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TAXING COLONEL SANDERS: RE-EXAMINING CONSTITUTIONAL NEXUS THROUGH THE LENS OF *KFC CORP. V. IOWA*

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ABSTRACT

Over twenty years ago, the Supreme Court of the United States decided that an entity must have a "physical presence" within a state before that state's taxing authority can require the entity to pay state taxes. Since this physical presence requirement was created, a deep divide among state courts has shaped a confusing landscape surrounding two issues with the requirement. First, the states disagree on what constitutes physical presence within a state. Some state courts have held that mere economic presence in a state is sufficient for a state to assert its tax jurisdiction. Second, the states disagree on whether the physical presence requirement applies to all state taxes or merely a narrow classification of state taxes, specifically sales and use taxes. When it created the physical presence requirement, the Supreme Court hinted that, while it was articulating a standard, the issue of a state's tax jurisdiction was best left for Congress to decide. Unfortunately, Congress has refused to legislate on this issue. Several state court decisions interpreting the physical presence requirement have been appealed to the Supreme Court—none of them have been granted certiorari.

The Supreme Court's physical presence requirement is the current

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standard, and it was never expressly limited by the Court to certain classes of state taxes. The author argues that the Supreme Court should articulate a bright-line rule requiring actual physical presence within a state before the state has the power to impose any tax on an entity. Given Congress's refusal to act, and the landscape of uncertainty currently faced by many multi-state businesses, it is time the Supreme Court clears up the tangled underbrush with a bright-line standard.

INTRODUCTION

In *KFC Corp. v. Iowa Department of Revenue*, the Supreme Court of Iowa joined the entrenched divide that currently exists among state courts over the power of a state to tax the income of an out-of-state business that has no physical presence within the taxing state.[1] Specifically, the court upheld a decision that an out-of-state holding company that licensed trademarks to restaurant franchisees was subject to Iowa corporate income tax on revenue earned from the use of its trademarks within Iowa.[2] By licensing franchises within Iowa, the court found that the taxpayer, KFC Corporation, received the benefit of an orderly society within the state and, as a result, was subject to income tax that otherwise satisfied the requirements of the Commerce Clause.[3] Similar to its predecessor case from South Carolina, *Geoffrey Inc. v. South Carolina Tax Commission*,[4] *KFC* seems to violate the Supreme Court's physical-presence requirement as provided in *Quill Corp. v. North Dakota*.[5] However, *KFC* appears to have gone two steps further.

First, *KFC* has added confusion to an already confusing area of the law by making the "oxymoronic" suggestion[6] that even if *Quill* requires a physical presence within the taxing state, KFC's licensing of its intangible property to Iowa franchisees gave it the functional equivalent of physical presence in the state.[7] As discussed *infra*, this "economic nexus" standard is of questionable basis and goes beyond the case law of both the Supreme Court and the state courts.

Second, the Iowa Supreme Court ignored a crucial distinction between the franchising arrangements in *Geoffrey* and *KFC*. That is,

1. 792 N.W.2d 308 (Iowa 2010), *cert. denied*, 132 S. Ct. 97, 98 (2011).
2. *Id.* at 322-23.
3. *Id.* at 328.
4. 437 S.E.2d 15 (S.C. 1993), *cert. denied*, 114 S. Ct. 550 (1993).
5. 504 U.S. 298 (1992).
6. Sheldon H. Laskin, *Only a Name? Trademark Royalties, Nexus, and Taxing that which Enriches*, 22 AKRON TAX J. 1, 23 (2007).
7. *See KFC*, 792 N.W.2d at 328.

unlike *Geoffrey*, the franchisor in *KFC* did not involve the state tax planning structure of an intangible holding company created and used by intellectual property owners to minimize state tax obligations.[8] Instead, *KFC* involved a contractual franchising agreement between two unrelated and independent parties.[9]

Recently, the Supreme Court declined to hear *KFC*[10] and continued its pattern of refusing to hear cases that would determine whether the *Quill* physical presence requirement extends beyond the realm of state sales and use tax.[11] The Supreme Court has never directly addressed the question of whether mere economic presence in a state is sufficient grounds for a state to assert its income tax jurisdiction.[12] Given the contentious nature of the state taxation area, and in the wake of high-profile state decisions such as *KFC*, *Amazon.com, LLC v. New York State Department of Taxation and Finance*,[13] and, most recently, *Lamtec Corp. v. Washington Department of Revenue*,[14] the Supreme Court is long overdue to grant certiorari on a case relevant to its Commerce Clause nexus requirement.

This Article will analyze the Commerce Clause's physical presence requirement for state taxation issues through the lens of *KFC*. The purpose of this Article is to (1) argue that courts like *KFC* and *Geoffrey* have inappropriately narrowed the *Quill* physical presence requirement; and (2) argue that, given the unsettled landscape, the Supreme Court needs to clarify its position on what qualifies as a substantial nexus to a state and affirmatively declare that physical presence in the taxing state is required before a state can exercise its taxing authority over a person or entity. Part I of this Article will provide an overview of the Commerce Clause and will trace the history of the Supreme Court's Commerce Clause nexus jurisprudence. Part II details the *KFC* ruling while arguing that it represents an overextension of *Quill*'s physical presence requirement by the Iowa Supreme Court. Part II also provides a detailed analysis of a number of the post-*Quill* state court decisions in

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8. 437 S.E.2d 13, 15-16 (S.C. 1993).

9. 792 N.W.2d at 310.

10. KFC Corp. v. Iowa Dep't of Revenue, 132 S. Ct. 97 (2011) (denying writ of certiorari).

11. *See, e.g.*, Lanco v. Dir., Div. of Taxation, 908 A.2d 176 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007); A&F Trademark, Inc. v. Tolson, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 546 U.S. 821 (2005); *Geoffrey*, 437 S.E.2d 15 (S.C. 1993).

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

13. 913 N.Y.S.2d 129 (App. Div. 2010).

14. 246 P.3d 788 (Wash. 2011).

an effort to illustrate the great divide that currently exists among the states. Part III argues for requiring a bright-line physical presence requirement for all state-imposed taxes using economic factors and undue burdens placed on interstate commerce as justification. Finally, this Article concludes that, due to the failure of Congress to act in this area of the law, it is time the Supreme Court steps in to settle the split among the states and affirmatively declare a bright-line rule extending *Quill*'s physical presence requirement to all state-imposed taxes.

I. THE COMMERCE CLAUSE AND HISTORICAL FOUNDATIONS FOR *QUILL*'S NEXUS STANDARD

"Article I, § 8, cl. 3, of the [United States] Constitution expressly authorizes Congress to 'regulate Commerce with foreign Nations, and among the several states.'"[15] This is commonly referred to as the Commerce Clause. Although the Commerce Clause does not affirmatively provide for the protection of interstate commerce, the Supreme Court has long recognized that the Commerce Clause "has a negative sweep" that unquestionably places limitations on state taxation powers.[16] This and other limits are, commonly referred to as the "dormant" Commerce Clause.

Although the dormant Commerce Clause, as it relates to state taxation issues, has had numerous makeovers since Justice Johnson first suggested it in his concurring opinion in *Gibbons v. Ogden*,[17] under current Commerce Clause jurisprudence, "with certain restrictions, interstate commerce may be required to pay its fair share of state taxes."[18] The Supreme Court created a test in *Complete Auto Transit, Inc. v. Brady*[19] to express the restrictions that the Commerce Clause places on state-imposed taxes. Under that test, a state tax will only pass dormant Commerce Clause muster if it (1) is assessed against a taxpayer having a "substantial nexus with the taxing State"; (2) "is fairly apportioned"; (3) "does not discriminate against interstate commerce"; and (4) "is fairly related to the services provided by the State."[20] In *Quill*, the Supreme Court confirmed that the four-part test articulated in *Complete Auto* governs the constitutionality of state taxes with respect to

15. Quill Corp. v. North Dakota, 504 U.S. 298, 309 (1992).

16. *Id.*; Leloup v. Port of Mobile, 127 U.S. 640, 648 (1888) ("[N]o state has the right to lay a tax on interstate commerce in any form . . . .").

17. 22 U.S. (9 Wheat.) 1, 236 (1824) (Johnson, J., concurring).

18. D.H. Holmes Co. v. McNamara, 486 U.S. 24, 31 (1988).

19. 430 U.S. 274 (1977).

20. *Id.* at 279.

the Commerce Clause.[21]

The first prong of the *Complete Auto* test, the nexus requirement, has been the subject of many court decisions in the past and continues to be the subject of many tax controversies today.[22] The Supreme Court's first interpretation of the nexus prong came ten years earlier in *National Bellas Hess, Inc. v. Department of Revenue*.[23] There the Court held that a state could not impose a use tax obligation on a mail-order vendor where the vendor's only contact with the taxing state was by mail or common carrier.[24] Thus, the *Bellas Hess* court created a safe harbor, under the Commerce Clause, from a state-imposed tax in circumstances where a taxpayer has no physical presence in the taxing state.[25]

Twenty-five years later, in *Quill*, the Supreme Court reconsidered its *Bellas Hess* holding.[26] *Quill* involved an attempt by North Dakota to require Quill Corporation, an out-of-state seller of office furniture that lacked a physical presence in the state, to collect a use tax on its sales to North Dakota residents.[27] Quill Corporation "had solicit[ed] business through catalogs and flyers, advertisements in national periodicals, and telephone calls."[28] But Quill had no offices, no real property, and no employees located in North Dakota.[29] The Supreme Court held that, absent a "physical presence" in North Dakota, Quill Corporation's sales into North Dakota did not provide a "substantial nexus" for purposes of the use tax collection obligation imposed by North Dakota.[30] In so holding, the Court noted that:

> [T]he bright-line rule of *Bellas Hess* furthers the ends of the dormant Commerce Clause. Undue burdens on interstate commerce may be avoided not only by a case-by-case evaluation of the actual burdens imposed by particular regulations or taxes, but also, in some

21. *Quill*, 504 U.S. at 311.

22. *See, e.g.*, Orvis Co. v. Tax Appeals Tribunal, 86 N.Y.2d 165, 169-70 (N.Y. 1995).

23. 386 U.S. 753 (1967), *overruled by Quill*, 504 U.S. 298.

24. *Id.* at 758.

25. *Id.* ("In order to uphold the power of Illinois to impose use tax burdens on [Bellas Hess] in this case, we would have to repudiate totally the sharp distinction which these and other decisions have drawn between mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business. But this basic distinction, which until now has been generally recognized by the state taxing authorities, is a valid one, and we decline to obliterate it.").

26. *Quill*, 504 U.S. at 315.

27. *Id.* at 303.

28. *Id.* at 302.

29. *Id.*

30. *Id.* at 313-14.

> situations, by the demarcation of a discrete realm of commercial activity that is free from interstate taxation.[31]

Although *Quill* involved a sales and use tax, the physical presence requirement is the current doctrine regarding state tax nexus issues and there is no United States Supreme Court precedent expressly limiting that requirement to sales and use taxes.

II. *KFC CORPORATION V. IOWA DEPARTMENT OF REVENUE*

KFC Corporation was "a Delaware corporation with its principal place of business in . . . Kentucky."[32] KFC owned and licensed restaurant trademarks and the related system designed to maintain a uniform nationwide restaurant product.[33] As part of its business model, KFC entered into franchise agreements with franchisees in Iowa who paid royalty payments of four percent of gross monthly revenue to KFC for the right to use KFC's trademarks and systems.[34] Under the agreements, KFC controlled the franchisees' use of KFC's trademarks, as well as the nature and quality of the goods sold by the franchisees.[35] However, KFC did not own any restaurant property in Iowa and had no employees in Iowa.[36] After years of contracting with Iowa franchisees and receiving royalty income pursuant to its franchise agreements, KFC was issued a tax assessment by the Iowa Department of Revenue (IDOR) for unpaid corporate income taxes.[37]

KFC appealed to an Iowa administrative law judge (ALJ) who issued a detailed ruling in favor of the IDOR holding that the tax assessment did not violate the Commerce Clause.[38] The ALJ determined that "KFC owned, managed, protected, and licensed" the KFC trademarks and systems within Iowa.[39] The ALJ also concluded that "[t]hroughout the period, KFC had the rights to control the use of its [trade]marks" as well as "the right to control the nature and quality of

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31. *Id.* at 314-15.

32. KFC Corp. v. Iowa Dep't of Revenue, 792 N.W.2d 308, 310 (Iowa 2010).

33. *Id.* The "system" in a franchise context is often defined in a franchise agreement and typically refers to a system of distinctive business formats, methods, procedures, designs, store layout, signage, equipment, menus, recipes and standards of operation. *Id.*; *see*, *e.g.*, FSC Franchise Co., LLC v. Bel-Mar, Inc., NOS. 8:10-CV-450-T-23TBM, 2010 WL 1627083, at *1, n.4 (M.D. Fla. 2010).

34. *KFC*, 792 N.W.2d at 311.

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.* at 311.

39. *Id.*

the goods sold under" its trademarks in Iowa.[40] Additionally, the ALJ found that the franchise agreements required the franchisees to adhere to KFC's requirements regarding menus, advertising, marketing, and restaurant facilities.[41] Finally, the ALJ found that the Iowa franchisees could deduct the royalty payments made to KFC from their taxable income.[42]

Applying the law to its factual findings, the ALJ held that the IDOR assessment did not violate the Commerce Clause because "physical presence is not required when a state imposes taxation on income."[43] Further, the ALJ concluded "that KFC had a sufficient nexus to Iowa to support" the imposition of a tax.[44] According to the ALJ, "[t]he imposition of [a] tax on income generated by a franchisor within a state was not an undue burden on commerce, but rather a payment to [the State of Iowa] that provided the economic climate for [KFC] to prosper."[45]

KFC appealed the ALJ ruling several times before the case ended up before the Iowa Supreme Court.[46] After conducting a *de novo* review, the *KFC* court issued two holdings with respect to Iowa's ability to tax KFC without violating the Commerce Clause. First, limiting the physical presence requirement of *Quill* to sales and use tax, the Iowa Supreme Court held that physical presence is not required for the imposition of a corporate income tax.[47] Therefore, according to the Iowa Supreme Court, KFC had a sufficient nexus with the state so as not to violate the Commerce Clause.[48] Second, surprisingly, the court held that KFC's licensing of its trademarks to its Iowa franchisees was the "functional equivalent" of physical presence in the state.[49] Thus, according to the court, KFC would have been subject to the Iowa corporate income tax regardless of whether there was a physical presence requirement.[50]

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40. *Id.*
41. *Id.*
42. *Id.*
43. *Id.*
44. *Id.*
45. *Id.*
46. *Id.* at 311-12.
47. *Id.*
48. *Id.* at 323-24.
49. *Id.* at 324.
50. *Id.*

A. *The "Functional Equivalent" of Physical Presence Holding*

As support for its finding that KFC's licensing of its trademarks to Iowa franchisees was the functional equivalent of physical presence, the Iowa Supreme Court stated:

> Unlike in *Quill*, where the only presence in the state, except for "title to a few floppy diskettes," resulted from the use of United States mail and common carriers, this case involves the use of KFC's intangible property within the State of Iowa to produce royalty income.[51]

Thus, according to the court, the mere "presence of transactions within the state that give rise to KFC's revenue" was sufficient to satisfy the Commerce Clause nexus requirement.[52]

This new functional equivalency test goes beyond the jurisprudence of both the Supreme Court and the other state courts that have considered the issue. Moreover, this novel jurisprudential invention by the Iowa Supreme Court is of questionable basis. Every case cited by the *KFC* court as support for the proposition that intangible property is the functional equivalent of physical presence in the state was decided before *Quill*.[53] More importantly, the cases cited were decided solely on Due Process, and *not* Commerce Clause, grounds.[54] The Iowa Supreme Court ignored this critical distinction when it issued its decision in *KFC*.[55]

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51. *Id.* at 323.

52. *Id.*

53. *Id.* The *KFC* court acknowledged this by stating that "[u]nder the applicable pre-*Quill* case law, the use of intangibles within a state to generate revenue for an out-of-state entity was generally regarded as a sufficient nexus under the dormant Commerce Clause to support the imposition of a state income tax." *Id.*

54. *See* Nw. States Portland Cement Co. v. Minnesota, 358 U.S. 450, 464-65 (1959) (observing that, *for due process purposes*, income tax could be supported if the "activities form a sufficient nexus between such a tax and transactions within a state for which the tax is an exaction") (internal quotations omitted); Int'l Harvester Co. v. Wis. Dep't of Taxation, 322 U.S. 435, 441 (1944) (stating that, for *purposes of the Fourteenth Amendment*, "[p]ersonal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's . . . earnings as is distributed to them"); State of Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444-45 (1940) (physical presence in state is not required by the *Due Process* Clause); New York *ex. rel.* Whitney v. Graves, 299 U.S. 366, 372 (1937) ("business situs" of intangible property in taxing state is sufficient nexus for *due process* purposes).

55. *See generally KFC*, 792 N.W.2d at 310-12.

1. *Quill* Established Different Standards for the Due Process Clause and the Commerce Clause

In *Quill*, the United States Supreme Court articulated separate and distinct nexus standards under the Due Process and Commerce Clauses.[56] The *KFC* court failed to recognize this critical distinction and based its functional equivalency test on pre-*Quill* cases that were decided on due process grounds.[57]

Under the Due Process Clause, the *Quill* court held that *in personam jurisdiction* principles, including a minimum contacts standard, should apply.[58] The *Quill* court then concluded that Quill Corporation had "purposefully directed its activities at North Dakota residents" and that imposing a use tax collection obligation was "related to the benefits Quill receive[d] from access to the State," so as to satisfy the Due Process Clause.[59] Critically, however, the Supreme Court noted that "a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause."[60]

Despite *Quill*'s clear distinction between the Due Process and Commerce Clause nexus, as well as its physical-presence requirement, the *KFC* court found that "[u]nder the applicable pre-*Quill* case law, the use of intangibles within a state to generate revenue for an out-of-state entity was generally regarded as a sufficient nexus under the dormant Commerce Clause to support the imposition of a state income tax."[61] The *KFC* court then cited *New York ex. rel. Whitney v. Graves*[62] as an example of a Supreme Court case that supports its holding that in-state intangible property of an out-of-state entity is "the functional equivalent of physical presence."[63]

Whitney involved a Due Process Clause challenge to the taxation of profits made from the sale of a seat on the New York Stock Exchange by a Massachusetts partnership.[64] Although the partnership-taxpayer in

56. Quill Corp. v. North Dakota, 504 U.S. 298, 305 (1992).

57. *See generally supra* notes 53-54.

58. *Quill*, 504 U.S. at 306-07 ("The Due Process Clause 'requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax . . . .'").

59. *Id.* at 308.

60. *Id.* at 313.

61. KFC Corp. v. Iowa Dep't of Revenue, 792 N.W.2d 308, 323 (Iowa 2010).

62. 299 U.S. 366 (1937).

63. *KFC*, 792 N.W.2d at 323-24 (quotations omitted).

64. 299 U.S. at 369. The taxpayer argued that the tax "contravene[d] the Fourteenth Amendment." *Id.* at 370.

Whitney had no physical presence in New York, the Supreme Court found that the partnership's seat on the New York Stock Exchange was sufficiently localized so as "to bring it within the taxing power of" the state.[65] According to the *KFC* court, "under *Whitney*," KFC's licensing of its trademarks to Iowa franchisees "provide[s] a 'business situs' sufficient to" meet *Quill*'s physical-presence requirement.[66]

By relying on *Whitney* as its foundational basis for the functional equivalency test, the *KFC* court ignored *Quill*'s physical-presence requirement and created its own constitutional standard.[67] Inasmuch as *Quill* established that there are two different standards for Due Process and Commerce Clause nexus, the *Whitney* case lends little support to the *KFC* court's holding.[68] Critically, *Whitney* was decided exclusively on Due Process grounds; there was no Commerce Clause challenge in that case.[69] When *Quill* severed the Commerce Clause nexus standard from the Due Process Clause analysis, the pre-*Quill* cases that were decided on Due Process grounds became irrelevant for current Commerce Clause nexus purposes. Accordingly, the *KFC* court's heavy reliance on nexus theories that predate the Supreme Court's split of the Due Process and Commerce Clause analysis is of questionable validity.

2. *Quill*'s "Bright-Line" Nexus Standard

The *KFC* decision also ignored the Supreme Court's recognition of "the continuing value of a bright-line rule in this area" of the law.[70] While at least one commentator has argued that an economic presence standard is in line with the tax policy values of "equity, efficiency, and administrability,"[71] there are advantages to the bright-line physical-presence standard.

As the *Quill* court recognized, "our law in this area is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in exercise of their

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65. *Id.* at 374.

66. *KFC*, 792 N.W.2d at 323.

67. *Id.* at 323-24.

68. Quill Corp. v. North Dakota, 504 U.S. 298, 305 (1992) (establishing two separate standards).

69. *See Whitney*, 299 U.S. 366.

70. *Quill*, 504 U.S. at 317. *Compare KFC*, 792 N.W.2d at 314 (opining incorrectly that the Supreme Court "has emphasized a flexible approach based on economic reality"), *with Quill*, 504 U.S. at 317-18 (endorsing a "bright-line, physical-presence requirement" for Commerce Clause nexus).

71. Swain, *supra* note 12, at 374.

indispensable power of taxation.'"[72] The *Quill* court quoted an income tax case, *Northwestern States Portland Cement Co. v. Minnesota*,[73] and did not state that the "quagmire" it intended to remedy was limited to sales and use tax. A state's reach must end somewhere and the bright-line test—while not perfect—is clear, administrable, and protects against a state's propensity to outsource its tax burden and overburden interstate commerce. Given the current economic climate, with many states starved for revenue, the bright-line physical-presence requirement ensures that states cannot impose a tax on taxpayers who receive no benefits from the state.

B. *Current Split Among State Courts as to Whether a State Can Tax an Out-of-State Entity That Lacks a Physical Presence in the State*

Currently, there is a deep divide among state courts over the question of whether *Quill*'s physical-presence requirement applies outside the sales and use tax context. In *KFC*, the Iowa Supreme Court recognized this split but chose to hold that *Quill*'s physical-presence requirement was not required for a state to impose a corporate income tax.[74] Many of the cases and law review articles cited by the *KFC* court as supporting its holding find their foundation in the South Carolina Supreme Court decision of *Geoffrey, Inc. v. South Carolina Tax Commission*.[75]

1. *Geoffrey, Inc. v. South Carolina Tax Commission*

Geoffrey involved Geoffrey, Inc., a wholly owned subsidiary of the mega toy retailer Toys 'R' Us, Inc.[76] Geoffrey was a Delaware corporation with its principal offices in Delaware.[77] The company owned no tangible property in South Carolina and did not have any employees in that state.[78] In 1984, Toys 'R' Us, Inc. granted Geoffrey ownership of several trademarks and trade names, including "Toys 'R' Us."[79] Later that year, Geoffrey and Toys 'R' Us, Inc. executed a License Agreement (the "Agreement").[80] Under the Agreement Toys 'R'

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72. *Quill*, 504 U.S. at 315-16 (quoting an income tax case, Nw. States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457-58 (1959)).

73. 358 U.S. 450 (1959).

74. *KFC*, 792 N.W.2d at 328.

75. 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 114 S. Ct. 550 (1993).

76. *Id.* at 15.

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.*

Us, Inc. was entitled to use the trade name "Toys 'R' Us" as well as other trademarks and trade names in South Carolina and several other states.[81] Additionally, the Agreement granted Toys 'R' Us the right to use Geoffrey's "merchandising skills, techniques and 'know how' in connection with marketing, promotion, advertising, and sale of products covered by the Agreement."[82] In return, Geoffrey received royalty payments that amounted to one percent of Toys 'R' Us, or any of its subsidiaries', net sales of products and services.[83] It was this royalty income that the South Carolina Tax Commission sought to tax.[84] Geoffrey challenged the assessment on the grounds that it lacked a substantial nexus with South Carolina sufficient for the state to tax the associated royalty income.[85]

In summary fashion, the *Geoffrey* court concluded that the physical-presence requirement of *Bellas Hess* and *Quill* was not required for purposes of the royalty tax at issue.[86] According to the South Carolina Supreme Court, "any corporation that regularly exploits the markets of a state should be subject to its jurisdiction to impose an income tax even though not physically present."[87] Although the *Geoffrey* court did not expressly say it, implicit in its analysis is the fact that Geoffrey was created as a Toys 'R' Us subsidiary intangible holding company (IHC) for the sole purpose of minimizing state tax obligations. That was not the case in *KFC*. *KFC* involved wholly independent franchisors and franchisees.[88]

2. State Courts That Followed *Geoffrey*

Like *Geoffrey*, a number of state courts have refused to extend *Quill*'s physical-presence requirement in situations where a state imposed a tax other than a sales and use tax.[89] Critically, however, the

81. *Id.*
82. *Id.*
83. *Id.*
84. *Id.*
85. *Id.*
86. *Id.* at 18-19.
87. *Id.* at 18 (citations omitted).
88. *See* KFC Corp. v. Iowa Dep't of Revenue, 792 N.W.2d 308, 310 (Iowa 2010).
89. *See, e.g.*, A&F Trademark, Inc. v. Tolson, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004) ("[W]e hold that under facts such as these where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within [the State], there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause."), *cert. denied*, 546 U.S. 281 (2005); Kmart Properties, Inc. v. Taxation & Rev. Dep't of New Mexico, 131 P.3d 27, 36 (N.M. Ct. App. 2001) (holding that "the use of KPI's marks within New Mexico's economic market, for the purpose of generating substantial income for KPI, establishes a

majority of those cases involved situations where a wholly owned subsidiary licenses its trademarks to a *related* retail company operating stores located within the state.[90]

In *A&F Trademark, Inc. v. Tolson*,[91] the North Carolina Court of Appeals upheld the assessment of corporate franchise and income taxes against wholly-owned, non-domiciliary subsidiary corporations of Limited, Inc.[92] The case involved an arrangement by a group of retailers—including Abercrombie & Fitch, Lane Bryant, Inc., and Victoria's Secret, Inc.—whereby the retailers assigned their trademarks and associated goodwill to an IHC in a tax-free transaction for little or no consideration.[93] Subsequent to the assignment of the trademarks, the retailers and their related IHC entered into licensing agreements that required the IHC to license the trademarks back to the retailer.[94] The related retail companies had over 130 locations in North Carolina.[95] The taxpayers did not file corporate franchise and income tax returns in North Carolina for the years that were at issue.[96] The North Carolina Secretary of Revenue proposed assessments to the taxpayers for the unpaid franchise and income taxes.[97] After a number of unsuccessful appeals by the taxpayers, the case ultimately landed in front of the North Carolina Court of Appeals.[98]

"The taxpayers contend[ed] that the presence of their intangible property in North Carolina [as a result of license fees paid for use of trademarks] is irrelevant in light of the lack of physical presence of offices, facilities, employees, and real or tangible property . . . ."[99] Accordingly, the taxpayer asserted that the *Bella Hess* decision required a finding that the tax sought to be imposed by North Carolina violated the Commerce Clause.[100] Specifically, the taxpayers argued that they

sufficient nexus between that income and the legitimate interests of the state and justifies the imposition of a state income tax"), *rev'd on other issues*, 131 P.3d 22 (N.M. 2005).

90. *See, e.g.*, Geoffrey, Inc. v. Oklahoma Tax Comm'n, 132 P.3d 632, 634 (Okla. Civ. App. 2006); Lanco, Inc. v. Dir., Div. of Taxation, 879 A.2d 1234, 1236 (N.J. Super. Ct. App. Div. 2005), *aff'd*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007); *A&F Trademark, Inc.*, 605 S.E.2d at 195; *Kmart Properties, Inc.*, 131 P.3d at 30-31.

91. 605 S.E.2d 187 (N.C. Ct. App. 2004).

92. *Id.* at 195.

93. *Id.* at 189.

94. *Id.*

95. *Id.*

96. *Id.* at 190.

97. *Id.*

98. *Id.*

99. *Id.* at 193.

100. *Id.*

lacked a substantial nexus with North Carolina because they had no physical presence within the state.[101]

The North Carolina Court of Appeals stated three reasons for declining to hold that *Quill* required a physical presence in the taxing state for income tax purposes.[102] First, the court stated that the tone in *Quill* "hardly indicates a sweeping endorsement of the bright-line test it preserved, and the Supreme Court's hesitancy to embrace the test certainly counsels against expansion of it."[103] The court observed that "recent Commerce Clause decisions [signaled] a retreat from the formalistic constrictions of a stringent physical presence test in favor of a more flexible [] approach."[104] Second, the court felt that the retention of the *Bella Hess* decision in *Quill* was based "on the principle of *stare decisis* and the 'substantial reliance' on the physical-presence test, which had become a part of the basic framework of a sizable industry."[105] Finally, *A&F Trademark* found "important distinctions between sales and use taxes [as compared to] income and franchise taxes that 'makes [sic] the physical presence test of the vendor use tax collection cases inappropriate as a nexus test'" for taxation other than sales and use taxes.[106] Thus, the North Carolina court in *A&F Trademark* followed the *Geoffrey* decision and concluded:

> [W]e reject the contention that physical presence is the *sine qua non* of a state's jurisdiction to tax under the Commerce Clause for purposes of income and franchise taxes. Rather, we hold that under facts such as these where a wholly-owned subsidiary licenses trademarks to a related retail company operating stores located within North Carolina, there exists a substantial nexus with the State sufficient to satisfy the Commerce Clause.[107]

In *Lanco, Inc. v. Director, Division of Taxation*,[108] the New Jersey Appellate Division relied heavily on *A&F Trademark* in holding that New Jersey could constitutionally subject a foreign corporation with no offices, employees, or real tangible property in New Jersey to the state's corporate income tax.[109] Lanco, Inc. (Lanco) was a Delaware

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101. *Id.*

102. *Id.* at 194-95.

103. *Id.* at 194.

104. *Id.* (quoting *Quill*, 504 U.S. at 314).

105. *Id.* (quoting *Quill*, 504 U.S. at 317).

106. *Id.* (quoting Jerome R. Hellerstein, *Geoffrey and the Physical Presence Nexus Requirement of Quill*, 8 ST. TAX NOTES, 671, 676 (1995)).

107. *Id.* at 195.

108. 879 A.2d 1234 (N.J. Super. Ct. App. Div. 2005).

109. *Id.* at 1239-42.

corporation that owned intangible property such as trademarks, trade names, and service marks.[110] It was undisputed that Lanco had no offices, employees, or real property in New Jersey.[111] In exchange for royalty payments, Lanco licensed to Lane Bryant, Inc., one of its affiliate corporations, the use of intangible property in the conduct of Lane Bryant's retail operations, including its locations in New Jersey. New Jersey's Division of Taxation determined that the activity under the license agreement gave New Jersey the requisite nexus to tax Lanco.[112]

After a detailed review of *Quill*, *Geoffrey*, and *A&F Trademark*, the *Lanco* court concluded that "[t]he recent and, in our view, the more persuasive authority leads us to join the jurisdictions which have followed *Geoffrey* and to uphold the tax."[113] Using *A&F Trademark* as its guide through the law, the *Lanco* court declared "that the physical presence requirement applicable to use and sales taxes is not applicable to income tax . . . ."[114] On appeal, the New Jersey Supreme Court affirmed "substantially for the reasons expressed in [the appellate court's] thorough and thoughtful opinion."[115] While recognizing that "a split of authority has developed" since *Quill*, the court held that "the better interpretation of *Quill* is the one adopted by those states that limit the Supreme Court's holding to sales and use taxes."[116] In their view, the United States Supreme Court did not intend "to create a universal physical-presence requirement for state taxation under the Commerce Clause."[117]

3. State Courts That Refused to Follow *Geoffrey*

As discussed *supra*, a number of state courts have chosen to limit *Quill*'s physical-presence requirement to state sales and use taxes. However, courts in states such as Michigan, Tennessee, and Texas have not so limited *Quill*'s application, but have alternatively retained the Supreme Court's Commerce Clause physical-presence requirement.

In *Rylander v. Bandag Licensing Corp.*, the court held that Texas cannot impose a franchise tax on an out-of-state business with no physical presence in the state.[118] Bandag Licensing Corporation (BLC)

110. *Id.* at 1236.
111. *Id.*
112. *Id.*
113. *Id.* at 1238.
114. *Id.* at 1242.
115. Lanco, Inc. v. Dir., Div. of Taxation, 908 A.2d 176, 176 (N.J. 2006).
116. *Id.* at 177.
117. *Id.*
118. 18 S.W.3d 296, 301 (Tex. App. 2000).

was a wholly-owned subsidiary of Bandag Corporation (Bandag).[119] Bandag was a corporation organized and existing under the laws of Iowa.[120] During the tax years at issue in the case, BLC maintained a certificate of authority to transact business in Texas, but "did not own, possess, use, or maintain any real property" in Texas.[121] Additionally, "BLC did not have salespeople, employees, independent contractors, or any other type of representatives in Texas."[122]

The Texas comptroller argued that BLC had a "substantial nexus" with the state simply because the corporation was licensed to conduct business in Texas and had receipts from the use of intangible property in the state.[123] In its decision, the *Rylander* court first noted that "[t]his question seems to have little to do with whether the tax in question is a sales tax, an income tax, a franchise tax, a gross receipts tax, or some other form of tax. The issue is whether the state may impose *any* kind of tax in light of the Commerce Clause."[124] Next, the court rejected the comptroller's argument, holding that the "physical presence" requirement in *Quill* is not limited to sales and use taxes, stating:

> While the decisions in *Quill Corp.* and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause. As construed in *Quill Corp.* and *Bellas Hess*, when the corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax.[125]

Thus, the court held the imposition of the franchise tax on the taxpayer violated the Commerce Clause.[126]

Similarly, in *J.C. Penney National Bank v. Johnson*,[127] the Tennessee Court of Appeals rejected an attempt by the Tennessee Commissioner of Revenue to impose the state's income-based franchise and excise taxes on income from J.C. Penney's credit card business operated by J.C. Penney's out-of-state credit card bank.[128] Making sure not to decide whether physical presence was required, the court noted

119. *Id.* at 298.
120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.*
124. *Id.* at 299 n.2.
125. *Id.* at 300.
126. *Id.*
127. 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000).
128. *Id.* at 842.

that the Commissioner of Revenue cited no authority in which the United States Supreme Court had "upheld a state tax where the out-of-state taxpayer had absolutely no physical presence."[129] Specifically, the court said:

> While it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case. In fact, the Commissioner is unable to provide any authority as to why the analysis should be different for franchise and excise taxes. It is certainly true that the *Quill* Court expressed some reservations about the vitality of the *Bellas Hess* decision . . . . However, we are not in a position to speculate as to how the Supreme Court might decide future cases. We are only able to rely on past decisions. Any constitutional distinctions between the franchise and excise taxes presented here and the use taxes contemplated in *Bellas Hess* and *Quill* are not within the purview of this court to discern. As such, we feel that the outcome of this case is governed by *Bellas Hess* and *Quill*, as those decisions interpret the first prong of the *Complete Auto* test.[130]

Accordingly, the *J.C. Penney* court held that since the bank was not physically present in Tennessee, "the activities which allowed [J.C. Penney] to conduct its credit card operation did not occur in" that state and the tax violated the Commerce Clause.[131] Interestingly, under Tennessee law, by allowing the Tennessee Court of Appeal's opinion to be published, the Tennessee Supreme Court gave the *J.C. Penney* decision statewide precedential effect.[132]

The Michigan Court of Appeals also held that the *Quill* "physical presence" requirement was applicable to all taxes, not just sales and use taxes, in *Guardian Industries Corp. v. Department of Treasury*.[133] In that case, Guardian was an entity having its principal place of business in Michigan.[134] Guardian was in the business of soliciting "sales in various target states with activities which include calling on customers

129. *Id.*

130. *Id.* at 839.

131. *Id.* at 841-42.

132. *See, e.g.*, Meadows v. State of Tennessee, 849 S.W.2d 748, 752 (Tenn. 1993) ("[T]he published opinions of the intermediate appellate courts [of Tennessee] are opinions which have precedential value and may be relied upon by the bench and bar of this state as representing the present state of the law with the same confidence and reliability as the published opinions of this Court, so long as [they] are not overruled or modified by subsequent decisions.").

133. 499 N.W.2d 349, 374-75 (Mich. Ct. App. 1993), *appeal denied sub nom.* Cargill, Inc. v. Dep't of Treasury, 512 N.W.2d 846 (Mich. 1994).

134. *Id.* at 352.

and taking orders."[135] Guardian challenged a tax imposed by the Michigan Department of Treasury that sought to tax sales Guardian had made in target states. Guardian claimed it was subject to taxation for those same sales by the target states.[136]

The *Guardian* court noted that the "principal question [was] whether a taxpayer's solicitation of business in foreign states, alone, creates a sufficient nexus with the states that they may tax the sales."[137] The Michigan Court of Appeals held that *Quill* made it "abundantly clear that [the taxpayer] must show a physical presence within a target state to establish a substantial nexus to it."[138] Subsequent to the *Guardian* decision, the Michigan Department of Revenue announced that it would adhere to *Quill*'s physical-presence requirement.[139]

In summary, post-*Quill* state tax nexus decisions reflect a deep divide over the applicability of *Quill*'s physical-presence requirement to taxes other than sales and use taxes. Clearly, "there is a 'need for clearing up the tangled underbrush of past cases' with reference to the taxing power of the States . . . ."[140]

III. ARGUMENT FOR A BRIGHT-LINE STANDARD

Contrary to what other commentators have said,[141] *Quill* clearly establishes that Commerce Clause "substantial nexus" requires a corporation to be physically present for all taxing purposes.[142] Moreover, for a "court to hold that physical presence is not mandatory upsets settled expectations, reliance interests, and the rule of stare decisis."[143] By continuing to refuse to weigh in on nexus cases, the Supreme Court is turning a blind eye to a number of consequences that are associated with permitting state high courts to side with their taxing

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135. *Id.*

136. *Id.*

137. *Id.* at 353.

138. *Id.* at 356.

139. *See* J.W. Hobbs Corp. v. Dep't of Treasury, 706 N.W.2d 460, 463 (Mich. Ct. App. 2005), *appeal denied*, 731 N.W.2d 745 (Mich. 2007).

140. Nw. States Portland Cement Co. v. State of Minnesota, 358 U.S. 450, 457 (1959) (quoting State of Wisconsin v. J.C. Penney Co., 311 U.S. 435, 445 (1940)).

141. *See, e.g.*, Michael T. Fatale, Geoffrey *Sidesteps* Quill*: Constitutional Nexus, Intangible Property and the State Taxation of Income*, 23 HOFSTRA L. REV. 407, 425 (1994); Laskin, *supra* note 6, at 12.

142. Quill Corp. v. North Dakota, 504 U.S. 298, 311 (1992).

143. Richard H. Kirk, *Supreme Court Refuses to Re-Examine Whether Physical Presence Is a Prerequisite to State Income Tax Jurisdiction:* Geoffrey, Inc. v. South Carolina Tax Commission, 48 TAX LAW. 271, 277 (1994).

authorities.

First, while at least one commentator has argued that "the unique burdens of use tax collection justify" a physical-presence standard only for sales and use tax,[144] income taxes impose a far greater burden on companies engaging in interstate commerce than do sales and use taxes. Sales and use taxes are imposed on the buyer, not the seller; thus the primary cost associated with a sales and use tax is the administrative costs of calculating, collecting, and remitting the taxes on behalf of the buyers. By contrast, income taxes come right out of the pocket of the business engaging in interstate commerce. Moreover, income taxes require companies to make a myriad of determinations that are arguably more complex than those associated with a sales or use tax, including:

> (1) filing methodology, i.e., whether the franchisor must file a combined return with affiliates or a separate return; (2) tax base, i.e., the calculation of state taxable income, including the use of corporate attributes such as net operating loss deductions and tax credits; (3) division of income based on each state's particular formulary apportionment; (4) procedural rules such as estimated tax and final return due dates; and (5) tax rates to apply to the different amounts of taxable income allocated to each jurisdiction.[145]

Unlike the approximately 1,500 other franchisors who represent a significant percentage of the franchising community's U.S. economy, KFC may have sufficient resources to carry the additional administrative burdens and expenses associated with filing 50 or more state income tax returns.[146] For these smaller franchisors, the combination of paying more taxes on the same royalty dollar, a drastic increase in the number of income-based tax filings, and the associated costs of those filings, may be too heavy a burden to carry.[147] Absent a physical-presence requirement for all state-imposed taxes, out-of-state businesses will be forced to incur both the administrative burden, as well as the burden of actually paying the tax. Surely it cannot be reasonably argued that this is less of a burden then those associated with sales and use taxes.

Additionally, franchising in the United States has grown from producing $624.6 billion of economic output in 2001 to $802 billion in

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144. Laskin, *supra* note 6.

145. Brief of Amicus Curiae International Franchise Association in Support of Granting the Petition at 14, KFC Corp. v. Iowa Dep't of Revenue, 792 N.W.2d 308 (Iowa 2010) (No. 10-1340) *cert. denied*, 132 S. Ct. 97, 98 (2011).

146. *Id.* at 6.

147. *See id.*

2007.[148] As the International Franchise Association has said, "[w]hile no single factor can account for franchising's growth, franchisors' ability to limit and know in advance their state tax filing obligations undoubtedly played a significant role. Specifically, it permitted franchisors to lower franchise costs while maintaining sufficient returns on investment, thereby spurring economic activity and job growth."[149] The *Quill* court had similar concerns when it determined that "it is not unlikely that the mail-order industry's dramatic growth over the last quarter century is due in part to the bright-line exemption from state taxation created in *Bellas Hess*."[150] Thus, the economic growth of the country was, and still is, an important Commerce Clause factor to consider and bolsters the argument that physical presence in a state should be required before a tax can be imposed.

Second, contrary to what other commentators have said,[151] "substantial nexus" under the Commerce Clause demands a single nexus standard for purposes of state taxation. Giving "substantial nexus" differing meanings, based on the tax in question and the state imposing the tax, is without logic. As the Institute for Professionals in Taxation has explained:

> The [*KFC* court's] "economic nexus" contention fails to square with the Court's directive that the Commerce Clause be applied upon the basis of the "practical effect" of the tax. Any effort to distinguish a use tax as an "indirect" tax from an income tax as a "direct" levy would be a step backwards to the type of semantic formalism the Court has definitively repudiated.[152]

Moreover, bifurcating "substantial nexus" into two remarkably different standards, one for income taxes and a second for sales and use taxes, "would invite the formulation of additional jurisdictional standards for other taxes"–a result surely not implicit in the *Quill*

148. *Economic Impact of Franchised Businesses: Vol. 2—Executive Summary and Highlights*, INT'L FRANCHISE ASSOC., at 7, *available at* http://www.franchise.org/uploadedFiles/Franchisors/Other_Content/economic_impact_documents/EconImpact_Vol2_HiLights.pdf.

149. Brief of Amicus Curiae International Franchise Association, *supra* note 145, at 10.

150. Quill Corp. v. North Dakota, 504 U.S. 298, 316 (1992).

151. *See, e.g.*, Laskin, *supra* note 6, at 23 ("[T]he Commerce Clause nexus test itself should not be identical for all taxes, because a 'one size fits all' physical presence test does not reflect material differences in the nature of each tax and the characteristics of the asset or income being taxed. Such differences render a physical presence Commerce Clause nexus test entirely unworkable as applied to the taxation of intangibles or the income derived therefrom.").

152. *Id.* at 17 (quoting Complete Auto Transit Inc. v. Brady, 430 U.S. 274, 288-89 (1977)).

decision.[153] *Quill* expressly endorsed the bright-line physical-presence rule because it "firmly establishes the boundaries of legitimate state authority" and "reduces litigation" concerning state taxation.[154] Further, as noted by the *Quill* court, the bright-line rule "encourages settled expectations and, in doing so, fosters investment by business[es] and individuals."[155]

CONCLUSION

The Supreme Court has long held that the Commerce Clause requires a "substantial nexus" between a taxing state and an out-of-state business "before *any* tax may be levied" against the business.[156] It has been almost twenty years since the Supreme Court decided *Quill*.[157] An obvious concern that the *Quill* court had was that this area of the law was best reserved to the legislative, as opposed to the judicial branch. Unfortunately, the legislature has not heeded the *Quill* court's advice. As a result, it is time the Supreme Court steps in and helps to clarify the issue. Without Supreme Court intervention, tax-starved states will be able to tax income derived from any contractual or economic relationship in which an out-of-state party receives income from an in-state party.

Moreover, a bright-line rule requiring physical presence cuts down on litigation costs, allows companies to reasonably forecast and plan for their state tax liabilities, and helps foster economic growth by reducing the tax burdens on businesses transacting across state lines. Given that income taxes impose, at a minimum, the same burden on companies engaged in interstate commerce that sales and use taxes do, the bright-line rule benefits both types of taxes equally. Varying state definitions of what constitutes a taxable presence, and palpable uncertainty over their constitutional validity, are at odds with "the national interest in keeping interstate commerce free from interferences which seriously impede it."[158]

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153. *Id.* at 17-18.
154. *Quill*, 504 U.S. at 314-15.
155. *id.* at 316.
156. Commonwealth Edison Co. v. Montana, 453 U.S. 609, 626 (1981).
157. *Quill*, 504 U.S. 298.
158. S. Pac. Co. v. State of Arizona, 325 U.S. 761, 776 (1945).