furthermore, the area of "substantial nexus" is evolving as evidenced by *Magnetek* currently on appeal before the Michigan Supreme Court. Petitioner brought forth several cases in support of its position, and the challenge to the Single Business Tax was neither frivolous nor capricious.[18]

State Taxing Agency's Prior Conduct or Statement

In *Universal Instruments Corp. v. Commissioner of Revenue*, the Massachusetts Appellate Tax Board held that a corporation acted with reasonable cause in not filing returns or paying the corporation excise tax ("CET").[19] The substantive issue involved whether Public Law 86-272 protected the corporation from being subject to the CET. The Massachusetts Appellate Tax Board found that the company's consignment of inventory in and contacts with Massachusetts exceeded those activities protected by Public Law 86-272.

The Appellate Tax Board found that the corporation had reasonable cause for not filing, in part, because the Department of Revenue's "prior practices" with the taxpayer (*i.e.*, for earlier periods) was to not assert nexus based on consignment of inventory in Massachusetts.

The Massachusetts Department of Revenue also asserted late filing penalties. The Massachusetts statute provided for a waiver of the late filing penalty "if it is shown that any failure to file a return . . . is due to reasonable cause and not due to willful neglect."[20] The Appellate Tax Board found that the corporation had reasonable cause for not filing, in part, because the Department of Revenue's "prior practices" with the taxpayer

(*i.e.*, for earlier periods) was to not assert nexus based on consignment of inventory in Massachusetts.[21] The court also noted that the taxpayer's position was supported by existing Massachusetts case law that was subsequently invalidated by a U.S. Supreme Court decision.

In *Media Graphics, Inc. v. Director, Division of Taxation*, a sales tax case, the Tax Court of New Jersey addressed penalties where the taxpayer claimed to have relied on a statement of the New Jersey Division of Taxation.[22] The substantive issue involved whether certain sales of tangible personal property that was produced by the corporation ("Media Graphics") and sent by United States mail to customers outside of New Jersey were subject to sales tax in the State. The Tax Court determined that the sales took place in New Jersey and were, thus, subject to the sales tax.

... the director's statement in the State Tax News that certain sales were not taxable was sufficiently misleading in the circumstances of this case to warrant the abatement of interest and penalty.

Media Graphics unsuccessfully argued that the location where a sale takes place is determined by where delivery takes place. It argued that statements of the Division of Taxation in *State Tax News* supported its position. The publication stated that "taxability is limited to those transactions in which either '(1) the vendee takes delivery or possession of the tangible personal property upon purchase in this State or (2) the vendor is required to deliver tangible personal property, by means of his own vehicles and employees, a common carrier, parcel post or the United States mails, to a destination within this State.'"[23] The publication further provided that "sales are not taxable 'where the vendor, as a condition of the sale, is required to deliver the tangible personal property to the vendee, by means of the vendors['] own vehicles and employees, a common carrier, parcel post or the United States mails, to a destination outside this State.'"[24]

Ultimately, the Tax Court held that because title to the products passed when Media Graphics delivered the products to the United States post office in New Jersey, the transactions were subject to sales tax. However, the Tax Court held that penalties (and interest) should be abated, stating that:

> Nonetheless, I am persuaded that the director's statement in the State Tax News that certain sales were not taxable was sufficiently misleading in the circumstances of this case to warrant the abatement of interest and penalty. In the State Tax News the director announced to taxpayers that sales would not be taxable "where the vendor, as a condition of the sale, is required to deliver the tangible personal property to the vendee, by means of . . . the United States mails, to a destination outside this State." Plaintiff's challenge to the assessment was based in large measure on this directive. A taxpayer should not be made to pay additional interest and a penalty when its position is reasonably based upon the director's published statement.[25]

Conclusion

The above scenarios are only a few of the instances in which taxpayers should not be subjected to penalties. Although state taxing agencies may choose not to assert penalties in such situations, sometimes it is necessary to litigate in order to defend against penalties.

1 *See, e.g.*, Mass. Gen. L. ch. 62C, § 33(a), (b); N.C. Gen. Stat. § 105-236(a)(5)(a); N.Y. Tax Law § 1085(a)(1), (a)(2), (a)(3), (k).

2 This article does not address amnesty penalties.

3 No. 09-ALJ-17-0160-CC (S.C. Admin. Law Ct. Apr. 22, 2010), *rev'd on substantive grounds other than penalties*, 725 S.E.2d 711 (S.C. Ct. App. 2012), *cert. granted*, (S.C. Aug. 29, 2013).

4 *CarMax*, No. 09-ALJ-17-0160-CC (citing S.C. Code Ann. § 12-54-43(F)(1) (2000)).

5 *Id.* (citing S.C. Code Ann. § 12-54-43(F)(3) (2000)).

6 *Id.*

7 *Id.* (emphasis added).

8 *Id.*

9 *Id.* (citing S.C. Code Ann. § 12-54-155(B)(2)(b) (2000 and Supp. 2009)).

10 *Id.* (citing S.C. Code Ann. § 12-54-155(D)(1) (2000 and Supp. 2009)).

11 *Id.*

12 *Id.*

13 Nos. 227850, 239890 (Mich. Tax Trib. July 15, 1997), *rev'd*, No. 207207 (Mich. Ct. App. June 18, 1999), s*ubsequent proceeding at* Nos. 227850, 239890 (Mich. Tax Trib. Sept. 24, 1999).

14 *Gear Research*, Nos. 227850, 239890.

15 *Id.*

16 *Id.* (citing 562 N.W.2d 219 (Mich. Ct. App. 1997)).

17 *Id.*

18 *Id.*

19 Nos. 196059-60 (Mass. App. Tax Bd. Apr. 17, 1998).

20 *Id.* (citing Mass. Gen. Laws ch. 62C, § 33(f)).

21 *Id.*

22 7 N.J. Tax 23 (Tax Ct. 1984), *aff'd*, 8 N.J. Tax 321 (Super. Ct. App. Div. 1986).

23 7 N.J. Tax at 27-28.

24 *Id.* at 28.

25 *Id.* at 34.

DUELING "DOING BUSINESS" INTERSTATE-COMMERCE EXEMPTIONS: ANACHRONISTIC OR REALISTIC?

By Amy F. Nogid

While tax professionals often address, and are familiar with, state *tax* registration requirements, qualification or registration with state attorneys general of "foreign" businesses "doing business" in states other than their state of incorporation is often a task relegated to corporate counsels.[1] However, as businesses more frequently operate in multiple jurisdictions, a critical element of a tax professional's arsenal of knowledge should include familiarity with state registration requirements. Unfortunately, the seemingly basic task of determining the level of activity that constitutes "doing business" for registration purposes is often unclear. In reviewing the standards for "doing business," one is reminded of Justice Potter Stewart's "standard" for determining what constitutes obscenity: "I know it when I see it," which is hardly a standard at all.[2]

In reviewing the standards for "doing business," one is reminded of Justice Potter Stewart's "standard" for determining what constitutes obscenity: "I know it when I see it," which is hardly a standard at all.

Further complicating the determination are the varying "doing business" standards: state tax imposition standards differ from those employed under state registration statutes. In fact, it is not unusual for a single jurisdiction to apply three different "doing business" thresholds for: (1) personal jurisdiction; (2) tax jurisdiction; and (3) business registration.[3] While rationales can be crafted for having different standards, the current lack of a single, consistent definition for "doing business"—at least for qualification and tax imposition, both of which are guided by Commerce Clause concerns—is a trap for the unwary. In addition, the registration exemption for interstate commerce, and potentially other registration exemptions, may be an unfortunate by-product of the failure of the state registration laws to "catch up" to tax law precedents.

In this article, the history of state registration requirements for foreign corporations will be briefly discussed, including the exception found in most qualification statutes for businesses engaged in "interstate commerce." Some background will be provided regarding the U.S. Supreme Court's views as to the extent of the protection afforded to interstate commerce by the Commerce Clause. A sampling will then be provided of states' "doing business" provisions under their registration statutes, with some examples of how such definitions vary from those under tax imposition provisions. The article will next address the lack of parity between tax jurisdiction and non-tax registration requirements with respect to interstate commerce.

... state tax imposition standards differ from those employed under state registration statutes.

Historical Background of State Registration Requirements for Foreign Corporations

Corporations are creatures of state law. The state of incorporation provides the corporation with the right "to be" and requires that the corporation comply with the state's laws or be divested of that right to exist. Historically, foreign corporations could "have no legal existence beyond the sovereignty where it is created, and unless it is engaged in interstate commerce, or is employed by the federal government, [it] has no right to enter another state except by the consent of the latter."[4] Without such consent, state registration statutes, sometimes referred to as "door-closing" statutes, prohibit foreign corporations from transacting business in the state.

Although state registration provisions vary, failure to comply with state registration requirements often results in (1) imposing penalties, (2) treating as void contracts made in the state or (3) barring a corporation from maintaining a suit or interposing counterclaims in the state's courts. Some state courts have held that the failure of a corporation to qualify is waived if not raised timely, while other state courts have allowed the defense to be raised at any time during the litigation.[5] Certain states permit a noncompliant foreign corporation to cure its registration defect, even after litigation is commenced, while other states bar enforcement of in-state contracts if the foreign corporation was not qualified when the contract was executed.[6]

The American Bar Association's ("ABA's") comments to the Model Business Corporation Act ("MCBA") also recognize the lack of precision in the negative definition of "doing business" and advise against the imposition of harsh penalties or sanctions as "inappropriate."[7]

The Commerce Clause's Protection of Interstate Commerce

A state's right to withhold consent to a foreign corporation seeking to do business in the state is not limitless. A state can bar a foreign corporation from engaging in a purely local

business in the state, but the state cannot prohibit a business from engaging in interstate commerce.[8] The Commerce Clause provides that "Congress shall have Power . . . to regulate Commerce . . . among the several states" and ensures that states do not abuse their power by impinging on interstate commerce.[9]

In drafting the U.S. Constitution, its framers recognized the importance of regulating interstate commerce.[10] Before the adoption of the Constitution, the states exercised sovereign power, under no limitations other than those contained in the Articles of Confederation, wherein it was declared that "no State shall lay any imposts or duties which may interfere with any stipulations in treaties entered into by the United States in Congress assembled."[11] Alexander Hamilton, one of the framers of the Constitution, noted the problems with the Articles of Confederation:

> The interfering and unneighborly regulations of some States, contrary to the true spirit of the Union, have, in different instances, given just cause of umbrage and complaint to others, and it is to be feared that examples of this nature, if not restrained by a national control, would be multiplied and extended until they became not less serious sources of animosity and discord than injurious impediments to the intercourse between the different parts of the Confederacy.[12]

In drafting the U.S. Constitution, its framers recognized the importance of regulating interstate commerce.

The restrictions on state regulation of interstate commerce—which were viewed as applying uniformly to both business qualification and taxation—were succinctly summarized by the U.S. Supreme Court in 1890:

> [N]o state has the right to lay a tax on interstate commerce in any form, whether by way of duties laid on the transportation of the subjects of that commerce, or on the receipts derived from that transportation, or on the occupation or business of carrying it on, for the reason that such taxation is a burden on that commerce, and amounts to a regulation of it, which belongs solely to Congress.[13]

So, what precisely is interstate commerce? The U.S. Supreme Court has viewed it broadly as including "every species of commercial intercourse" that "concerns more States than one."[14] It has been defined by regulation as:

> Trade, traffic, or transportation in the United States— (1) Between a place in a State and a place outside of such State (including a place outside the U.S.); (2) Between two places in a State through another State or a place outside the United States; or (3) Between two places in a State as part of trade, traffic, or transportation originating or terminating outside the State or the U.S.[15]

Determining whether a local activity of interstate commerce was protected from state regulation or could be subject to federal regulation as part of interstate commerce became an exercise in legal gymnastics.

However, interstate commerce often has *intrastate* components, that is, elements of the business that are local and that would result in a permanent establishment in the state, such as an office, manufacturing plant, warehouse, store or employees based therein. Activities such as manufacturing and mining have been held to be *intrastate* activities, but the shipping of the manufactured or mined goods could constitute a separate *interstate* activity.[16] Such *intrastate* activities are encompassed within the scope of the Commerce Clause.[17]

Determining whether a local activity of interstate commerce was protected from state regulation or could be subject to federal regulation as part of interstate commerce became an exercise in legal gymnastics. Sophistic distinctions were made between activities that had a "direct" impact on interstate commerce and those that only had an "indirect" impact on interstate commerce with states being barred from regulating and taxing the former but not the latter.[18] Another formalistic distinction, embodied by the Court, was between the regulation or exaction for the "privilege" of engaging in interstate business, versus the regulation or exaction based on the receipt of net income from interstate business, the former being unconstitutional, while the latter was allowed.[19]

With technological changes and the modernization of transportation came the increased ability for businesses to engage in interstate commerce. So, too, grew the states' attempts to garner revenue from subjecting such interstate activities to tax, resulting in more puzzling pronouncements from the Court. In 1959, in *Northwest Portland Cement v. Minnesota,* the Court upheld a net income tax on a business engaged exclusively in interstate commerce, maintaining the distinction between the acceptable—interstate commerce being used to measure the tax—and the unacceptable—interstate commerce being the subject of the imposition of the tax.[20]

In 1977, the Court decided *Complete Auto Transit, Inc. v. Brady*, which explicitly overruled *Spector Motor Service,*

Inc. v. O'Connor, and held that there was no bar to taxing the "privilege" of engaging in interstate commerce, as long as: (1) the tax is applied to an activity with a substantial nexus with the taxing state; (2) the tax is fairly apportioned; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to the services provided by the state.[21]

In following Justice Rutledge's practical approach in his concurring decision in *Freeman v. Hewitt* that the propriety of "a state tax or *regulation*" "be judged by its economic effects rather than its formal phrasing," the Court stated, in *Complete Auto Transit*, that the "philosophy underlying" the former *per se* immunity of interstate commerce "has been stripped of any practical significance."[22] Despite the general consensus that taxation is but one form of regulation and both qualification requirements and tax imposition provisions are governed by the same Commerce Clause concerns against burdening interstate commerce, state registration and qualification provisions and interpretive case law still retain outmoded protections for businesses engaged in interstate commerce.

States, many of which comport with the MBCA, often avoid defining "doing business" in their qualification statutes and will simply list activities that do not constitute "doing business."

State Definitions of "Doing Business" for Registration Purposes

The ABA's MBCA employs a list of representative activities that *do not* establish that a company is transacting business in a state for registration purposes. Comments to the MBCA state that the definition of doing business "is not applicable to other questions such as whether the corporation is amenable to service of process under state 'long-arm' statutes or liable for state or local taxes."[24] However, the MBCA comments also state that "[a] corporation that has obtained (or is required to obtain) a certificate of authority to transact business [as a foreign corporation] will generally be subject to suit and state taxation in the state, while a corporation that is subject to service of process or state taxation in a state will not necessarily be required to obtain a certificate of authority [as a foreign corporation]."[25]

States, many of which comport with the MBCA, often avoid defining "doing business" in their qualification statutes and will simply list activities that *do not* constitute "doing business."[26]

Perhaps the most interesting exception from "doing business" is the exception for engaging in interstate commerce. As discussed above, while the original view of the U.S. Supreme Court had been to absolutely bar state regulation of exclusively interstate commerce, that bar eroded over time and became obsolete with the Court's decision in *Complete Auto Transit*, which approved, in the context of state taxation, the state's regulation of local incidences of interstate commerce, if the four-pronged test set forth by the Court was met. Although many states' "doing business" registration provisions explicitly provide that they do not apply for determining personal jurisdiction and/or tax jurisdiction, the Court's post-*Complete Auto Transit* view of the Commerce Clause's limitation on interstate commerce should apply equally in the qualification arena and would allow qualification statutes to now take a more limited view of interstate commerce.[27] States can, of course, choose to continue to apply a more expansive view of interstate commerce.

Distinctions Between "Doing Business" for Registration and Tax Imposition Purposes

There are some notable distinctions between the scope of "doing business" under qualification and tax imposition provisions.[28] Generally, the exemptions from "doing business" for registration purposes hail from an earlier time, which had kinder and gentler—and more reasonable—views of "doing business." For example, isolated transactions usually do not trigger registration by a foreign corporation, while very limited in-state presence is often viewed as sufficient to create nexus for tax imposition purposes.[29] Although the U.S. Supreme Court stated that "the venerable maxim *de minimis non curat lex* ('the law cares not for trifles') is part of the established background of legal principles against which all enactments . . . (absent contrary indication) are deemed to accept," states have not traditionally viewed nexus determinations with that caveat in mind.[30]

Generally, the exemptions from "doing business" for registration purposes hail from an earlier time, which had kinder and gentler—and more reasonable—views of "doing business."

The mere ownership of in-state real or tangible personal property without more is generally insufficient to require that a foreign corporation register. However, the same cannot be said under state tax imposition provisions.[31] Given that the existence of a "physical presence" does not activate registration requirements in most states, it is not surprising that state qualification statutes do not embrace economic nexus concepts and, unlike the position taken by many states for state tax imposition purposes, the existence of in-state intangible property would likely not constitute "doing business" for qualification purposes.[32] While state registration

statutes adhere to traditional notions of "doing business" by giving effect to the commonly understood notion of "doing" as requiring activity, states are broadening their definitions of "doing business" for tax purposes to morph activity into passivity. Thus, in the tax context, states have asserted that the mere receipt of income from intangible property used by others in the state is sufficient to establish "substantial nexus" and trigger tax filing obligations. Further, despite the continuing expansion of the "doing business" definition in taxing provisions, certain jurisdictions still retain time-honored exclusions found in many qualification provisions, such as the exclusion for maintaining bank accounts in the state.[33]

While most states' qualification statutes have stricter standards for determining "doing business" than under those states' tax imposition statutes—and corporations should not assume that the lower tax "doing business" standards apply in the context of foreign corporation registration requirements—it is not abundantly clear why the differing "doing business" standards should continue to exist.

Another difference between the registration and tax requirements is that qualification statutes focus only on the entity in question, while states often look to the activities of a corporation's affiliates and independent contractors in determining whether the corporation is "doing business" in the state for tax purposes.[34]

As these examples illustrate, a foreign corporation that is subject to a state's tax laws may not have a registration requirement. However, corporations should be aware that by qualifying to do business in a state—without any in-state activity—a foreign corporation may actually create tax nexus.[35]

While most states' qualification statutes have stricter standards for determining "doing business" than under those states' tax imposition statutes—and corporations should not assume that the lower tax "doing business" standards apply in the context of foreign corporation registration requirements—it is not abundantly clear *why* the differing "doing business" standards should continue to exist.[36] New York State's Secretary of State confirmed its position that "a higher level of contact [is necessary] to involve the qualification requirement" than under the tax statutes.[37] The Secretary explained that the higher threshold is appropriate for qualification on the basis that qualification requires that a foreign corporation's in-state business be "permanent, continuous, and regular" before it can be made to register and that it is "not the quantum but rather the nature of the business" that determines whether a foreign corporation must register.[38] Further, and as discussed above, some secretaries of state continue to rely on time-worn and arguably obsolete case law to provide blanket protection from registration requirements for corporations engaged entirely in interstate commerce.[39]

The same legislatures that have chosen to only require foreign businesses with a permanent location in the state or having continuous and regular businesses to qualify, should be urged to adopt the same–more reasonable–"doing business" thresholds for tax purposes, particularly given that both thresholds are under the same regulatory umbrella and are both governed by Commerce Clause concerns.

A Push for Parity

The explosive expansion of corporations' multistate operations coupled with the developments in Commerce Clause jurisprudence suggest that state legislatures take a page from their foreign business registration statutes and adopt, for state tax imposition purposes, definitions that ensure that interstate commerce is not unduly burdened. The unfortunate trend of states adopting provisions or implementing policies subjecting foreign corporations engaged in *de minimis* activities or having limited presence in the state to taxation is an unwarranted disconnect with the qualification statutes.

While state registration statutes may be outdated and updates to the exclusion for interstate commerce could be made to conform to developments in Commerce Clause jurisprudence, parity would best be achieved by heightening the "doing business" thresholds for tax purposes rather than lowering those for qualification. Keeping the four prongs of *Complete Auto Transit* in mind, legislatures should adopt consistent, reasonable and objective *de minimis* standards for both qualification and tax purposes, such as excluding from "doing business" in-state isolated, casual and sporadic transactions and activities, and should avoid the fiscal allure of economic nexus and other tenuous nexus standards.

Given states' unwillingness to follow *Quill* and *Complete Auto Transit*, Congress should consider adopting or mandating state enactment of uniform standards for "doing business" for qualification and tax imposition purposes (for all tax types as envisioned by the Commerce Clause).[40]

1 "Qualification" and "registration" will be used interchangeably in this article, and will refer to state registration requirements for foreign corporations that do business in the state. Further, although many types of business entities, *e.g.*, limited liability companies, nonprofit corporations, limited partnerships and limited liability partnerships, may be subject to state registration requirements, this article focuses only on business corporations.

2 *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964).

3 The "doing business" threshold for personal jurisdiction is not addressed in this article.

4 Elcanon Isaacs, *An Analysis of Doing Business*, 25 Colum. L. Rev. 1018, 1019 (1925).

5 Compare *Cox v. Doctor's Assoc., Inc.*, 613 N.E.2d 1306 (Ill. Ct. App., 5th Dist. 1993) (holding that the defense was waived because it was not raised until after the trial) with *Christian Servs., Inc. v. Northfield Villa, Inc.*, 385 N.W.2d 904 (Neb. 1986) (holding that the defense could be raised at any time during the pendency of litigation).

6 *See* Model Corporation Business Act § 15.02(c); *Uribe v. Merchants Bank of N.Y.*, 697 N.Y.S.2d 279 (1st Dep't 1999) (stating that the failure to register could be cured at any time prior to the resolution of the action); *Hays Corp. v. Bunge*, 777 So. 2d 62 (Ala. 2000) (dismissing a case that was commenced by a corporation that was not qualified in the State).

7 MCBA § 15.02 (2005)-Official Comment.

8 *Railway Express Agency v. Virginia*, 282 U.S. 440 (1931) (holding that a state can bar an unregistered company from engaging in intrastate commerce).

9 Art. I, Sec. 8, Clause 3.

10 *The Federalist* Nos. 6, 7, 11, 22 (Alexander Hamilton).

11 Art. 6, Sec. 3.

12 *The Federalist* No. 22 (Alexander Hamilton).

13 *Lyng v. Michigan*, 135 U.S. 161, 166 (1890).

14 *Gibbons v. Ogden*, 22 U.S. 1, 193-94 (1824).

15 49 CFR 390.5.

16 *Carter v. Carter Coal Co.*, 298 U.S. 238, 303 (1936) (stating that "[o]ne who produces or manufactures a commodity, subsequently sold and shipped by him in interstate commerce, whether such sale and shipment were originally intended or not, has engaged in two distinct and separate activities. So far as he produces or manufactures a commodity, his business is purely local. So far as he sells and ships, or contracts to sell and ship, the commodity to customers in another state, he engages in interstate commerce. In respect of the former, he is subject only to regulation by the state; in respect of the latter, to regulation only by the federal government").

17 *See, e.g., Houston, E. & W. T. R. Co. v. U.S.*, 234 U.S. 342, 351-52 (1914) (stating that "[w]herever the interstate and intrastate transactions of carriers are so related that the government of the one involves the control of the other, it is Congress, and not the State, that is entitled to prescribe the final and dominant rule").

18 *See, e.g., Santa Cruz Fruit Packing Co. v. NLRB*, 303 U.S. 453, 466-67 (1938) (stating that "where federal control is sought to be exercised over activities which separately considered are intrastate, it must appear that there is a close and substantial relation to interstate commerce in order to justify the federal intervention for its protection. However difficult in application, this principle is essential to the maintenance of our constitutional system . . . . 'Activities local in their immediacy do not become interstate and national because of distant repercussions.'") (internal citations omitted).

19 *Spector Motor Serv., Inc. v. O'Connor*, 340 U.S. 602 (1951) (holding that the Connecticut privilege tax, which was nondiscriminatory and fairly apportioned, was invalid on the basis that a state could not tax a federal privilege—interstate commerce).

20 358 U.S. 450, 457 (1959).

21 430 U.S. 274 (1977).

22 *Complete Auto Transit*, 430 U.S. at 288.

23 *See, e.g., Freeman v. Hewitt*, 329 U.S. 249, 253 (noting that attempts to tax interstate commerce are "more carefully scrutinized and more consistently resisted than police power regulations"); Scott Specht, *State Taxation of Interstate Business: An End to the Privilege Tax Immunity*, 29 U. Fla. L. Rev. 752, 753, n.12 (1976-1977) (stating that "[t]axation is a form of regulation[]").

24 MBCA § 15.01(2005)-Official Comment.

25 *Id.*

26 Common activities that are statutorily excluded from "doing business" include: (1) maintaining or defending any action or proceeding, whether judicial, administrative, arbitrative or otherwise, or effecting settlement thereof or the settlement of claims or disputes; (2) holding meetings of directors or shareholders; (3) maintaining bank accounts; (4) maintaining offices or agencies only for the transfer, exchange and registration of securities or appointing and maintaining trustees or depositaries with relation to securities; (5) selling through independent contractors; (6) soliciting orders by mail, through employees, agents or otherwise, if the orders require acceptance outside the state before becoming binding contracts; (7) creating as borrower or lender or acquiring debt or other security interests in real or personal property; (8) securing or collecting debts or enforcing rights in property securing debts; (9) conducting an isolated transaction that is completed within 30 days and that is not part of a course of repeated transactions of a similar nature; (10) conducting affairs in interstate (and/or foreign) commerce; (11) owning, without more, real or personal property; (12) being a limited partner of a limited partnership or a member of a limited liability company; (13) owning and controlling a subsidiary incorporated in or transacting business within the state; (14) serving as a trustee, executor, or guardian or in a like fiduciary capacity; (15) having a corporate officer or director resident in the state; (16) acquiring and disposing of property or a property interest, not as a part of any regular business activity; and (17) the production of motion pictures.

27 *See, e.g.*, Colo. Rev. Stat. § 7-90-801(4); Fla. Stat. § 607.1501(4); Kan. Stat. Ann. § 17-7303(c); Ky. Rev. Stat. Ann. § 14A.9-010(5); Nev. Rev. Stat. § 80.015(4); N.D. Cent. Code § 10-19.1-143(4).

28 This discussion is general in nature and readers are reminded to carefully review each particular state's provisions, along with the related interpretive guidance and case law under both the qualification and tax imposition provisions. "[D]oing business" is generally a statutorily defined term and "nexus" in the context of state tax is a term of art that is often used interchangeably with "substantial nexus," *i.e.*, the connection required from a constitutional vantage point to support the state's imposition of taxes. Despite the technical and legal distinctions between state tax "doing business" definitions and "nexus," "nexus" will be used here as a shorthand for "doing business for tax purposes."

29 *Ariz. Dep't of Revenue v. Care Computer Sys., Inc.*, 4 P.3d 469 (Ariz. Ct. App. 2000) (holding that seven visits by out-of-state personnel within a seven year period to solicit business and follow up on business opportunities was deemed sufficient to establish nexus); Cal. Tax Code § 23104 (providing that an out-of-state corporation will not be deemed to be doing business within the State if it does not engage in convention and trade show activities for more than seven days and does not derive more than $10,000 from such activities). *But see Fla. Dep't of Revenue v. Share Int'l, Inc.*, 667 So. 2d 226 (Fla. Ct. App., 1st Dist. 1995), *dec. approved*, 676 So. 2d 1362 (Fla. 1996), *cert. denied*, 519 U.S. 1056 (1997) (holding that there was no nexus despite displaying and selling products at a three-day affiliate-sponsored seminar and the presence of an in-state affiliate); *In re Appeal of Intercard, Inc.*, 14 P.3d 1111 (Kan. 2000) (holding that 11 visits over a four year period were insufficient to establish nexus).

30 *Wisconsin Dep't of Revenue v. William Wrigley, Jr. Co.*, 505 U.S. 214, 231 (1992).

31 In a recent survey of state tax departments, with very rare and limited exceptions, owning or leasing property in a state establishes tax nexus. One exception is Tennessee's position that the ownership of raw land producing no income does not trigger nexus. Bloomberg BNA, *2013 Survey of State Tax Departments*, Tax Mgmt. Multistate Tax Report (Apr. 26, 2013) ("2013 BNA Survey") at S-44-S-46.

32 Many states now believe the use of intangible property (*e.g.*, intellectual property, software) as establishing tax nexus. 2013 BNA Survey at S-56-S-57.

33 The 2013 BNA Survey lists all jurisdictions, other than Arkansas, California, the District of Columbia, Louisiana, New Hampshire and West Virginia as excluding maintaining a bank accountant as creating tax nexus. *Id.* at S-40-S-42.

34 *See, e.g., Tyler Pipe Indust., Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232 (1987) (holding that Washington could impose its business and occupation tax on an out-of-state wholesaler that had no office, property or employees in Washington based solely on the solicitation of business by an independent contractor that was in Seattle). *But see Barnesandnoble.com LLC v. State Bd. of Equalization*, CGC-06-456465 (Cal. Super. Ct., San Francisco County Oct. 12, 2007) (holding that an online vendor did not have nexus based on its affiliates' activities).

35 The 2013 BNA Survey lists 13 jurisdictions where registration of a foreign corporation is sufficient to establish nexus. *But see, e.g., Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. Ct. App., 3d Dist. 2000) (stating that the franchise tax could not be imposed under the Due Process Clause on the sole basis that the company had a certificate of authority to do business in Texas).

36 *See, e.g., Begole Aircraft Supplies, Inc. v. Pacific Airmotive Corp.*, 121 Colo. 88, 89-90 (1949) (suggesting that there is no distinction between tax imposition and qualification "doing business" standards).

37 N.Y.S. Dep't of State-General Counsel, "*Doing Business*" *in New York: An Introduction to Qualification* (Feb. 2000), http://www.dos.ny.gov/cnsl/do_bus.html ("NYS Counsel Memo").

38 *Id.*; *see also Filmakers Releasing Org. v. Realart Pictures of St. Louis, Inc.*, 374 S.W.2d 535, 539 (Mo. Ct. App., St. Louis Dist. 1964) (concluding that "the greatest amount of business activity is required to subject a corporation to the State's statutory qualification requirements").

39 *See, e.g.*, NYS Counsel Memo.

40 *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). Numerous bills have been introduced to address state tax imposition issues. *See, e.g.*, H.R. 2992: Business Activity Tax Simplification Act of 2013; S. 336, S.743, H.R. 684: Marketplace Fairness Act (2013); H.R. 1129: Mobile Workforce State Income Tax Simplification Act of 2013; S.31: Permanent Internet Tax Freedom Act of 2013; S. 1364: Digital Goods and Services Tax Fairness Act of 2013.

ABB v. Missouri
Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
AE Outfitters Retail v. Indiana
American Power Conversion Corp. v. Rhode Island
Citicorp v. California
Citicorp v. Maryland
Clorox v. New Jersey
Colgate Palmolive Co. v. California
Consolidated Freightways v. California
Container Corp. v. California
Crestron v. New Jersey
Current, Inc. v. California
Deluxe Corp. v. California
DIRECTV, Inc. v. Indiana
DIRECTV, Inc. v. New Jersey
Dow Chemical Company v. Illinois
DuPont v. Michigan
EchoStar v. New York
Express, Inc. v. New York
Farmer Bros. v. California
General Motors v. Denver
GMRI, Inc. (Red Lobster, Olive Garden) v. California
GTE v. Kentucky
Hair Club of America v. New York
Hallmark v. New York
Hercules Inc. v. Illinois
Hercules Inc. v. Kansas
Hercules Inc. v. Maryland
Hercules Inc. v. Minnesota
Hoechst Celanese v. California
Home Depot v. California
Hunt-Wesson Inc. v. California
IGT v. New Jersey
Intel Corp. v. New Mexico
Kohl's v. Indiana
Kroger v. Colorado
Lorillard Licensing Company v. New Jersey
McGraw-Hill, Inc. v. New York
MCI Airsignal, Inc. v. California
McLane v. Colorado
Mead v. Illinois
Meredith v. New York
Nabisco v. Oregon
National Med, Inc. v. Modesto
Nerac, Inc. v. New York
NewChannels Corp. v. New York
OfficeMax v. New York
Osram v. Pennsylvania
Panhandle Eastern Pipeline Co. v. Kansas
Pier 39 v. San Francisco
Powerex Corp. v. Oregon
Reynolds Metals Company v. Michigan
Reynolds Metals Company v. New York
R.J. Reynolds Tobacco Co. v. New York
San Francisco Giants v. San Francisco
Science Applications International Corporation v. Maryland
Scioto Insurance Company v. Oklahoma
Sears, Roebuck and Co. v. New York
Shell Oil Company v. California
Sherwin-Williams v. Massachusetts
Sparks Nuggett v. Nevada
Sprint/Boost v. Los Angeles
Tate & Lyle v. Alabama
Toys "R" Us-NYTEX, Inc. v. New York City
Union Carbide Corp. v. North Carolina
United States Tobacco v. California
UPS v. New Jersey
USV Pharmaceutical Corp. v. New York
USX Corp. v. Kentucky
Verizon Yellow Pages v. New York
Wendy's International, v. Illinois
Wendy's International v. Virginia
Whirlpool Properties v. New Jersey
W.R. Grace & Co.—Conn. v. Massachusetts
W.R. Grace & Co. v. Michigan
W.R. Grace & Co. v. New York
W.R. Grace & Co. v. Wisconsin

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