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Rethinking Tax Nexus and Apportionment: Voice, Exit, and the Dormant Commerce Clause

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RETHINKING TAX NEXUS AND APPORTIONMENT: VOICE, EXIT, AND THE DORMANT COMMERCE CLAUSE

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I. INTRODUCTION

Few have kind words for the constitutional requirement that states may only tax persons with physical presence within the taxing state. In *Quill Corporation v. North Dakota*, the U.S. Supreme Court, affirming the physical presence test for at least some dormant Commerce Clause purposes, held that the states lack tax nexus to out-of-state mail order sellers.[1] States accordingly cannot impose upon such sellers the obligation to collect use taxes. The precise contours of *Quill* and its physical presence requirement remain unclear. Many courts and commentators have criticized that requirement.[2] The physical presence test for tax nexus is, we are told, an anachronism in a modern economy, an artifact of an earlier time begrudgingly perpetuated by the Court in a misguided application of stare decisis.

The dormant Commerce Clause is also understood as requiring states taxing multistate actors to impose taxes which are properly apportioned to the activity occurring within the taxing state.[3] Unlike the dormant Commerce Clause rule requiring physical presence in the taxing state, the rule of apportionment is doctrinally noncontroversial. The application of that rule is, however, another matter. In particular, New York's taxation of nonresidents' incomes using its "convenience of the employer" rule has engendered significant controversy as violating the constitutional requirement of apportionment.[4]

Responding to the claim that dormant Commerce Clause nondiscrimination is doctrinally incoherent in tax cases, Professor Brannon Denning implies that the concepts of nexus and

[1] Quill Corp. v. North Dakota, 504 U.S. 298, 311, 317–18 (1992).

[2] *See infra* notes 267-294 and accompanying text.

[3] *See infra* notes 134-190 and accompanying text.

[4] Controversy which, I freely confess, I have helped to create. *See infra* notes 180-189 and accompanying text, concerning New York's "convenience of the employer" rule for taxing nonresidents' incomes.

apportionment are at least as problematic, perhaps more so.[5] Professor Denning thereby suggests that, if the dormant Commerce Clause notion of discrimination is to be abandoned as unworkable,[6] the nexus and apportionment tests suffer from the same theoretical malady.[7]

I write to take current stock of the dormant Commerce Clause tax concepts of nexus and apportionment and to assess the trajectories on which these constitutional concepts are traveling. Specifically, I find it fruitful to approach nexus and apportionment in the context of what Professor Hirschman famously called the "voice" and "exit" options,[8] i.e., taxpayers' ability to resist taxation through the political process of the taxing state and to depart the taxing state for a more favorable tax environment. From this vantage, the Commerce Clause concept of tax nexus is best understood as a rough, but serviceable, proxy for the taxpayer's standing in the political process. This perspective leads me to defend *Quill* and the much maligned physical presence test for tax nexus. As a matter of legislative policy, the critics of this test may be correct. However, as a matter of constitutional law, the courts should adhere to an expanded physical presence standard as Congress crafts for the long term broader nexus rules based on economic presence.

Taxation is an inherently and irreducibly political matter. An expanded notion of physical presence is a rough, but serviceable, proxy for taxpayers' practical abilities to protect themselves in the

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[5] *See* Brannon P. Denning, *Is the Dormant Commerce Clause Expendable? A Response to Edward Zelinsky*, 77 MISS. L.J. 623 (2007); Edward A. Zelinsky & Brannon P. Denning, Debate, *The Future of the Dormant Commerce Clause: Abolishing the Prohibition on Discriminatory Taxation,* 155 U. PA. L. REV. PENNUMBRA 196 (2007), *available at* http://www.pennumbra.com/debates/debate.php?did=7.

[6] *See* Zelinsky & Denning, Debate *supra* note 5; Edward A. Zelinsky, *The Incoherence of Dormant Commerce Clause Nondiscrimination: A Rejoinder to Professor Denning,* 77 MISS. L. J. 653 (2007); Edward A. Zelinsky, *Davis v. Dep't of Revenue: The Incoherence of Dormant Commerce Clause Nondiscrimination,* 44 ST. TAX NOTES 941 (June 25, 2007), reprinted at 118 TAX NOTES 57 (July 2, 2007); Edward A. Zelinsky, *Restoring Politics to the Commerce Clause: The Case for Abandoning The Dormant Commerce Clause Prohibition on Discriminatory Taxation,* 29 OHIO N.U. L. REV. 29 (2002) [hereinafter Zelinsky, *Restoring*].

[7] *See* Zelinsky & Denning, Debate, *supra* note 5, at 202 ("[W]e might as well do away with the [dormant Commerce Clause doctrine] altogether, since the antidiscrimination principle is the [dormant Commerce Clause doctrine's] most robust branch.").

[8] ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 21, 30 (1970).

political process of the taxing state. A physical presence test for tax nexus thereby protects, albeit imperfectly, against the modern version of taxation without effective representation.

In similar fashion, the dormant Commerce Clause rule of tax apportionment serves four functions. First, apportionment constrains a state from exporting taxes by targeting immobile taxpayers who lack practical exit options to leave the state. Second, apportionment minimizes the out-of-state disruption stemming from taxpayer exit by ameliorating the mobile taxpayer's need to depart the taxing jurisdiction. Third, the constitutional principle of apportionment, by minimizing interstate actors' state tax burdens, encourages entry by such actors and thus facilitates the interstate mobility of persons and capital. Finally, by curtailing the exit of the most tax-sensitive persons, apportionment bolsters the voices for tax-restraint within the taxing state's political process.

I develop my analysis in six steps. In the first section of this paper, I survey highlights of the case law establishing and implementing the principle that the Constitution requires substantial nexus between the taxing state and the taxpayer. This case law articulates the themes which have so far informed discussion of the nexus requirement: the transactional costs to multistate employers of complying with myriad states' tax laws, Congress's ultimate power to regulate the states' taxation of interstate commerce, the evolution of the contemporary economy and modern technology, the settled expectations of the mail order industry on a physical, rather than an economic, concept of nexus.

In the second section, I similarly survey the tax apportionment case law under the dormant Commerce Clause. Among other applications of the apportionment principle, I discuss New York's convenience of the employer doctrine, used by New York to tax the incomes of nonresidents on days they work at their out-of-state homes. In the third section, I review the federal statutes which restrict states' abilities to tax by placing off-limits persons as to whom would-be taxing states satisfy constitutional standards for nexus. In this section, I also discuss contemporary proposals for further federal legislation as well as important state laws relevant to the nexus and apportionment principles. In the fourth section of this article, I survey the commentary on the nexus and apportionment requirements. That commentary is largely negative in its assessment of the physical presence test for tax nexus.

The fifth section of this article presents the core of my analysis including my defense of physical presence as a rough, but serviceable, proxy for the taxpayer's practical standing in the taxing state's political process. I start this section by revisiting first principles: why do persons need any constitutional protection from state taxes? I identify three answers. First, some taxpayers lack practical voice, i.e., effective standing in the political process of the taxing state. Second, immobile taxpayers lack feasible exit options to leave the taxing state. Third, taxpayers, while possessing exit options, may inflict external costs outside the taxing state by exercising such options to leave the taxing state.

In this context, the dormant Commerce Clause principle of tax nexus, defined as an expanded test of physical presence in the taxing state, is a rough, but serviceable, indicator that a taxpayer has practical standing in the taxing state's political process to protect the taxpayer's interests. The rule of apportionment also constrains a state's ability to target taxes at immobile taxpayers opportunistically to force them to export tax burdens to persons outside the taxing state. Apportionment also minimizes taxpayers' need to exit from the taxing state and thereby curtails the external costs imposed by such exit from the taxing state. In addition, apportionment serves to encourage taxpayer entry by limiting states' authority to tax opportunistically and bolsters tax-discipline by encouraging the most tax-sensitive interstate actors to stay in the taxing state and exercise their political voice.

In the final section of this article, I revisit the contemporary case law controversies and legislative proposals in light of my analysis of the nexus and apportionment rules. Among other conclusions, my understanding of physical presence as a proxy for taxpayers' political voice leads me to defend the much maligned *Quill* decision and to propose applying an expanded version of the physical presence test to other forms of state taxation. While Congress crafts federal legislation (as it should), a dormant Commerce Clause physical presence test for tax nexus limits a state's ability to tax persons without effective political voice in the political system of the taxing state.

While not a perfect doctrine (and what is?), an expanded notion of physical presence proves to be a workable proxy for political standing which the courts should enforce under the dormant Commerce Clause while Congress crafts more detailed legislative rules for interstate taxation of a modern economy.

II. THE NEXUS CASE LAW

In this section, I review the highlights of the case law establishing and implementing the constitutional principle that states require adequate nexus to tax. While any such review necessarily involves arbitrary choices from among the myriad decisions in this area, a good starting place is *Wisconsin v. J.C. Penney Co.*[9] In that case, Wisconsin taxed, for "the privilege of declaring and receiving dividends,"[10] a Delaware corporation headquartered in New York.[11] In the case of such multistate corporations, Wisconsin only taxed "dividends declared and paid out of income derived from business transacted and property located within the state of Wisconsin."[12] Writing for a five-justice majority, Justice Frankfurter sustained the Wisconsin tax against a Due Process challenge. In doing so, he articulated two of the elements which would later become part of the celebrated *Complete Auto* test.[13]

In terms of Due Process, Justice Frankfurter wrote, the relevant inquiry is "whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return."[14] Moreover, it does not matter that such "a tax is contingent upon events brought to pass without a state," i.e., the corporate directors' vote in New York declaring a dividend.[15] There remains "nexus between such a tax and transactions within a state for which the tax is an exaction."[16] While Justice Frankfurter framed these observations as part of a single inquiry – does the Wisconsin dividend tax deprive the taxpayer of Due Process of law? – *Complete Auto* would later codify these concerns by identifying as two (of four) discrete requirements for a constitutional tax that the taxpayer have "substantial nexus" to the taxing state and that the tax imposed "is fairly related to the services provided by the [taxing] State."[17] *Complete Auto* would also situate these requirements in the dormant Commerce Clause.

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[9] Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940).

[10] *Id.* at 440 (quoting section 3(1), Chapter 505, Laws of Wisconsin, 1935).

[11] *Id.* at 443.

[12] *Id.* at 440 (quoting section 3(4), Chapter 505, Laws of Wisconsin, 1935).

[13] *See infra* notes 47–49 and accompanying text.

[14] *J.C. Penney*, 311 U.S. at 444.

[15] *Id.* at 445.

[16] *Id.* at 444.

[17] *See infra* notes 47–49 and accompanying text.

The four-justice dissent in *J.C. Penney* analogized the Wisconsin tax on dividends to a California tax on reinsurance premiums which the Court had struck two years earlier in *Connecticut General Life Insurance Co. v. Johnson.*[18] In *Connecticut General*, a Connecticut-based insurance company entered into reinsurance contracts with California insurers insuring California risks. California sought to tax the Connecticut reinsurer on these "premiums on [its] reinsurance policies effected and payable in Connecticut."[19] Seven justices[20] concluded that California could not tax these reinsurance premiums since California "had no relationship to [the Connecticut-based reinsurer] or to the reinsurance contracts."[21] These justices reasoned that "[n]o act in the course of [the contracts'] formation, performance, or discharge, took place [in California]. The performance of those acts was not dependent upon any privilege or authority granted by [California], and California laws afforded to them no protection."[22]For the *J.C. Penney* dissenters, there was no constitutional difference between California's taxation of these reinsurance premiums paid to a Connecticut-based reinsurer and the Wisconsin dividend tax.[23] Both violated the Due Process Clause. In contrast, for the *J.C. Penney* majority, the California levy was "neither in its measure nor in its incidence . . . related to California transactions."[24] However, "the incidence of the [Wisconsin] tax as well as its measure is tied to the earnings which the State of Wisconsin has made possible."[25] In the terms later articulated in *Complete Auto*, there was "substantial nexus" between Wisconsin and the transactions giving rise to the Wisconsin dividend tax while, in the California case, nexus, if any existed, was not sufficiently substantial to justify the tax.[26]

In *Northwestern States Portland Cement Co. v. Minnesota,* the Supreme Court upheld Minnesota and Georgia corporate income taxes against constitutional challenge on the ground that, inter alia, there was "sufficient nexus to support" such taxes.[27] The Minnesota

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18 Conn. Gen. Life Ins. Co. v. Johnson, 303 U.S. 77 (1938).

19 *Id.* at 79.

20 Justice Cardozo did not participate.

21 *Conn. Gen.*, 303 U.S. at 81.

22 *Id.*

23 Wisconsin v. J.C. Penney Co., 311 U.S. 435, 450–52 (1940).

24 *Id.* at 446.

25 *Id.*

26 *See infra* notes 47–49 and accompanying text.

27 Nw. States Portland Cement Co. v. Minn., 358 U.S. 450 (1959).

tax was a levy on net income imposed on an Iowa corporation which made cement at its Iowa plant and sold almost half of its output in Minnesota. The Iowa corporation leased a Minnesota sales office and employed sales and clerical personnel in Minnesota. Through this office and personnel, the corporation engaged in "a regular and systematic course of solicitation of orders for the sale of its products, each order being subject to acceptance, filling and delivery by [the corporation] from its plant" in Iowa.[28]

The Georgia tax was levied on the net income of a Delaware corporation "with its principal office and plant in" Alabama.[29] At an office in Atlanta, the corporation employed a salesman and a secretary. Orders were taken from customers in Georgia "subject to approval of the home office" in Alabama.[30] Product was shipped from Alabama "direct to the customer on an 'f.o.b. warehouse' basis," i.e., was placed on a common carrier at the Alabama warehouse with no separate shipping charge to the buyer.[31]

Among their other constitutional challenges to these state exactions, the corporate taxpayers argued that there was insufficient nexus to support taxation. The Court, treating nexus as a Due Process issue, disagreed, relying heavily on *J.C. Penney*:

> The taxes imposed are levied only on that portion of the taxpayer's net income which arises from its activities within the taxing State. These activities form a sufficient nexus between such a tax and transactions within a state for which the tax is an exaction .... [B]oth corporations engage in substantial income-producing activity in the taxing States.[32]

While three justices dissented in *Northwestern States*,[33] there was no dissent from the majority's conclusion that Minnesota and Georgia had sufficient nexus to impose their respective taxes. Justice Frankfurter argued that both state levies violated the Commerce Clause as they taxed corporations "carrying on exclusively interstate commerce" in the taxing states.[34] Justice Frankfurter distinguished

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[28] *Id.* at 454.

[29] *Id.* at 455.

[30] *Id.* at 456.

[31] *Id.*

[32] *Id.* at 464–65 (internal quotation marks omitted).

[33] Justice Frankfurter wrote a dissent for himself. Justice Whittaker wrote a dissent joined by Justices Frankfurter and Stewart.

[34] *Nw. States*, 358 U.S. at 473–74 (Frankfurter, J., dissenting).

these cases from "situation[s] where conjoined with the interstate commerce was severable local state business on the basis of which the state taxing power became constitutionally operative."[35]

While Justice Frankfurter did not take issue with the majority's conclusion that Minnesota and Georgia each had sufficient nexus to tax, his dissent identified two considerations central to today's debate about nexus. First, Justice Frankfurter highlighted the transactions costs of businesses' compliance with multiple state taxing systems.[36] Second, he emphasized Congress's authority under the Commerce Clause to determine the scope of state taxation of interstate commerce.[37]

Similarly, Justice Whittaker's dissent in *Northwestern States* argued that the Commerce Clause denies states the ability to tax corporations engaged exclusively in interstate commerce, as opposed to corporations which "conduct[] *both* intrastate and interstate commerce in the taxing State."[38] However, Justice Whittaker, like Justice Frankfurter, did not contest the majority's conclusion that Wisconsin and Georgia possessed sufficient nexus to tax.

In *Scripto, Inc. v. Carson*, Florida required a Georgia corporation to collect use tax on the products the corporation sold in Florida.[39] The corporation had neither a "place of business in Florida" nor "any regular employee or agent there."[40] The corporation was represented in Florida by ten "specialty brokers" who, by contract, were characterized as independent contractors.[41] Orders were sent for acceptance to the corporation's office in Atlanta and merchandise was shipped from there into Florida.

On these facts, the U.S. Supreme Court held that, for two reasons, there was sufficient nexus for Florida to impose a use tax collection obligation on the Georgia corporation. First, "[t]he burden of the tax is placed on the ultimate purchaser in Florida and it is he who enjoys the use of the property."[42] Second, it was constitutionally irrelevant that the seller's dealers were independent contractors, rather than

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[35] *Id.* at 473.

[36] *Id.* at 474.

[37] *Id.* at 475–77.

[38] *Id.* at 477, 485 (Whittaker, J., dissenting) (emphasis added).

[39] Scripto Inc. v. Carson, 362 U.S. 207 (1960).

[40] *Id.* at 209.

[41] *Id.*

[42] *Id.* at 211.

"regular employees ... devoting full time to [the corporation's] service."[43] "To permit such formal 'contractual shifts' to make a constitutional difference would open the gates to a stampede of tax avoidance.... The test is simply the nature and extent of the activities of the appellant in Florida."[44]

Against this background, the Court decided the watershed cases, *Complete Auto Transit, Inc. v. Brady*[45] and *National Bellas Hess, Inc. v. Department of Revenue*.[46]

In *Complete Auto*, Mississippi levied a tax on a Michigan corporation which accepted General Motors cars at the railhead in Jackson, Mississippi. The corporation then loaded these cars onto trucks and distributed such cars to Mississippi auto dealers. The Court used *Complete Auto* to confirm that states can impose taxes on firms doing business in interstate commerce if "the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[47]

The Court characterized this soon-to-be influential statement as a codification of its prior case law under the Commerce Clause.[48] Since the taxpayer in *Complete Auto* conceded that Mississippi had sufficient nexus to impose its tax, *Complete Auto* did not require the Court to explicate when nexus is "substantial" or to explore the relationship between the Due Process Clause and the nexus requirement.[49]

In contrast, the Court's opinion a decade earlier in *National Bellas Hess* held that there is constitutionally insufficient tax nexus to out-of-state mail order corporations when such corporations only solicit orders via mail and satisfy such orders by shipping goods on common carriers or by mail.[50]

National Bellas Hess was a Delaware corporation based in Missouri.[51] It had no sales representatives, stores, warehouses, offices, or bank accounts in Illinois.[52] National Bellas Hess solicited customers

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[43] *Id.*

[44] *Id.* at 211–12.

[45] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

[46] Nat'l Bellas Hess, Inc. v. Dep't of Revenue, 386 U.S. 753 (1967).

[47] 430 U.S. at 279.

[48] *Id.*

[49] *Id.* at 277–78.

[50] 386 U.S. at 758.

[51] *Id.* at 753–54.

[52] *Id.* at 754.

in Illinois by mailing them catalogues and occasional "flyers."[53] National Bellas Hess satisfied the resulting orders by mailing goods from Missouri to its Illinois customers or by sending goods to such customers by common carrier.[54]

A six-justice majority held that, on these facts, Illinois lacked authority to require National Bellas Hess to collect Illinois use tax on goods sold to Illinois customers.[55] For this majority, the earlier decision in *Scripto* marked the outer bounds at which tax nexus is present. The line to be drawn is "between mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business."[56]

The *National Bellas Hess* majority buttressed its conclusion with the transactional concerns articulated by Justice Frankfurter in his *Northwestern States* dissent. If there is tax nexus in the kind of situation at issue in *National Bellas Hess*, the majority opined, "[t]he many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle . . . interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose a fair share of the cost of the local government."[57]

The taxpayer had asserted that both the Due Process Clause and the Commerce Clause proscribed the use tax collection responsibility imposed by Illinois.[58] However, the *National Bellas Hess* majority framed its nexus concerns in Commerce Clause terms.[59] Moreover, that majority, for good measure, also noted the second consideration articulated by Justice Frankfurter in his *Northwestern States* dissent, namely, Congress's role as the ultimate regulator of interstate commerce.[60]

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[53] *Id.*

[54] *Id.* at 754–55.

[55] *Id.* at 758.

[56] *Id.*

[57] *Id.* at 759–60 (internal quotation marks omitted).

[58] *Id.* at 756.

[59] *Id.* at 760 ("The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements.").

[60] *Id.* ("Under the Constitution, this is a domain where Congress alone has the power of regulation and control.").

The three dissenters in *National Bellas Hess* saw no difference between that case and *Scripto*.[61] Articulating a theme that would prove influential, the dissent by Justice Fortas contended that National Bellas Hess's "large-scale, systematic, continuous solicitation and exploitation of the Illinois consumer market is a sufficient 'nexus' to require [National] Bellas Hess to collect from Illinois customers and to remit the use tax."[62] Moreover, the dissent belittled the transactional costs predicted by the majority, costs, the dissented asserted, readily surmountable by "the skill of contemporary man and his machines."[63]

At one level, *National Bellas Hess* was an exercise in line drawing: the majority drew a line between that case and *Scripto*, a line with which the dissenters disagreed. At another level, *National Bellas Hess* was a seminal statement of the concept which has come to be called "physical nexus," although that term never appears as such in the opinion: Illinois lacked nexus to impose use tax collection responsibilities upon National Bellas Hess because that out-of-state firm had no representatives or facilities within the borders of Illinois. Similarly, the *National Bellas Hess* dissent presaged what is today called "economic nexus," the notion that tax nexus exists whenever a firm engages in "large-scale, systematic, continuous solicitation and exploitation of the [taxing state's] consumer market."[64]

Tyler Pipe Industries, Inc. v. Washington State Department of Revenue addressed a variety of challenges to Washington State's business and occupation tax.[65] Among these challenges, Tyler Pipe, which manufactured products out-of-state and shipped them to Washington wholesalers, contended that Washington lacked sufficient nexus to Tyler Pipe to assess tax on Tyler Pipe's wholesale sales in Washington.[66] Tyler Pipe had no office, property, or employees in Washington.[67] Tyler Pipe's only physical presence in Washington was a single "independent contractor located in Seattle."[68] Relying on *Scripto*, the *Tyler Pipe* Court declared this enough to "support the

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[61] *Id.* at 764–65 (Fortas, J., dissenting) ("I do not see how *Scripto* is meaningfully distinguishable from this case.").

[62] *Id.* at 761–62.

[63] *Id.* at 766.

[64] *Id.* at 761.

[65] Tyler Pipe Indus. v. Wash. State Dep't of Revenue, 483 U.S. 232 (1987).

[66] *Id.* at 249.

[67] *Id.*

[68] *Id.*

State's jurisdiction to impose its wholesale tax on Tyler [Pipe]."[69] The Court's brief discussion of the merits of the nexus issue indicates that the application of *Scripto* was straightforward: one independent contractor representing the out-of-state taxpayer suffices to create sufficient nexus for the state's taxation of that taxpayer.[70]

In *National Geographic Society v. California Board of Equalization*, the Society maintained two offices in California which solely solicited advertising for the Society's magazine.[71] Independently of these offices, the Society, from its Washington, D.C. and Maryland offices, conducted a mail order business which sold "maps, atlases, globes, and books" to California residents.[72] California demanded that the Society collect use tax on these mail order sales to California customers. The U.S. Supreme Court agreed and held that "the two offices in California and activities there adequately establish a relationship or 'nexus' between the Society and the State."[73] Citing *National Bellas Hess,* the Court held that the "Society clearly falls" into the category of "mail order sellers with retail outlets, solicitors, or property within [the taxing] State," sellers with sufficient nexus to be required to collect use tax.[74]

In an effort to analogize itself to the taxpayer in *National Bellas Hess*, the Society argued that the Constitution requires nexus, not between California and the Society, but between California and the Society's "activity . . . sought to be taxed," i.e., the Society's mail order sales into California.[75] Since the Society's two California offices only solicited advertising for the magazine and had nothing to do with the Society's mail order sales in California, the argument ran, those offices did not provide nexus for the duty to collect use tax on such sales.

The Court was unpersuaded, reasoning that "the Society's two offices, without regard to the nature of their activities, had the advantage of the same municipal services — fire and police protection, and the like — as they would have had if their activities . . .

[69] *Id.* at 251.

[70] *Id.* at 250–51.

[71] Nat'l Geographic Soc'y v. Cal. Bd. Of Equalization, 430 U.S. 551, 552 (1977).

[72] *Id.*

[73] *Id.* at 556.

[74] *Id.* at 559.

[75] *Id.* at 560.

included assistance to the mailorder operations that generated the use taxes."[76]

Against this background, *Quill Corp. v. North Dakota* constituted a major revision of the Court's nexus doctrine, distinguishing nexus under the Due Process Clause from nexus for Commerce Clause purposes and identifying Due Process nexus with economic presence and Commerce Clause nexus with physical presence – at least in use tax collection cases.[77]

The facts in *Quill* were essentially identical to those of *National Bellas Hess*: the taxing state (in this case, North Dakota) imposed upon an out-of-state corporation the obligation to collect use tax on sales of merchandise shipped to customers in the taxing state by mail or common carrier.[78] The out-of-state firm conducting this mail order business had no offices, representatives, or other physical presence in North Dakota.[79]

As to Due Process tax nexus, the *Quill* Court observed that, in nontax Due Process cases, the Court had abandoned the requirement of physical presence for the exercise of state jurisdiction: "if a foreign corporation purposely avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's *in personam* jurisdiction even if it has no physical presence in the State."[80]

Applying this standard, the Court in part overruled *National Bellas Hess*, holding that, for Due Process purposes, there was sufficient nexus to impose on Quill the duty to collect North Dakota use tax because "there is no question that Quill has purposefully directed its activities at North Dakota residents, that the magnitude of those contacts is more than sufficient for due process purposes, and that the use tax is related to the benefits Quill receives from access to the State."[81] Due Process, the *Quill* Court opined, "centrally concerns the fundamental fairness of governmental activity."[82] Accordingly, "the analytic touchstone of due process analysis" is whether a person

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[76] *Id.* at 561.

[77] Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

[78] *Id.* at 302.

[79] *Id.*

[80] *Id.* at 307.

[81] *Id.* at 308.

[82] *Id.* at 312.

has "notice," "fair warning" that the state can exercise jurisdiction over him.[83]

Commerce Clause nexus, however, is a different matter. In contrast to Due Process, the Commerce Clause nexus requirement is "informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy."[84] In particular, the dormant Commerce Clause "ensure[s] that state taxation does not unduly burden interstate commerce."[85] In this context, "the bright-line rule" of physical presence facilitates interstate commerce by establishing "a safe harbor for vendors" like National Bellas Hess and Quill which know that, as long as they avoid such physical presence, they can sell into the various states unencumbered by the burden of complying with their myriad use tax collection laws.[86]

In its *Quill* opinion, the North Dakota Supreme Court cited the expansive growth of mail order sales, including Internet commerce, as impelling reconsideration of the *National Bellas Hess* requirement of physical presence for tax nexus.[87] From that "dramatic" growth, the U.S. Supreme Court drew the opposite inference: since the enormous expansion of interstate mail order commerce was "due in part to the bright-line exemption from state taxation created in" *National Bellas Hess*, that case "has engendered substantial reliance and has become part of the basic framework of a sizable industry."[88] Accordingly, "the doctrine and principles of *stare decisis*" indicate that physical presence should remain a requirement for Commerce Clause nexus, at least until Congress utilizes its "ultimate power to resolve" the proper scope of state taxation under the Commerce Clause.[89]

Thus, the *Quill* Court, in sustaining the physical presence test for Commerce Clause tax nexus, reprised two of the themes articulated over three decades earlier by Justice Frankfurter in his *Northwestern States* dissent, namely, the transactional costs to interstate businesses of complying with various states' tax laws and Congress's ultimate authority to determine the scope of state taxation using its affirmative

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[83] *Id.*

[84] *Id.*

[85] *Id.* at 313.

[86] *Id.* at 314–15.

[87] North Dakota v. Quill Corp., 470 N.W.2d 203, 208-09 (N.D. 1991).

[88] Quill Corp v. North Dakota, 504 U.S. at 316–317.

[89] *Id.* at 317–18.

power under the Commerce Clause. *Quill* also grounded Commerce Clause nexus in "structural concerns" about the "national economy," namely, the need to keep state taxation from burdening interstate commerce "unduly."[90]

Among the first of the post-*Quill* cases was *Geoffrey, Inc. v. South Carolina Tax Commission*, which explored the state income tax implications of a popular planning technique, the Delaware holding company for intangible corporate property.[91] In *Geoffrey*, Toys R Us, Inc. had incorporated such a company, Geoffrey, Inc. To this Delaware subsidiary, Toys R Us contributed its trade names and trademarks which Geoffrey then leased back to the parent corporation in return for a royalty payment from the parent. Toys R Us had stores in South Carolina and thus paid royalties to Geoffrey for the use of the trade names and trademarks in that state. Toys R Us deducted its royalty payments to Geoffrey for South Carolina income tax purposes, thereby reducing Toys R Us' taxable income in South Carolina. Geoffrey had no employees, offices or tangible property in South Carolina.[92]

While the South Carolina Tax Commission had originally challenged the deductibility of the royalty payment from Toys R Us to Geoffrey, the Commission subsequently argued that Geoffrey owed South Carolina income tax on that payment.[93] Geoffrey responded that, for both Due Process and Commerce Clause purposes, it lacked nexus to South Carolina. The South Carolina Supreme Court read *Quill* as confirming the existence of nexus for tax purposes.

For Due Process purposes, the Court held that Geoffrey had "purposefully directed its activities toward South Carolina's economic forum . . . by licensing intangibles for use in South Carolina and receiving income in exchange for their use."[94] In addition to such

[90] *Id.* at 312.

[91] Geoffrey, Inc. v. S.C. Tax Comm'n, 437 S.E.2d 13 (S.C. 1993). Evidence of the popularity of this technique is the recent comment of the U.S. Court of Federal Claims observing that "state officials around the country [have been] actively pursuing the misuse of Delaware holding companies." H.J. Heinz Co. v. United States, 76 Fed. Cl. 570, 586 (2007). *See also* Mark J. Cowan & Clint Kakstys, *A Green Mountain Miracle and the Garden State Grab: Lessons from Vermont and New Jersey on State Corporate Tax Reform*, 60 TAX LAW. 351, 355-56 (2007) ("By using holding companies, corporate taxpayers can shift income out of a taxing state and into a state with no tax.").

[92] *Geoffrey*, 473 S.E.2d at 15.

[93] *Id.*

[94] *Id.* at 16.

economic presence, nexus existed for Due Process purposes via "the presence of Geoffrey's intangible property in" South Carolina, namely, the account receivable owed to Geoffrey from the parent's South Carolina sales and Geoffrey's South Carolina "franchise" of its trade name and trademark used by its corporate parent in South Carolina.[95]

In Commerce Clause terms, the South Carolina court limited to the sales and use tax context *Quill* and its dormant Commerce Clause requirement of physical presence for nexus.[96] In any event, the *Geoffrey* court stated, "intangible property" in the taxing state establishes nexus for Commerce Clause purposes.[97] In this case, "by licensing intangibles for use in [South Carolina] and deriving income from their use here, Geoffrey has a 'substantial nexus' with South Carolina."[98]

On similar facts, the Missouri Supreme Court in *ACME Royalty Co. v. Director of Revenue* came to the opposite result, concluding that Delaware subsidiaries holding intellectual property leased back to their respective corporate parents were not subject to Missouri's corporate income tax.[99] Although the four-justice majority in *ACME Royalty* discussed the issue solely as a matter of Missouri law, the majority's inquiry was nexus-driven: whether the royalties paid to these Delaware subsidiaries from the parents' Missouri sales were "Missouri source income" to these subsidiaries depended on whether "there [was] some activity by the *taxpayer* in Missouri that justifie[d] imposing the tax."[100] Since these Delaware subsidiaries had no "property, payroll, or sales, in the State of Missouri," the majority reasoned, they were not subject to Missouri income tax.[101]

The three dissenters, citing *Geoffrey*, would have followed the South Carolina Supreme Court's approach to tax nexus: the parent corporation's "use [in Missouri] of the intellectual property" leased by the subsidiaries to their parents was "an essential ingredient of the

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[95] *Id.*

[96] *Id.* at 18 n.4. *See also* Lanco, Inc. v. Dir., Div. of Taxation, 908 A.2d 176, 177 (N.J. 2006) ("We believe that the better interpretation of *Quill* is the one adopted by those states that limit the Supreme Court's holding to sales and use taxes.").

[97] *Geoffrey*, 437 S.E.2d at 18.

[98] *Id.*

[99] ACME Royalty Co. v. Dir. of Revenue, 96 S.W.3d 72 (Mo. 2002).

[100] *Id.* at 75.

[101] *Id.*

products sold in Missouri" by those parents.[102] Moreover, the dissenters declared, "a taxpayer need not have a tangible, physical presence within a state for income to be taxable there."[103]

Of similar import to *ACME Royalty* is the decision of the Tennessee Court of Appeals in *J.C. Penney National Bank v. Johnson*, a decision holding that a Delaware bank's credit cards used in Tennessee did not generate Commerce Clause nexus for Tennessee income tax purposes.[104] J.C. Penney National Bank (JCPNB) is a Delaware subsidiary of J.C. Penney. A national banking corporation, JCPNB issued Visa and MasterCard credit cards. JCPNB contracted for services with its parent which, in turn, subcontracted for many of these services with unrelated corporations. JCPNB solicited Tennessee credit card customers by mail and its cards were used by "between 11,000 and 17,000" Tennessee card holders. However, JCPNB had neither employees nor offices in Tennessee.[105]

The Tennessee Commissioner of Revenue asserted corporate excise and franchise taxes against JCPNB based on its Tennessee credit card operations. When the case reached the Tennessee appeals court, the sole issue was whether JCPNB had Commerce Clause nexus to Tennessee. The appeals court, citing *Quill*, held for JCPNB, finding that JCPNB lacked the physical presence in Tennessee required for nexus.

The Tennessee commissioner asserted that JCPNB had two forms of physical presence in Tennessee: the actual credit cards, owned by JCPNB and used by Tennessee card holders, and the J.C. Penney stores of the parent corporation in Tennessee. The cards, the appeals court found, "in and of themselves, are virtually worthless."[106] JCPNB's "real asset is the intangible account which the card represents," an intangible "located, for tax purposes, in the State of Delaware."[107]

As to the J.C. Penney stores in Tennessee, the court dismissed them as a basis for Commerce Clause nexus between Tennessee and JCPNB because these stores

> were not affiliated with JCPNB's Visa and MasterCard credit card operations. The retail stores conducted no activities

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[102] *Id.* at 78 (Wolff, J., dissenting).

[103] *Id.* at 80.

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

[105] *Id.* at 833.

[106] *Id.* at 840.

[107] *Id.*

> which assisted JCPNB in maintaining its credit card business in Tennessee. The record shows that one could not apply for the JCPNB credit cards at the J.C. Penney retail stores, nor could individuals make a payment on their Visa or MasterCard account at the retail stores.[108]

Curiously, the Tennessee court did not address *National Geographic*, in which the U.S. Supreme Court held that analogous offices soliciting magazine advertising in California generated nexus for purposes of imposing use tax collection responsibility on mail order sales into California.[109] The Tennessee appeals court did, however, distinguish *Scripto* and *Tyler Pipe* on the ground that the in-state independent contractors in those cases "substantially contributed to the taxpayer's ability to maintain operations in the taxing state."[110] By contrast, the independent contractors hired by the parent for JCPNB's credit card operations all performed their services outside of Tennessee. Since these out-of-state contractors had no "physical presence in Tennessee," they did not create tax nexus in Tennessee for JCPNB.[111]

In contrast, the West Virginia Supreme Court of Appeals held in *Tax Commissioner v. MBNA* that an out-of-state credit company with no physical presence in West Virginia was subject to franchise and income taxes levied by that state.[112] Like JCPNB, "MBNA had no real or tangible personal property and no employees located in" the taxing

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[108] *Id.* at 840-41.

[109] The California offices in *National Geographic* were owned by the same legal entity which made mail order sales into that state. In contrast, J.C. Penney's stores in Tennessee were owned by the separate, parent corporation of JCPNB. On this basis, *National Geographic* can be distinguished from the Tennessee case.

However, the Tennessee appeals court focused, not upon the separate corporate ownership of the J.C. Penney's retail stores and the credit cards operations, but upon the operational independence of those stores from the credit card operations. That focus on operational independence is difficult to square with the Supreme Court's analysis in *National Geographic*, holding that the operationally independent offices of the National Geographic Society in California created constitutionally adequate nexus for California to force the Society to collect California use taxes on its mail order sales into that state.

[110] *J.C. Penney*, 19 S.W.3d at 841.

[111] *Id.*

[112] Tax Commissioner v. MBNA Am. Bank, 640 S.E.2d 226 (W. Va. 2006).

state.[113] Similar to JCPNB, MBNA conducted its Visa and MasterCard operations in West Virginia "via mail and telephone solicitation."[114]

Explicitly rejecting the holding in *J.C. Penney National Bank v. Johnson,* the West Virginia court in *Tax Commissioner v. MBNA* held that, for three reasons, MBNA had tax nexus to West Virginia under the Commerce Clause.[115] First, the West Virginia court concluded that *Quill's* physical presence test for Commerce Clause nexus "applies only to use and sales taxes and not to business franchise and corporation net income taxes."[116] Second, the court opined that "compliance burdens" are lower for state corporate income taxes than for state sales and use levies.[117] Third, "the staggering evolution in commerce" including "the internet and electronic commerce" permit an out-of-state company like MBNA to conduct "systematic and continuous business activity" without physical presence.[118] In light of this change, the West Virginia court concluded, "a significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes."[119] As the sole dissenter in *MBNA* correctly observed, this "economic presence" test is in substance the nexus standard suggested by Justice Fortas in his *National Bellas Hess* dissent.[120]

Other cases reflect the intersection of the nexus and apportionment principles. These cases arise in the context of multistate corporations with diverse operations and investments. The nexus inquiry in these cases is which of the corporation's operations and investments have sufficient ties to the taxing state to be included in the base for determining the corporate income properly apportioned to that state.

Underlying these cases are the difficulties of identifying the income earned by a multistate enterprise in any particular state. Assume, for example, that a corporation manufactures in state *X* and conducts its sales and management activity in state *Y*. Theoretically, it is possible to determine the arm's length terms on which the corporation's two operations would deal with each other if they were

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[113] *Id.* at 227.

[114] *Id.*

[115] *Id.* at 235.

[116] *Id.* at 232.

[117] *Id.* at 233.

[118] *Id.* at 236.

[119] *Id.* at 234.

[120] *Id.* at 240–41 (Benjamin, J., dissenting).

independent enterprises. The resulting calculations would indicate the income earned in each state.

In practice, however, such "separate accounting"[121] has proved difficult to implement. Consequently, to apportion this corporation's income between *X* and *Y*, each state typically multiplies the corporation's total income by a fraction with the resulting product deemed to be the income earned in, and thus taxable in, that state. In one classic case, a corporation's "main office [was] in New York City, . . . its manufacturing [was] done in Connecticut" and, in light of "the impossibility of allocating specifically the profits earned by the processes conducted within its borders," Connecticut taxed 47% of the corporation's overall income.[122] This percentage reflected the ratio of the corporation's property in Connecticut to the corporation's total property.[123]

Such "formulary apportionment"[124] obviates the need to determine the terms on which the multistate corporation's separate operations, if independent of each other, would contract with each other on arm's length terms. However, such apportionment by fractional formula poses its own conundrums, particularly if the corporation engages in multiple activities. Suppose, for example, that, in addition to its manufacturing in state *X* and its sales and management activities in state *Y*, a corporation owns a minority interest in an independently-operated ski resort in state *Z*. Should some of the resort's income be included in the base against which State X applies its fraction to determine the income apportionable to X?

Under the "unitary business doctrine," the U.S. Supreme Court has answered, "No." Absent common management, economies of scale and functional integration of the ski resort with the activity occurring in state *X*, state *X* lacks nexus to the ski resort. Hence, state *X* may only tax a portion of the income attributable to the "unitary business" with which state *X* has adequate contact, i.e., the corporation's integrated activities in state *X* and state *Y*. The corporation's income derived in state *Z* is off-limits to state *X*'s tax commissioner as insufficiently connected to the corporation's manufacturing activity which occurs in state *X*.

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[121] Mobil Oil Corp. v. Commissioner of Taxes of Vt., 445 U.S. 425, 438 (1980).

[122] Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 119, 121 (1920).

[123] *Id.* at 119.

[124] Trinova Corp. v. Mich. Dep't of Treasury, 498 U.S. 358, 390 (1991).

This approach poses its own interpretative questions, namely, determining the contours of the "unitary business": when are out-of-state activities sufficiently related to operations in the taxing state to be part of the unitary business, the income of which the taxing state can tax an appropriate fraction? In nexus terms, the task is to separate the components of a multistate enterprise's operations into the activity some of which occurs in the taxing state and the remaining components unrelated to any operations in the taxing state.

The U.S. Supreme Court confronted this task in *Allied-Signal, Inc. v. Director, Division of Taxation.*[125] Bendix was a Delaware corporation headquartered in Michigan.[126] Bendix engaged in a variety of operations. In New Jersey, the taxing state, Bendix developed and manufactured aerospace products.[127] Bendix also owned shares of ASARCO, "one of the world's leading producers of nonferrous metals."[128] Bendix subsequently sold these shares back to ASARCO for a profit of $211,500,000. In taxing its fraction of Bendix's overall income, New Jersey included in the base for apportionment this gain from the ASARCO stock sale.

The *Allied-Signal* Court, having reaffirmed the unitary business principle, applied that principle to the stipulated facts of the case and concluded that Bendix's gain from its ASARCO stock was not part of the unitary, multi-state business Bendix operated in New Jersey. ASARCO and Bendix were separate entities in all relevant respects. There was no "functional integration" between these two businesses nor were there "economies of scale" achieved by the two businesses.[129] "There was no centralization of management."[130] Bendix's ownership of ASARCO stock was a "passive investment"[131] rather than "a short-term investment of working capital analogous to a bank account or certificate of deposit."[132] Because Bendix's ownership of ASARCO stock was unrelated to Bendix's New Jersey activities developing and manufacturing aerospace products, New Jersey, lacking nexus to Bendix's investment in ASARCO stock, could not tax a portion of Bendix's gain from selling that stock.

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[125] Allied-Signal, Inc. v. Dir., Div. of Taxation, 504 U.S. 768 (1992).

[126] The named party, Allied-Signal, was "the successor-in-interest to" Bendix. *Id.* at 773.

[127] *Id.* at 774.

[128] *Id.*

[129] *Id.* at 788.

[130] *Id.*

[131] *Id.*

[132] *Id.* at 790.

Most recently, in *MeadWestvaco Corp. v. Illinois Department of Revenue*, the U.S. Supreme Court reaffirmed that, for corporate income tax purposes, "the 'hallmarks' of a unitary relationship [are] functional integration, centralized management, and economies of scale."[133]

In sum, the nexus principle, as it stands today, is both deeply-embedded and, in important respects, ill-defined. In tax cases, the contemporary understanding of both the Due Process Clause and the Commerce Clause is that they impose a nexus requirement between the taxing state and the taxpayer. For tax purposes, Due Process nexus is understood in economic terms with no requirement that the taxpayer be physically present in the taxing state, as long as the taxpayer has deliberately utilized the taxing state's market and is thus unsurprised to be taxed there. The scope of Commerce Clause nexus is less clear. In at least one setting – the imposition of use tax collection responsibilities on out-of-state mail order sellers – nexus is understood as requiring the seller's physical presence in the taxing state. Whether the Commerce Clause requires physical presence in other tax contexts remains uncertain.

III. THE APPORTIONMENT CASE LAW

Just as *J.C. Penney* is an arbitrary but convenient place to commence review of the case law explicating the nexus principle, *Central Greyhound Lines, Inc. v. Mealey*[134] is a workable point of embarkation for assessing the dormant Commerce Clause rule of apportionment. In *Central Greyhound*, New York imposed a tax upon the taxpayer's entire "gross receipts from transportation between points within [New York] but over routes that utilize[d] the highways of Pennsylvania and New Jersey."[135] Indeed, "nearly 43% of the mileage" of the taxpayer's vehicles occurred on Pennsylvania and New Jersey roads.[136] The portion of the taxpayer's receipts attributable to transportation in those two states could legitimately be taxed by them.[137] Consequently, the Court reasoned, if New York could tax the total receipts of this interstate transportation, the result would be to "subject interstate commerce to the unfair burden of

[133] MeadWestvaco Corp. v. Ill. Dep't of Revenue, 128 S. Ct. 1498, 1508 (2008).

[134] Cent. Greyhound Lines, Inc. v. Mealey, 334 U.S. 653 (1948).

[135] *Id.* at 654.

[136] *Id.* at 660.

[137] *Id.* at 662.

being taxed" twice, i.e., once by New York where the trips started and ended, once by the other states in which the vehicles also physically operated during the course of these trips.[138] To avoid this threat of double taxation, New York was constitutionally required to apportion its tax burden based on the vehicles' relative mileage in and out of New York.[139]

Central Greyhound and its ancestors were codified a generation later when the *Complete Auto* Court indicated that, to pass constitutional muster, a state tax on interstate commerce must, among other features, be "fairly apportioned."[140] The taxpayer in *Complete Auto* acknowledged that the challenged Mississippi sales tax was so apportioned.[141]

In contrast, the taxpayer in *Oklahoma Tax Commission v. Jefferson Lines, Inc.* asserted that it had been subjected to an unapportioned tax comparable to New York's tax in *Central Greyhound*.[142] In *Jefferson Lines*, Oklahoma sought from the taxpayer sales tax, defined statutorily as "an excise tax of four percent (4%) of the gross receipts or gross proceeds of each sale of . . . [t]ransportation for hire to persons by common carriers."[143] The taxpayer collected and remitted to the state the sales tax for intrastate bus trips totally within Oklahoma, but not for bus trips starting in Oklahoma and ending out-of-state,[144] arguing that, as to those trips, the Oklahoma sales tax was an unapportionment levy imposed on interstate commerce.

Seven justices of the Court disagreed, finding the Oklahoma sales tax different from the New York gross receipts tax at issue in *Central Greyhound*.[145] Under the Oklahoma sales tax, "the taxable event," i.e., the one-time sale of the bus ticket in Oklahoma, "is wholly local."[146] There was consequently no threat of double taxation and nothing to apportion since the tax was imposed on a single, wholly intrastate transaction, namely, the sale of the bus ticket in Oklahoma.[147]

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[138] *Id.*

[139] *Id.* at 663.

[140] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977).

[141] *Id.* at 287.

[142] Okla. Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175 (1995).

[143] *Id.* at 178 n.1.

[144] *Id.* at 178.

[145] *Id.* at 176–77.

[146] *Id.* at 188.

[147] *Id.* at 191 ("the sales taxation here is not open to the double taxation analysis on which *Central Greyhound* turned, and that decision does not control.").

Unlike the *Jefferson Lines* majority, Justice Breyer, dissenting for himself and Justice O'Connor, found the analogy between the Oklahoma tax and the New York tax compelling. Indeed, he concluded, the two levies "are, for all relevant purposes, identical."[148] Hence, Justice Breyer would have required apportionment of the Oklahoma tax.

There were no underlying doctrinal differences in *Jefferson Lines.* Both the majority and the dissent agreed that apportionment is constitutionally required to preclude double taxation of interstate commerce. They disagreed upon the proper characterization of the Oklahoma tax and thus upon the application of the apportionment principle to that tax.

Similarly, in *Moorman Manufacturing Co. v. Bair*, the Court divided as to the proper application of the apportionment principle.[149] As observed earlier,[150] most states tax multistate corporations' business incomes through formulary apportionment rather than separate accounting, that is, by taxing a fraction of the corporation's total income rather than assigning income to each state by hypothesizing the income which would have been earned in that state if the corporation's in-state activities had been conducted by an independent entity dealing with the rest of the corporation on an arm's-length basis. At the time of the *Moorman* decision, most states determined this fraction by using the "three-factor formula."[151] Under this method, the fraction applied to the corporation's total income is an average of three fractions, the corporation's in-state property to its total property, the corporation's in-state sales to its total sales, and the corporation's in-state payroll to its total payroll. Under this approach, if 20% of a corporation's property is located in state *X* while 30% of the corporation's sales and 40% of its payroll are also in state *X*, *X* taxes 30% of the corporation's total income.[152]

In contrast, for the years at issue in *Moorman*, Iowa applied against Moorman's total income just a sales fraction, i.e., the taxpayer's Iowa sales divided by the taxpayer's total sales.[153] Since Moorman's unused property and payroll fractions were often lower

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[148] *Id.* at 201 (Breyer, J., dissenting).

[149] Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978).

[150] *See supra* notes 121–124 and accompanying text.

[151] *Moorman*, 437 U.S at 283-84. *See also* 2 RICHARD D. POMP & OLIVER OLDMAN, STATE AND LOCAL TAXATION 10–13 to 10–20 (5th ed. 2005).

[152] *(20% + 30% + 40%)/3 = 30%.*

[153] *Moorman*, 437 U.S. at 270.

than its sales fraction, Iowa, by using just the higher sales fraction to apportion income, apportioned to itself and thus taxed more of the taxpayer's income than it would have using the three-factor formula.[154]

Moorman, an Illinois corporation which manufactured and sold animal feed, objected on constitutional grounds to Iowa's heavier taxation of its income resulting from Iowa's use of the single-factor apportionment formula rather than the three-factor method. The gravamen of Moorman's complaint was that, at that time, most other states, and in particular Illinois, used the three-factor formula.[155] Hence, Iowa, by using only the single, higher sales fraction, taxed income not properly attributable to that state, thereby causing double taxation at the state level of interstate income.

A majority of the U.S. Supreme Court disagreed. The Court construed its prior case law as "refus[ing] to impose strict constitutional constraints on a State's selection of a particular formula" for apportionment.[156] "[T]he States have wide latitude in the selection of apportionment formulas."[157]

While much of the *Moorman* opinion is framed in Due Process terms, at its core, *Moorman* is a statement about dormant Commerce Clause apportionment, in particular, the deference which the Court gives to states' efforts to apportion unless such efforts lead to "grossly distorted results."[158] *Moorman*'s grounding in the dormant Commerce Clause was made explicit by the Court's invitation to Congress to reverse that decision: Iowa can apportion the income of multistate enterprises using only the sales factor "until Congress prescribes a different rule."[159]

> It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body,

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[154] *Id.* at 271 n.4.

[155] *See infra* note 235 and accompanying text (stating that after *Moorman*, many states abandoned the three-factor test).

[156] *Moorman*, 437 U.S. at 273.

[157] *Id.* at 274.

[158] *Id.* (quoting *Norfolk & W. Ry. Co. v. N.C. ex rel. Maxwell*, 390 U.S. 317, 326 (1968)).

[159] *Id.* at 281.

> and not this Court, that the Constitution has committed such policy decisions.[160]

At one level, the fundamental disagreement between the *Moorman* majority and the *Moorman* dissenters was the willingness of the latter to undertake the detailed supervision of states' apportionment formulas which the majority believed to be the job of Congress.[161]

Central Greyhound, Jefferson Lines, and *Moorman* epitomize the application of the apportionment principle in the "old" economy of ground transportation and traditional manufacturing. In contrast, *Goldberg v. Sweet*[162] was the Court's first confrontation with that principle in the context of the "new" economy. Illinois imposed a five percent tax on intra- and interstate telephone calls.[163] As to the latter, Illinois imposed the tax if the call originated or terminated in Illinois and was "charged to an Illinois service address."[164] Illinois also provided a credit against its tax for any tax paid on the same call to another state.[165]

Among their other objections, the *Goldberg* taxpayers argued that the Illinois telephone tax, as applied to interstate calls, was unapportioned and therefore unconstitutional. The Court unanimously disagreed, noting that cases like *Central Greyhound* "dealt with the movement of large physical objects over identifiable routes, where it was practicable to keep track of the distance actually traveled within the taxing State."[166] On the other hand, *Goldberg* "involve[d] the more intangible movement of electronic impulses through computerized networks."[167] Indeed, the *Goldberg* Court observed, it is "virtually impossible to trace and record the actual paths taken by the electronic signals which create an individual telephone call."[168] These technological realities made mileage-type apportionment impractical. Moreover, the double taxation at which

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[160] *Id.* at 280.

[161] *See id.* at 281–98 (dissenting opinions).

[162] Goldberg v. Sweet, 488 U.S. 252 (1989).

[163] *Id.* at 255–56.

[164] *Id.* at 256.

[165] *Id.*

[166] *Id.* at 264.

[167] *Id.*

[168] *Id.* at 255.

the apportionment requirement is aimed "is precluded by the credit" Illinois offered against its tax for tax paid in another state.[169]

Container Corp. of America v. Franchise Tax Board was another case addressing the application of the unitary business principle and the three-factor apportionment formula.[170] In *Container Corp.*, a Delaware corporation headquartered in Illinois disputed its California corporate income tax liability.[171] The taxpayer had several foreign subsidiaries.[172] Among its other complaints, the taxpayer objected to California's use of the three-factor apportionment formula to determine the percentage of the taxpayer's income attributable to its California operations. Separate accounting, the taxpayer contended, demonstrated that its foreign subsidiaries were more profitable than its domestic operations. Hence, California's application of the three-factor formula to the taxpayer's entire income (including foreign subsidiary profits) overstated the income of the taxpayer's California operations.

The Court was unpersuaded, reasoning that "[b]oth geographical accounting and formula apportionment are imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory."[173] Since both systems entail "substantial margin of error," there is no reason to conclude that the apportionment of income among the states achieved by separate accounting is more accurate than the apportionment of income resulting from formulary apportionment.[174] To demonstrate that apportionment by formula has assigned excessive income to the taxing state, more proof is needed than discrepant results from the two different methods.

Container Corporation introduced into the apportionment lexicon two new terms, "internal consistency" and "external consistency."[175] The former exists when the challenged apportionment formula, "if applied by every jurisdiction, . . . would result in no more than all of the unitary business income being taxed."[176] In contrast to this purely logical test, "external consistency" requires that, in practice, the challenged formula "must actually reflect a reasonable sense of how

[169] *Id.* at 265.
[170] Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983).
[171] *Id.* at 162–63.
[172] *Id.* at 163.
[173] *Id.* at 182.
[174] *Id.* at 184.
[175] *Id.* at 169.
[176] *Id.*

income is generated."[177] The taxpayer did not deny that California's use of the three-factor formula was internally consistent, that is, if emulated by all jurisdictions, it would result in the single taxation of the taxpayer's total income by those jurisdictions. As to external consistency, the Court essentially rejected the taxpayer's apportionment complaint for a failure of proof: since there is no reason to prefer the inherently imperfect results of separate accounting to the inherently imperfect results of California's three-factor apportionment, the taxpayer had failed to demonstrate an "outrageous"[178] and "distortive"[179] effect.

In the state courts, the most controversial apportionment issue in recent years has been New York's "convenience of the employer" doctrine.[180] In practice, New York applies this doctrine to tax the income earned by nonresident taxpayers on days such nonresidents work at their out-of-state homes. New York characterizes the income earned out-of-state as earned at home for the employee's (rather than the employer's) convenience. From this characterization, New York concludes that this income is taxable in New York, though the employee performs the services to earn such income at his out-of-state home. The employer convenience doctrine has become increasingly contentious as more employees "telecommute," i.e., work at home for their employers using modern technologies such as email, the Internet, and fax machines.

The taxpayer[181] in *In re Zelinsky v. Tax Appeals Tribunal* was a law professor in Manhattan who lived in New Haven, Connecticut.[182] The taxpayer spent roughly forty percent of his work days in New York, teaching and meeting with students and colleagues. The remainder of his work days were spent at home in Connecticut, researching, writing, and grading. On his New York nonresident income tax return, the taxpayer apportioned forty percent of his salary to New York, reflecting the days he actually worked in that state. The

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[177] *Id.*

[178] *Id.* at 183.

[179] *Id.* at 182.

[180] *See* N.Y. COMP. CODES R. & REGS. tit. 20, § 132.18(a) (2006) ("However, any allowance claimed for days worked outside New York State must be based upon the performance of services which of necessity, as distinguished from convenience, obligate the employee to out-of-state duties in the service of his employer.").

[181] i.e., me.

[182] In re Zelinsky v. Tax Appeals Tribunal of State of N.Y., 801 N.E.2d 840 (N.Y. 2003).

New York Department of Taxation and Finance and the taxpayer stipulated that the taxpayer's days worked at home were motivated by his personal choice not to commute to Manhattan, rather than the employer's convenience. Consequently, New York taxed the taxpayer's entire salary including the part of his salary the taxpayer had apportioned to Connecticut to reflect the days he worked there at home. Connecticut, the state of the taxpayer's residence and the location in which he worked on a majority of his working days, also taxed this income. The upshot was the double taxation at which the apportionment rule is aimed.

Despite *Central Greyhound* and the apportionment principle, New York's highest tribunal, that state's Court of Appeals, upheld the New York tax commissioner's assessment of state income tax on the taxpayer's entire salary, including the portion of his professorial salary the taxpayer earned by researching, writing, and grading at home in Connecticut. As I discuss below,[183] the *Zelinsky* decision and New York's employer convenience rule have been the subject of withering criticism from legal commentators. However, the harshest criticism of New York's employer convenience doctrine has come from within the court itself.

Judge Robert S. Smith joined the New York Court of Appeals after the court decided *Zelinsky*, but before the court subsequently revisited the employer convenience rule in *Huckaby v. New York State Division of Tax Appeals*.[184] Thomas Huckaby is a computer programmer who spent three-quarters of his time working at home in Nashville, Tennessee. He worked the remainder of his time at his employer's office in New York. New York's tax commissioner, supported by a four-judge majority of the Court of Appeals, taxed Mr. Huckaby's entire salary under the rubric of employer convenience, even though Mr. Huckaby worked the bulk of his days at home in Tennessee.

In *Huckaby*, Judge Smith's dissent was joined by two of his colleagues who had earlier voted to uphold the employer convenience test in *Zelinsky*. Judge Smith concluded "that New York is free to tax only the one quarter of [Mr. Huckaby's] salary that he earns in New York" on the days he is there.[185] Characterizing the constitutional restrictions on New York's taxing authority as a requirement of

[183] *See infra* notes 299–314 and accompanying text.

[184] In re Huckaby v. N.Y. State Div. of Tax Appeals, 829 N.E.2d 276 (N.Y. 2005).

[185] *Id.* at 288 (Smith, J., dissenting).

"proportionality,"[186] Judge Smith declared, "[i]t also seems to me beyond question that the tax in this case — applied to 100% of Huckaby's income — is out of all proportion to the time he spent working in New York — 25%."[187] The majority's contrary holding, Judge Smith wrote, is "unsupported by any precedent" and is "a radical departure from long-accepted limits on the powers of states to tax nonresidents."[188] The *Huckaby* majority propounded a "new interpretation of the Commerce Clause," an interpretation, said Judge Smith, for which there is "no authority at all," nor is there any "persuasive reason."[189]

In summary, the principle that the Commerce Clause requires states to avoid double taxation by apportioning the tax obligations of actors in interstate commerce has, as a theoretical matter, proved relatively uncontroversial. This is not surprising since it is intuitively compelling to conclude that commerce flows unimpeded between the states when the tax each state levies is proportionate to the portion of the activity in that state and no state overreaches to tax incommensurately. On a visceral level, double taxation is a bad thing. I argue below that we can go beyond this instinctive response and identify four functions served by the apportionment rule.[190] While the apportionment principle as such is uncontroversial, particular applications of that principle have been contentious. A more detailed account of the Commerce Clause requirement of tax apportionment helps to sort out these disagreements.

IV. LEGISLATION

In this section, I review federal and state legislation (including proposed legislation) relevant to the nexus and apportionment principles.[191] The oldest of these federal laws is P.L. 86-272[192] adopted

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[186] *Id.* at 289.

[187] *Id.* at 290.

[188] *Id.*

[189] *Id.* at 291.

[190] *See infra* Part VI.C–F.

[191] Since this review is limited to legislation relevant to the nexus and apportionment principles, I do not discuss legislation addressing the issue of discriminatory taxation. *See, e.g.*, 49 U.S.C. § 11501 (forbidding states and localities from imposing any "tax that discriminates against a rail carrier providing [interstate] transportation"); *see also* 49 U.S.C. § 14502 (restricting the property taxation of "motor carrier transportation property" used in interstate commerce); 49 U.S.C. § 40116 (restricting the property taxation of "air carrier transportation property").

by Congress in response to the business community's displeasure with *Northwestern States.*[193] P.L. 86-272 was the first federal statute ever enacted "restricting the states' power to tax interstate businesses."[194] P.L. 86-272 forbids states from levying "any tax imposed on, or measured by, net income"[195] on nonresidents' "business activities"[196] in "interstate commerce"[197] if such nonresidents' activities stay within either of two statutory safe harbors. Specifically, a state may not assess nonresident income taxes if a nonresident merely solicits orders in the state for sales of "tangible personal property" which orders are approved or rejected out-of-state and, if approved, "are filled by shipment or delivery from" out-of-state.[198] Alternatively, a state may not impose income taxes on a nonresident, e.g., an out-of-state manufacturers' representative, who merely solicits orders for sales of tangible personal property for another person, e.g., an out-of-state manufacturer, who similarly accepts, rejects and ships from out-of-state.[199] In applying these safe harbors, the activities of an independent contractor do not authorize state income taxation as long as the independent contractor represents "more than one principal and . . . holds himself out as such in the regular course of his business activities."[200]

P.L. 86-272 does not quite overturn *Northwestern States.* As Professors Hellerstein and Hellerstein observe, the offices in the taxing states maintained by the *Northwestern States* nonresident

For a discussion of proposed legislation aimed at discriminatory taxation, see Dolores W. Gregory & Brett Ferguson, *Federal Bills That Would Impact State Taxes Include Efforts To Restrict "Discriminatory" Taxes on Telecommunications, Rental Cars,* Daily Tax Report (BNA) No. 224, at J-1 (Nov. 21, 2007). The U.S. Supreme Court has recently construed the federal statute prohibiting discriminatory taxation of railroad property. *CSX Transp., Inc. v. Ga. State Bd. of Equalization,* 128 S. Ct. 467 (2007).

192 Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified at 15 U.S.C. §§ 381-84).

193 *See supra* notes 27–32 and accompanying text.

194 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION 402 (8th ed. 2005).

195 Pub. L. No. 86-272, § 103, 73 Stat. 556 (1959) (codified at 15 U.S.C. § 383).

196 Pub. L. No. 86-272, § 101(a), 73 Stat. 555 (1959) (codified at 15 U.S.C. § 381(a)).

197 *Id.*

198 Pub. L. No. 86-272, § 101(a)(1), 73 Stat. 555 (1959) (codified at 15 U.S.C. § 381(a)(1)).

199 Pub. L. No. 86-272, § 101(a)(2), 73 Stat. 555 (1959) (codified at 15 U.S.C. § 381(a)(2)).

200 Pub .L. No. 86-272, §§ 101(c)-(d), 73 Stat. 555 (1955) (codified at 15 U.S.C. §§ 381(c)-(d)).

taxpayers would have pushed these nonresidents outside the statutory safe harbors and thus subjected them to corporate income taxation.[201] Nevertheless, P.L. 86-272 deprives states of the ability to tax the income of a category of nonresidents as to whom, in constitutional terms, the states have nexus to tax. Today, interstate businesses selling tangible personal property invest considerable effort in keeping their activities within the safe harbors established by P.L. 86-272[202] while some states probe the boundaries of those safe harbors, often quite aggressively.[203]

While P.L. 86-272 has given rise to important interpretive issues,[204] the statute itself is today largely uncontroversial.[205] The same cannot be said of the Internet Tax Freedom Act.[206] Congress first adopted a version of the Act as a temporary measure in 1998 and subsequently modified and extended the Act in 2001 and 2004.[207] Most recently, Congress further altered and extended the Act until November 1, 2014.[208]

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[201] Hellerstein & Hellerstein, *supra* note 194 at 405.

[202] *See, e.g.*, Jennifer Carr & Cara Griffith, *Retroactive Application of Michigan's Nexus Changes*, 43 ST. TAX NOTES 47, 50 (Jan. 8, 2007) ("When IHF structured its business operations, it relied on the department's published guidance," applying Pub. L. No. 86-272 to Michigan's single business tax.).

[203] *See, e.g.*, Cowan & Kakstys, *supra* note 91 at 375–81 (describing New Jersey's "Alternative Minimum Assessment," (AMA), a corporate tax based on "gross receipts" or "gross profits," "as an End-Run Around Public Law 86-272."); Arthur R. Rosen & Jeffrey S. Reed, *The New Jersey AMA and P.L. 86-272: A Constitutional Violation*, 43 ST. TAX NOTES 207, 207 (Jan. 22, 2007) (describing New Jersey's AMA as "clearly unconstitutional under" U.S. Supreme Court precedent because "[i]ts sole function is to interfere with P.L. 86-272 by imposing a special tax only on corporations that are otherwise protected from New Jersey income taxation by P.L. 86-272.").

[204] *See, e.g.*, Wis. Dep't of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214, 223–32 (1992) (determining the scope of the term "solicitation of orders" in Pub. L. No. 86-272 and whether the Act includes a *de minimis* exception that eliminates its immunity).

[205] Though commentators do call for its modification or repeal. Among these is Professor Swain, who advocates for the abolition of Pub. L. No. 86-272. *See infra* note 289.

[206] Internet Tax Freedom Act, 47 U.S.C. § 151 note (enacted by Pub. L. No. 105-277, 112 Stat. 2681 (1998) and amended by the Internet Tax Nondiscrimination Act, Pub. L. No. 108-435, 118 Stat. 2615 (2004), and the Internet Tax Freedom Act Amendments Act of 2007, Pub. L. No. 110-108, 121 Stat. 1025 (2007)).

[207] John Buhl & Meg Shreve, *Senators Rally Support for Permanent Ban on Internet Access Taxes*, 116 TAX NOTES 1127, 1127 (Sept. 24, 2007).

[208] *See* Internet Tax Freedom Act Amendments of 2007, Pub. L. No. 110-108, § 2, 121 Stat. 1024, 1024 (2007) (codified at 47 USC § 151 note).

The Internet Tax Freedom Act bans state[209] "[t]axes on Internet access."[210] The Act also forbids "[m]ultiple or discriminatory taxes on electronic commerce."[211] The Act's prohibitions do not apply to certain state taxes which were "generally imposed and actually enforced prior to October 1, 1998."[212]

The Act raises several important interpretative issues. While the Act forbids the imposition of any taxes on "Internet access," it does not preclude state taxation of certain "telecommunications."[213] Given the rapid convergence of technologies, this distinction is coming under pressure. The courts are just starting to grapple with the difference between "Internet access" and "telecommunications services."[214] When Congress extended the Act to 2014, it revised the statutory definitions in an effort to provide further guidance as to the distinction between "Internet access," which the states cannot tax, and telecommunications services, which they can.[215] However, the distinction is still likely to be a source of contention in the years ahead.

The Act also contains two alternative definitions of a "discriminatory tax" which the states cannot levy. The first of these definitions is straightforward: to avoid the statutory ban on discriminatory taxes, a state tax on electronic commerce must apply "generally"[216] and not just to such commerce, must have a uniform tax rate,[217] and must prescribe generally applicable collection

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[209] The Act also applies to the "political subdivision[s]" of states. Internet Tax Freedom Act § 1101(a), 47 U.S.C. § 151 note.

[210] *Id.* § 1101(a)(1).

[211] *Id.* § 1101(a)(2).

[212] *Id.* § 1104(a)(1).

[213] *Id.* § 1105(5).

[214] *See, e.g.*, Prodigy Servs. Corp., Inc. v. Johnson, 125 S.W.3d 413, 419 (Tenn. Ct. App. 2003) (stating that Prodigy "was a consumer of telecommunication services, not a provider"); In re Frontline Commc'ns Corp., No. 819786, 10 (D.T.A. Mar. 10, 2005)("[P]etitioner was not selling telephone or telecommunications services to its customers, but was purchasing telecommunications service (subject to tax) to be used in the provision of its own (nontaxable) service of Internet access."); In re Cent. New York Online, No. 819631, 7 (D.T.A. Mar. 10, 2005) ("[N]etwork circuitry purchases, like local exchange purchases, are clearly subject to tax . . . as purchases of taxable telecommunications services notwithstanding that the same are, in turn, used in the provision of a nontaxable service, to wit, Internet access.").

[215] Internet Tax Freedom Act § 1105(5), (9), 47 U.S.C. § 151.

[216] *Id.* § 1105(2)(A)(i).

[217] *Id.* § 1105(2)(A)(ii), (iv).

obligations.[218] Thus, if a consumer orders a book online from an Internet vendor like Amazon.com, the state in which the consumer lives may impose a use tax on the consumer only if the same book, purchased at a local store, is subject to a sales tax imposed at the same rate.

Under the Act's second definition of a discriminatory tax on electronic commerce, a state cannot impose a "tax collection obligation" on a "remote seller[]" by virtue of a consumer's "ability to access a site on [the] remote seller's out-of-State computer server."[219] In addition, a state cannot impose a "tax collection obligation" on a "remote seller" by deeming "a provider of Internet access service or online services"[220] to be such seller's agent by virtue of such provider "display[ing] . . . [the] remote seller's information or content on the [provider's] out-of-State computer server"[221] or by virtue of the provider's "processing of orders through the out-of-State computer server of [such] provider."[222]

Despite the statutory label, this language has nothing to do with discrimination. Rather, this terminology confirms the *Quill* requirement of physical presence to impose upon the out-of-state seller a legal obligation to collect the use tax. Thus, to continue the example, under the Act, the state cannot require Amazon.com to collect the use tax owed by the consumer who purchases a book online, unless the state happens to be the location of Amazon.com's server. In practical terms, this statutory ban on "discriminatory" taxation makes it unlikely the state will actually collect the use tax it theoretically imposes on its residents' online purchases since the out-of-state seller cannot be required to collect and remit that tax.

Finally, for purposes of the Internet Tax Freedom Act, to avoid classification as a prohibited "multiple tax" on electronic commerce, a tax must provide a credit for taxes paid in another jurisdiction on the same transaction.[223]

Another nexus-related area in which Congress has legislated is state income taxation of "retirement income."[224] Specifically, Congress

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[218] *Id.* § 1105(2)(A)(iii).

[219] *Id.* § 1105(2)(B)(i).

[220] *Id.* § 1105(2)(B)(ii).

[221] *Id.* § 1105(2)(B)(ii)(I).

[222] *Id.* § 1105(2)(B)(ii)(II).

[223] *Id.* § 1105(6)(A).

[224] 4 U.S.C. § 114 (2006).

has precluded any state from taxing "any retirement income of an individual" unless such individual is "a resident or domiciliary" of the taxing state.[225] Consider in this context an individual who spent her career living and working in a state with a state income tax (e.g., California or New York) and who earned a pension during her career. Let us assume that, on retirement, this individual moves to a state without an income tax (e.g., Nevada or Florida) and starts to receive her pension there.

For years prior to 1996, the state in which this individual formerly worked and lived could tax these pension payments on the theory that that state had substantial nexus to those payments: the individual, in this example, lived and worked in the taxing state and earned her pension in that state by performing services there during her working years. The taxing state provided the public amenities which enabled its then-resident to perform and earn, as well as the government services to which the resident was entitled by virtue of her residence during this earlier time.

However, for years subsequent to 1995, Congress has decreed that (notwithstanding this nexus to the individual's prior state of residence), only the state in which she currently resides can tax her retirement income. As this example suggests, in practical terms, this federal legislation immunizes this individual's retirement income from any state taxation since she now resides in a state without an income tax and that state, as the current state of residence, is now the only state with authority to tax her retirement income.

For these purposes, the statute defines "retirement income" broadly to include, *inter alia*, any distribution from a qualified plan,[226] from an individual retirement account[227] or from a Section 457 plan.[228]

Yet other federal laws address the unique problems of individuals who work in interstate transportation and thus routinely cross state boundaries. Most recently, Congress addressed the state income tax status of individuals who work "on the navigable waters of more than one State."[229] The particular plight which prompted this legislation was the taxation of crew members working on the Columbia River.[230]

[225] *Id.* § 114(a).

[226] *Id.* § 114(b)(1)(A).

[227] *Id.* § 114(b)(1)(E).

[228] *Id.* § 114(b)(1)(F). For the history and structure of Section 457 plans, see EDWARD A. ZELINSKY, THE ORIGINS OF THE OWNERSHIP SOCIETY: HOW THE DEFINED CONTRIBUTION PARADIGM CHANGED AMERICA 80–81 (2007).

[229] 46 U.S.C. § 11108(b)(2)(B) (2000).

[230] Doug Sheppard, *Waterway Worker Tax Bill Passes Senate, Moving in House,*

This river is the boundary between Oregon and Washington. During his working day on the river, a crew member may spend parts of the day on the Oregon side of the river and parts on the Washington side. Oregon assessed nonresident income taxes against crew members who were Washington residents for the portion of their wages earned on the Oregon side of the river.

The resulting uproar prompted Congress in 2000 to forbid states and localities from imposing income taxes on nonresidents' compensation for executing their "regularly-assigned duties while engaged as a master, officer, or crewman on a vessel operating on the navigable waters of more than one State."[231] Thus, today, Oregon (or any similarly situated state) cannot tax income earned by nonresidents on the Columbia (or any similar body of water), notwithstanding the physical nexus between such income and the taxing state in which the income is earned. This legislation extends a form of income tax relief Congress had previously granted to interstate bus[232] and railroad[233] employees.

The pattern of this legislation confirms Professor Denning's observation that Congress exercises its Commerce Clause powers in response to either "powerful interests that can command congressional attention" or "abuse[s] . . . of such a magnitude that Congress dare not ignore" them.[234]

Turning to the states, in the wake of *Moorman*, many states emulated Iowa and abandoned for corporate income tax purposes the traditional three-factor apportionment formula widely used before *Moorman*.[235] Some of these states moved to an apportionment formula under which the fraction used by the corporate taxpayer doubles the weight of the sales factor.[236] In contrast to the three-factor formula,

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2000 TNT 197-3 (Oct. 11, 2000).

[231] 46 U.S.C. § 11108(b)(2)(B).

[232] 49 U.S.C. § 14503(a) (2000).

[233] *Id.* § 11502(a).

[234] Zelinsky & Denning, Debate, *supra* note 5, at 206.

[235] DAVID BRUNORI, STATE TAX POLICY: A POLITICAL PERSPECTIVE 89–91 (2d ed. 2005); Richard D. Pomp, *The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer*, *in* THE FUTURE OF STATE TAXATION, 55–59 (David Brunori ed., 1998).

[236] *See, e.g.*, Conn. Gen. Stat. § 12-218(c) (2008) ("[T]he net income of the taxpayer when derived from the manufacture, sale or use of tangible personal or real property, shall be apportioned within and without the state by means of an apportionment fraction, to be computed as the sum of the property factor, the payroll factor and twice the receipts factor, divided by four.").

this formula, by placing greater emphasis on the sales fraction, increases the taxable income (and thus the tax burden) of corporations with relatively less property or payroll in the taxing state but significant sales in that state.[237] The double-weighted sales formula correspondingly decreases the income and tax liability of firms with much property and payroll in the taxing state but relatively fewer sales there.[238] Other states have gone further, adopting the sales-only apportionment formula used by Iowa and upheld in *Moorman*.[239]

In the aftermath of *Quill*, many states undertook an effort to adopt uniform and simplified sales and use tax laws.[240] Today this effort, known as the "Streamlined Sales Tax Project," includes "22 states representing 28 percent of the country's population" which have amended their tax laws to comply, in whole or in part, with the standards recommended by the Project.[241] While the adoption of simplified and uniform sales and use tax laws carries its own benefits, a fundamental goal of the Project is to persuade Congress that the states participating in the Project have made it easier for firms to

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[237] Consider, for example, a corporation which has, in the taxing state, 1% of its total property and 1% of its total payroll but has in the taxing state 10% of the corporation's total sales. Under the traditional three factor formula, this corporation apportions to the taxing state 4% of its total income. *(1% + 1% + 10%)/3 = 4%*. In contrast, with double-weighting of the sales factor, this corporation apportions to the taxing state 5.25% of its total income. *(1% + 1% + 10% + 10%)/4 = 5.25%*. Thus, double-weighting the sales factor increases by 35% this corporation's tax liability to the state deploying that double-weighted factor. *(5.25% - 4%)/4% = 35%*.

[238] Consider, for example, a corporation which has, in the taxing state, 10% of its total property and 10% of its total payroll but has in the taxing state only 1% of the corporation's total sales. Under the traditional three factor formula, this corporation apportions to the taxing state 7% of its total income. *(10% + 10% + 1%)/3 = 7%*. In contrast, with double-weighting of the sales factor, this corporation apportions to the taxing state only 5.25% of its total income. *(10% + 10% + 1% + 1%)/4 = 5.25%*. Thus, double-weighting the sales factor reduces by 25% this corporation's tax liability to the state deploying that double-weighted factor. *(7% - 5.25%)/7% = 25%*.

[239] *See, e.g.*, Tex. Tax Code § 171.106(b) (effective Jan. 1, 2008) ("[A] corporation's taxable earned surplus is apportioned to this state to determine the amount of tax imposed . . . by multiplying the taxable earned surplus by a fraction, the numerator of which is the corporation's gross receipts from business done in this state . . . and the denominator of which is the corporation's gross receipts from its entire business . . . .").

[240] *See* BRUNORI, *supra* note 235, at 68–69; Billy Hamilton, *A Small Miracle — The Streamlined Governing Board Compromises on Sourcing*, 47 ST. TAX NOTES 53 (Jan. 7, 2008).

[241] Timothy P. Noonan & Paul R. Comeau, *Practical Difficulties in Streamlining the Sales Tax: A View From One Industry Perspective*, 46 ST. TAX NOTES 573 (Nov. 19, 2007).

comply with such states' sales and use tax laws. From this premise, the states hope to induce Congress to overturn *Quill* by means of federal legislation authorizing the states adopting the Project's standards to impose collection obligations on out-of-state sellers with no physical presence in the taxing states.

In another post-*Quill* sales and use tax development, some states have probed the boundaries of *Quill.* Idaho, for example, has recently expanded its statutory definition of nexus for sales and use tax purposes to include an out-of-state retailer if such retailer is related to an entity with in-state physical presence in Idaho.[242] For these purposes, Idaho incorporates several of the Internal Revenue Code's tests to determine if persons are related.[243]

In a similar vein, New York State has recently broadened the use tax collection obligations of out-of-state sellers. Consistent with the lines drawn in *National Bellas Hess, Quill, Scripto* and *Tyler Pipe,* New York distinguishes, for use tax collection purposes, an out-of-state seller who only advertises in New York from an out-of-state seller whose solicits sales through independent contractors located in New York. An out-of-state seller who merely advertises in New York lacks in-state physical presence. Falling on the *Bellas Hess/Quill* side of the line, this out-of-state seller is not a "vendor" for New York use tax purposes and thus need not collect use tax on its sales to New York customers.[244] In contrast, out-of-state sellers who solicit sales in New York through independent contractors fall on the *Scripto/Tyler Pipe* side of the line.[245] By virtue of their agents' physical presence in the Empire State, these out-of-state sellers are "vendors" and therefore must collect New York use tax when they sell and ship goods into New York.

New York recently expanded its statutory definition of the solicitation which is deemed to constitute physical presence in New York and which thus triggers the obligation of an out-of-state seller to

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[242] IDAHO CODE § 63-3611 as amended by H.B. 360, 59th Leg., 2d Reg. Sess. (Idaho 2008); IDAHO CODE § 63-3615A as added by H.B. 360, 59th Leg., 2d Reg. Sess. (Idaho 2008).

[243] IDAHO CODE § 36-3615A as added by H.B. 360, 59th Leg., 2d Reg. Sess. (Idaho 2008).

[244] N.Y. Tax Law § 1101(b)(8)(i)(C)(II) (person soliciting sales in New York is a vendor only if, in addition to "distribution of catalogs or other advertising matter," "such person has some additional connection with the state which satisfies the nexus requirement of the United States constitution.")

[245] N.Y. Tax Law § 1101(b)(8)(i)(C)(I).

collect New York use tax on its sales to New York customers.[246] In particular, the New York tax statute now provides that an out-of-state seller is "presumed to be soliciting business" through an agent in New York if the seller has an agreement with a New York resident to "refer . . . potential customers" to the out-of-state seller "by a link on an internet website or otherwise" and if the out-of-state seller's New York sales from such referrals exceed $10,000 during the preceding four quarters. This presumption of in-state solicitation through an agent physically present in New York may be rebutted if the out-of-state seller can prove that the New York person with whom it has a referral agreement does not "engage in any solicitation" which "would satisfy the nexus requirement of the United States Constitution," i.e., which would place the New York person in the same category as the independent contractors who, in *Scripto* and *Tyler Pipe*, established in-state presence for the out-of-state sellers they represented.

The administrative pronouncements of the New York Department of Taxation and Finance interpret this statutory language as covering click-through arrangements under which New York residents link customers from their websites to the websites of out-of-state sellers. According to the Department,[247] no New York nexus results from mere advertisement by an out-of-state firm on the website of a New York person. The analysis, however, is different if the New York person receives a commission from the sale which results from the referral from the New York person's website to the out-of-state seller. In this case, the activities of the New York person presumptively go beyond advertising and are presumed instead to constitute in-state solicitation by the New York person for the out-of-state seller. This, in turn, results in the imposition on the out-of-state seller of "vendor" status and the consequent responsibility to collect New York use tax on all of its sales to New York customers unless the presumption is affirmatively rebutted. Such rebuttal, for example, may be established by adequate documentation that the New York person whose website links to the out-of-state seller's website does nothing further which would make the New York person a solicitor for the out-of-state seller per *Scripto* and *Tyler Pipe*.[248]

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[246] N.Y. Tax Law § 1101(b)(8)(iv).

[247] Memorandum from the N.Y. State Dep't of Taxation and Fin., Office of Tax Policy Analysis, Taxpayer Guidance Div., TSB-M-08(3)S (May 8, 2008) ("[A]n agreement to place advertisement does not give rise to the presumption" that an out-of-state seller is a "vendor" who must collect use taxes on sales to New York customers.).

[248] Memorandum from the N.Y. State Dep't of Taxation and Fin., Office of Tax

Amazon.com[249] and Overstock.com[250] have challenged the new New York statute. They allege, *inter alia*, the practical impossibility of overcoming the statutory presumption that the New York persons with whom they have click-through arrangements conduct solicitation which establishes nexus for use tax collection purposes.

In contrast to proposals for federal legislation that would expand the taxing authority of the states participating in the Streamlined Sales Tax Project,[251] other proposals in Congress would curb states' ability to tax. Chief among these is the Business Activity Tax Simplification Act, introduced in the Senate by Senators Schumer and Crapo[252] and in the House by Representative Boucher.[253] In three major ways, this legislation would restrict states' tax jurisdiction. First, the Schumer-Crapo-Boucher legislation would expand the class of persons which P.L. 86-272 protects from state income taxes as long as they stay within the statute's safe harbors. Currently, P.L. 86-272 only immunizes from state income taxes persons selling tangible personal property.[254] The legislation proposed by Senators Schumer and Crapo and Representative Boucher would extend P.L. 82-272's protection from state income taxes to persons selling "all other forms of property, services, and other transactions, fulfilled or distributed from a point outside the State."[255] Second, for this enlarged category of protected persons, the Schumer-Crapo-Boucher legislation would provide additional safe harbors within which those persons can

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Policy Analysis, Taxpayer Guidance Div., TSB-M-08(3.1)S (June 30, 2008) (An out-of-state "seller may rebut the presumption" that it is a "vendor" for use tax purposes).

[249] Summons and Verified Compl., Amazon.com, LLC and Amazon Services, LLC v. N.Y. State Dep't of Taxation and Finance, Supreme Court of the State of New York, County of New York (Apr. 17, 2008).

[250] Summons and Verified Compl., Overstock.com, Inc. v. N.Y. State Dep't of Taxation and Finance, Supreme Court of the State of New York, County of New York (May 30, 2008).

[251] Sales Tax Fairness and Simplification Act, S. 34, H.R. 3396, 110th Cong. (2007). The House Judiciary Subcommittee on Commercial and Administrative Law has held a hearing on H.R. 3396. *See*, Eric Parker, *Wait Till Next Year on Streamlining Bill, House Subcommittee Chair Says*, 117 TAX NOTES 1023 (Dec. 10, 2007).

[252] Business Activity Tax Simplification Act of 2007, S. 1726, 110th Cong. (2007).

[253] Business Activity Tax Simplification Act of 2008, H.R. 5267, 110th Cong. (2008).

[254] Pub. L. No. 86-272, §§ 101(a)(1)-(2), 73 Stat. 555 (1959) (codified at 15 U.S.C. §§ 381(a)(1)-(2)).

[255] Business Activity Tax Simplification Act of 2007, S.1726, 110th Cong. § 2(a)(2)(B)(2007).

operate without incurring state income tax.[256] Third, the Schumer-Crapo-Boucher bill would codify the physical presence test for tax nexus in certain contexts. Specifically, the bill would prevent states from levying "a net income tax or other business activity tax on any person relating to such person's activities in interstate commerce unless such person has a physical presence in the State during the taxable period with respect to which the tax is imposed."[257]

Physical presence is also central to the Mobile Workforce State Income Tax Fairness and Simplification Act of 2007.[258] This Act would prevent a state from assessing its income tax against a nonresident employee unless such nonresident "is physically present performing duties for more than 60 days during the calendar year in which the income is taxed."[259] This Act, sponsored by Representatives Johnson and Cannon, would not restrict states' abilities to tax athletes, entertainers or "certain public figures."[260]

The Telecommuter Tax Fairness Act of 2007 also addresses state income taxation of nonresidents. This Act is aimed specifically at New York's employer convenience doctrine and would overturn *Zelinsky* and *Huckaby*.[261] Introduced by Senator Dodd[262] and Representative Shays,[263] this legislation would permit state income taxation of nonresidents' compensation only "with respect to any period of time when such nonresident individual is physically present in another State."[264] In determining such physical presence, the Act would bar "any convenience of the employer test or any similar test."[265]

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[256] *Id.*

[257] *Id.* § 3(a).

[258] Mobile Workforce State Income Tax Fairness and Simplification Act of 2007, H.R. 3359, 110th Cong. (2007).

[259] *Id.* § 2(a).

[260] *Id.* § 2(d)(2). On November 1, 2007, the House Judiciary Committee's Subcommittee on Commercial and Administrative Law held a hearing on H.R. 3359. John Buhl, *Panelists Differ Over Thresholds in Nonresident State Income Tax Bill*, 2007 STT 213-1 (Nov. 2, 2007). My submission to the Subcommittee can be found at 2007 STT 217-1 (2007).

[261] In the interest of full disclosure, I note that I have played a role in drafting this Act and have, on several occasions, spoken on its behalf. *See, e.g.*, Rob Varnon, *Dodd Targets Double Taxing in New York; Legislation to Fight System*, CONN. POST, August 3, 2004.

[262] Telecommuter Tax Fairness Act of 2007, S. 785, 110th Cong. (2007).

[263] Telecommuter Tax Fairness Act of 2007, H.R. 1360, 110th Cong. (2007).

[264] *Id.* § 2(a).

[265] *Id.*

In a proposal aimed at state efforts like New York's new law expanding the use tax collection obligations of out-of-state sellers, Senator Bunning has introduced federal legislation which would require a seller to have specified physical presence in a state before the state can obligate such seller to "collect . . . and remit . . . a State tax . . . resulting from . . . electronic commerce."[266] Under the Bunning legislation, tax collection obligations could only be imposed upon an out-of-state seller operating in "electronic commerce" if the seller has an employee in the taxing state, if the seller has "an agent" in the state who works only for the seller, or if the seller leases or owns tangible property in the taxing state.

V. COMMENTARY

In this section, I sample the commentary on the apportionment and nexus principles. There is, in particular, voluminous commentary critical of *Quill* and its physical presence requirement. Other commentary is similarly critical of New York's employer convenience doctrine and the New York courts' support of that doctrine.

Several years after the Supreme Court decided *Quill*, Professors Richard D. Pomp and Michael J. McIntyre articulated many of the themes now central to the anti-*Quill* oeuvre.[267] The *Quill* Court, they contend, "appeared reluctant to reaffirm *Bellas Hess*" and was "ambivalen[t] about the wisdom of its decision."[268] The "bifurcation approach" of *Quill* – Due Process nexus requires economic presence, Commerce Clause nexus requires physical presence – "was novel, without support in existing case law."[269] Since *Quill*'s physical presence test was intended merely "to protect the reliance interests of the mail-order industry," that test has "no relevance to income taxes."[270] Moreover, as to sales and use levies, *Quill*, by excusing many out-of-state sellers from collecting use tax, "creates an unfair competitive bias against in-state merchants that collect the sales tax."[271]

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[266] S. 3670, 110th Cong., 2d Sess. (2008).

[267] Richard D. Pomp & Michael J. McIntyre, *State Taxation of Mail-Order Sales of Computers after* Quill: *An Evaluation of MTC Bulletin* 95-1, 11 ST. TAX NOTES 140 (July 19, 1996).

[268] *Id.* at 179.

[269] *Id.*

[270] *Id.* at 184.

[271] *Id.*

Even more outspoken is Robert D. Plattner who describes *Quill* "as a blunder of major proportions by the Court."[272] While *Quill* presented an opportunity to fix the Commerce Clause concept of substantial nexus, "[i]nstead, the Court compounded the errors of *Bellas Hess*."[273] In lieu of the *Quill* physical presence test, Mr. Plattner states "[t]he presence or absence of Commerce Clause nexus [should] be determined on the same basis as Due Process Clause nexus."[274]

Sheldon H. Laskin is similarly skeptical of *Quill* and its physical presence test in the context of Delaware holding companies.[275] For intangible-based income, he tells us, a nexus test premised on physical presence "would be totally incongruous in our modern, service-based economy."[276] Like his fellow critics of *Quill*, Mr. Laskin starts with *Bellas Hess* which, he states, "merely mirrored state practice" at the time it was decided.[277] The Court's subsequent affirmance in *Quill* of the physical presence test, first articulated in *Bellas Hess*, was "grudging."[278] Concludes Mr. Laskin: "a physical presence Commerce Clause nexus test [is] entirely unworkable as applied to the taxation of intangibles or the income derived therefrom."[279]

Not surprisingly, the critics of *Quill* have, with a united voice, called for Congress to accept the Court's invitation to overturn that decision by establishing an economic presence test for nexus under the sales and use taxes. Professor John L. Mikesell emphasizes the difficulty of collecting use tax as long as out-of-state vendors with no physical presence in the buyer's state are immune from the obligation to collect use tax on their sales. "The problem" of collecting the use tax, he warns, "will only worsen as more and better information technology options become available for concluding transactions without face-to-face contact between buyer and seller."[280] The only solution, Professor Mikesell writes, is for Congress "to help the states" by enacting legislation permitting the states to impose upon out-of-

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[272] Robert D. Plattner, Quill: *Ten Years After*, 2002 STT 189-3, ¶ 4 (Sept. 30, 2002).

[273] *Id.* at ¶ 29.

[274] *Id.* at ¶ 35.

[275] Sheldon H. Laskin, *Only A Name? Trademark Royalties, Nexus, and Taxing That Which Enriches*, 22 AKRON TAX J. 1 (2007).

[276] *Id.* at 4.

[277] *Id.* at 9.

[278] *Id.* at 12.

[279] *Id.* at 23.

[280] John L. Mikesell, *The Future of American Sales and Use Taxation*, *in* THE FUTURE OF STATE TAXATION 29 (David Brunori ed., 1998).

state sellers the obligation to collect use tax on sales into the taxing state.[281]

The analysis of Professor William F. Fox is similar: "[a] nexus standard relying on physical presence is simply inconsistent with an economy that no longer connects vendors and consumers via physical contact."[282] Consequently, "federal legislation is necessary to achieve . . . . an economic concept of nexus."[283]

In his influential treatise, Professor Walter Hellerstein aligns himself with the *Quill* skeptics.[284] Doctrinally, he contends that, prior to *Quill*, the Supreme Court "had never indicated that there was any distinction in the meaning of the nexus requirement" for Due Process and Commerce Clause purposes.[285] "Indeed, [the Court] had suggested precisely the opposite."[286] In light of the Court's "almost apologetic . . . defense" of the physical presence test,[287] Professor Hellerstein suggests that *Quill* may be of limited applicability:

> In light of the Court's lukewarm endorsement of the physical-presence standard of nexus, the implications of *Quill* for jurisdiction to impose corporate income, franchise, capital stock, and other taxes are neither as clear nor as sanguine as they are for mail-order vendors. Rather than defending the physical-presence standard on its merits, the Court pointed to the administrative advantages of the old rule, the reliance interests it had engendered, principles of *stare decisis*, concerns about retroactive application of a new rule, and the superior ability of Congress to address the problem as the key factors motivating its decision to reaffirm *Bellas Hess*. It is by no means apparent that these pragmatic considerations would justify a bright-line physical-presence standard with respect to other taxes.[288]

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281 *Id.* at 30.

282 William F. Fox, *Can the State Sales Tax Survive a Future Like Its Past? in* THE FUTURE OF STATE TAXATION, *supra* note 275, at 40–41.

283 *Id.*

284 1 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 6.02[2] (3d ed. 2007).

285 *Id.* at ¶ 6.02.

286 *Id.*

287 *Id.* at ¶ 6.02[2].

288 *Id.*

Professor John A. Swain is also a *Quill* skeptic, emphasizing the undesirability of physical presence as a nexus standard.[289] Stressing the Court's "[a]pologetic [t]one" in *Quill*,[290] he criticizes *Quill* in the use tax context for hurting state revenues by making the use tax difficult to collect and for "put[ting] physically present businesses at a competitive disadvantage by tilting the economic playing field in favor of mail-order businesses" which need not collect tax on their sales.[291] Professor Swain argues that *Quill* should be limited to the use tax setting[292] and that, in the corporate income tax context, "economic nexus ensures that similarly situated taxpayers are treated the same, both within each state and nationally."[293] He bemoans the fact that "state tax policy has been frozen in the *Quill* headlights" and, for good measure, calls on Congress to repeal P.L. 86-272.[294]

While most commentary on *Quill* is negative, Joseph Henchman mounts a spirited defense of that decision and its physical presence standard.[295] He argues that a nexus "standard unconstrained by geography risks multiple taxation and burdensome compliance costs."[296] While *Quill* critics indict the physical presence approach to nexus as unfair to local merchants who must collect sales tax while out-of-state sellers do not, Mr. Henchman predicts that an economic nexus standard "will burden electronic commerce more than brick-and-mortar businesses" as "there is a high likelihood that e-commerce would become subject to multiple taxation under an economic nexus standard."[297] Moreover, Mr. Henchman suggests, the boundaries of economic nexus are indeterminate. Hence, "adopting an economic nexus standard would unsettle expectations and threaten retroactive application of taxes, endangering economic investments."[298]

While the post-*Quill* literature is largely critical of that decision and its physical presence standard, the commentary on New York's

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

290 *Id.* at 331.

291 *Id.* at 339.

292 *Id.* at 372 ("The central conclusion of this Article is that physical presence is not an income tax nexus requirement.").

293 *Id.* at 383.

294 *Id.* at 393.

295 Joseph Henchman, *Why the* Quill *Physical Presence Rule Shouldn't Go The Way of Personal Jurisdiction*, 46 ST. TAX NOTES 387 (Nov. 5, 2007).

296 *Id.* at 395.

297 *Id.* at 396.

298 *Id.* at 397.

employer convenience doctrine is, if anything, even more negative.[299] Professor Hellerstein, for example, is highly critical of the employer convenience doctrine and its particular application in *Zelinsky*. New York, he contends, simply allocates all such income to itself rather than apportion nonresidents' income as is constitutionally required to avoid double taxation.[300] The employer convenience doctrine, Professor Hellerstein argues, "ignores the distinction between the state's" plenary authority to tax all of a resident's income and its more limited power to tax the income of nonresidents.[301] On days when nonresidents work at their out-of-state homes, New York is not "providing benefits or protections with respect to the production of [the nonresident's] income"[302] and thus lacks the constitutional authority to tax that income. Professor Hellerstein continues:

> Because there can be no serious dispute concerning the power of a state where an employee performs his services to tax the employee's income from such services, the state of the employee's base of operations would appear to lack the power to tax such income on an unapportioned basis.[303]

"[I]t is difficult," Professor Hellerstein observes, "to imagine how the New York Fire and Police departments are protecting Zelinsky while he is grading exams in Connecticut."[304] *Central Greyhound*, he notes, "lent powerful support to Zelinsky's claim" to apportion to New York only the salary attributable to his days actually worked in New York.[305]

Professor William V. Vetter has been similarly critical of New York's employer convenience doctrine and of the New York courts'

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[299] For my own comments on *Zelinsky* and the employer convenience doctrine, *see* Edward A. Zelinsky, *New York's "Convenience of the Employer" Rule is Unconstitutional,* 48 ST. TAX NOTES 553 (May 19, 2008); Edward A. Zelinsky, *Employer Convenience, Telecommuting and the Constitution: The Empire State Really Strikes Back*, 40 ST. TAX NOTES 451 (May 8, 2006); Edward A. Zelinsky, *Yeshiva University Law Professor Issues Statement in Support of H.R. 3359*, 2007 STT 217-1 (Nov. 8, 2007).

[300] 2 Hellerstein & Hellerstein, *supra* note 284, at ¶ 20.05[4][e][i].

[301] *Id.*

[302] *Id.*

[303] *Id.*

[304] 2 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION, ¶ 20.05[4][e][i] (3d ed. Supp. 2007).

[305] *Id.*

justification of that doctrine. Among its other constitutional deficiencies, Professor Vetter concludes that the doctrine flunks the external consistency requirement for a properly apportioned tax:

> [T]he "convenience of the employer" rule necessarily creates the risk of multiple taxation.... A rule that creates a recognizable risk of double taxation does not pass the external consistency test and is therefore void under Commerce Clause principles. Eliminating the risk is the enacting state's duty and is not to be foisted on to other states.[306]

Nicole Belson Goluboff is another outspoken critic of New York's employer convenience rule. A prolific commentator on the legal issues affecting telecommuters,[307] Ms. Goluboff argues that the employer convenience rule, by double taxing nonresidents who work at their out-of-state homes, discourages interstate telecommuting when such telecommuting should instead be encouraged.[308] Telecommuting, she observes, reduces traffic and energy consumption as telecommuters work at home rather than take to the roads.[309] Telecommuting also facilities work by individuals for whom working at home is their best, perhaps their only, option for employment, e.g., certain disabled persons, parents with young children.[310] Ms. Goluboff also notes that encouraging work at home increases the economy's ability to cope with physical disruptions such as hurricanes and terrorist attacks by establishing an at-home work force which can continue to function when central offices are shut down.[311]

Professor Morgan L. Holcomb also concludes that "the *Zelinsky* court erred" in upholding the employer convenience doctrine against Commerce Clause challenge.[312] She agrees with Ms. Goluboff that the kind of double taxation caused by the employer convenience doctrine

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[306] William V. Vetter, *New York's Convenience of the Employer Rule Conveniently Collects Cash From Nonresidents, Part 2*, 42 ST. TAX NOTES 229 (Oct. 23, 2006).

[307] *See, e.g.*, NICOLE BELSON GOLUBOFF, THE LAW OF TELECOMMUTING (2001).

[308] Nicole Belson Goluboff, *The Telecommuter Tax Fairness Act Is Back, and the Climate Is Right*, 44 ST. TAX NOTES 109 (Apr. 9, 2007).

[309] *Id.* at 112.

[310] *Id.*

[311] *Id. See also New York Lawyer Urges Advance of H.R. 3359 Together with H.R. 1360*, 2005 STT 217-2 (Nov. 8, 2007).

[312] Morgan L. Holcomb, *Tax My Ride: Taxing Commuters in Our National Economy*, 46 ST. TAX NOTES 679, 688 (Dec. 3, 2007).

generates serious efficiency costs: "discriminatory taxation of commuters has the potential to impact the flow of capital, impair commerce and alter or impair individual travel and work habits."[313] Professor Holcomb raises equity concerns as well:

> To the extent that a taxing system requires interstate commuters to pay more than similarly situated intra-state commuters, the double-taxation is perceived to be, and is, unfair. This perception of unfairness chips away at the taxpaying public's faith in the tax system. This is a serious critique given the current "tax gap."[314]

VI. VOICE AND EXIT

A. Overview

Against this background of case law, legislation and commentary, in this section I revisit the dormant Commerce Clause nexus and apportionment tests and argue that an unarticulated logic underlies these tests: the nexus principle is a rough, but serviceable, proxy for interstate taxpayers' political voice in the taxing state. The apportionment principle serves four important purposes. First, the apportionment rule constrains the states' abilities to export taxes by opportunistically burdening immobile taxpayers acting in interstate commerce. Second, the Commerce Clause requirement that states properly apportion taxes mitigates the external costs arising from taxpayer exit by reducing the need for such exit. Third, by minimizing state tax burdens, the rule of apportionment facilitates entry into the taxing state. Finally, apportionment, by reducing the need for taxpayer exit, reinforces the discipline of the taxing state's political processes since the persons most likely to exit for tax reasons are the most tax-sensitive persons in the state. The dormant Commerce Clause apportionment rule, by keeping these tax-sensitive persons within the taxing state, bolsters the voices for tax discipline in the political process.

My reexamination of the nexus and apportionment tests starts with first principles: why does anyone need federal constitutional

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[313] *Id.* at 687.

[314] Morgan L. Holcomb, *Tax My Ride: Taxing Commuters in our National Economy* 31 (Univ. of Minn. Law Sch., Legal Studies Research Paper Series, Paper No. 07-36, 2007), *available at* http://ssrn.com/abstract=1007088.

protection from state taxation? At first blush, the need for such protection is not apparent. A person subjected to state taxation to which he objects has, in Professor Hirschman's famous formulation,[315] resort to both voice, i.e., recourse to the political process, and exit, i.e., the option to leave the taxing state. The voice option in tax settings plays an iconic role in Americans' understanding of their nation's origins: the core narrative of the American Revolution starts with the colonists' protest against taxation without representation.[316] The exit option is the central feature of the Tiebout model which is today critical for much legal and economic scholarship.[317]

In an ideal world of political voice and Tieboutian exit, states' overtaxation is self-correcting: taxpayers' political protests lead state policymakers to reconsider imprudent taxes or to avoid them in the first place. Taxpayers' (explicit or implicit) threats to leave the state similarly discipline policymakers who will be held responsible for such departure. If some taxpayers actually make good on the threat to leave, the political consequences impel policymakers to stem the tide of departures by reducing state tax burdens. Since this ideal world is also a world without externalities, the economic and political effects of any particular state's tax policies impact wholly within the boundaries of that state. We can accordingly rely on each state's own political system to assess fully the burdens of taxation and the corresponding benefits of the public services which such taxation finances.

In this ideal world, there is no need for federal judicial protection for interstate actors as there is no "structural"[318] problem of state taxation that requires remediation under the dormant Commerce Clause. In this world, voice and exit preclude states from adopting or

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[315] Hirschman, *supra* note 8.

[316] *See, e.g.*, CHRISTOPHER HITCHENS, THOMAS PAINE'S RIGHTS OF MAN 28 (2006) ("Crown policy, like a brittle antique sword, was dull and inflexible, and insisted upon taxation without representation."); ROBERT KAGAN, DANGEROUS NATION 30 (2006) ("The colonists at the time insisted the issue was taxes and the right to levy them, and if one understands it in the broadest sense, there is no reason to quarrel with the claim."); STEVEN WALDMAN, FOUNDING FAITH 40 (2008) ("No taxation without representation. That's what the American Revolution was about — the fight for political and economic liberty, or so we're taught in school.").

[317] *See, e.g.*, THE TIEBOUT MODEL AT FIFTY (William A. Fischel ed., Lincoln Institute of Land Policy 2006); Edward A. Zelinsky, *Metropolitanism, Progressivism, and Race*, 98 COLUM. L. REV. 665 (1998); Edward A. Zelinsky, *Tax Incentives for Economic Development: Personal (and Pessimistic) Reflections*, 58 CASE W. RES. L. REV. (forthcoming 2008).

[318] Quill Corp. v. North Dakota, 504 U.S. 298, 312 (1992).

continuing overly-burdensome tax policies. These political and market mechanisms obviate the need for judicial intervention.

B. Physical Presence as Proxy for Political Voice

While the three assumptions underpinning this model world — the responsiveness of the political process, taxpayer mobility in the face of undue tax burdens, the absence of externalities from state tax policies — are often plausible, they often are not.

As to political processes, modern public choice theory cautions that political decision-making may be captured by concentrated and narrow interests.[319] Such well-organized but often parochial interests may benefit from tax policies that burden interstate businesses without those capturing interests bearing much, perhaps any, of the resulting costs. Consequently, an interstate taxpayer may be subject to state taxation but possess little practical standing in the state's political process to challenge that taxation. The classic example is the nonresident who is subject to state taxation but does not vote for the legislature of the taxing state. The nonresident can lobby in the state capital, contribute to the campaigns of elected officials in the taxing state, and otherwise make common cause with others. However, at its core, this nonresident lacks the basic entitlement for effective political voice, namely, the right to vote for the public officials taxing him. The inability of nonresidents to vote for the New York legislature in large measure explains the persistence of that state's employer convenience doctrine: the temptation to tax nonvoters is politically irresistible.

Consider also two interstate corporations, one with property and employees in the taxing state, the other without. In practical terms, the former's political status is more formidable than the latter's. A corporation with an in-state payroll is a significant political force: few legislators want their constituents to be told by their respective employers that jobs have been jeopardized by state tax policies the legislators have enacted. In contrast, an out-of-state corporation that merely ships goods into the taxing state carries less political weight than its counterpart with in-state employees and property. The

[319] *See, e.g.*, Clayton P. Gillette, *Local Redistribution, Living Wage Ordinances, and Judicial Intervention*, 101 NW. U. L. REV. 1057, 1086 (2007) ("potential beneficiaries constitute an intense and discrete interest group, more capable than the diffuse subsidizers of overcoming obstacles to organized lobbying"); Edward A. Zelinsky, *Unfunded Mandates, Hidden Taxation and the Tenth Amendment: On Public Choice, Public Interest, and Public Services*, 46 VAND. L. REV. 1355 (1993).

consumers purchasing a corporation's products in-state are the kind of scattered and disorganized interest which can rarely form a politically efficacious constituency.

Central to this familiar diagnosis of political processes are the transactional costs of monitoring political actors and of organizing interests to influence such actors. These costs cause the widely-noted imbalance between concentrated interests with much at stake in the political process and dispersed interests which, while potentially great in the aggregate, entail comparatively small stakes for every individual member of the interest group. For the former, monitoring the political process and expending resources to influence that process are rational economic choices, given the relative ease with which concentrated interests can organize themselves and the potential profit of doing so. In contrast, dispersed interests are likely to remain disorganized and ill-informed and, hence, politically quiescent.

These widely-shared public choice premises confront the courts with a conundrum: can they distinguish those situations in which interstate taxpayers' political remedies effectively protect them from excessive state taxation from those situations in which the political process is inadequate to safeguard such taxpayers' legitimate concerns? One tempting possibility is for the courts to ignore in every case the potential deficiencies of political processes and thereby relegate all interstate taxpayers claiming overly-burdensome taxation to their political remedies. Under this approach, the courts would ignore all complaints about excessive taxation of interstate actors on the theory that the complaining taxpayer has resort to the legislature imposing the taxes to which he objects.[320]

The chief problem with this approach is that interstate taxpayers' political remedies do not always protect them from excessive tax burdens. One need not be a devotee of public choice theory in its strongest forms to recognize that, in many contexts, this theory's portrayal of the political process is correct. There are instances in which taxpayers lack effective political voice and can accordingly be subjected to excessively onerous taxation.

If it is unrealistic to suppose that interstate taxpayers always possess adequate political remedies to avoid undue tax burdens, it is equally unrealistic for the courts to second guess every tax law and

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[320] The courts would still hear taxpayers' complaints that particular statutes or regulations are being applied improperly to them. They would not, however, adjudicate the kind of cases today brought under the Commerce Clause claiming undue burden on the taxpayer in interstate commerce.

regulation, on the theory that political processes can never be trusted to allocate tax burdens to interstate actors. On a pragmatic level, in our integrated national economy, if every unhappy interstate taxpayer has a justiciable claim, the courts will be doing little else but hearing tax cases. On a theoretical level, the mere fact that a legislature or tax administrator has decided against a taxpayer does not prove that the political process has failed. The taxpayer's position may be wrong on the merits. Even if the taxpayer can muster convincing arguments for lowering his tax burden, his loss does not prove that he had no voice in the political process, only that he lost a particular battle. Taxation is, at its core, an inherently political matter.

In between these polar positions (never intervene to protect interstate taxpayers from undue taxation, always intervene to protect them) is the possibility that, on a case-by-case basis, the courts should assess whether a particular interstate taxpayer is a member of a concentrated interest, capable of organizing to protect itself politically, or is part of the disorganized whole. Only interstate actors falling into the latter group would, because of their presumptive political impotence, receive judicial review of their complaints about undue taxation.

Whatever the theoretical merits of this approach, the distinction between concentrated and disorganized interests does not readily yield administrable standards. Would the courts examine campaign contributions and other forms of lobbying to determine if the complaining taxpayer was adequately represented in the legislature? Perhaps the tax policies to which a taxpayer objects reflect the victory of another organized interest over the organized interest group to which the taxpayer belongs. It is unlikely that the courts could make these kinds of judgments well or should make them at all, even if they could do so.

At this point in the analysis, the underlying logic of a dormant Commerce Clause test of physical presence nexus emerges: physical presence serves as a rough, but serviceable, proxy for political voice. While it involves interpretive and borderline issues (what important legal principle does not?), physical presence is a workable standard for distinguishing between interstate taxpayers with political remedies in the taxing state and interstate taxpayers with inadequate standing in the political system of the taxing state. My claim is not that physical presence is a perfect marker for identifying those interstate taxpayers with standing in the taxing state's political processes. It is, however, the best of the available alternatives for deciding which interstate taxpayers have political recourse for their claims of overtaxation and which do not. A physical presence test for dormant Commerce Clause tax nexus thus mitigates the modern version of taxation without representation.

Both the Supreme Court and commentators have identified as an important dormant Commerce Clause concern the adequacy of taxpayers' political voice in the taxing state. In *Goldberg v. Sweet*, the Court, upholding the Illinois tax on interstate telephone calls, distinguished that levy from "Pennsylvania's flat taxes on the operation of all trucks on Pennsylvania highways."[321] For the Court, an important difference between the two taxes is that the Illinois tax falls on Illinois telephone customers who have resort to the Illinois legislature. In contrast, the stricken Pennsylvania tax "burdened out-of-state truckers who would have difficulty effecting legislative change" in the Pennsylvania legislature.[322]

In *West Lynn Creamery, Inc. v. Healy*, the Court invalidated a Massachusetts milk tax on dormant Commerce Clause grounds because, *inter alia*, of similar concerns about out-of-state taxpayers' lack of political voice.[323] The challenged tax applied to milk produced both in-state and out-of-state but the proceeds of the tax financed subsidies restricted to Massachusetts dairy farmers. The Court reasoned that there would be no effective voice against the tax in the Massachusetts legislature since the tax funded Massachusetts farmers who would otherwise oppose the tax.[324] Because of this neutering of in-state political opposition to the milk tax, the "State's political processes can no longer be relied upon to prevent legislative abuse" against out-of-state dairy farmers.[325]

Most recently, in *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Management Authority* the Supreme Court rejected a dormant Commerce Clause challenge to local "flow control" ordinances.[326] The challenged ordinances require that solid waste be taken for disposal to public processing facilities which are more expensive than private, out-of-state alternatives. Among the Court's reasons for sustaining the local ordinances is "that the most palpable harm imposed by the

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[321] Goldberg v. Sweet, 488 U.S. 252, 266 (1989); *see also* Am. Trucking Ass'n v. Scheiner, 483 U.S. 266 (1987).

[322] Goldberg, 488 U.S. at 266.

[323] West Lynn Creamery, Inc. v. Healy, 512 U.S. 186 (1994).

[324] *Id.* at 200.

[325] *Id.*

[326] United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth., 127 S. Ct. 1786 (2007).

ordinances — more expensive trash removal — is likely to fall upon the very people who voted for the laws."[327]

Commerce Clause commentators have made similar observations. For example, Professors Eskridge and Ferejohn identify as a central concern in the historical evolution of the dormant Commerce Clause the possibility that "state and local legislation is . . . more likely to impose external costs on people not well-represented in the state or local political process."[328]

What the courts and commentators have not yet done is draw the connection between physical presence and political voice: physical presence is a rough, but serviceable, marker for political voice in the taxing state.

I expect opponents of a physical presence standard for Commerce Clause tax nexus to mount four criticisms of this conclusion. While these criticisms all carry some weight, in the final analysis, they do not counterbalance the benefits of physical presence as a proxy for the interstate taxpayer's ability to protect himself in the taxing state's political process.

First, physical presence as a proxy can be attacked as both overinclusive and underinclusive. Under a physical presence test, the single in-state sales representative in *Tyler Pipe*[329] provides nexus to the taxing state while a massive out-of-state retailer, e.g., Amazon.com, is deemed to lack influence in the political system of the taxing state. A critic might plausibly argue that, in this example, the physical presence test imputes to the single sales representative political influence he likely lacks and ignores the potential political heft of the large out-of-state retailer.

In particular cases, this critique rings true, although it is not obviously true in all cases: if Amazon.com or another similar firm threatens to stop selling into a particular state because of the state's tax policies, many legislators may well shrug their shoulders with the observation that other firms will fill any resulting gap. Elected officials may be criticized for taking campaign funds from out-of-state interests while the lobbyists for those interests may be hampered in their efforts by the fact that they represent a firm with no in-state employees or property. In contrast, the concerns of a single in-state

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327 *Id.* at 1797.

328 William N. Eskridge, Jr. & John Ferejohn, *The Elastic Commerce Clause: A Political Theory of American Federalism*, 47 VAND. L. REV. 1355, 1367 (1994).

329 *See supra* notes 65–69 and accompanying text.

sales representative may well energize the legislators in whose district the representative is located.

Nevertheless, I would agree that, in particular cases, physical presence will impute political standing to interstate actors who lack it and will deny such standing to those who possess it. Most obviously, New York's employer convenience doctrine reflects the political impotence in New York of nonvoting nonresidents who physically spend part of their working time in that state and telecommute from their out-of-state homes for the remainder of their working time. If the relevant criterion is one of doctrinal perfection, physical presence fails. But so do the alternatives, i.e., assuming the political system always works to protect interstate taxpayers from undue tax burdens, assuming the political system never works to protect them, attempting a case-by-case analysis of interest group influence. Among these, physical presence as a proxy for political standing is the best of the choices because it provides a workable, if rough, marker of political voice.

To those skeptical that physical presence is a workable marker for political standing in the taxing state, I would cite the widespread post-*Moorman* shift to formulas for apportioning corporate income taxes which double count sales fractions or, sometimes, only use a sales fraction for such apportionment.[330] This shift indicates that corporations with significant in-state physical presence carry more political influence than corporations with little payroll and property but many sales in the taxing state. Professor Pomp argues that states' movement to apportionment formulas with double-weighted sales factors reflects the political heft of in-state industry which, by virtue of its in-state presence, has "easy access to the state legislature and can threaten to move their facilities and jobs elsewhere."[331] He specifically attributes to the influence of such local producers the shift to double-weighted sales formulas in Maine, Georgia, Florida, West Virginia and New Mexico.[332] I believe the same is true of other states, namely, that corporations with significant in-state physical presence in the form of property and payroll have catalyzed legislatures to shift the state corporate tax burden to corporations with minimal in-state presence but with large sales in the taxing state. In this context, physical presence proves to be a very accurate proxy for political influence.

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[330] *See supra* notes 235–239, and accompanying text.

[331] Pomp, *supra* note 235, at 56.

[332] *Id.*

The shift to double-weighted sales formulas is instructive in the context of a second possible argument against the use of physical presence as a proxy for political standing in the taxing state, namely, that corporations with significant physical presence provide virtual representation to those without it. This line of argument would accept the premise that firms with property and payroll in the taxing state have greater political influence than businesses lacking such physical presence, but would counter that the latter can free ride on the political efforts of the former.

However, a theory of virtual representation, whether of nonvoting colonials[333] or unborn heirs,[334] is plausible only if those with actual representation in the political system have interests closely aligned with those of the persons they are deemed to be representing virtually. The shift to double-weighted sales formulas suggests that this is not so. At least in tax settings, corporations with substantial in-state property and payroll have different, indeed often competing, interests from firms lacking such in-state presence. The shift to double-weighted sales factors is plausibly viewed as a device by which firms with minimal sales in the taxing state (but much property or payroll) transfer their corporate income tax burdens to the firms with significant in-state sales (but little property or payroll in the taxing state). If so, it is hard to see how the former are virtually representing the latter.

This is not an isolated example of differing tax interests between firms with significant in-state physical presence and those without it. Rather, such differences are systematic and inherent. For example, firms with large manufacturing facilities in the taxing state benefit from liberal depreciation schedules for machinery, equipment and buildings while firms with large in-state payrolls benefit from lower costs for workers' compensation and unemployment compensation. In contrast, firms which predominantly sell into the taxing state will be concerned with their potential sales and use tax collection obligations, a subject of less concern to firms with much property and payroll but few sales in the taxing state. Indeed, insofar as firms with in-state physical presence must collect sales taxes on their in-state sales, their interests are diametrically opposed to those of out-of-state firms which, per *Quill*, need not collect use taxes on their sales and thus

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[333] A. E. Dick Howard, *The Bridge at Jamestown: The Virginia Charter of 1606 and Constitutionalism in the Modern World*, 42 U. RICH. L. REV. 9, 23 (2007).

[334] Mayfield v. Estate of Mayfield, 680 N.E.2d 784 (Ill. App. Ct., 4th Dist. 1997).

enjoy a comparative price advantage. In short, it is unrealistic to assume that, in tax contests, the interests of sales-oriented firms are advanced in the political process of the taxing state by corporations whose physical presence yields differing tax interests.

When an out-of-state and an in-state corporation are affiliated, the latter can properly be deemed to virtually represent the former. The mutual interests which flow from common ownership, I suggest below,[335] incent and enable the corporation with in-state physical presence to protect the political interests of its affiliate without such presence. However, absent such common ownership, it is unpersuasive to view firms with significant physical presence in the taxing state as advancing the very different tax interests of firms with little or no physical presence, but substantial sales, in that state.

A third rejoinder to my defense of a dormant Commerce Clause physical presence test is the frequently-advanced argument that such a test is ill-suited to a modern economy. As an ultimate matter of tax policy, I agree. As discussed below,[336] I conclude that Congress, when it legislates for the nation as a whole, should utilize the concept of economic nexus to regulate state income, sales, and use taxes. One reason I come to this conclusion is that the taxpayers lacking physical (and thus political) presence in particular states (e.g., mail order and Internet retailers, Internet access providers) are represented in the national Congress. We can accordingly be confident that the political voices of such firms will be heard in the halls of Congress. Indeed, the Internet Tax Freedom Act[337] is testimony to the influence in Washington of these firms.

However, the issue for the courts under the dormant Commerce Clause is not one of long-term federal tax policy but of the adequacy of political voice in the individual states while Congress formulates such policy. While Congress deliberates, a physical nexus test identifies interstate taxpayers with standing in the political processes of the taxing state. A physical presence nexus test thereby protects taxpayers without such standing from the modern version of taxation without effective representation in the political system of the taxing state.

In short, if the inquiry is the proper nexus standard that Congress should legislate, there is a compelling argument that Congress (in

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335 *See* discussion *infra* pp. 72–74.

336 *See infra* pp. 74-76.

337 Internet Tax Freedom Act, 47 U.S.C. 151; *see supra* notes 206–223 and accompanying text.

which all domestic firms have representation) should enact an economic nexus test for states' authority to tax. However, until then, the task under the dormant Commerce Clause should be identifying which persons have political standing in the taxing state to protect themselves from the states' overreaching. For this purpose, a physical presence test is an administrable proxy for such standing.

A final charge against the physical presence test is that it is manipulable: interstate firms can arrange their affairs to avoid physical presence (and thus tax liability) in particular states. This, in a nutshell, is the etiology of the Delaware holding company[338] by which, for tax purposes, interstate corporations purportedly keep valuable assets such as trademarks and other intellectual properties outside the physical jurisdiction of the states in which such assets are used. As I discuss further below, the U.S. Supreme Court has shown the way to minimize, if not eliminate, such manipulation of the physical presence standard, namely, by an expansive definition of physical presence as manifested in *National Geographic.*[339] It is, for example, compelling to impute the physical presence of a parent corporation that owns in-state stores or factories to the parent's wholly-owned subsidiary which leases intangible assets or makes Internet sales into that state. The parent's in-state political voice will protect the interests of the parent's subsidiary.[340]

In sum, the physical presence test for dormant Commerce Clause nexus, while not a perfect marker for political voice in the taxing state, is a reasonable marker, the best of the available approaches for determining when interstate actors have effective political representation in the state taxing them.

C. Exit, Immobility, and Apportionment

Just as political processes often fall short of democratic ideals, so too the Tieboutian exit option proves wanting in particular cases. As an initial matter, some interstate taxpayers may, in practical terms, be immobile, making exit an infeasible response to overly-burdensome state tax policies. Such immobile taxpayers, unable as a practical matter to leave the taxing state, may, in lieu of departing, instead export their tax burdens to persons in other states. Moreover, state

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338 *See supra* note 91 and accompanying text.

339 *See infra* notes 363–372 and accompanying text.

340 *See* discussion *infra* pp. 72-74.

legislators may target such immobile firms deliberately to force them to shift tax burdens onto out-of-state persons.

Taxpayer immobility may stem from a variety of sources. Some taxpayers own in-state investments they can neither sell nor afford to abandon, e.g., a recently-built, single purpose facility which is not attractive to another buyer except at a heavily discounted price or a lengthy rail line produced at great (and now sunk) cost. The locations of other firms may be constrained by the particular attributes of specific geographic areas. A company that cans cranberries must locate its factory near the farms which supply that facility. As Professor Gillette has noted, in a modern urbanized economy, the most important source of taxpayer immobility is the existence of agglomeration economies,[341] i.e., the efficiencies which result from the proximity of related firms. To take a classic example, a software company may be required to operate in Silicon Valley to be near its customers and suppliers. In similar fashion, a manufacturer of auto parts must locate adjacent to the factory in which its parts are used.

In sum, particular taxpayers may in practice not possess exit options because the costs of moving are prohibitive. State legislatures can single out these immobile taxpayers for heavy taxation, confident that these taxpayers cannot depart for more favorable tax environments. Insofar as the economic incidence of the higher tax inflicted on immobile in-state actors stays within the taxing state, the story is still relatively[342] benign as in-state shareholders, consumers and/or employees incur the cost of that tax as reduced dividends, higher prices or reduced employment. If these in-state shareholders, consumers and employees perceive and object to these burdens (which will not always be the case), they have resort to their respective voices in the political process: they vote for the legislature which imposed the tax which ultimately impacts upon them.

However, immobile interstate actors may instead export taxes targeted at them to out-of-state owners, consumers or employees, particularly if there are no ready substitutes for the goods or services the immobile firm provides. In that case, there is neither political nor market-based discipline on state policymakers since the ultimate economic incidence of the tax falls on nonresidents who do not vote in the taxing state while the immobile taxpayer upon whom the legal

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[341] Gillette, *supra* note 319, at 1081–85 (defining agglomeration economies as "benefits realized by proximity to other firms within the industry or related to the industry" and arguing that "agglomeration economies constrain the locational decisions of firms").

[342] Not totally benign since the tax may be hidden from many taxpayers.

incidence of the tax falls has no realistic exit option. In this context, the rule of apportionment constrains states from opportunistically exporting taxes by unduly burdening immobile interstate taxpayers.

Not all tax exportation is necessarily bad. Consider, for example, a manufacturer subject to a general property tax along with other similarly-situated property owners. The manufacturer treats this tax as a cost of its operations. Consequently, this property tax will be embedded in the prices of the manufacturer's products and thus ultimately paid by the purchasers of those products, purchasers who may mostly be located in the other forty-nine states. Few, if any, would claim that it is feasible or desirable to preclude this manufacturer from passing its general property tax obligation to its customers throughout the nation in this fashion.

A tax narrowly targeted at this manufacturer because of its interstate sales is a different matter. Such opportunistic tax exportation offends the constitutional intuition that states should not burden the channels of interstate commerce by singling out immobile interstate actors for tax obligations not simultaneously imposed on reasonably comparable local firms. As Professor Shaviro has observed, "tax exportation may pose unusually serious equity and efficiency problems by placing tax burdens on what may often be nonconsenting nonbeneficiaries" of the public services financed by the exported tax.[343]

The distinction between acceptable and opportunistic tax exportation confronts the courts with choices similar to those raised in the context of interstate taxpayers' political voice: the courts could declare the theoretical distinction between permitted and opportunistic tax exportation too unworkable for judicial decision-making and thus ignore the issue entirely. From this vantage, an immobile interstate firm, claiming to have been targeted by an opportunistic legislature for selective, exportable taxation should be consigned to its political remedies. At the other extreme, the courts could interpret the dormant Commerce Clause as condemning all state taxation of interstate actors as unacceptably carrying the risk of opportunistic legislative behavior. Under this expansive approach, the courts would intrude deeply into the substance of state policy.

Alternatively, on a case-by-case basis, the courts could identify when a state opportunistically burdens immobile actors to encourage

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[343] Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 908 (1992).

the exportation of taxes out-of-state. Under this approach, the courts would examine in particular cases such factors as the breadth and economic incidence of particular taxes, the legislative motivations for adopting such taxes, the mobility (or lack thereof) of the complaining taxpayer, as well as the taxpayer's ability to shift the economic incidence of the tax to out-of-state consumers, shareholders and employees. The result would be a body of untidy, indeed unruly, case law decisions, enmeshed in difficult, fact-specific determinations.

Against this background, the rule of apportionment emerges as the best of the possible tests under the dormant Commerce Clause for identifying when states are and are not opportunistically seeking to export tax burdens by unduly burdening immobile taxpayers. Apportionment can be understood as a rough, but workable, approximation of the taxes imposed by a legislature acting in good faith to spread the costs of public services equitably, rather than opportunistically levying upon immobile interstate firms onerous taxes that such firms will export to out-of-state consumers, shareholders and employees. Apportionment thus avoids messy inquiries into legislative intent or ultimate economic incidence. Rather, it poses a manageable, reasonably objective inquiry – are the taxes asserted against interstate actors proportionate to their activities in the taxing state? – designed to assess whether the complaining taxpayer has been singled out unacceptably because it is an immobile actor capable of exporting its tax burden out-of-state.

I anticipate two objections to this understanding of the dormant Commerce Clause rule of apportionment. First, it can be argued, states use different, often inconsistent, apportionment formulas which permit some, perhaps much, tax exportation. As we have seen,[344] after *Moorman*, state *A* may tax the income of an interstate corporation using the traditional three factor formula, state *B* may tax that same corporation's income using a formula which double counts the sales fraction, and state C may tax that same corporation's income based only on the corporation's ratio of in-state sales to total sales. States B and C may assign a greater tax burden to this corporation in the (perhaps *sub silentio*) expectation that the corporation will spread some of that tax burden among out-of-state consumers.

If the standard for assessing the dormant Commerce Clause apportionment test is perfection, this criticism carries considerable force: the post-*Moorman* flexibility of the apportionment rule permits

[344] *See supra* notes 235–239 and accompanying text.

states to manipulate their respective apportionment formulas to achieve a measure of tax exportation.

We should, however, assess the apportionment standard by more modest and realistic criteria. The apportionment test requires a reasonable effort on the part of the state taxing an interstate actor. A sales-only apportionment formula may well approach the boundary of the constitutionally permitted; perhaps it marks that boundary. But whatever the boundary may be, the dormant Commerce Clause rule of apportionment is a useful, if imperfect, constraint on state efforts to export taxation opportunistically by targeting immobile taxpayers for burdensome taxation.

A second possible objection to my formulation of the apportionment rule (also applicable to the physical nexus test) is that the rule fails in practice. Instances of such failure are *Zelinsky*[345] and *Huckaby*[346] in which New York's courts upheld New York's taxation of income earned by nonresidents on days worked at their out-of-state homes.

Such unprincipled judicial decisionmaking does not indicate that the apportionment rule is wrong, but, rather, that it can be ignored by state courts determined to protect the local fisc. The problem evidenced in *Zelinsky* and *Huckaby* stems not from the substance of the dormant Commerce Clause apportionment test but, rather, from two realities of current tax law practice. First, the Tax Injunction Act[347] effectively requires nonresident taxpayers to use the courts of the taxing state to challenge the constitutionality of the state's taxes. These courts are often unsympathetic to the tax claims of nonresidents. Second, the only review of state court decisions in these tax cases is by writ of certiorari to the U.S. Supreme Court.[348] That Court hears few cases and very few tax cases.

In this legal environment, state courts can choose to play what can be called "the cert lottery", holding for the home team while betting on the unlikelihood that aggrieved taxpayers can get the U.S. Supreme Court to hear their cases. The state courts will often win this gamble, as the N.Y. Court of Appeals did in *Zelinsky* and *Huckaby*.

[345] In re Zelinsky v. Tax Appeals Tribunal, 801 N.E.2d 840 (N.Y. 2003).

[346] In re Huckaby v. N.Y. State Div. of Tax Appeals, 829 N.E.2d 276, 284–85 (2005).

[347] 28 U.S.C. § 1341 (2000).

[348] 28 U.S.C. § 1257 (2000).

This is a serious problem, but it is not a problem with the substance of the dormant Commerce Clause apportionment rule. Rather, it is a problem with the current procedures for enforcing that rule and others like it in tax cases. Properly applied, the apportionment rule precludes states from piling taxes upon immobile interstate actors to export such taxes out-of-state.

D. Exit, Externalities. and Apportionment

While some taxpayers are immobile, other taxpayers can in practice exercise their exit options. However, exercising such options may inflict external costs outside the taxing state.

In a classic Tieboutian world, the costs of departure all fall within the taxing state, making state policymakers fully cognizant of such costs. Despite the great value of the Tiebout model, in practice mobile taxpayers, by leaving the taxing state, often cause economic dislocation outside the taxing state. For this reason, tax-motivated exit may move the interstate economy to an economic and geographic allocation of resources that is less efficient than the pre-exit allocation.

Consider again in this context *Complete Auto*.[349] In that case, the taxpayer was the final actor in the interstate manufacture and shipment of cars into Mississippi, a process that started in Michigan. Suppose that the *Complete Auto* taxpayer, instead of litigating against its Mississippi state tax liability, had left Mississippi. This departure would have disrupted the stream of interstate commerce because, for at least the short run, the taxpayer would have no longer completed the chain of delivery to Mississippi car dealers. Eventually, perhaps quite quickly, this departing taxpayer would have been replaced by another firm. However, this replacement firm would have been a less efficient choice than the firm that left Mississippi. Had this replacement firm been the desired supplier all along, it would have been hired *ab initio*.

In other cases, a firm departing the taxing state will not be easily replaced. Most importantly for the dormant Commerce Clause, a taxpayer's departure from the taxing state may alter the economic and geographic allocation of interstate economic activity in ways that harm other states.

Consider, for example, a multistate manufacturing corporation which, in good Tieboutian fashion, closes a plant in state *A* because of state *A*'s tax burden and opens a new replacement plant in state *B*.

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[349] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

Insofar as the costs of this move fall within state *A*, we can plausibly rely on state *A*'s political process to account for those costs. However, in this scenario, the shift from state *A* to state *B* also inflicts costs on persons outside state *A*. If state *B* had been the economically optimal location for its activities, the corporation would have been there all along. While state *B* and its residents benefit from the new plant there,[350] the corporation's shareholders and consumers have been harmed by the tax-induced movement from state *A* (the more desirable location on a pre-tax basis) to state *B* (the less efficient, but tax-induced second best choice). Whether the switch from state *A* to state *B* results in higher prices to consumers, lower profits to shareholders, dislocation of employees who follow the corporation to state *B*, or some combination of these effects, the exercise of the corporation's exit option inflicts costs on persons outside state *A* — whose tax policies trigger the exit. The policymakers of state *A* have no incentive to concern themselves with those external costs. However, the apportionment rule impels those policymakers to behave as if they were concerned about the external costs of taxpayer exit by requiring such policymakers to ameliorate the tax burdens of potential tax-motivated emigrants.

Consider also an individual like Mr. Huckaby who divides his work time between his employer's New York office and his out-of-state home from which he telecommutes, communicating with his New York employer via email, fax, long distance telephone and the Internet.[351] Suppose further that this telecommuter responds to New York's unapportioned taxation of his income earned at his out-of-state home by severing his economic ties to New York.[352] That severance causes tax and economic loss to New York since the telecommuter no longer pays any taxes to New York (New York no longer has tax nexus to him) and no longer generates the economic activity in New York previously created on the days on which the telecommuter was physically present in New York.

If the story ended there, the unapportioned tax levied under the rubric of employer convenience might be dismissed as merely New York's self-inflicted problem. However, the story does not end there: the employer convenience rule, by imposing income tax on days the

[350] Assuming that economic growth is desirable.

[351] *Supra* note 184 and accompanying text.

[352] My very informal survey of persons against whom New York applies its employer convenience doctrine indicates that many, as would be expected, respond by severing their business ties to New York.

interstate telecommuter works at home, has, in this instance, forced him into a less desirable pattern of work designed to skirt New York's tax collector. Had the work arrangement adopted by the telecommuter as a result of New York's tax policies been the economically optimal arrangement, the telecommuter would have pursued that arrangement all along. The telecommuter's exit from New York thus inflicts cost, not just on New York, but on the double taxed telecommuter and the economy as a whole by coercing the telecommuter to undertake his activities in a less desirable, tax-induced geographic pattern to avoid New York. Even if those costs are small as to any individual telecommuter, in the aggregate they constitute significant external costs imposed by New York on the interstate economy.

By requiring New York to levy properly apportioned income taxes on nonresidents, the rule of apportionment minimizes tax-induced exit and the external inefficiencies resulting from such exit. Again, the argument is not that the apportionment principle implements this, or any other, purpose faultlessly. Rather, the argument is that, in a world of imperfect choices, apportionment provides a sensible rule for the courts to manage the imperatives of an interstate economy until Congress exercises its affirmative responsibilities under the Commerce Clause. By minimizing the tax liabilities of mobile interstate firms and persons, the apportionment rule reduces exit and thus curtails the external costs resulting from such exit.

Professors Jack L. Goldsmith and Alan O. Sykes identify "cross-border externalities" as "a problem that has not been well-theorized in either the dormant Commerce Clause cases or the literature."[353] I suggest that the tax rule of apportionment plays an unappreciated role in minimizing such externalities by reducing the need for taxpayer exit.

E. Entry, Immobility, and Apportionment

A third virtue of the apportionment rule is that, just as the minimization of tax burdens discourages exit, it also facilitates entry. This entry-encouraging aspect of the rule of apportionment is particularly important for potential taxpayers contemplating investments which will make them immobile and thus vulnerable to

[353] Jack L. Goldsmith & Alan O. Sykes, *The Internet and the Dormant Commerce Clause*, 110 YALE L. J. 785, 798 (2001).

opportunistic taxation in the state in which they will invest. The apportionment rule assures such taxpayers that, if they make the contemplated investments, they cannot subsequently be targeted for disproportionate taxation.

Consider again in this context *Central Greyhound.*[354] In that case, buses started their journeys in New York, traveled through Pennsylvania or New Jersey, and returned to New York. If Pennsylvania or New Jersey each had the right to tax the full proceeds of the entire trip, Central Greyhound's buses would likely have entered neither of these states, but would instead have stayed wholly within New York and thereby paid a single state's tax. The dormant Commerce Clause apportionment rule permitted Central Greyhound's buses to enter Pennsylvania and New Jersey, confident that such entry would not entail a significant tax penalty.

Concern about potential tax penalties for entry are particularly acute for firms planning major investments which will effectively render them immobile. Suppose, for example, that firm *X* is examining the possibility of a major investment in state *A* to construct a large, single purpose facility. Once built, this facility cannot easily be abandoned or converted to another use. In deciding whether to build, firm *X* will be concerned about state *A*'s future tax policies. Once the facility is erected, *X*'s immobility will make it vulnerable to state *A*'s opportunistic behavior. State *A* may be tempted to impose onerous tax burdens on this now-immobile firm, confident that *X*, once it is entrenched in state *A*, cannot leave. Even if *X* can pass these taxes onto its customers, it will view this potential scenario with concern — adding onerous taxes to the price of its goods will disadvantage *X* in the marketplace. Equally serious for *X* is the possibility that burdensome taxes imposed upon *X* after it has invested in state *A* cannot be transferred to the firm's customers. In this case, *X*'s shareholders, whose dividends will be decreased by these taxes, will retroactively view the decision to build in state *A* as mistaken. These risks will deter firm *X* from building in state *A*, even if state *A* is the most efficient location for *X*'s new facility.

State *A* may attempt to mitigate *X*'s tax concerns to encourage the contemplated investment. State *A* might, for example, provide contractual assurances about its future tax policies. Alternatively, state *A* might provide inducements to firm *X* in the form of direct subsidies for *X*'s proposed investment in *A*. However, these

[354] Cent. Greyhound Lines v. Mealey, 334 U.S. 653 (1948).

assurances are hindered by the possibility that state *A* might later renege on its promises or might attempt to recoup its earlier largesse to *X* through subsequent taxation. The governor who recruits firm *X* to state *A* may find it difficult to bind his successor, a difficulty that will deter *X* from entering state *A*.

A constitutional rule of apportionment assures firm *X* that there are limits on the taxes which state *A* can impose once *X* makes its investment in state *A*. Under this rule, *X* can invest in state *A* with a degree of assurance, knowing that the dormant Commerce Clause places outer boundaries on state *A*'s subsequent adoption of opportunistic tax policies. The principle of apportionment thereby encourages interstate mobility of capital: *X* can enter state *A* knowing that it is protected by constitutional limits on *A*'s ability to tax it.

The U.S. Supreme Court often speaks of the dormant Commerce Clause as precluding the "Balkanization" of the U.S. economy.[355] While this rhetoric is overstated,[356] facilitating the movement of persons and capital across state lines is an important rationale for the clause. If every state can assess tax against all of the income of a corporation which operates throughout the nation, the corporation will be deterred from entering many, perhaps most, states. By instead placing limits on the tax each state may impose, the dormant Commerce Clause rule of apportionment encourages persons and capital to enter new states. In particular, this constitutional limit reduces the risk that, once they invest, immobile interstate actors will subsequently be targeted for onerous taxation, disproportionate to such actors' activity in the taxing state. The rule of apportionment thereby encourages persons and capital to move across state lines.

F. Exit, Apportionment, and Voice Within the Taxing State

A final virtue of the apportionment rule is that it preserves the in-state constituency for tax discipline by minimizing tax-motivated departures. It is tax-sensitive taxpayers who are most likely to exit because of the taxes imposed on them. By curtailing the tax burdens of these tax-sensitive taxpayers and thus reducing their departures from the taxing state, apportionment bolsters the in-state voices for tax restraint.

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[355] *See, e.g.*, Camps Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564, 577 (1997).

[356] Zelinsky, *Restoring*, *supra* note 6, at 81–82.

Instructive in this context is Professor Hirschman's observation that "those customers who care *most* about the quality of the product and who, therefore, are those who would be the most active, reliable, and creative agents of voice are for that very reason also those who are apparently likely to exit first in case of deterioration."[357] A well-known example of this phenomenon, cited by Professor Hirschman, is urban public education: the parents most concerned about school quality are the parents most likely to move their children to suburban and private schools which they perceive as better. Had these parents not had these exit options, they would have been the most vociferous proponents for improving the urban systems which they instead left.[358]

There is much debate about the extent to which business firms respond to state tax incentives.[359] For present purposes, I simply advance the modest claim that the firms that depart first for tax reasons are those that are most sensitive to their tax burdens and that, following Professor Hirschman's logic, would have been the most vocal about their tax burdens had they stayed instead. By minimizing tax burdens and thus tax-related exit, apportionment reinforces voice in the in-state political processes since those who depart are the firms which, because they are the most tax-sensitive, would have been most outspoken politically if they had stayed.

This concern is particularly salient when the in-state political process has been captured by groups that do not feel the pain of taxpayer exit. In these circumstances, the tax-motivated departure of firms and residents will not be self-correcting because the political system responds only to interests that do not incur the costs of such departure. The best hope for this state is that tax-sensitive firms will stay and use their voice to overcome the capture of the political system. Thus, the underlying concerns of apportionment and nexus reinforce each other: apportionment keeps in the state those who are vocal by minimizing their tax burdens and thus curtailing their exit from the state and its political process.

G. Why Not Nondiscrimination?

It is now time to confront what is perhaps the strongest potential riposte to my defense of the apportionment and physical nexus tests:

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357 *See* Hirschman, *supra* note 8, at 47.

358 *Id.* at 45–46.

359 *See, e.g.*, James R. Rogers, *The Law and Policy of State Tax Competition: Much Ado About Nothing?* 4 GEO. J. L. & PUB. POL. 101 (2006).

how can I justify these dormant Commerce Clause concepts while I simultaneously call for abandonment of the *Complete Auto* nondiscrimination principle?[360]

My call for abolishing the dormant Commerce Clause nondiscrimination rule rests on the contemporary doctrinal incoherence of that rule. Whatever the historic logic of the nondiscrimination principle, this principle's past service in creating a continental common market, or its intuitive appeal, the dormant Commerce Clause notion of nondiscrimination is today fundamentally incoherent. Certain ill-defined state tax policies are stricken as discriminatory while economically and procedurally equivalent direct expenditures are sustained. Within the universe of tax policies, no reliable or convincing criteria separate discriminatory taxes from nondiscriminatory taxes. The problem is not at the borderlines of the dormant Commerce Clause nondiscrimination principle, but at its core. We cannot identify which tax policies are discriminatory and which are not, nor can we explain why certain taxes violate the dormant Commerce Clause while economically and procedurally comparable direct expenditures do not. If we retire the dormant Commerce Clause principle of nondiscrimination, those claiming to be victimized by "discriminatory" taxation will still have their political remedies in Congress and in the state legislatures imposing the challenged taxation, as well as their option to exit from the taxing state.

In contrast, the nexus and apportionment rules today both serve important purposes and serve these purposes tolerably well. Physical nexus is a rough measure for identifying taxpayers with political standing in the taxing state. The requirement that taxes imposed on interstate actors be properly apportioned minimizes states' abilities to target immobile taxpayers who will export their tax burdens out-of-state. The apportionment test also curtails interstate taxpayers' tax liabilities and thereby both reduces their need to exit and facilitates their entry. Reducing taxpayer exit moderates the external costs such exit imposes and keeps within the taxing state the most tax-sensitive and thus most vocal taxpayers.

If state taxation of a particular taxpayer passes the nexus and apportionment tests, we can be reasonably confident that this taxation is being imposed in a proper measure on a taxpayer with political voice in the taxing state. At that point, if the taxpayer still believes himself to be overly taxed (i.e., believes that he has been treated

360 *See supra* note 6.

"discriminatorily"), his claim should be treated politically, rather than judicially.

It is consequently compelling to insist, for dormant Commerce Clause purposes, that states tax interstate actors only if such actors have adequate nexus and thus political standing in the taxing state. It is also convincing to restrict states' taxation of interstate actors to properly apportioned taxes. At that point, it is appropriate to declare that any further claims the taxpayer may advance belong in political fora.[361]

Indeed, the doctrinal viability of the nexus and apportionment rules facilitates the abandonment of the now incoherent principle of nondiscrimination. Consider, in this context, an interstate taxpayer who claims to be the victim of discriminatory taxation but who acknowledges that, for dormant Commerce Clause purposes, he has physical nexus to the taxing state and that this state has imposed a tax burden which is properly apportioned to the taxpayer's in-state activities. If so, it is appropriate to relegate this taxpayer's claim of discrimination to the political arena since this taxpayer, by virtue of his physical presence, has standing in the political process and the tax imposed on this taxpayer is admittedly apportioned. Any residual claim of discrimination should be pursued politically.

VII. REVISITING THE CASE LAW AND LEGISLATIVE PROPOSALS

In this final section, I revisit the contemporary case law controversies and legislative proposals in light of my analysis of the nexus and apportionment rules. My understanding of physical presence as a proxy for taxpayers' political voice leads me to defend the much criticized *Quill* decision and to propose, for dormant Commerce Clause purposes, an expanded version of the physical presence test for other forms of state taxation. While Congress crafts federal legislation in this area (as it should), the judiciary should enforce a physical presence test for tax nexus under the dormant

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[361] I agree with those who argue that there is little content to the fourth element of the *Complete Auto* test, i.e., that state taxes must be "fairly related to the services provided by the State." Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977). *See, e.g.*, Robert D. Plattner, *New York's 'Convenience of the Employer' Doctrine – A Role for* Complete Auto Transit's *Fourth Prong*, 29 ST. TAX NOTES 55 (July 7, 2003) ("[T]he fourth prong of the *Complete Auto Transit* test [was] emasculated in *Commonwealth Edison* and appropriately relegated to bit-player status ever since.") (footnotes omitted).

Commerce Clause. Such a judicially-enforced test precludes a state from taxing persons without effective voice in the political system of that state. From this vantage, the Court got *Quill* right: state taxation of physically absent taxpayers is taxation without effective representation.

I also conclude that Congress should adopt comprehensive legislation addressing state taxation of interstate actors. In particular, Congress should enact federal statutes prescribing objective standards for state tax nexus and for identifying commonly controlled entities for state tax purposes. Congress should also require nationally uniform apportionment formulas for corporate income taxes and should regulate state taxation of nonresidents' incomes.

As we have seen,[362] its many critics view *Quill* as, at best, a misguided application of stare decisis, a begrudging acknowledgment of reliance interests which *National Bellas Hess* engendered for the mail order industry and for other out-of-state sellers. In contrast, I suggest an unarticulated logic to *Quill* and its physical presence requirement for tax nexus, namely, physical presence as a workable, if imperfect, proxy for voice in the political process of the taxing state.

The political voice rationale for the physical presence standard indicates that the courts should, as a matter of dormant Commerce Clause jurisprudence, extend *Quill* and its physical presence test to other forms of state taxation until Congress legislates in this area. The political voice rationale also suggests that physical presence should, in some cases, be understood broadly. In particular, a corporation's in-state physical presence should, for tax nexus purposes, be imputed to its affiliated out-of-state corporation because the political voice in the taxing state of the physically present taxpayer can protect the political interests of its affiliate which lacks such physical presence.

From this perspective, the taxing state possesses dormant Commerce Clause nexus to a Delaware (or other out-of-state) holding company which leases intangible property to a parent, subsidiary or brother-sister corporation with physical presence in the taxing state. The political standing of the firm with physical presence in the taxing state, combined with the common ownership of that firm and of the out-of-state holding company which leases to it, creates a relationship of virtual representation. The corporation with in-state physical presence and its out-of-state affiliate are ultimately owned by the same shareholders who have the ability and the incentive to deploy

[362] *See supra* notes 267-294 and accompanying text.

the political voice of the in-state firm to protect the tax concerns of its out-of-state affiliate.

Deciding when firms are commonly-controlled necessarily involves drawing lines that will often be arbitrary and fact-specific: Need a single owner possess majority voting power in each of two entities to be deemed in control of both of them? Can two large, publicly-traded corporations with widely-scattered ownership both be controlled by a single common owner who owns a minority interest in each? As I discuss in a moment, these and other issues are best addressed legislatively.

However, pending such federal legislation, the courts can and should identify those situations in which an out-of-state firm has nexus to a taxing state by virtue of the physical presence in that state of a commonly-controlled corporate affiliate. The courts currently undertake similar determinations under the unitary business rubric.[363] In cases such as *Allied-Signal*,[364] the courts assess, *inter alia*, whether sufficient common control exists between different corporations to treat them as a single entity for apportioning income to the states in which they operate. Until Congress legislates, the courts should similarly determine for dormant Commerce Clause nexus purposes whether a corporation with physical presence in the taxing state and another corporation outside the taxing state are commonly-controlled. If so, the outside-of-state corporation affiliated with the corporation physically present in the taxing state should also be deemed to have tax nexus to that state.

I would thus approach *Geoffrey*[365] differently than did the South Carolina Supreme Court. The Delaware holding company in that case was part of a group of commonly-controlled corporations. One member of the group had physical presence in South Carolina in the form of Toys R Us stores and payroll. The political voice of that physically present corporation should be imputed to the out-of-state holding company which leased intangible property to the physically present corporation for use in South Carolina.

Similarly, under an expanded physical presence test for dormant Commerce Clause nexus, *J.C. Penney National Bank v. Johnson*[366] is decided wrongly. The Tennessee appeals court found it significant

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[363] *See supra* pp. 21-23.

[364] Allied-Signal, Inc. v. Dir., Div. of Taxation, 504 U.S. 768 (1992).

[365] Geoffrey, Inc. v. S.C. Tax Commission, 437 S.E.2d 13 (S.C. 1993).

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

that J.C. Penney's credit card activities were operationally independent of the J.C. Penney's stores in Tennessee.[367] Under the political voice rationale for physical presence nexus, this fact is irrelevant. The J.C. Penney's stores and payroll gave the J.C. Penney's controlled group political standing in Tennessee's political process. That controlled group had the incentive to use this political standing to protect the tax interests of the out-of-state credit card company which was part of the broader J.C. Penney's group.

Likewise, under an expanded physical presence test for dormant Commerce Clause tax nexus, the Missouri Supreme Court decided *ACME Royalty Company*[368] wrongly. The in-state nexus of the corporations physically present in Missouri should be imputed to the out-of-state holding companies owned by the same interests.

In these, and similar cases, it is just a first step to conclude that the out-of-state leasing corporation has physical presence nexus for tax purposes by virtue of the in-state presence of an affiliated corporation. To assess a constitutional income tax against these out-of-state corporations, the taxing state must, under the dormant Commerce Clause, also apportion its levy to capture only the income earned by the out-of-state corporation through its intangible property used within the taxing state.

The physical presence test for tax nexus also indicates that the West Virginia Supreme Court decided *MBNA*[369] wrongly. Neither MBNA itself nor any corporation commonly controlled with it had physical presence in West Virginia. Under the political voice rationale for physical presence nexus, the West Virginia court in *MBNA* condoned taxation without effective representation. The taxpayer had no political voice in West Virginia since it had no physical presence in that state.[370] The taxpayer had no virtual representation in West Virginia either since no affiliate had physical presence in that state.[371] Absent such physical presence, the dormant Commerce Clause forbade West Virginia from taxing MBNA.

My defense of a physical presence test for dormant Commerce Clause nexus applies for the (likely extended) period during which Congress crafts legislation regulating the state taxation of interstate commerce. That defense buttresses state statutes like Idaho's recently-

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367 *Id.* at 840–42.

368 Acme Royalty Co. v. Dir. of Revenue, 96 S.W.3d 72 (Mo. 2002).

369 Tax Commissioner v. MBNA Am. Bank, 640 S.E.2d 226 (W. Va. 2006).

370 *Id.* at 229.

371 *Id.*

adopted law which assert that out-of-state firms have nexus for tax purposes when such out-of-state firms are related to entities with in-state presence.[372]

In contrast, I oppose the proposals advanced by Senators Schumer and Crapo,[373] Representative Boucher[374] and Senator Bunning[375] to enshrine a physical presence test permanently in the federal statute books. For the period before federal legislation is enacted, a physical presence test under the dormant Commerce Clause prevents the states from taxing firms without voice in their respective political systems. Those firms, however, are represented in Congress which can and should legislate broader criteria for state taxation of interstate actors.

Here, the critics of *Quill* score points. To respond to the imperatives of a modern economy, Congress (in which all domestic and many foreign firms have political representation) should promulgate statutorily comprehensive nexus and apportionment rules. As many have suggested,[376] for nexus purposes, these federal rules should establish objective numerical thresholds in terms of payroll, property or sales. A firm hitting any or some combination of those thresholds in any state (e.g., $100,000 annual sales in such state) should be deemed to have tax nexus to that state. Consequently, the state could assess properly apportioned taxes against such a firm and could require it to collect use taxes on sales shipped into that state. Below those federally-promulgated thresholds, no tax nexus would exist.

As part of this tax nexus legislation, Congress should adopt federal rules defining common control of interstate firms. These rules would prevent firms from artificially dividing themselves into legally separate entities to stay below the federal statutory thresholds for tax nexus. The Internal Revenue Code today includes provisions which, for pension,[377] corporate tax,[378] and consolidated return purposes,[379]

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[372] IDAHO CODE § 63-3611 as amended by H.B. 360, 59th Leg., 2d Reg. Sess. (Idaho 2008); IDAHO CODE § 63-3615A as added by H.B. 360, 59th Leg., 2d Reg. Sess. (Idaho 2008).

[373] Business Activity Tax Simplification Act of 2007, S. 1726, 110th Cong. (2007).

[374] Business Activity Tax Simplification Act of 2008, H.R. 5267, 110th Cong. (2008).

[375] *See supra* note 266 and accompanying text.

[376] *See* Laskin, *supra* note 275, at 42–43.

[377] I.R.C. § 414 (2000).

[378] I.R.C. § 318 (2000).

treat legally separate corporations as a single entity based on objective tests of common ownership. Similar legislation should define common control for nexus purposes so that separate corporations cannot be used to keep business activity in any state below the numerical thresholds for tax nexus. Such a statutory definition of common control could also play an important role in making the unitary business inquiry more objective and thus more administrable.

As part of a comprehensive federal statute concerning tax nexus, Congress should require all states to establish statewide sales tax bases that apply to all sales and use taxes assessed by such states and their political subdivisions. The interstate coordination of sales tax bases encouraged by the Streamlined Sales Tax Project is desirable.[380] However, such coordination is ultimately not necessary as long as myriad local sales tax bases are consolidated under a single statewide base. If an out-of-state firm sells sufficient merchandise into a particular state to trigger tax nexus in that state, it is not overly onerous to expect that firm to learn about that state's particular sales tax base.[381] While it is practical to expect an Internet or mail order firm selling nationwide to master as many as fifty-one sales tax bases promulgated by the states and the District of Columbia, it is not practical to expect such a firm to master 8000 separate sets of rules for local sales tax bases.[382] In sum, interstate sales tax base uniformity, while desirable, is not imperative; intrastate sales tax base uniformity is.

The benefits of an apportionment rule for states' taxation of interstate actors — constraining the states from exporting taxes by targeting immobile taxpayers, minimizing the out-of-state disruption stemming from taxpayer exit, facilitating entry by interstate actors, bolstering the voices for tax-restraint within the taxing state's political process — suggest that Congress should codify the apportionment rule

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[379] I.R.C. § 1504 (2000).

[380] *See supra* note 241 and accompanying text.

[381] While I would require each state to promulgate a single statewide sales tax base for the state and its localities, I would not require a single statewide sales tax rate. The mail order and Internet sales industries have become adept at identifying and targeting customers geographically. Once assured of a single tax base in each state, these industries can collect differing local taxes levied on those statewide bases. Moreover, permitting each locality in a state to assess its own local sales tax rate on a state-determined base serves the Tiebout function of signaling the tax price of residing in that particular locality. On the Tiebout model, see *supra* note 317.

[382] Andrew W. Swain and John D. Snethen, *Economic Nexus: Past, Present, and Future*, 44 ST. TAX NOTES 243, 250 (Apr. 23, 2007) ("Today, more than 8,000 jurisdictions impose" sales and use taxes.).

and provide nationwide standards for states' apportionment of interstate corporations' incomes. I prefer a return to the pre-*Moorman* world by requiring every state with a corporate income tax to use the traditional three-factor formula which was dominant before the *Moorman* decision. However, more important than the particular formula Congress picks is the promulgation of a single formula to mandate nationwide what the court has labeled "external consistency,"[383] i.e., assuring that in practice each taxpayer's interstate income is subject to state taxation *in toto* just once. Such an outcome can only be achieved by requiring each state to use the same apportionment formula.

As to the apportionment of personal incomes, decisions such as *Zelinsky* and *Huckaby* indicate the need for federal legislation in this area as well. Congress should enact the Mobile Workforce State Income Tax Fairness and Simplification Act of 2007[384] and The Telecommuter Tax Fairness Act of 2007.[385] Indeed, the two proposals ought to be enacted simultaneously.[386] Together, these would provide an objective, nationwide nexus test for states to tax nonresidents' personal incomes while preventing states from defeating their obligation to apportion nonresidents' incomes via the employer convenience doctrine and similar artifices. This would encourage interstate mobility of workers since the tax consequences of entering a state and producing income there would be predictable, uniform and proportionate. After a nonresident's presence satisfies the threshold for nexus in a state, that state could then impose properly apportioned tax upon the income the nonresident earns while present in that state.

I do not expect Congress to enact this legislative package overnight. All of these proposals will be politically contentious. For the long run, however, I am an optimist. To thrive in a modern economy, both states and interstate actors will require a national statutory framework for state taxation. It will thus, at some point, become politically compelling for Congress to provide the comprehensive legal framework for state taxation of interstate

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383 Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983).

384 Mobile Workforce State Income Tax Fairness and Simplification Act of 2007, H.R. 3359, 110th Cong. (2007).

385 Telecommuter Tax Fairness Act of 2007, S. 785, H.R. 1360, 110th Cong. (2007).

386 *See* Edward Zelinsky, *Yeshiva University Law Professor Issues Statement in Support of H.R. 3359*, 2007 STT 217-1 (2007).

commerce which only Congress can affirmatively promulgate under the Commerce Clause.[387]

VIII. CONCLUSION

Taxation is an inherently and irreducibly political matter. Physical presence is a rough, but serviceable, proxy for a taxpayer's voice in the political processes of the taxing state. Until Congress legislates, it is compelling to view dormant Commerce Clause nexus per the *Quill* test of physical presence.

The dormant Commerce Clause rule of tax apportionment serves four functions. Apportionment constrains the states from exporting taxes by targeting immobile taxpayers who lack practical exit options to leave the taxing states. Apportionment minimizes the out-of-state disruption from taxpayer exit, by reducing the mobile taxpayer's need to depart the taxing jurisdiction. By minimizing interstate actor's state tax burdens, the dormant Commerce Clause rule of apportionment encourages entry by such actors and thus facilitates the interstate mobility of capital and persons. Finally, by minimizing state tax burdens and thereby curtailing the exit of the most tax-sensitive persons, apportionment bolsters the voices for tax-restraint within the taxing state's political process.

For the long run, Congress, using its powers under the Commerce Clause, should regulate states' taxation of interstate actors. Until then, the dormant Commerce Clause concepts of nexus and apportionment, properly understood and applied, are workable, if imperfect, tools for such regulation.

[387] In the interim, Congress should also amend the Tax Anti-Injunction Act, 26 U.S.C. § 7421(a) (2000), to give nonresident taxpayers like Mr. Huckaby and me the opportunity to present our federal constitutional claims to a federal court.