The U.S. Supreme Court Should Accept a Nexus Case

by Jeffrey A. Friedman, J. Page Scully, and Natanyah Ganz

Introduction

The U.S. Supreme Court’s denial of certiorari in Capital One Bank v. Commissioner of Revenue¹ and Geoffrey, Inc. v. Commissioner of Revenue² leaves many tax practitioners wondering if the Court will ever again take a case concerning constitutional nexus standards. While no conclusions on the Court’s view of the merits can be gleaned from its denial of a petition for certiorari,³ the string of unsuccessful certiorari petitions is creating the impression among some that the Court is unlikely to take such a case in the foreseeable future.⁴ We believe the Court will take a nexus case because of the importance of the issue, the differing interpretations and applications of nexus standards, and the ramifications of ambiguous constitutional nexus principles affecting interstate commerce.

History and Background of Supreme Court Nexus Cases

Before the Supreme Court established the contemporary constitutional framework for evaluating nexus issues in Quill Corp. v. North Dakota,⁵ the Court, without distinguishing between the U.S. Constitution’s commerce clause and due process clause nexus for tax purposes, had articulated constitutional nexus principles in a number of important decisions, including:

- **International Shoe Co. v. Washington,**⁶ in which the Court described the relevant inquiry in determining nexus for due process purposes as whether the taxpayer has the minimum contacts with a jurisdiction “such that the maintenance of [a] suit does not offend ‘traditional notions of fair play and substantial justice.’”⁷

- **Wisconsin v. J.C. Penney Co.,** in which the Court described the nexus inquiry as “whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return.”⁸


2009), cert. denied, 2009 WL 733877 (2009) (No. 08-1169). (For the decision in J.C. Penney, see Doc 1999-39731 or 1999 STT 148-17; for the decision in SYL, see Doc 2003-14066 or 2003 STT 112-8; for the decision in Lanco, see Doc 2006-21177 or 2006 STT 199-22; for the decision in MBNA, see Doc 2006-23668 or 2006 STT 228-18; for the decision in Geoffrey, see Doc 2009-471 or 2009 STT 6-13; for the decision in Capital One, see Doc 2009-470 or 2009 STT 6-12.)
⁶326 U.S. 310 (1945).
⁷Id. at 316.
⁸311 U.S. 435, 444 (1940).
• **Miller Bros. v. Maryland,** in which the Court found that the taxpayer did not have nexus with Maryland sufficient to justify a Maryland use tax collection obligation based on its solicitation of Maryland customers through circulars and delivery to Maryland customers using the taxpayer’s own trucks. The Court stated that “due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.”

• **Northwestern States Portland Cement Co. v. Minnesota,** in which the taxpayer had engaged in a “regular and systematic course of solicitation” in the taxing state, and the Court concluded that that presence was sufficient to warrant Minnesota’s imposition of income tax.

• **National Geographic Society v. California Board of Equalization,** in which a District of Columbia corporation, with two California offices devoted to soliciting advertising unconnected with its mail-order sales business, was held to have a duty to collect California use tax on mail-order sales to California residents. While the mail order activity took place outside California, the presence of the California offices justified the state’s imposition of a use tax collection obligation.

The Court has also considered whether a taxpayer has nexus in a state based on the activities of others:

• In **Scripto, Inc. v. Carson,** an out-of-state corporation had no property or employees in Florida, but it employed independent contractors to solicit sales of its products there. This use of independent contractors to solicit orders was attributed to the out-of-state taxpayer to justify a use tax collection obligation.

• In **Tyler Pipe Industries v. Washington State Department of Revenue,** the Court determined that Washington could impose its business and occupation tax (a gross receipts tax) on an out-of-state wholesaler that had no office, property, or employees in Washington. However, the taxpayer did engage an in-state independent contractor to solicit sales. The Court affirmed the Washington Supreme Court’s conclusion that the crucial factor governing nexus is whether the activities performed by the independent contractor on behalf of the out-of-state company are “significantly associated with the taxpayer’s ability to establish and maintain a market in [the] state for the sales.”

The Court in **Quill** set out the current constitutional nexus analysis under which due process nexus is established if the taxpayer has “purposely avail[ed] itself of the benefits of an economic market” in the state, and it held that commerce clause nexus is established if the nexus is “substantial,” which, at least in the context of a use tax collection obligation, requires a physical presence.

Taken together, those cases have provided state tax administrators and taxpayers with several bedrock principles. The **Quill** Court’s bright-line physical presence test that satisfies the dormant commerce clause’s substantial nexus requirement for sales and use tax collection obligations, is perhaps the most oft-cited nexus rule. Also, **National Geographic’s** holding that the taxpayer’s in-state presence need not be associated with its sales activity to justify a sales or use tax collection obligation and...
Scripto’s and Tyler Pipe’s guidance regarding attributional nexus provide further guidance for contemporary nexus analysis. However, several critical nexus questions remain unanswered.

Getting to Court: Considerations Governing Review

Before addressing the types of nexus questions that the Court should consider hearing, we will consider the criteria used by the Court in determining whether to grant certiorari. It is unsurprising that petitions have not been granted for the recent nexus cases seeking certiorari — petitions for writs of certiorari to the U.S. Supreme Court are rarely granted. In fact, roughly 1,825 regularpetitions for certiorari are filed per term. Of those, approximately 80 (or 4 percent) are granted. Also, more than 6,000 in forma pauperispetitions are filed in a given term, and, on average, the Supreme Court grants certiorari to only five of those petitions.

While the Supreme Court frequently denies certiorari, that denial is not a decision based on the merits and is neither persuasive nor binding authority. Therefore, one cannot properly draw conclusions on the Court’s view of the merits of a case from its denial of certiorari, and that the Court has not accepted a petition regarding a nexus case does not mean it will not do so in the near future.

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A petition for writ of certiorari will be granted only for compelling reasons. Among them is whether there is a conflict on an important federal question between two courts of appeals, between a court of appeals and the highest court of a state, or between two state courts of last resort. The Supreme Court also may consider whether a state court has decided an important federal question that should be decided by the Supreme Court or that conflicts with a decision already made by the Supreme Court.

Unresolved Nexus Issues That Call for Supreme Court Guidance

The bedrock nexus principles described above leave many important nexus questions unanswered. It would be unrealistic to expect the Court to hear all of them. Indeed, the Court should not address every nexus question that arises, because those issues are often best left for Congress and state courts to resolve. The following issues have proved to be particularly important and should be considered issues that present important federal questions.

Is the Economic Presence Standard Constitutional?

Since 1992 and the Quill Court’s warning that nexus issues may be better resolved by Congress, the Supreme Court has declined to hear a number of important constitutional cases concerning nexus outside the context of sales and use tax collection. In 1993 the Court declined to hear Geoffrey, Inc. v. South Carolina, which turned out to be the first of several cases concerning the application of nexus standards to a holding company licensing intangible property to an affiliate using the property, in part, in the taxing state. In Geoffrey, the South Carolina Supreme Court held that merely licensing intangibles for use in South Carolina and receiving royalty income therefrom created a sufficient connection with the state to justify the imposition of income tax. In reaching that determination, the court noted that “the U.S. Supreme Court recently revisited the physical presence requirement of Bellas Hess and, while reaffirming its vitality as to sales and use taxes, noted that the physical presence requirement had not been extended to other types of taxes.”

More recently, in MBNA America Bank, the West Virginia Supreme Court of Appeals concluded that the taxpayer’s continual and systematic business activity of direct mail and telephone solicitation into West Virginia produced a significant economic presence in the state that was sufficient to establish...
substantial nexus for an income-based tax. The court reached that conclusion even though the taxpayer had no real or tangible property in West Virginia and had no employees in the state. Similarly, in Capital One, the Massachusetts Supreme Judicial Court determined that the state’s financial institutions excise tax (an income-based tax) could constitutionally be imposed on credit card banks that derived interest, penalties, and transaction fees from dealings with Massachusetts’s borrowers even though the credit card banks had no physical presence in Massachusetts. In considering whether physical presence was required for there to be substantial nexus in the context of an income-based tax, the court noted that in Quill, the Supreme Court “explicitly emphasized, on more than one occasion, a narrow focus on sales and use taxes for the physical presence requirement.”

These cases highlight what has become the most prominent constitutional nexus question: the application of Quill’s physical presence commerce clause standard outside the realm of sales and use taxes.

Is Flash Nexus Constitutional?

Other important nexus issues have yet to make their way into a Supreme Court certiorari petition, including “nanosecond” (or “flash”) nexus cases such as Matter of the Petition of Wascona Energy Marketing (U.S.), Inc. That case involved a foreign corporation that purchased and sold oil and natural gas imported from Canada to customers in the United States, and specifically in New York. Under contracts with its customers, title to the product passed at an interconnect to the pipeline at the U.S.-Canada border. All activities connected with the company’s business occurred in Canada. The New York Division of Taxation determined that the company was doing business in New York. However, the administrative law judge held in favor of the taxpayer, concluding that while Quill requires physical presence within the taxing state, the momentary transfer of title, without more, failed to establish the requisite physical presence.

The Multistate Tax Commission’s Factor Presence Nexus Standard

The Multistate Tax Commission adopted a uniformity proposal that would provide a bright-line presence test based on a taxpayer’s apportionment factors. A taxpayer is deemed to have substantial nexus for corporate income tax purposes if it has any of the following in a tax period:

- over $50,000 of property in the state;
- over $50,000 of payroll in the state;
- over $500,000 of sales in the state; or
- 25 percent of total property, total payroll, or total sales in the state.

Several states — including Ohio, Michigan, and most recently, California — have enacted that or similar “factor presence” nexus statutes. Given the controversy surrounding application of the physical presence requirement in the context of an income-based tax, it is unclear whether those statutes could be constitutionally applied to taxpayers without a physical presence in that state.

When Is Affiliate Nexus Constitutional?

Scripto and Tyler Pipe have allowed states to attribute activities of in-state persons to out-of-state taxpayers. In both cases, the in-state person engaged in market-making activities on behalf of the out-of-state taxpayer. However, states have expanded the scope of those cases. For instance, many states have enacted legislation providing that the activities of an in-state retailer are sufficient to establish sales and use tax nexus over a related, out-of-state company.

Generally, these statutes create a sales and use tax collection obligation when the in-state and out-of-state affiliates are commonly owned and the in-state and out-of-state companies sell similar products; operate under similar business names, trademarks, trade names, or goodwill; share a similar business plan; the in-state business provides services to the out-of-state vendor that helps maintain the in-state market; or the companies pay for

were consummated on delivery in Rhode Island, we are of the opinion that Koch’s activities created in practical effect a physical presence within this state. Given Koch’s physical presence in Rhode Island, we agree with the District Court’s conclusion that Koch had sufficient contact with the state to satisfy the substantial-nexus requirement of the Complete Auto test.” (For the decision, see Doc 96-16045 or 96 STN 106-36.

MTC Policy Statement 02-02 (Oct. 17, 2002).

Ohio Rev. Code Ann. section 5751.01(I); Mich. Comp. Laws section 208.1200; California Revenue and Taxation Code section 23101(b) (effective for tax years on or after Jan. 1, 2011).
each other’s services based on sales. However, these statutes create a sales and use tax obligation over an out-of-state seller if the seller is related to an in-state company and, for instance, the two entities use similar names. Also, at least one state provides that sales and use tax collection obligations can be based simply on membership in an affiliated group when one of the members has in-state physical presence.

Is common ownership of the in-state and out-of-state companies alone sufficient to establish nexus over the out-of-state company?

These affiliate nexus statutes highlight questions that the Supreme Court has yet to answer: Will the Supreme Court allow the imposition of a sales and use tax obligation if the in-state company is not attempting to establish and maintain a market on behalf of the out-of-state taxpayer? Is common ownership of the in-state and out-of-state companies alone sufficient to establish nexus over the out-of-state company?

As constitutionally shaky as traditional affiliate nexus laws are, even more troubling is the emergence of another type of nexus law. New York state has recently enacted controversial legislation that extends beyond the traditional notions of attributional nexus. New York has enacted an “Internet tax” that establishes a sales and use tax collection obligation on an out-of-state Internet retailer based on its contractual relationship with an unrelated in-state company. New York’s Internet tax is aimed at a common business practice — the placing of links to other companies’ Web sites on a Web page. Customers who click on the link are directed to another company’s Web site. A commission or fee is paid based on the amount of sales derived from those click-through sales. The purpose of that click-through activity is to solicit sales. However, the solicitation of those sales is not focused on any particular state’s market, and the in-state presence is therefore not directly associated with generating New York sales.

New York’s Internet tax establishes a presumption that if an out-of-state company has a click-through agreement with an in-state resident that leads to at least $10,000 of New York sales, then the out-of-state Internet retailer must collect New York’s sales or use tax. That presumption of nexus may be rebutted if the taxpayer proves that the in-state person did not engage in solicitation within the state. However, the practical import of that rebuttal remains unclear because of contractual and compliance difficulties. New York’s tax raises many important constitutional questions — for example, do the in-state sellers engage in activities designed to lead to in-state sales, or do the in-state sellers participate in a virtual marketplace that is not associated with New York’s market?

New York’s Internet tax statute has been considered by several other states, including Hawaii, Rhode Island, North Carolina, Minnesota, Tennessee, Connecticut, and California. And a pending California law would trigger nexus over an out-of-state retailer when the out-of-state retailer has any type of representative in the state servicing or repairing tangible personal property.

Because these Internet tax laws are leading to significant business practice and economic changes, taxpayers can be expected to challenge their constitutionality.

When May a State Constitutionally Tax Nonresidents’ Income?

In International Harvester v. Wisconsin Department of Taxation, the Supreme Court heard a due process challenge to a law that imposed an income tax on the dividends of nonresident shareholders. The Court concluded that a state may require a corporation to withhold taxes on dividends paid to nonresident shareholders because the state had afforded “protection and benefits to appellant’s corporate activities and transactions within the state.” It is unclear whether this regime is constitutional under modern dormant commerce clause principles.

Why the Court Should Grant Certiorari on a Nexus Issue

We believe, based on the number and importance of unresolved nexus issues, that the Supreme Court will grant certiorari in a nexus case. It is only a matter of time. Nexus is a fundamental state tax principle that is dependent on U.S. constitutional law. The number of unanswered nexus questions continues to grow, partly because of new state tax provisions that stretch taxing jurisdiction far beyond the bedrock principles that the Court has previously provided. Compounding the importance of these issues is the dire fiscal condition of the states.

The growing uncertainty also significantly affects taxpayers’ financial reporting. For instance, Financial Accounting Standards Board Interpretation No. 48, “Accounting for Uncertainty in Income Taxes,” requires public companies to identify uncertain income tax positions and to assert that in management’s judgment, it is more likely than not that the tax position will be sustained on audit, in order for it to recognize any benefit. Otherwise, the company must book an unrecognized tax benefit (or reserve) of 100 percent of the potential tax benefit from the tax position. The uncertainty surrounding constitutional nexus, particularly as it applies to new states’ laws based on novel and expansive nexus theories, makes it difficult to render more likely than not nexus opinions. As a result, many taxpayers are required to create a “full” reserve because of the uncertainty.

FIN 48’s additional requirement that reserves be maintained for all periods that remain open to assessment exacerbates the problem because almost all states retain the authority to assess additional tax indefinitely when a return is not filed. Consequently, the financial statement reserves may have to be maintained indefinitely for taxpayers with uncertain nexus positions. These financial statement issues magnify the importance of unresolved nexus standards. The financial statement impact of these issues can also lead to “bet the company” litigation.

Another consequence of nexus uncertainty is the states’ movement to restructure their tax regimes. For example, several states have recently adopted, or are considering, mandatory combined reporting.

Conclusion

Nexus standards among the states differ, and the differences are increasing. Those differences create unjustifiable uncertainty and confusion for both taxpayers and states. Virginia, joined by South Dakota, filed an amicus brief in Capital One Bank v. Commissioner of Revenue in support of Capital One’s petition for certiorari asserting the need for the Supreme Court’s guidance on the commerce
clause nexus standard.\textsuperscript{64} While the Supreme Court in \textit{Quill} noted that these nexus issues may be better resolved by Congress and that Congress has the ultimate authority to resolve them,\textsuperscript{65} it is unlikely that any legislation would be comprehensive enough to cover all situations. In fact, federal legislation that would provide return filing standards associated with a number of specific situations only complements additional U.S. Supreme Court guidance, as federal lawmakers cannot anticipate every type of transaction or potential nexus controversy.\textsuperscript{66} Nexus is based on fundamental U.S. constitutional principles. Not addressing the evolution of these principles creates significant federal questions.

The Court may want to see nexus issues simmer for some time before accepting a case.

Moreover, state legislative attempts to expansively define nexus are creating significant differences among state filing requirements. It may be that the Court has not granted a petition for certiorari in a nexus case because there has not been enough deviation among state supreme court decisions to justify its involvement. Thus, the Court may want to see nexus issues simmer for some time before accepting a case. However, varied state-defined nexus standards are tantamount to the same inconsistent legal structures that emanate from divergent state supreme court decisions.

For these reasons, we believe that the time will soon come when the Court views a case raising one of the issues discussed above as appropriate for its plenary review.

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\textsuperscript{64}See Brief of Amici Curiae Commonwealth of Virginia & South Dakota, \textit{Capital One Bank}, 2009 WL 733877 (June 22, 2009) (No. 08-1169).

\textsuperscript{65}\textit{Quill}, 504 U.S. at 318.

\textsuperscript{66}See Business Activity Tax Simplification Act of 2007 (BATSA) S. 1726, 110th Cong. (2007). BATSA was introduced in 2007 as an update to P.L. No. 86-272. It sets forth clear rules as to the activities that give rise to nexus in a state. For example, under the proposed legislation, taxpayers that spend less than 15 days in a taxing state would not be subject to that state’s income tax. \textit{Id.}