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Follow the Giraffe's Lead - Lanco, Inc. v. Director, Division of Taxation Gets Lost in the Quagmire that Is State Taxation

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Comment

Follow the Giraffe's Lead – *Lanco, Inc. v. Director, Division of Taxation* Gets Lost in the Quagmire that is State Taxation

Cory D. Olson[*]

When there is an income tax, the just will pay more and the unjust less.[1]

I. PIPE DREAMS OR A PIPELINE? *LANCO*, INTELLECTUAL PROPERTY AND THE CREATION OF TAX FREE INCOME.

Everyone is familiar with Benjamin Franklin's admonition that nothing in this world is certain, except for death and taxes. In fact, one wonders whether humankind has spent more time searching for the Fountain of Youth or the perfect tax loophole. While both endeavors have been fruitless, modern tax planners have found a system which goes a long way toward achieving one of these two goals. Using confusing and ambiguous Supreme Court precedent as a cover, tax planners have found a method of structuring assets that has the potential to save companies millions of dollars in state taxation. It is accomplished through a tax tool known as a "passive investment company," or "PIC." Combining the potential value of intellectual property, the relative ease of creating and maintaining subsidiary corporations, and favorable state tax laws, companies have been able to use PICs to effectively shift their income out of one state and into the state with the most favorable tax laws, generally resulting in complete avoidance of

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1. PLATO, THE REPUBLIC, I.20 (Benjamin Jowett trans., Willey Book Co. 1901).

state corporate income tax. Recognizing the threat to tax revenue this method poses, states have taken steps to recapture the income and re-subject it to state taxation. The PICs and their holders have fought back, claiming that the income derived from the intellectual property is outside of the permissible reach of a state's taxing powers.[2]

Lanco, Inc. v. Director, Division of Taxation[3] is one of the most recent salvos in the battle over whether a state can constitutionally tax income shifted to a PIC. Lanco, Inc. was incorporated in 1982 in Delaware.[4] Lanco and Lane Bryant, Inc., a national clothing retailer, are members of the same corporate family, each ultimately owned by The Limited, Inc.[5] After Lanco was incorporated, Lane Bryant assigned its trademark "Lane Bryant," together with the goodwill it had developed, to Lanco for little or no consideration.[6] Lanco immediately licensed this intangible property back to Lane Bryant for use in its operations, including operations taking place in New Jersey.[7] In exchange for the license, Lane Bryant paid Lanco a royalty of 5.5% of the gross retail sales made by Lane Bryant.[8] Using this agreement as a jurisdictional hook, the New Jersey Division of Taxation assessed Lanco with the Corporate Business Tax,[9] the state's corporate income tax, for income Lanco derived from the royalties paid by Lane Bryant.[10]

2. *See, e.g.*, Lanco, Inc. v. Dir., Div. of Taxation, 21 N.J. Tax 200 (N.J. Tax Ct. 2003); Geoffrey Inc. v. S.C. Tax Comm'n, 437 S.E.2d 13 (S.C. 1993).

3. 21 N.J. Tax 200 (N.J. Tax Ct. 2003).

4. Secretary of Revenue v. A&F Trademark, Inc., Admin. Decision No. 381 at 8 (N.C. Tax Review Bd. May 7 2002), *available at* http://www.dor.state.nc.us/practitioner/hearing/A&F_TrademarkDecision2002.pdf (last visited Mar. 25, 2005).

5. *Id.* The Limited, Inc. is an Ohio corporation which specializes in retail clothing. Originally formed in 1963, The Limited, Inc. has expanded to include twelve retailers and a combined total of more than five thousand stores nationwide. The Limited, Inc. retailers include the well-known names Abercrombie & Fitch, Express, and Victoria's Secret. *Id.* at 3-4; A & F Trademark, Inc. v. Tolson, 605 S.E.2d 187, 189 (N.C. App. 2004).

6. *Secretary of Revenue*, Admin. Decision No. 381 at 8.

7. *See id.* at 16; Brief of Amicus Curiae Multistate Tax Comm'n at 2, Lanco, Inc. v. Dir., Div. Of Taxation, No. A-3285-03T1 (N.J. Super. Ct. App. Div. filed 2004), *available at* http://www.mtc.gov/POLICY/LancoAmicusBriefFinal.pdf (last visited Mar. 25, 2005) [hereinafter Multistate Brief].

8. Multistate Brief, *supra* note 7, at 3.

9. N.J. STAT. ANN. § 54:10A-1-41 (West 2002 & Supp. 2004).

10. While the two corporations are affiliated, this relationship ultimately has no effect on whether Lanco should be subject to taxation. It is important, however, to understand this relationship when analyzing the practical effects

Lanco protested, claiming that since it did not have a physical presence in New Jersey, a fact which New Jersey did not contest, the state could not constitutionally assess the tax.[11] The Division of Taxation disagreed with Lanco's assertion that it must be physically present in order to be taxed and argued that the license agreement alone brought Lanco within the state's taxing jurisdiction.[12]

The case boiled down to one question: does a company whose sole connection with a state is a licensing agreement on intellectual property located within the state have a sufficient nexus with the state such that it may be subject to state income taxes?[13] Intellectual property can be a company's top asset and, as a result, can be strategically used to avoid taxation, such as through a PIC.[14] Whether in the form of registered trademarks, patents, copyrights, or simply "goodwill," every company is going to have some form of intellectual property. If a simple licensing agreement is enough to avoid state taxation, then every business, every patent holder, artist, or other owner of intellectual property can dodge New Jersey taxation. The level of revenue at stake is anything but inconsequential. With states facing declining revenues, PICs threatening to exempt millions in taxes, and few options to address the problem other than through direct taxation, the ultimate outcome of *Lanco* carried a large potential impact for tax payers and tax assessors alike.

This goal of this Comment is to demonstrate why Lanco and other PICs should be subject to state taxation. Despite the Supreme Court's admonition that state taxation cases represent something of a "quagmire,"[15] this Comment will first unravel the cases and explain the basic parameters that confine state taxation. Next, the comment will discuss how other courts have addressed the same question at issue in

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of the Lanco decision and how courts should consider similar future issues.

11. *See* Lanco, Inc. v. Dir., Div. of Taxation, 21 N.J. Tax 200, 216 (N.J. Tax Ct. 2003); Multistate Brief, *supra* note 7, at 4.

12. *See Lanco*, 21 N.J. Tax at 215-16.

13. *See id.* at 200.

14. *See* George T. Bell et al., *A State Tax Strategy for Trademarks*, 81 Trademark Rep. 445, 445 (1991).

15. Quill Corp. v. North Dakota, 504 U.S. 298, 315 (1992). The Supreme Court conceded that the law regarding interstate taxation is something of a "quagmire . . . [leaving] much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation." *Id.* at 215-16 (quoting Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457-58 (1959)).

Lanco and how courts and commentators have reacted to those decisions. Third, this comment will analyze the *Lanco* decision and will explain why the *Lanco* court decided the case incorrectly. This Comment will show that even having incorrectly required a physical presence, the *Lanco* court still should have decided in New Jersey's favor; however, the court incorrectly read Supreme Court precedent and applied the incorrect test. Having made these two critical errors, this Comment concludes that the *Lanco* court reached the wrong outcome and prevented New Jersey from subjecting Lanco, or any other PIC or similar tax device, to the state business income tax.

II. STATE TAXATION AND ITS CONFINES – UNRAVELING THE QUAGMIRE THAT IS STATE TAXATION

A. EARLY VIEWS OF INTERSTATE TAXATION

After the Revolutionary War, a young nation discovered that it was not a unified country but an association of independent states organized under the Articles of Confederation. As a result of this independence, states were free to tax imports and exports as if the states were independent countries.[16] This independence inevitably caused deep animosity between the states and in turn threatened the emerging nation.[17] Seeking to address the failures of the Articles of Confederation, the Continental Congress gave Congress the sole power to regulate trade "among the several states."[18] Not only was this sole power an affirmative grant of power, but it contained an implied limit on state power as well. This negative power, known as the Dormant Commerce Clause, prohibits certain state acts that interfere with interstate commerce.[19]

Early challenges to state taxation of interstate business took advantage of the Supreme Court's laissez faire interpretation of the Dormant Commerce Clause, which

16. *See, e.g.*, THE FEDERALIST NO. 42, at 274 (James Madison) (Random House 1937).

17. *See id*.

18. U.S. CONST. art. I, § 8, cl. 3.

19. *See Quill*, 504 U.S. at 309 (citing Gibbons v. Ogden, 22 U.S. (9 Wheat.) 222, 231-232, 239 (1824) (Johnson, J., concurring)); South Carolina State Highway Dep't v. Barnwell Bros., 303 U.S. 177, 185-86 (1938).

prohibited *any* taxation of interstate goods or services.[20] Congress alone possessed the power to regulate interstate commerce and any form of taxation by the states encroached upon this power.[21] This general prohibition on interstate taxation continued for nearly seventy-five years, lasting into the 1890s.[22] Around the turn of the century, the Court began to retreat from its earlier philosophy. For example, in *Adams Express Co. v. Ohio State Auditor*,[23] the Court upheld a tax based on the apportioned market value of a corporation, which included goodwill derived from instate transactions, even though it was a tax on interstate activity.[24] This ushered in an era in which concern shifted away from protecting interstate commerce from any tax burden to a system that ensured that interstate commerce was only subject to one state's taxes.[25]

By the middle of the twentieth century, states were again expanding their taxing jurisdiction to include entities located outside of their respective territorial boundaries.[26] At this

20. Brown v. Maryland, 25 U.S. 419, 448 (1827) ("Any charge on the introduction and incorporation of the articles into and with the mass of property in the country, must be hostile to the power given to Congress to regulate commerce, since an essential part of that regulation, and principal object of it, is to prescribe the regular means for accomplishing that introduction and incorporation.").

21. *See id.* at 447-48.

22. *See, e.g.*, Leloup v. Port of Mobile, 127 U.S. 640, 648 (1888) ("In our opinion such a construction of the Constitution leads to the conclusion that no State has the right to lay a tax on interstate commerce in any form, . . . and the reason is that such taxation is a burden on that commerce, and amounts to a regulation of it, which belongs solely to Congress.").

23. 165 U.S. 194 (1897).

24. Adams Express Co. v. Ohio State Auditor, 165 U.S. 194, 220-21 (1897).

25. *See* W. Live Stock v. Bureau of Revenue, 303 U.S. 250, 258 (1938).

> But we think the [gross receipts] tax assailed here finds support in reason, and in the practical needs of a taxing system which, under constitutional limitations, must accommodate itself to the double demand that interstate business shall pay its way, and that at the same time it shall not be burdened with cumulative exactions which are not similarly laid on local business.

Id.

26. *See* Miller Bros. v. Maryland, 347 U.S. 340, 342-43 (1954).

> In the last twenty years, revenue needs have come to exceed the demands that legislatures feel it expedient to make upon accumulated wealth or property with fixed location within the state. The states therefore have turned to taxing activities connected with the movement of commerce, such as exchange and consumption. If there is some jurisdictional fact or event to serve as a conductor, the reach of the state's taxing power may be carried to objects of taxation

point, state jurisdictional powers met up against the second constitutional restriction: the Due Process Clause of the Fourteenth Amendment.[27] Under the Fourteenth Amendment, due process was concerned with territorial restrictions; thus, states were prevented from asserting jurisdiction outside of their borders.[28] This did not mean businesses located outside of a state's borders were exempt from taxation. States were still allowed to tax interstate commerce so long as there was "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax,"[29] and "the state [had] given anything for which it [could] ask in return."[30] According to this formula, a state could only tax that which was located inside its borders. This view was based on the belief that a state provides benefits to those who were located there and that the residents could be forced to pay their share of the cost for these protections.[31] Thus, as states were allowed to expand their reach to include non-citizens,[32] the Court required

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beyond its borders.

Id.

27. U.S. CONST. amend. XIV, § 1.

28. *See Miller Bros.*, 347 U.S. at 344-45.

29. *Id.*

30. State of Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940).

31. *See id.* at 445 (stating that the test was a reformulation of the classic approach in Lawrence v. State Tax Comm'n, 286 U.S. 276 (1932)). According to the *Lawrence* Court,

> [t]he obligation of one domiciled within a state to pay taxes there, arises from unilateral action of the state government in the exercise of the most plenary of sovereign powers, that to raise revenue to defray the expenses of government and to distribute its burdens equably among those who enjoy its benefits. Hence, domicile in itself establishes a basis for taxation. Enjoyment of the privileges of residence within the state, and the attendant right to invoke the protection of its laws, are inseparable from the responsibility for sharing the costs of government.

Lawrence, 286 U.S. at 279. The reformulation found in Wisconsin v. J.C. Penney Co., 323 N.W.2d 168 (Wis. Ct. App. 1982), extended this concept of domicile as a basis for taxation to an entity operating within the physical boundaries of a state being responsible to help defray the governmental expenses. Presumably, an entity which was not a domiciliary of a state but which simply entered a state's jurisdiction would not be subject to taxation since the state government would not be providing any protections.

32. *See Miller Bros.*, 347 U.S. at 342-43. The *Miller Bros.* Court stated:

> visible territorial boundaries do not always establish the limits of a state's taxing power or jurisdiction . . . If there is some jurisdictional fact or event to serve as a conductor, the reach of the state's taxing power may be carried to objects of taxation beyond its borders . . . . [I]f [a state] has jurisdiction of [an entity's] taxable property or

a showing of a territorial link between the state and the taxed entity, a restriction consistent with the then current notions of territorial jurisdiction.[33] Once this territorial connection was found, however, all of an entity's in-state activities could be taxed, even if those activities were not directly related to the physical presence.[34]

B. THE *COMPLETE AUTO* PRONGS – THE CONCEPTS COME TOGETHER

In the 1977 case, *Complete Auto Transit, Inc. v. Brady*[35] the Due Process and Commerce Clause considerations were synthesized into a seemingly straightforward four-prong test.[36] Under the *Complete Auto* test, a tax will be sustained if it (1) is fairly apportioned; (2) does not discriminate against interstate commerce; (3) is fairly related to the services provided by the state; and (4) is applied to an activity with a substantial nexus to the taxing state.[37] Dormant Commerce Clause concerns are addressed by the first two prongs of the test. Fair apportionment, the first prong, prevents states from overreaching and taxing activities unconnected with the state.

Reaching a determination of whether a tax is fairly apportioned under the first prong of the *Complete Auto* test is a two step process. First, the court must decide whether the tax is "internally" consistent.[38] "Internal consistency is preserved

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transactions, it may sometimes, through these, reach the nonresident.
Id.

33. *See*, *e.g.*, *id.* at 347 (holding that a store which sold goods to Maryland residents but did not enter Maryland was not subject to forced collection of use taxes); Scripto, Inc. v. Carson, 362 U.S. 207, 210-11 (1960) (holding that the presence of independent contractors was sufficient to subject the entity to state taxation); National Geographic Soc'y v. Cal. Bd. of Equalization, 430 U.S. 551, 552, 562 (1977) (holding that the maintenance of two offices with two to four employees each was sufficient to give California the power to tax all of National Geographic's activities within the state).

34. *See, e.g., National Geographic Soc'y*, 430 U.S. at 561 (holding that physical presence of offices creating jurisdiction hook to tax all in state magazine sales); D. H. Holmes Co. v. McNamara, 486 U.S. 24 (1988) (upholding assessment of use tax based on value of magazines sent from out of state against physically present retailer); Department of Revenue v. Sears, Roebuck & Co., 660 P.2d 1188 (Alaska 1983) (upholding assessment of sales tax on mail orders sent from out of state center of physically present retailer).

35. 430 U.S. 274 (1977).

36. Complete Auto Transit v. Brady, 430 U.S. at 279 (1977).

37. *See id.*

38. *See* Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175, 185 (1995).

when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear."[39] This test does not look to the economic reality of the tax, but merely whether the imposition of the exact formula in every other state would place a greater burden on interstate commerce than on intrastate commerce.[40] If this test is met, a court then looks to see whether the tax is "externally" consistent.[41] "External consistency . . . looks not to the logical consequences of cloning, but to the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State."[42] External consistency looks for a real threat of multiple taxation, even if it is not through identical statutes.[43] Such a threat may be a sign that one state is overreaching its fair portion of income attributable to that state.[44]

Moving to the second prong, state taxes may not discriminate against interstate commerce. While in some ways this test is similar to the apportionment tests under the first prong,[45] this test is broader, as it checks for all forms of discrimination against interstate or out-of-state activities.[46] For example, a state may not tax interstate commerce or activities occurring wholly in another state at a higher rate than what local activities are charged.[47]

39. *Id.*

40. *Id.* For an example of a tax that is externally inconsistent, see Am. Trucking Ass'n. v. Scheiner, 483 U.S. 266 (1987) (invalidating a flat tax as discriminatory against interstate commerce).

41. *Okla. Tax Comm.*, 514 U.S. at 185.

42. *Id.*

43. *See id.*

44. *Id.*

45. By subjecting the interstate operator to a higher tax burden, the state is discriminating in favor of the intrastate carrier. Whether it is using a tax structure that subjects the interstate carrier to higher taxes (internal consistency) or using a system that possibly subjects income to double taxation (external consistency), the main concern is discrimination.

46. *Okla. Tax Comm.*, 514 U.S. at 197-98.

47. *See e.g.*, American Trucking Ass'n. v. Scheiner, 483 U.S. 266, 266-67 (1987) (holding a flat tax discriminatory because it subjects interstate carriers to a higher per-mile fee than intrastate carriers); Boston Stock Exch. v. State Tax Comm'n., 429 U.S. 318319, 337 (1977) (holding a taxing scheme which charged out-of-state sales on securities transactions a higher tax as discrimination against interstate activities).

The third and fourth prongs, fair relation and substantial nexus, ensure that the state remains within the confines of the Due Process Clause of the Constitution, the second limit on interstate taxation.[48] Consistent with the old territorial limits of due process, the fourth prong requires a "definite link" or ensures there is a "minimum connection between a state and the person, property or transaction."[49] The third prong requires a rational relationship between the tax and the activities connected with the state.[50]

While the *Complete Auto* prongs remained grounded in the territorial based taxation restrictions, the rest of the due process jurisprudence moved away from the old territorial limits towards the goal of "fair play and substantial justice."[51] The notion of "presence" for jurisdictional due process broke out of its territorial mold and turned upon a determination of whether an entity had purposely availed itself of the protections of the jurisdiction.[52] Taxation due process, however, continued to rely on a showing of physical presence. Therefore, after *Complete Auto*, a disconnect formed between personal jurisdiction due process, which extended to entities that had purposefully availed themselves of the protections of the jurisdiction, and taxation due process, which stopped at the borders.

C. THE CHANGE IN DUE PROCESS: DOES IT CHANGE THE *COMPLETE AUTO* TEST?

The expanded jurisdictional due process limits challenged the validity of prior taxation cases which were based on the older, territorial notions of the Due Process Clause. The Supreme Court addressed this question in the 1992 case *Quill*

48. The third prong is derived from the territorial notions of the Due Process Clause. It was this territorial presence of the taxed entity which determined whether it was within the taxing jurisdiction or not. *See supra* notes 28-34 and accompanying text. The fourth prong flows from the language in Miller Bros. and Wisconsin v. J.C. Penney Co. *See supra* notes 26-30 and accompanying text.

49. Quill Corp. v. North Dakota, 504 U.S. 298, 306 (1992); Miller Bros. v. Maryland, 347 U.S. 340, 344-45 (1954).

50. *Quill*, 504 U.S. at 306; Moorman Mfg. Co. v. Bair, 437 U.S. 267, 273 (1978).

51. International Shoe Co. v. Wash., 326 U.S. 310, 316 (1945) (quoting Milliken v. Meyer, 311 U.S. 457, 463 (1940)).

52. *See, e.g.,* Burger King Corp. v. Rudzewicz, 471 U.S. 462, 473-76 (1985).

Corp. v. North Dakota.[53] Quill, which did not own any tangible property in North Dakota, sold office products across the United States, including North Dakota, which were delivered to customers via common carrier.[54] North Dakota sought to require Quill to charge North Dakotans a use tax which Quill would then remit to the state.[55] Factually, the case was indistinguishable from *National Bellas Hess, Inc. v. Department of Revenue of Illinois*.[56] In that case, the Court used territorial notions of due process to hold that Illinois could not force Bellas Hess to charge such a tax because it lacked physical presence in the state.[57] North Dakota argued that modern due process left *Bellas Hess* untenable.[58]

The Court half agreed. Instead of completely overturning or affirming *Bellas Hess*, the *Quill* Court split the "substantial nexus" prong of the four-part *Complete Auto Complete Auto Transit, Inc. v. Brady*[59] test.[60] Rather than determining whether there is a sufficient nexus in order to meet due process requirements, the Court required that taxpayers have a substantial nexus under a Commerce Clause analysis.[61] "Thus the 'substantial nexus' requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce."[62] The Court reinterpreted its original *Bellas Hess* holding. It overruled the due process portion of *Bellas Hess*, but kept its Commerce Clause holding. Now, instead of being exempt to taxes due to its lack of due process, Bellas Hess was exempt from state taxes because it did not have a "substantial nexus" in the form of physical presence under a Commerce Clause analysis.

Just like Bellas Hess, Quill had purposely availed itself of the state, and so met modern due process requirements.[63] The question thus was whether the Commerce Clause analysis

53. 504 U.S. 298 (1992).

54. *Quill*, 504 U.S. at 302.

55. *Id.* at 302-03.

56. 386 U.S. 753 (1967).

57. National Bellas Hess, Inc. v. Dep't of Revenue of Ill., 386 U.S. 753, 758-60 (1967).

58. *See Quill*, 504 U.S. at 312.

59. 430 U.S. 274 (1977).

60. *See Quill*, 504 U.S. at 305, 312.

61. *See id.* at 308, 314.

62. *Id.* at 302-03.

63. *Id.* at 308.

would require a showing of physical presence, as the Court had required in *Bellas Hess*. The North Dakota Supreme Court held that it did not, but the U.S. Supreme Court disagreed and retained the physical presence requirement, no longer to meet due process, but to serve the Commerce Clause.[64] Since Quill did not have a substantial physical presence in North Dakota, it lacked the requisite "substantial nexus" and thus could not be subject to taxation.[65] In retaining the physical presence requirement the Court admitted that were the case decided today, it may come out differently, but principles of *stare decisis* weighed heavily upon it. As a result, the Court decided to maintain the *Bellas Hess* bright-line, physical presence requirement, albeit under a different restrictive banner.[66] Possibly in recognition of this dissonance between today's likely outcome and the commands of precedent, the Court expressly limited its holding to sales and use taxes and left open for the lower courts the question of whether the same requirement would apply to other forms of taxes.[67]

It is important to note that under *Quill*'s "substantial nexus" requirement, a *de minimis* physical presence is insufficient; the test requires a "substantial connection between the entity and the state–the "substantial nexus." The parties agreed that Quill possessed property within the state of North Dakota in the form of licensed software copied on floppy diskettes which were provided to customers.[68] The Court recognized that the presence of this intellectual property created some nexus between Quill and North Dakota, but while this property "might constitute some minimal nexus," it was

64. *Id*. at 314-19.

65. It is important to note that the *Quill* court recognized that physical presence alone was not sufficient to provide the requisite substantial nexus. The parties agreed that Quill in fact did possess property within the state of North Dakota in the form of licensed software which located on floppy diskettes which were provided to customers. *Id.* at 315 n.8. It should also be noted that the trial court found that the title to the goods being shipped by common carrier passed from Quill to the purchaser at the point the merchandise was received. This would suggest that Quill also possessed a cumulative total of nearly $1 million dollars throughout the year. *Id.* at 302.

66. *Quill*, 504 U.S. at 317.

67. *Id.* at 314, 317.

68. *Id.* at 315, n.8. It should also be noted that the trial court found that the title to the goods being shipped by common carrier passed from Quill to the purchaser at the point the merchandise was received. This would suggest that Quill also possessed a cumulative total of nearly one million dollars throughout the year. The Court did not mention this property in any of its analysis and did not appear to consider it in determining a substantial nexus.

insufficient to create the requisite jurisdictional hook.[69] So, while intellectual property had created a nexus, "Quill's licensing of software . . . [did] not meet the 'substantial nexus' requirement of the Commerce Clause."[70]

D. PICs – Creating the Perfect Tax Loophole

In order to fully understand the taxation issues surrounding PICs, it is important to understand what they are and how they operate. Passive Investment Companies (PICs), also known as Delaware Holding Companies, Intangible Holding Subsidiaries, or Intellectual Property Holding Companies, among other possible names, are subsidiary corporations whose sole purpose is to hold and manage the intellectual property of a related corporation. In addition to providing business benefits, such as making it easier for a corporation to manage its intellectual property, protecting members of the corporate family from creditors and lawsuits, and hindering hostile takeovers, the PICs may create substantial tax benefits.[71] First, the parent company, the original owner of some form of intellectual property, creates a wholly-owned subsidiary.[72] Next, the subsidiary agrees to exchange its stock for the parent's intellectual property.[73] At the same time, the subsidiary licenses the intellectual property back to the parent, the original holder, in exchange for royalty payments.[74] Ideally, these royalty payments are just below the parent's net profit margin.[75] The effect of this system is to convert what would be profit into a royalty payment passed onto the PIC. By forming the subsidiary in a state which does not tax holding companies (Delaware), does not tax royalties

69. *Id.*
70. *Id.*

71. Pamela S. Chestek, *Control of Trademarks by the Intellectual Property Holding Company*, 41 IDEA 1, 1 (2001). The actual formation and maintenance of a PIC can involve substantial tax and trademark issues. These issues are beyond the scope of this comment and cannot be dealt with fully. For further discussion on creation of a PIC, including examples of actual savings a PIC can provide, see generally Ira H. Rosen, *Use of a Delaware Holding Company to Save State Income Taxes*, 3-89 TAX ADVISER 180 (1989); George T. Bell et al., *A State Tax Strategy for Trademarks*, 81 TRADEMARK REP. 445 (1991).
72. Chestek, *supra* note 71, at 1.
73. *Id.*
74. *Id.*
75. *Id.* at 8.

(Michigan), or does not have corporate taxes at all (Nevada), the parent essentially shifts its income into a tax free state.[76] Since payments made to the PICs are tax deductible business expenses, it appears as if the parent made little or no profit, and thus is assessed only minimal state tax.[77] In reality, the payment to the PIC is simply passed through the PIC and returned to the parent corporation in the form of a dividend payment or as a loan from the subsidiary to the parent, dodging all state taxation.[78] The net effect is tax free income, or as one court put it, "nowhere income."[79]

With direct taxation of PICs in question, some states have looked to alternate methods of taxing PICs. There are several ways do this. For example, Alabama, Connecticut, Mississippi, North Carolina, and Ohio have disallowed deductions for payments made to PICs under license agreements.[80] This essentially keeps the income within the state where it can be subjected to taxation.[81] While this method eliminates the tax loophole, it is far from perfect. Since this method essentially allows two states to tax the same income, it may violate the fair apportionment prong of the *Complete Auto* test. In essence, two states could make claims over the same money, thereby subjecting the PIC income to a threat of double taxation.[82]

A second method for states to recover lost revenue is to use a combined reporting system, often known as the "unitary

76. *Id*. at 6-7.

77. *Id.* at 7.

78. *See* Chestek*, supra* note 71, at 7; Bell, *supra* note 71, at 456. By transferring the licensing fee back to the parent through a loan, the parent's potential taxable equity is not increased and the parent may be able to obtain an interest deduction, further reducing its state tax burden. *Id*.

79. Geoffrey, Inc. v. S.C. Tax Comm'n, 437 S.E.2d 13, 15 n.1 (S.C. 1993).

80. Tun-Jen Chiang, Comment, *State Taxation of Out-of-State Trademark Holding Companies*, 70 U. CHI. L. REV. 1533, 1547 (2003).

81. By not allowing the deduction, any payment that would convert profit into a royalty is still considered a profit on tax returns.

82. Chiang, *supra* note 80, at 1547; *see* Complete Auto Transit, Inc. v. Brady, 430 U.S., 274, 279 (1977). For example, if Lanco had been located in New Jersey instead of Delaware, it would be physically present and thus subject to the Corporate Business Tax. Under this hypothetical, say that Lane Bryant's payment to Lanco was $100. By refusing the deduction, Lane Bryant must pay the disallowing state $100 of income worth in tax. At the same time, Lanco would also be forced to pay the New Jersey tax on the $100 of royalty income. Thus, the same $100 is subjected to double the income tax as it would have been were it never transferred, even though it really has only been "earned" once.

business principle."[83] This method, currently used by sixteen states, levies a tax on a pro rata share of all the income of a corporation and its subsidiaries based on a three factor apportionment formula.[84] The formula is based in equal parts on the proportion of a unitary business's total payroll, property, and sales which are located within the taxing state.[85] Since the overwhelming amount of the total unitary business's payroll, property, and sales occur in a taxing state, the taxing state effectively captures the income of the PIC.[86] In addition to being held constitutional by the Supreme Court,[87] the unitary business principle removes tax incentives to shift income within the corporate structure, yet allows such transfers where they result in other types of economic benefit.[88] For this reason, this method is generally favored by academics.[89] While the unitary business principle appears superior, moving to this system requires wholesale changes to a state's revenue code, which comes with a high price, making it impracticable for some states.[90]

A final method is to view the PIC as a "phantom entity" or a "sham corporation."[91] This determination is based on whether the subsidiary "lacked economic substance."[92] Once this label is applied, the state treats the PIC as another office or branch of the corporation, and attributes the PIC's income to the already physically present corporation.[93] For example, in

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83. Chiang, *supra* note 80, at 1550-52.

84. *Id.*

85. Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 170 (1983).

86. Again, assume that Lane Bryant had made a $100 payment to Lanco. Since Lanco has only a negligible level of payroll, property, or sales, only a negligible amount of the Lanco/Lane Bryant family's income is attributed to it and subject to taxation by the PIC's home state. The remainder of the income remains with Lane Bryant, where it will be subject to state taxation. In essence, since the apportionment factors are based on external factors, shifting money from one branch to another does not affect state taxation levels.

87. *See Container Corp. of Am.*, 463 U.S. at 183-85.

88. Chiang, *supra* note 80, at 1552.

89. *Id*.

90. *Id.*

91. Ashley B. Howard, Comment, *Does the Internal Revenue Code Provide a Solution to a Common State Taxation Problem?: Proposing State Adoption of § 367(D) to Tax Intangibles Holding Subsidiaries*, 53 EMORY L.J. 561, 579 (2004).

92. *Id.*

93. *See id.*

Comptroller of the Treasury v. SYL, Inc.,[94] the court found that two PICs, SYL, Inc. and Crown Cork & Seal Company, Inc. each lacked sufficient substance to be recognized as separate entities.[95] Both PICs were Delaware corporations and utilized a "nexus service" in Delaware to manage their businesses. Neither entity had more than $1,200 in total payroll per year, and neither incurred virtually any expenses.[96] However, this method of reaching PICs is unreliable—many PICs are not shams. As discussed above, PICs may provide a number of legitimate benefits in addition to their use as a tax loophole. Furthermore, this does not solve the problem as forcing the PIC creators to provide the needed economic substance does little more than increase the cost of operating the shelter.[97] As long as the tax savings outweigh the costs of providing the necessary economic substance, companies will still have an incentive to use PICs, providing little help to revenue starved states.[98]

94. 825 A.2d 399 (Md. 2003).

95. *Comptroller of the Treasury v. SYL, Inc.*, 825 A.2d at 415.

96. *See id.* at 402. A "nexus service" is a company which specializes in providing office management services in Delaware. For example, Registered Agents Legal Services, LLC provides a wide range of services for the creation of a Delaware Holding Company. *See* Registered Agent Legal Services, LLC, Incorporation Improves Your Bottom Line, *available at* http://www.inclegal.com/how2improve.html (last visited Mar. 25, 2005).

97. *See* Bell, *supra* note 71, at 449-50. According to Bell, to avoid being considered a sham corporation, the parent should follow a number of guidelines when forming and operating a PIC. This includes maintaining an office in the PIC's state, producing stationary or business cards, setting up a home banking account, maintaining a physical presence in the PIC's state (such as office furniture, equipment, etc.), and holding meetings in the PIC's state. *Id.* This does not change the essential feature of the PIC, but merely adds to the transactional costs of forming and operating one. While this increased cost may cause some businesses to find a PIC inefficient, this hardly solves the problem of dealing with large companies such as The Limited, Inc.

98. For example, assume a sham PIC costs $1,000 per year to maintain, but a PIC with economic substance costs $5,000. The "sham entity" view simply means that the company paying between $1,000 and $5,000 in state taxation will no longer find a PIC economically feasible. Companies saving over $5,000 per year in state taxation will still find the system useful and would continue to operate the PIC. For a company such as Lanco, which was able to save The Limited, Inc. hundreds of thousands of dollars in taxation in one state alone, the "sham entity" doctrine poses little threat. *See* Secretary of Revenue v. A&F Trademark, Inc., Admin. Decision No. 381 at 26-27 (N.C. Tax Review Bd. May 7 2002), *available at* http://www.dor.state.nc.us/practitioner/hearing/A&F_TrademarkDecision2002.pdf (last visited Mar. 25, 2005); *cf.* Rosen, *supra* note 71, at 180 (providing an analysis of the potential tax savings by using a PIC, including a simple breakdown of operational expenses).

E. *GEOFFREY, INC. V. SOUTH CAROLINA* – HOW SOUTH CAROLINA STUCK ITS NECK OUT AND CAPTURED THE GIRAFFE

Faced with dramatically declining revenues, states have attempted to either recapture the PIC payments and subject them to taxation, or have attempted to tax the PICs directly.[99] PICs and their parent companies have fought back, claiming the state methods violate the constitutional restrictions on state taxing power. The first of these cases, *Geoffrey, Inc. v. South Carolina Tax Commission*,[100] was brought in 1993, just a year after *Quill* was decided.[101] Geoffrey, Inc., a PIC utilized by Toys R Us, held several valuable trademarks and trade names, including the name Toys R Us, Inc., which it then licensed back to Toys R Us for use in its retail stores.[102] As a part of the agreement, Toys R Us paid Geoffrey one percent of the net sales of the licensed material.[103] Originally, the South Carolina Tax Commission disallowed Toys R Us's deduction of royalty payments made to Geoffrey, but it later rescinded on this position and instead directly assessed Geoffrey with its state business income tax based on the royalties received for use of Geoffrey's intellectual property in the South Carolina Toys R Us stores.[104] Geoffrey paid under protest and brought a claim for a refund of the taxes, asserting that it did not have the requisite substantial nexus with South Carolina.[105]

In accordance with *Quill Corp. v. North Dakota*,[106] the *Geoffrey* court separated the due process concerns from the Dormant Commerce Clause requirement of a "substantial nexus." The court began by analyzing Geoffrey's claim that the Commission failed to satisfy the due process requirements.[107] Based on Geoffrey's contacts with South Carolina, the *Geoffrey* court found that it had.[108] In addition to the licensed

99. *See* John A. Swain, *State Income Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 321 n.1 (2003).

100. 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

101. Geoffrey v. S.C. Tax Comm'n, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

102. *Id*. at 15.

103. *Id.* This method enabled Geoffrey, who had no full-time employees, to generate approximately $55 million in income, all free of state taxation. *Id*. at 15 n.1.

104. *Id*. at 15.

105. *Id.*

106. 504 U.S. 298 (1992).

107. *Geoffrey*, 437 S.E.2d at 16.

108. *Id.*

intellectual property the court found Geoffrey also possessed a franchise and accounts receivable in South Carolina.[109] According to the court, while there were no Toys R Us stores in South Carolina at the time it created its licensing agreement, Geoffrey had purposely availed itself in South Carolina since it was not brought into South Carolina unwillingly, nor did it prohibit the use of the intangibles in the state.[110] While not required for due process, the court also found that the "presence of Geoffrey's intangible property" provided an additional contact.[111] Geoffrey had challenged this point, arguing that the situs of its intangibles was its corporate headquarters in Delaware, not in South Carolina. The court rejected this contention, citing *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*[112] for the proposition that intangible property may have a situs in more than one jurisdiction, and thus could exist in both Delaware and South Carolina.[113] Finding that Geoffrey possessed intangible property in and purposefully directed its activity at South Carolina, the court

109. *Id.*

110. *Id.* The court stated:

> Geoffrey argues that the [Tax] Commission has failed to satisfy [due process] requirements. We disagree. The nexus requirement of the Due Process Clause can be satisfied even where the corporation has no physical presence in the taxing state if the corporation has purposely directed its activity at the state's forum.

Id.

111. *Id.* "In addition to our finding that Geoffrey purposely directed its activities toward South Carolina, we find that the "minimum connection" required by due process also is satisfied by the presence of Geoffrey's intangible property in this State." *Geoffrey*, 437 S.E.2d at 16.

112. 445 U.S. 425 (1980). The case involved a question of whether Vermont could consider income Mobil Oil received in the form of dividends from foreign subsidiaries which were paid in New York. The Supreme Court determined that "[a]lthough a fictionalized situs for intangible property sometimes has been invoked to avoid multiple taxation of ownership, there is nothing talismanic about the concepts of 'business situs' or 'commercial domicile' that automatically renders those concepts applicable when taxation of income from intangibles is at issue." Mobil Oil Corp. v. Comm'r of Taxes of Vt., 445 U.S. 425, 445 (1980). The Supreme Court also stated:

> The Court also has recognized that the reason for a single place of taxation no longer obtains when the taxpayer's activities with respect to the intangible property involve relations with more than one jurisdiction. Even for property or franchise taxes, apportionment of values is not unknown. Moreover, cases upholding allocation to a single situs for property tax purposes have distinguished income tax situations where the apportionment principle prevails.

Id. (citations and internal quotes omitted).

113. *Geoffrey*, 437 S.E.2d at 16-18.

held that Geoffrey could be taxed without violating the Due Process Clause.[114]

The court then moved to the Commerce Clause portion of its analysis.[115] Geoffrey argued that it did not have the requisite substantial nexus with South Carolina since it was not physically present within the state, relying on the Commerce Clause portion of *National Bellas Hess, Inc. v. Department of Revenue of Illinois*[116] and *Quill*. The court found that reliance on *Bellas Hess* and *Quill* was "misplaced" since the physical presence requirement was limited to sales and use taxes only.[117] Justifying its conclusion in part on the Supreme Court's decision in *International Harvester Co. v. Wisconsin Department of Taxation*,[118] the court found that "[t]he presence of intangible property alone is sufficient to establish nexus."[119] Thus the only remaining question was whether this nexus was "substantial." The court did not articulate the ultimate value of Geoffrey's activities in South Carolina, but concluded that "by licensing intangibles for use in [South Carolina] and deriving income from their use [there], Geoffrey [had] a 'substantial nexus' with [the state]."[120]

Thus, *Geoffrey* represents two important points, both of which were rejected by the *Lanco* court. First, the physical presence requirement set forth in *Bellas Hess* is limited to sales and use taxes only.[121] Second, *Geoffrey* states that property need not be tangible in order to be considered present in the

114. *Id.*

115. *Id.* at 18.

116. 386 U.S. 753 (1967).

117. *Geoffrey*, 437 S.E.2d at 18.

118. 322 U.S. 435 (1944). *International Harvester* involved a challenge to a Wisconsin tax on dividends distributed by corporations doing business in Wisconsin, which included International Harvester. *Id.* at 438. The stockholders challenged the tax on due process grounds, as they had no physical connection with the state. *Id.* at 439-40. The Supreme Court rejected the challenge on the basis that the stockholders had received benefits from the state, even though they had no physical presence in the state. *Id.* at 441-43.

119. *Geoffrey*, 437 S.E.2d at 18 (citing International Harvester Co. v. Wisconsin Dep't of Taxation, 322 U.S. 435 (1944); Dairy Queen Corp. v. Taxation and Revenue Dep't, 605 P.2d 251 (N.M. Ct. App. 1979) (involving taxation of franchise agreements)).

120. *Geoffrey*, 437 S.E.2d at 18.

121. *Id.* "It is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. *The presence of intangible property alone is sufficient to establish nexus.*" *Id.* (emphasis added).

state, and thus create nexus.[122] While Geoffrey, Inc. filed for a Writ of Certiorari with the Supreme Court, this writ was rejected, and the Supreme Court let the decision stand.[123]

F. STICKING ITS NECK OUT THERE: STATES CONSIDER WHETHER *GEOFFREY* WAS THE CORRECT DECISION

Geoffrey has received mixed reviews. Some commentators attacked it as a renegade decision or out of line with *Quill*.[124] For example, one commentator questioned whether *Geoffrey*'s position on the location of intangibles was necessary, and argued that the decision should be questioned for both purpose and accuracy, ultimately concluding that the court "directly contravened the intent of the Supreme Court" by not requiring a physical presence for income tax purposes.[125] Other commentators have rejected the arguments put forth by *Geoffrey*'s critics.[126] For example, one article claimed the criticisms were directed at *Geoffrey* "in essence for not paying lip service to the notion of physical presence," even though it could have easily done so without impacting the crux of its analysis.[127]

Courts have also treated *Geoffrey* with inconsistent and

122. *Id*. at 17.

123. *See* Geoffrey, Inc. v. S.C. Dep't of Revenue and Taxation, 510 U.S. 992 (1993). Of course, it should be noted that denial of a petition for a writ of certiorari imparts no implication or inference on the Court's views of the merits of a case. Hughes Tool Co. v. Trans World Airlines, Inc., 409 U.S. 363, 365 (1973); *cf.* Ponte v. Real, 471 U.S. 491, 501-02 (1985).

124. Swain, *supra* note 99, at 359 (noting that many commentators attacked *Geoffrey*); *see also* Douglas Poms, Geoffrey, Inc. v. South Carolina Tax Commission: *South Carolina Sticks its Neck Out and Taxes Delaware Holding Company*, 13 VA. TAX REV. 771 (1994); Mark A. McGinnis, *Marching to the Beat of the Itinerant Drummer: States Increasingly Refuse to Get Physical before Finding Nexus*, 32 CAP. U. L. REV. 149, 175-78 (2003).

125. Douglas Poms, Geoffrey, Inc. v. South Carolina Tax Commission: *South Carolina sticks its Neck out and Taxes Delaware Holding Company*, 13 VA. TAX REV. 771, 779-80 (1994).

126. *See, e.g.*, Michael T. Fatale, *Geoffrey Sidesteps Quill: Constitutional Nexus, Intangible Property and the State Taxation of Income*, 23 HOFSTRA L. REV. 407, 441-47 (1994) (stating that *Geoffrey* relied on a doctrine that dates back almost one hundred years and has gained state reliance); *see also* John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, *supra* note 99, at 358-62 (2003) (agreeing with *Geoffrey*'s outcome, but noting that states are timid to implement it).

127. Michael T. Fatale, *State Tax Jurisdiction and the Mythical "Physical Presence" Constitutional Standard*, 54 TAX LAW. 105, 137 (2000).

mixed results. For example, in *Couchot v. State Lottery Commission*,[128] the court cited *Geoffrey* for support in its decision to reject a physical presence requirement on taxation of lottery winnings,[129] and in *GMC v. City of Seattle*,[130] the court used *Geoffrey* to reject a physical presence requirement for a business and occupation tax.[131] The clearest example of *Geoffrey*'s acceptance comes out of North Carolina, in *A & F Trademark, Inc. v. Tolson*.[132] *Tolson* is identical to *Lanco*, except that North Carolina sought to include the other members of The Limited, Inc. family as well.[133] Just as in *Lanco* and *Geoffrey*, the taxpayers challenged the authority of North Carolina to assess them with a tax without a showing of physical presence.[134] Ultimately, the *Tolson* court decided to follow *Geoffrey* and assess the PICs with state taxes. Of course, this put North Carolina directly at odds with the decision in *Lanco*.[135] Instead of just dismissing *Lanco* as non-controlling, the court analyzed *Lanco's* justifications, disagreeing with each of them.[136]

Other courts have either explicitly or implicitly rejected *Geoffrey*, requiring a physical presence of tangible property no matter what type of tax is being applied.[137] An argument has been put forth that *Geoffrey*'s cool reception may not indicate

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128. 659 N.E.2d 1225 (Ohio 1996).

129. Couchot v. State Lottery Comm'n, 659 N.E.2d 1225, 1230 (Ohio 1996). It should be noted that the court nevertheless found that physical presence would nonetheless exist in the case. *Id*. This statement, however, is dicta and does not impact the cases proposition.

130. 25 P.3d 1022 (Wash. App. 2001).

131. GMC v. City of Seattle, 25 P.3d 1022, 1029 (Wash. App. 2001); *see, e.g.*, Borden Chems. & Plastics, L.P. v. Zehnder, 726 N.E.2d 73 (Ill. App. 2000) (interest in partnership creates substantial nexus).

132. 605 S.E.2d 187 (N.C. Ct. App. 2004).

133. *See* A & F Trademark v. Tolson, 605 S.E.2d 187, 189 (N.C. Ct. App. 2004). In fact, Lanco, Inc. was one of the named parties to the case. *Id*. Just as in *Lanco*, North Carolina sought to tax the PICs with its version of the state franchise tax. *Id*.

134. *See id.* at 193.

135. *Id.* at 196.

136. *See id.* at 195-96.

137. *See*, *e.g.*, Orvis Co. v. Tax Appeals Tribunal of N.Y., 654 N.E.2d 954, 960-61 (N.Y. 1995); Scholastic Book Clubs v. Dep't of Treasury, 567 N.W.2d 692, 694 (Mich. App. 1997); Rylander v. Bandag Licensing Corp. 18 S.W.3d 296, 300-01 (Tex. App. 2000) (finding licensing agreement insufficient to create substantial nexus as it was not physically present); Cerro Copper Prods., Inc. v. Ala. Dep't of Revenue, No. F-94-444, 1995 Ala. Tax LEXIS 211, at *4-6 (Admin. Law Div. Dec. 11, 1995).

its weakness, but may have resulted from uncertain readings of *Quill*, taxpayer willingness to litigate the issue, and timid taxing authorities who are unwilling to test the limits of *Quill*.[138] Judging from the number of decisions which have refused to require a physical presence, yet find physical presence in dicta, this may be an accurate reading.[139]

III. *LANCO, INC.*–PHYSICAL OR NOT? PRESENT OR NOT? NEW JERSEY TAXES, PICS AND PHYSICAL PRESENCE

In the middle of this morass of changing doctrines, conflicting cases and divergent analysis, Lanco, Inc. challenged New Jersey's ability to assess it, and other similarly situation PICs, with the New Jersey Corporate Business Tax. Lanco, Inc., the PIC affiliated with Lane Bryant, a national clothing retailer and a part of The Limited, Inc. family of corporations, licensed various forms of intellectual property to Lane Bryant.[140] Lanco did not have any offices, employees, real or tangible property in New Jersey; however, it held the rights to intangible property in the form of trademarks, trade names, and service marks which it licensed to Lane Bryant for use in

138. John A. Swain, *supra* note 99, at 361.

139. *See*, *e.g.*, GMC v. City of Seattle, 25 P.3d 1022, 1029 (Wash. App. 2001); Couchot v. State Lottery Comm'n., 659 N.E.2d 1225 (Ohio 1996) (refusing to extend physical presence requirement to lottery winnings; however, the court, in dicta, did state that physical presence would be met since the income relates to taxpayer's presence in state at time of purchase of ticket); J.C. Penny Nat'l. Bank v. Johnson, 19 S.W.3d 831, 842 (Tenn. Ct. App. 1999) (while the court was careful not to require a physical presence, it did state that the Commissioner of Revenue cited no authority by the Supreme Court which had upheld a state tax where the taxpayer had no physical presence); Truck Renting & Leasing Ass'n., Inc. v. Comm'r. of Revenue 746 N.E.2d 143 (Mass. 2001). The court declined to extend a physical presence requirement to income taxes, yet based its decision to tax the Plaintiff on account of the physical presence of the trucks in the state, even though Plaintiff had no control over them. *See Truck Renting & Leasing Ass'n., Inc.*, 746 N.E.2d at 149-50. The court did not mention the lease agreement when determining whether there was a substantial nexus. *See id.* at 150.

140. Lanco v. Dir., Div. of Taxation, 21 N.J. Tax 200, 203 (N.J. Tax Ct. 2003). The Limited Inc. is primarily engaged in nationwide retail of Men's, Women's and Children's clothing. Secretary of Revenue v. A&F Trademark, Inc., Admin. Decision No. 381 at 4 (N.C. Tax Review Bd. May 7 2002), *available at* http://www.dor.state.nc.us/practitioner/hearing/A&F_TrademarkDecision2002.pdf (last visited Mar. 25, 2005). The Limited, Inc. has seven subsidiary clothing retailers. Each of these has a corresponding PIC which is either a subsidiary of The Limited or a second generation subsidiary under Limco Investments, Inc. *See id.* at 5. These include the popular brands of Abercrombie and Fitch, Victoria's Secret, Express and The Limited.

its New Jersey stores.[141] In exchange for the use of Lanco's intellectual property rights, Lane Bryant would pay royalties to Lanco. Viewing the licensing agreement as a form of doing business in the state, the New Jersey Department of Revenue assessed Lanco with the Corporate Business Tax, the state's business income tax.[142] *Lanco*'s ultimate question therefore became: does a company whose sole connection with a state is a licensing agreement on intellectual property located within the state have a sufficient nexus with the state such that it may be subject to local income taxes?

The *Lanco* court began by setting out the four part *Complete Auto Transit, Inc. v. Brady*[143] test outlined above.[144] Focusing on the "substantial nexus" prong, the court opened with a lengthy discussion of *Quill Corp v. North Dakota*,[145] its treatment of "substantial nexus" both in terms of Due Process and Commerce Clauses, and whether the physical presence requirement applied to all taxes or was limited to sales and use taxes.[146] In particular, the court noted that *Quill* removed the physical presence requirement under due process, but not under the Commerce Clause.[147] The court recognized the requirement relied a great deal on *stare decisis*; however, the court noted that *Quill* also analyzed the requirement on its own merits.[148] This analysis was important since,

> [t]he decisive question in [Lanco] is whether the physical presence requirement confirmed in Quill under the Commerce Clause applies simply to the use tax collection obligation directly at issue in that case, or whether it is also a necessary element of substantial nexus for the imposition of a state income or franchise tax.[149]

Materially indistinguishable from *Geoffrey, Inc. v. South*

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141. *Lanco*, 21 N.J. Tax at 203.

142. *Id*. The New Jersey Corporate Business Tax is a franchise tax for the privilege of doing business in New Jersey. *See* N.J. STAT. ANN. § 54:10A-1-41 (West 2002 & Supp. 2004). Out of state corporations must apportion a share of its overall income to New Jersey. *Id*. The percentage that is assigned to New Jersey is derived using an equation which is based on the corporation's value of property, sales and payroll which exist in New Jersey as compared to its total value. *Id*.

143. 430 U.S. 274 (1977).

144. *Lanco*, 21 N.J. Tax at 204.

145. 504 U.S. 298 (1992).

146. *Lanco*, 21 N.J. Tax at 204.

147. *Id.* at 204-05.

148. *See id.* at 206-07.

149. *See id*. at 207.

Carolina Tax Commission,[150] the South Carolina Supreme Court had already answered this question by holding that the physical presence requirement set forth in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*[151] and redefined in *Quill* did not apply to an income tax.[152] The *Lanco* court could choose to follow South Carolina or venture on its own. It chose the latter, finding the *Geoffrey* court's decision "not persuasive."[153] The *Lanco* court cited three reasons for its disagreement: the lack of differences between the Corporate Business Tax, the use and sales taxes at issue in *Quill* and *Bellas Hess*, cases prior to *Quill* that suggested physical presence was required, and the lack of acceptance of *Geoffrey* by other states.[154]

The court took the view that administrative difficulties encountered by a business forced to collect a sales and use tax, difficulties which concerned both the *Quill* and *Bellas Hess* courts, are equally present in administration of the income tax.[155] As the court saw it, "[i]f physical presence is a constitutional necessity for one [type of tax], it is illogical that it should not be for both."[156] Additionally, the court found precedent prior to the *Quill* decision to be consistent with its position, although it did not cite cases in support of its position. Rather, the court cited a number of cases which appeared to forego a physical presence requirement, but found these cases to be inapplicable, pointing out that each involved a taxed entity that had some degree of tangible physical presence in the taxing state.[157] The court then used *Geoffrey's* lack of broad acceptance as another justification for it to reject *Geoffrey's* reasoning.[158] As it had done with the pre-*Quill* cases, the court did not cite a case supporting its position, choosing instead to distinguish those cases which followed *Geoffrey*'s rejection of a

150. 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

151. 386 U.S. 753 (1967).

152. *See* Geoffrey, Inc. v. S.C. Tax Comm'n, 437 S.E.2d 13, 15-18 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

153. *Lanco*, 21 N.J. Tax at 207.

154. *Id*. at 208.

155. *Id*. at209.

156. *Id*.

157. *Id.* at 211-12.

158. *Id.* at 213-14.

physical presence requirement.[159] With each, the court found them inapplicable since each taxpayer had at least some level of physical presence in the taxing state.[160]

From the outset, the parties had stipulated that Lanco did not have a physical presence of tangible property in New Jersey.[161] Thus, the conclusion that *Bellas Hess* and *Quill* mandated a physical presence before an entity could be taxed in compliance with the Commerce Clause was a dispositive one. Because New Jersey was unable to show that Lanco had the necessary physical contacts with the state, the court held that constitutional restraints prevented New Jersey from assessing Lanco with the Corporate Business Tax. This allowed Lane Bryant and The Limited corporate family to continue to use the PIC loophole to avoid taxation in New Jersey.

IV. THERE'S NO NEED TO GET PHYSICAL–*LANCO, INC.* INCORRECTLY APPLIES A PHYSICAL PRESENCE REQUIREMENT TO INCOME TAXES

The decisive question for the *Lanco* court was whether the physical presence requirement of "substantial nexus" under the Commerce Clause applied to income taxes. *Geoffrey, Inc. v. South Carolina Tax Commission*,[162] the only case directly on point, held that it did not; whereas, *Lanco* found *Geoffrey* to be unpersuasive and held that the physical requirement did apply. A deeper look at *Lanco*'s arguments actually demonstrates that *Geoffrey's* holding is correct and *Lanco* was incorrectly decided.

A. BURDENS ON INTERSTATE COMMERCE AND DIFFERENTIATING THE TAXES

In deciding whether to extend *Quill Corp. v. North Dakota*'s[163] physical presence requirement to income taxes, the *Lanco* court found no reason to distinguish between income and sales taxes.[164] In reality, there are a number of reasons to distinguish between the two forms of tax. First, there are differences in administrative burdens. For any multi-jurisdictional business, the sheer number of possible taxes can

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159. *Lanco*, 21 N.J. Tax at 213-14.
160. *Id*. at 212-14.

161. *Id.* at 203.
162. 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).
163. 504 U.S. 298, 306 (1992).
164. *Lanco*, 21 N.J. Tax at 209.

be onerous. Recognizing this fact, both *Quill* and *Bellas Hess* discussed concerns about mail order carriers being subject to more than six thousand taxing jurisdictions,[165] the "many variations in rates of tax, in allowable exemptions and in administrative and record-keeping requirements,"[166] which could create "a welter of complicated obligations."[167] By its very nature, the burden multiple taxing jurisdictions create falls harder on interstate businesses, which conduct activities in several jurisdictions and may be forced to complete returns for each of those jurisdictions. When revisiting the point in *Quill*, the Court stated that imposing the duty to collect a sales or use tax such as the one suggested by North Dakota, which required a vendor to collect the tax if it made as few as three advertisements in the state, *might* unduly burden interstate commerce.[168] Justice White, on the other hand, rejected the excessive burden argument. According to Justice White, with modern technology, filing in each of these six thousand jurisdictions, both at the state and local levels, may only impose nominal expenses.[169]

Either way, the concern for administrative burden is not as prevalent with regard to income taxes. Compared to sales and use taxes, relatively few jurisdictions charge an income tax.[170] If the expense of monitoring six thousand jurisdictions charging a sales and use tax is nominal, as suggested by Justice White, then the expense of monitoring activity in jurisdictions with income taxes is only a fraction of nominal.[171] Thus, if protecting against unnecessary burdens is a goal, income taxes

165. *Quill*, 504 U.S. at 313 n.6; *National Bellas Hess*, 386 U.S. at 759-60.

166. *National Bellas Hess,* 386 U.S. at 759-60.

167. *Id.* at 760.

168. *See Quill*, 504 U.S. at 313 n.6. It should be noted that the Court did not say that such a tax would "necessarily" pose an excessive burden on the vendor. Furthermore, it could well be argued that the North Dakota tax would violate the "substantial" portion of the nexus test. While courts have found a nexus on thin strands of nexus, simply sending three advertisements into the state appears to be excessively low. Thus it may well be that the burdens caused in relation to the incredibly insubstantial nexus would make such the North Dakota tax suspect.

169. *See id*. at 332 (*White*, J., concurring in part and dissenting in part).

170. Chiang, *supra* note 80, at 1545.

171. Again, adherence to the requirement of a *substantial* nexus would help eliminate this concern. By requiring the taxpayer have a substantial nexus with a state, any potential administrative burden, which according to Justice White is nominal at best, can be spread across the larger number of connections to the state. This makes administrative burdens even less of a concern for both sales and income taxes.

need less scrutiny than sales and use taxes.

There are other reasons to differentiate between sales and use taxes and income taxes. For example, an economic theory known as "forwardshifting" suggests that sales and use taxes may be more disruptive to the national economy.[172] Assuming a seller operates on a profit-maximizing strategy, a tax on income will not affect the price or quantity of goods supplied since a change in either will reduce taxable income and thus reduce the seller's profits.[173] A sales or use tax, however, increases the ultimate price to the consumer, the individual who ultimately bears the tax burden.[174] Since the sales tax is based on total revenues and not net profits, it is possible to reduce the ultimate tax burden by simply selling fewer units, thereby reducing overall revenues.[175] If the combination of cost savings, including taxes, is greater than the lost profit, it is economically rational for sellers to limit sales.[176] In essence, some of the seller's tax burden can be "forwardshifted" to the consumer.[177] This may result in lowered overall sales, thereby reducing the overall level of interstate commerce.[178] Since the Commerce Clause, which guides the substantial nexus requirement, is concerned with the effect of state and local action on the national economy, "forwardshifting" should subject sales taxes to greater scrutiny than income taxes.[179] As a result, sales and use taxes should be subject to greater scrutiny under the Commerce Clause than income taxes.

Furthermore, requiring a physical presence for income taxes potentially exempts entire industries from state

172. Chiang, *supra* note 80, at 1540.
173. *Id.*
174. *Id.*
175. *Id.*
176. *Id.*
177. *Id.* at 1541.

178. Chiang, *supra* note 80, at 1542.

179. *But see id.* Chiang concludes that this economic theory actually runs against *Geoffrey* since "one goal of the dormant Commerce Clause is to ensure that each state taxes only its 'fair share' of interstate commerce." He argues that a physical presence requirement is needed since income taxes do not allow companies to shift the burden back to the state's citizens, and thus allow states to place an unfair burden on out-of-state companies. While it may be true that income taxes place a greater burden on out-of-state sellers, this is an issue for the discrimination prong of the *Complete Auto Transit, Inc.* test, not the nexus requirement.

taxation.[180] *Quill* and *National Bellas Hess, Inc. v. Department of Revenue of Illinois*[181] carved out a "discrete realm of commercial activity that is free from interstate taxation."[182] By using PICs to shift income to non-taxing states, companies are able to avoid paying for state provided protections. "It was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business."[183] It is this threat of allowing businesses to avoid all state taxation that makes a blanket physical presence requirement "potentially dangerous."[184]

The *Lanco* court's proposition that "[i]f physical presence is a constitutional necessity for one [type of tax], it is illogical that it should not be for both"[185] does not stand up to scrutiny. Sales and use taxes and income taxes are functionally different and ultimately have different effects on taxed entities. Simply put, income taxes carry fewer administrative burdens for the taxpayer and pose less of a threat to interstate commerce. Unlike a sales or use tax, which is paid by every consumer, creative tax planners can exempt entire industries from income taxation. Accordingly, it is illogical for a court to apply the same analysis to the constitutionality of income taxes as it does to sales and use taxes.

B. Prior Precedent and Physical Presence

Quill did not state whether the physical presence requirement should be extended to income taxes. However, the *Lanco* court found that "[t]he conclusion that physical presence is necessary to support state taxation of income is fully consistent with and strongly suggested by the Commerce Clause cases decided before *Quill*."[186] Analysis of these prior cases reveals the opposite.

The Supreme Court has in fact applied a tax without finding physical presence on more than one occasion. For

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180. *See* Michael T. Fatale, *State Tax Jurisdiction and the Mythical "Physical Presence" Constitutional Standard*, 54 TAX LAW. 105, 110 (2000).

181. 386 U.S. 753 (1967).

182. *See Quill*, 580 U.S. at 314.

183. W. Live Stock v. Bureau of Revenue, 303 U.S. 250, 254 (1938).

184. Fatale, *supra* note 180, at 110.

185. *Id.*

186. Lanco, Inc. v. Dir., Div. of Taxation, 21 N.J. Tax 200, 209 (N.J. Tax Ct. 2003).

example, in *Whitney v. Graves*,[187] the Court upheld New York's tax on the sale of an intangible right, even though the taxed person had no physical presence in the state.[188] In *Whitney*, a Massachusetts company was a member of the New York Stock Exchange (NYSE).[189] When the NYSE expanded its membership, the Massachusetts company was entitled to a portion of the new membership, which the Massachusetts company sold.[190] New York tried to tax the sale and the company fought.[191] The *Lanco* court found the use of this case unpersuasive because, "*Whitney* is also a due process case, in which New York was found to have jurisdiction to tax a Massachusetts resident on income from the sale of a right derived from a sale on the [NYSE]."[192] Contrary to this assertion, nowhere did the Supreme Court discuss due process restrictions on a state's taxing power. Instead, the Court focused on whether the Massachusetts company had created a "business situs" in New York, which would then give New York the authority to subject it to state taxation.[193] As the Court stated,

> When we speak of a "business situs" of intangible property in the taxing State we are indulging in a metaphor. We express the idea of localization by virtue of the attributes of the intangible right in relation to the conduct of affairs at a particular place. The right may grow out of the actual transactions of a localized business or the right may be identified with a particular place because the exercise of the right is fixed exclusively or dominantly at that place . . . . We think that the dominant attribute of relator's membership in the New York Stock Exchange so links it to the situs of the Exchange as to localize it at that place and hence to bring it within the taxing power of New York. Accordingly we hold that in laying the tax upon the profits derived by the relator from the sale of the right appurtenant to his membership the State did not exceed the bounds of its jurisdiction.[194]

Thus, *Whitney* is not a due process case and it closely

187. 299 U.S. 366 (1937).

188. *See* Whitney v. Graves, 299 U.S. 366, 372-74 (1937).

189. *Id.* at 369.

190. *Id.*

191. *Id.*

192. *Lanco*, 21 N.J. Tax at 210. Note that even if *Whitney* was a due process case, it should still guide modern Commerce Clause nexus requirements. As discussed earlier, the substantial nexus requirement was originally conceived of as a due process test. It was not until *Quill* that the substantial nexus test was placed under a Commerce Clause analysis. *Whitney*'s physical presence "nexus" requirement was read under the Due Process Clause, as were all other physical presence cases.

193. *Whitney*, 299 U.S. at 372-73

194. *Id.* at 372.

resembles *Lanco*. In both cases, an entity possessing an intangible right in another state sells or licenses the property to another for a fee. The state then uses that fee as a basis for determining the applicable state tax due. *Whitney* found that such a tax was within New York's power; *Lanco* found that New Jersey did not have that same right.

The *Lanco* court also cited *International Harvester Co. v. Wisconsin Department of Taxation*.[195] In *International Harvester Co.,* the Supreme Court held that Wisconsin's tax on derivatives paid out by a Wisconsin corporation was substantial, even though the vast majority of the shareholders had no physical presence in the state.[196] The *Geoffrey* court cited this case to support the proposition that a state may tax the income of a non-resident that is fairly attributed either to property in the state or to events or transactions which receive protections from the state.[197] *Lanco* disagreed with *Geoffrey's*[198] reading and saw *International Harvester Co.* as a tax on the corporation.[199] Contrary to the suggested reading in *Lanco*, the tax did not come out of the corporation's general fund; it came out of the pockets of the shareholders. Therefore, the tax would not have been assessed had the derivative not been paid.[200] The burden did not fall on the corporation; it fell on the shareholders.[201] To call the tax at issue in *International Harvester Co.* a tax on the corporation would be analogous to calling the income taxes taken from an employee's paycheck a tax on their employer, not the employee, a proposition that would likely not find support from America's workforce. Thus, *International Harvester Co.* demonstrated that source and benefits, not physical presence, are the hallmark of the requisite Commerce Clause nexus.[202]

C. STATE COURT ADOPTION OF *GEOFFREY*

Lanco's final justification for not following *Geoffrey, Inc. v.*

195. 322 U.S. 435(1944).
196. International Harvester Co. v. Wis. Dep't of Taxation, 322 U.S. 435, 441-42 (1944).
197. Geoffrey, Inc. v. S.C. Tax Comm'n, 437 S.E.2d 13, 18 (S.C. 1993).
198. 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).
199. *Lanco*, 21 N.J. Tax 200, 211 (N.J. Tax Ct. 2003).
200. *See International Harvester,* 322 U.S. at 439.
201. *Id.*
202. *See* Swain, *supra* note 99, at 349-51.

South Carolina Tax Commission[203] was the failure by state courts to adopt its analysis.[204] Despite the lack of overwhelming acceptance, *Geoffrey* has not been outright rejected. In fact, a number of courts have followed *Geoffrey*'s lead in finding the physical presence requirement inapplicable to income taxes.[205] In fact, three of the cases cited by *Lanco* as physical presence cases, *Truck Renting & Leasing Association v. Commissioner of Revenue*,[206] *Couchot v. State Lottery Commission*,[207] and *General Motors Corp. v. City of Seattle*,[208] are silent on the issue of physical presence, or actually held that physical presence is not required.[209]

First, in *Truck Renting & Leasing*, the Massachusetts Supreme Court held that a business with leased trucks entering Massachusetts was subject to income taxes, even if the lessor did not own or maintain a place of business in Massachusetts.[210] Like Lanco, the taxpayer protested the tax in part on its lack of physical presence in Massachusetts.[211] In its discussion of the Commerce Clause restrictions, the *Truck Renting & Leasing* court neither adopted nor declined a physical presence requirement, noting that neither party has argued that such a test would apply.[212] This is no more a rejection of *Geoffrey* as it is an adoption of its reasoning and offers little support for *Lanco*.

In analyzing the next cases cited in its decision, *Couchot* and *General Motors Corp.*, the *Lanco* court relied on dicta it found in the cases to support its position. The *Lanco* court used *Couchot* as support for the physical presence requirement.

203. 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

204. *Lanco,* 21 N.J. Tax at 213.

205. *See supra* note 139 and accompanying text.

206. 746 N.E. 2d 143 (Mass. 2001).

207. 659 N.E.2d 1225 (Ohio 1996).

208. 25 P.3d 1022 (Wash. App. 2001), *review denied*, 84 P.3d 1230 (Wash. 2004), *cert. denied*, 535 U.S. 1056 (2002).

209. *Lanco*, 21 N.J. Tax at 213.

210. Truck Renting & Leasing Ass'n. v. Comm'r of Revenue, 746 N.E.2d 143, 150 (Mass. 2001).

211. *Id.* at 146.

212. *Id.* at 149 n.13. The court stated:

> In [*Quill*], the Court upheld a "physical-presence requirement" before a State, consistent with the commerce clause, could subject an out-of-State vendor to a use or sales tax. The court did not extend this rule to other types of taxes. Neither party has argued that such a requirement would apply to the tax at issue here.

Id. (citations omitted).

Couchot involved a challenge to Ohio's taxation of lottery winnings by a recipient who had no physical presence in Ohio.[213] The court specifically held that physical presence was not a requisite for income taxes.[214] However, in dicta, the court conceded that had physical presence been required, by entering the state to purchase the lottery ticket, the recipient of the winnings would have had the requisite physical presence in Ohio.[215] The *Lanco* court looked past the conditional language and used the dicta of *Couchot* as evidence of the physical presence requirement. *Couchot*'s holding runs right up against the *Lanco* decision, not with it.

Much the same could be said for *General Motors Corp.* In *General Motors Corp.,* the court adopted *Geoffrey*'s market exploitation criteria instead of requiring physical presence.[216] The *General Motors Corp.* court declined to extend *Quill Corp. v. North Dakota*'s[217] requirement to the tax at issue.[218] As it had in *Couchot,* the court again looked past the *General Motors Corp.* holding, and asserted that the General Motors could be subject to taxation since, "[i]t is clear . . . that the automobile manufacturers had a physical presence in the taxing jurisdiction."[219] Thus, the court appeared to be less concerned with the holding than with the facts surrounding the case.

In order to support its contention that states have rejected *Geoffrey*, *Lanco* relied on one case that is neutral on the issue and two whose holdings were consistent with *Geoffrey.* If following the direction of other state courts is one of the justifications for adopting or rejecting a physical presence requirement, the *Lanco* court should have actually ruled differently.

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213. *See* Couchot v. State Lottery Comm'n, 659 N.E.2d 1225, 1227, 1229 (Ohio 1996).

214. *Id.* at 1230.

215. *See id.*; Lanco, Inc. v. Dir., Div. of Taxation, 21 N.J. Tax 200, 213 (N.J. Tax Ct. 2003). Note that the Ohio court in *Couchot* did not talk about whether entering the jurisdiction to purchase a single time would be a "substantial" nexus. This further demonstrates that the physical presence was merely an afterthought and cannot be viewed as one of the Court's holdings. *Couchot*, 659 N.E.2d at 1225.

216. General Motors Corp. v. City of Seattle, 25 P.3d 1022, 1029 (Wash. App. 2001), *review denied* 84 P.3d 1230 (2004), *cert. denied*, 535 U.S. 1056 (2002).

217. 504 U.S. 298, 306 (1992).

218. *General Motors Corp.*, 25 P.3rd at 1029.

219. *Lanco*, 21 N.J. Tax at 213.

D. CONCLUSION: *LANCO* INCORRECTLY GETS PHYSICAL AND ASSAULTS THE STATE'S COFFERS

Lack of in-depth analysis, selective reading, and subtle twisting of precedent, caused the *Lanco* court to incorrectly apply a physical presence requirement for Commerce Clause nexus. The potential burdens associated with the administration of sales and use taxes are not present with income taxes, or are only a fraction of nominal costs. In exchange, the *Lanco* court requires a system that could exempt entire industries from state taxation and poses a greater threat to the national economy, which the Dormant Commerce Clause was intended to protect. Contrary to *Lanco's* contention, prior Supreme Court holdings actually demonstrated that a taxed entity does not need to be physically present in a tax jurisdiction. State courts have not overwhelmingly adopted *Geoffrey*, but a small and growing number of states agree with its holding.[220] The *Lanco* court's position is ill-supported and untenable.

V. PHYSICAL PROPERTIES – WHY THE *LANCO* EXTENSION OF PHYSICAL PRESENCE STILL SHOULD NOT HAVE CHANGED THE OUTCOME

A. PHYSICAL PRESENCE V. NEXUS – AN INTERCHANGEABLE TERM USING INCOMPATIBLE WORDS

The *Lanco* court viewed the decision to extend the physical presence requirement to income taxes as the determinative question.[221] However, the court missed the mark. Despite having incorrectly extended the test, a close look at *Quill Corp. v. North Dakota*'s[222] articulation of a Commerce Clause nexus demonstrates that the court should have sided with New Jersey.

Once it was determined that a physical presence was required, contrary to the *Lanco* court's assertion, the truly determinative questions were whether or not Lanco had the requisite physical presence in New Jersey and, if so, whether this presence was "substantial." Beginning with whether presence existed, both parties agreed that Lanco's only connection with New Jersey was through a licensing agreement

220. *See supra* note 139 and accompanying text.
221. *Lanco,* 21 N.J. Tax at 207.
222. 504 U.S. 298, 306 (1992).

authorizing the use of its intellectual property by Lane Bryant.[223] Accordingly, the court should have asked whether intellectual property can be "physically present" under the test. The *Lanco* court skipped this step and simply assumed that that it could not.[224] Because

> [t]he decisive question in this case is whether the physical presence requirement confirmed in *Quill* under the Commerce Clause applies simply to the use tax collection obligation directly at issue in that case, or whether it is also a necessary element of substantial nexus for the imposition of a state income or franchise tax,[225]

a closer look at *Quill* demonstrates that intellectual property can, in fact, be physically present.

Under circumstances similar to Lanco's licensure of intangible property in New Jersey, Quill possessed intangible property in North Dakota. In addition to its physical products, Quill licensed a computer software program to its customers that enabled them to monitor Quill's inventories.[226] Quill retained ownership of the actual intellectual property,[227] just as Lanco retained ownership of its intellectual property utilized by Lane Bryant. In *Quill*, the Supreme Court found this situation established a nexus with North Dakota.[228] This nexus, based on just a few floppy disks containing a computer program, according to the Court, amounted to nothing more than a *de minimis* nexus.[229] The Supreme Court had previously rejected the use of a *de minimis* or "slightest presence" standard.[230]

Under the *Quill* Court's analysis, "physical presence" is a bit of misnomer, since the connection creating the nexus need not be physical at all. In reality "physical presence" is a shorthand expression and description of "nexus." The problem with using "physical presence" to define the requisite "nexus" is that it is under-inclusive, as it suggests that intangible property, such as a computer program on a floppy disk, is not enough. This sets a trap for unsuspecting courts, as happened

223. *Lanco*, 21 N.J. Tax 203. The parties stipulated that Lanco did not have offices, employees or real or tangible property in New Jersey. *Id.*

224. *Id.* at 207.

225. *Id.*

226. Quill Corp. v. North Dakota, 504 U.S. 298, 302 n.1 (1992).

227. *See id.*

228. *Id.* at 315 n.8.

229. *See id*.

230. *See id;* National. Geographic Soc'y v. Cal. Bd. of Equalization, 430 U.S. 551, 556 (1977) (rejecting the California Supreme Court's assertion that "slightest presence" met the Commerce Clause nexus requirement).

in *Lanco* court.

B. "SUBSTANTIAL NEXUS" – AN IGNORED SUBSTANTIVE QUESTION

The test is not just whether there is a nexus between the state and the taxpayer. *De minimis* contacts are insufficient; in order to subject an entity to taxation, the nexus must be *substantial*.[231] As discussed above, the licensing agreement with Lane Bryant, which was utilized by its New Jersey retail locations, created a nexus between Lanco and New Jersey. The *Lanco* court should have analyzed separately whether the nexus was "substantial." Having fallen into the "physical presence" trap, the court never analyzed the question of whether the nexus that existed was substantial. Nevertheless, it is a question which can be quickly solved. While the court does not state the level of activity needed, this issue is not just about "the existence . . . of a few floppy diskettes."[232] Receiving royalties of 5.5% of Lane Bryant's overall sales amounts to hundreds of thousands in IP rights.[233] In terms of money or

231. *See*, *e.g.*, *Quill*, 504 U.S. at 315 n.8; D.H. Homes Co. v. McNamara, 486 U.S. 24, 32-33 (1988) (finding a substantial nexus); Goldberg v. Sweet, 488 U.S. 252, 263 (1988) (doubting "that States through which the telephone call's electronic signals merely pass have a sufficient nexus to tax that call"). *Compare* Standard Pressed Steel Co. v. Was. Dept. of Revenue, 419 U.S. 560, 562 (1975) (taxing of company who employed a single agent working out of his own home, even though he did not make any sales or take any orders constituted a substantial nexus); Orvis Co., Inc. v. Tax Appeals Tribunal of N.Y., 654 N.E.2d 954, 954 (N.Y.1995) (agents entering New York to resolve problems give instructions regarding its products created a substantial nexus, even though the agents made no direct sales), *with In re* Appeal of Intercard, Inc., 14 P.3d 1111, 1112 (Kan. 2000) (eleven trips into Kansas by employees to install card reading units did not constitute a sufficient substantial nexus).

232. *Id*. at 313 n.8.

233. The number of stores located in New Jersey and their sales totals are relatively comparable. This is based on a search of the number and sales figures for Lane Bryant stores in both states via Lexis-Nexis's database of business records. From 1992 to 1994, Lanco was assessed with over $300,000 in franchise and income taxes in North Carolina. *See* Secretary of Revenue v. A&F Trademark, Inc. et al., Admin. Decision No. 381 at 26-27 (N.C. Tax Review Bd. May 7 2002), *available at* http://www.dor.state.nc.us/practitioner/hearing/A&F_TrademarkDecision2002.pdf (last visited Mar. 25, 2005). While North Carolina's sales appear to be on average higher than New Jersey's sales, but New Jersey's tax is higher than North Carolina's, which makes up for this difference. *Compare* N.C. GEN. STAT. § 105-130.3 (2004) *with* N.J. STAT. ANN. § 54:10A-5a(c)(1) (West 2002 & Supp. 2004). While this is not perfect calculation, it does demonstrate that New Jersey was providing protections for hundreds of thousands, if not millions, of dollars worth of Lanco's intellectual property.

time spent in the state, this level of activity goes beyond the *de minimis* level. It surpasses the level that various courts, including the Supreme Court, have found to be substantial.[234]

The *Lanco* court seemingly added the word "tangible" to "physical presence," a criteria which was never a part of the *Quill* analysis.[235] As a result of this misreading, the *Lanco* court never addressed whether Lanco's activities were "substantial." If Lanco's activities in other states serve as a reliable benchmark, undoubtedly the Court would have concluded that the activity was substantial. New Jersey could then rightfully subject Lanco to state taxation. In the end, after having incorrectly required a physical presence for income taxes, the *Lanco* court required a presence of "tangible" property, even though this was never required by *National Bellas Hess, Inc. v. Department of Revenue of Illinois*[236] or *Quill*. In essence, the *Lanco* court had an opportunity to take an alternate route to the correct destination, but ultimately got lost in the quagmire of state tax precedent.

VI. CONCLUSION: LACK OF IN DEPTH ANALYSIS LEADS TO THE WRONG DECISION

Lanco, Inc. v. Director, Division of Taxation[237] represented an opportunity for New Jersey to determine whether a state could constitutionally tax an entity whose only connection with a state was through a licensing agreement. By applying an incorrect reading of the relevant precedent, the *Lanco* court required a physical presence in order to subject a business to the New Jersey Corporate Business Tax. Even with this error, the court should still have found sufficient contacts with the state to allow the tax to stand. However, it failed to fully read *Quill Corp. v. North Dakota*,[238] and it determined that a

234. *See, e.g.*, National Geographic Soc'y v. Cal. Bd. of Equalization, 430 U.S. 551, 554 n.2 (1977) (two small offices each staffed by four employees and each with annual sales of less than $3,000 created a sufficient nexus); Standard Pressed Steel Co. v. Wash. Dept. of Revenue, 419 U.S. 560, 562 (1975) (single agent working out of his own home, even though he did not make any sales or take any orders, creates sufficient nexus); Aloha Freightways, Inc. v. Comm'r of Revenue, 701 N.E.2d 961 (Mass. 1998) (company's trucks traveling just over three thousand miles per year in Massachusetts sufficient nexus to subject company to income tax).

235. *See Lanco*, 21 N.J. Tax at 200, 214 (N.J. Tax Ct. 2003).

236. 386 U.S. 753 (1967).

237. 21 N.J. Tax 200 (N.J. Tax Ct. 2003).

238. 504 U.S. 298 (1992).

licensing agreement alone could not create the requisite "physical presence" under Commerce Clause nexus standards.

Had the court simply followed *Geoffrey v. South Carolina*,[239] a case which first stuck its neck out and led the way, it would have arrived at the correct outcome. Instead, the court ventured on its own. Along the way, it added the unnecessary requirement that the property be "tangible" in addition to being present, focused on dicta rather than the holdings of prior cases, and failed to fully analyze the practical impact of its decision. While this decision is not final,[240] PICs are currently free to grow in the Garden State.

239. 437 S.E.2d 13 (S.C. 1993).

240. *See* STATE OF NEW JERSEY DIVISION OF TAXATION, REFUND PROCEDURES FOR CLAIMS BASED ON THE TAX COURT'S DECISION IN LANCO, INC. V. DIRECTOR, DIVISION OF INSURANCE (Nov. 24, 2003), *available at* http://www.state.nj.us/treasury/taxation/index.html? lanco.htm~mainFrame (last updated Nov. 24, 2004).