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Why the *Quill* Physical Presence Rule Shouldn't Go the Way of Personal Jurisdiction

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I. Introduction

If a Delaware company sells its products to customers in West Virginia, which state has the power to tax the transaction? Should it matter if the company has no employees or buildings in West Virginia? If the company sells products in all 50 states, should all 50 be able to impose their taxes on the company?

In 2006, Americans spent $108.7 billion in online retail transactions, a 23 percent increase from the year before and 2.8 percent of total sales. Although that proportion is still small, it is growing quickly, and the increasing role of the Internet is challenging traditional legal concepts. As the world becomes less concerned with geographic boundaries, legal concepts premised on geographic lines — such as personal jurisdiction and state taxes — have grown more strained.

Personal jurisdiction — the place where a defendant can be sued — was once dominated by a physical presence rule. A state's ruling against a defendant could not be enforced unless he (or his property) was present in the state, because no state could reach beyond its territory. But in its landmark decision in *International Shoe*,[1] the U.S. Supreme Court abandoned the physical presence rule and adopted a defendant-specific multifactor fairness inquiry, focusing on "the defendant's *past* conduct . . . , such as employing forum residents, renting forum property, and shipping products to the forum."[2] If there are "minimum contacts," and it does not "offend 'traditional notions of fair play and substantial justice,'" the nonpresent defendant can be sued.

In the 62 years since, the Court has tried in a series of cases to revise and restate those factors to reduce the unpredictability and confusion its rulings have caused. Nevertheless, its rulings have been described as "erratic,"[3] a "doctrinal muddle,"[4] "inconsistent,"[5] and "a mess."[6]

Perhaps cognizant of that mess, the Court has stuck to a physical presence rule (the *Quill* rule) for determining when an out-of-state retailer can be compelled to pay taxes to a state or collect use taxes on purchases. But as states increasingly seek to tax nonresidents, especially for Internet transactions, "states are pushing for judicial adoption of economic nexus. Supported by some academics, economic nexus is a defendant-specific multifactor fairness inquiry much like that in *International Shoe*.

The attacks against physical presence nexus are a mistake. Embracing economic nexus would repeat the personal jurisdiction mess and destroy reliance interests and legal certainty. Overruling the *Quill* rule would usher in decades of confusion, running the risk of damaging the national economy. The Supreme Court has preferred to leave resolution of that issue to Congress, but congressional inactivity and state overreaching may make judicial action necessary.

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[1]*Int'l Shoe Co. v. Washington*, 326 U.S. 310 (1945).

[2]Kevin C. McMunigal, "Desert, Utility, and Minimum Contacts: Toward a Mixed Theory of Personal Jurisdiction," 108 *Yale L.J.* 189, 195 (1998) (emphasis added).

[3]*Id.* at 226.

[4]Wendy Collins Perdue, "Personal Jurisdiction and the Beetle in the Box," 32 *B.C.L. Rev.* 529, 532 (1991).

[5]*Id.* at 529-30.

[6]Russell J. Weintraub, "Comments on the Roundtable Discussion of Choice of Law," 48 *Mercer L. Rev.* 871, 881 fn. 68 (1997).

Part II describes the confusion in personal jurisdiction from 1945 to the present. Part III explains the *Quill* physical presence rule in state taxation, and looks at academic and state criticism of that rule. Part IV argues that preserving the *Quill* rule is beneficial because it does not inflict damaging uncertainty on businesses, consumers, and those who give legal advice.

II. The Mess of Personal Jurisdiction

On Ninth Street in Columbia, Mo., a town of 96,000 (including 33,000 students) and home of the annual Ragtime and Jazz Festival, Richard King opened a small cabaret club, The Blue Note, in 1980. By 1996 business was good and King decided to set up a Web site for the club. Shortly thereafter, he learned that the Bensusan Restaurant Co. of Manhattan had filed a lawsuit against him, in New York federal court, for violating its "The Blue Note" trademark registered in 1985. King's only contact with New York was that his Web site could be accessed from that state.[7]

> ***Embracing economic nexus would repeat the personal jurisdiction mess and destroy reliance interests and legal certainty.***

Courts have long been sympathetic to people like King, who face the expense and worry of defending (often meritless) lawsuits in a faraway place. The U.S. Constitution's due process clause has been held to protect such individuals "against the burdens of litigating in a distant or inconvenient forum" by ensuring that states do not "reach out beyond the limits imposed on them . . . in a federal system."[8] That principle — that it is unfair to be sued in a state where one has virtually no connections — is generally undisputed. The problem arises in drawing the line separating "virtually no connections" from "sufficient minimum contacts."

The historical line was physical presence. Looking at the due process clause, the Court explained that "proceedings in a court of justice to determine the personal rights and obligations of parties over whom that court has no jurisdiction do not constitute due process of law."[9] Unless a defendant appeared in person, enforcing a judgment against him was considered so unfair that it violated the U.S. Constitution. If there was such a judgment, other states could refuse to enforce it as an abuse of power. At the dawn of the 20th century, scholar Thomas M. Cooley summarized the rule in his *Constitutional Limitations* (1903): "No state has authority to invade the jurisdiction of another, and by service of process compel parties there resident or being to submit their controversies to the determination of its courts."

The physical presence rule in personal jurisdiction encountered difficulties regarding property, motorists, and corporations. States could seize (attach) the in-state property of an out-of-state defendant pending the outcome of the case, provided the state gave notice to the owner. While those "in rem" actions (as well as divorce actions, which were treated similarly) were within the confines of the physical presence rule, it allowed states to reach defendants who lived outside the state. Courts also developed the concept of implied consent to allow states to reach outside their borders to prosecute nonresident motorists who inflicted damages or injury within the state. By driving on the state's roads, a motorist was held to have automatically consented to jurisdiction over any lawsuits that might arise from the driving, although he had to receive notice of the lawsuit.[10]

The physical presence rule was stretched the most in suits involving corporate defendants, because corporations are a legal fiction and their physical existence is intangible. Some states required that corporations appoint an agent to receive service of process, and if a corporation was "present" without such an appointment, a state official was designated to receive service of process on its behalf. Determining presence became the critical question. "Under both the presence theory and the implied consent theory, the first question to be asked was whether the corporation was 'doing business' within the state. . . . '[D]oing business' gradually came to be a test in and of itself."[11]

In 1945 in *International Shoe*, the Court abandoned the physical presence rule in favor of a defendant-specific multifactor fairness inquiry. The inquiry focuses "primarily on the defendant's *past conduct* . . . , such as employing forum residents, renting forum property, and shipping products to the forum" (emphasis added). If there are sufficient "minimum contacts" and "the suit does not offend 'traditional notions of fair play and substantial justice,'" the nonpresent defendant can be sued. Although that was clearly an attempt to fix the law, by

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[7]*See Bensusan Rest. Corp. v. King*, 126 F.3d 25, 26 (2d Cir. 1997).

[8]*World-Wide Volkswagen v. Woodson*, 444 U.S. 286, 292 (1980).

[9]*Pennoyer v. Neff*, 95 U.S. at 733.

[10]*See, e.g., Hess v. Pawloski*, 274 U.S. 352, 355 (1927).

[11]Jack H. Friedenthal, Arthur R. Miller, and John E. Sexton, *Civil Procedure: Cases and Materials*, at 74 (8th Ed. 2001) John J. Cound, ed.

unmooring personal jurisdiction from physical presence, "the Court has been unable to develop a coherent doctrine."[12]

The doctrinal twists in a few cases depict that incoherence. In *McGee v. Int'l Life Ins. Co.*,[13] the Court held that a Texas insurance company's one policy with a Californian constituted sufficient minimum contact with the state: "Residents would be at a severe disadvantage if they were forced to follow the insurance company to a distant State in order to hold it legally accountable." The Court dismissed concerns that the defendant would be forced to defend a suit in a distant forum. Prof. Kevin C. McMunigal described *McGee* as giving "equal attention to prospective factors never mentioned in *International Shoe*, including the forum's interest in regulating the defendant's conduct, the *plaintiffs' inconvenience* in using an alternate forum, and the likely location of witnesses."[14] More broadly, "the Court has regularly added new factors in a process of gradual accumulation, each addition aggravating the test's ambiguity and complexity. . . . [*McGee*] foreshadowed two persistent problems in minimum contacts doctrine: the unexplained addition of new factors and the inconsistent shifting of temporal viewpoint."[15]

Both problems arose again in *Hanson v. Deckla,*[16] in which the Court focused on whether the defendant had deliberately intended to conduct activities in the forum state. "It is essential in each case that there be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws." That test — purposeful availment — was reiterated in *World-Wide Volkswagen v. Woodson*,[17] in which the Court held that it was the *only* test. Concerns about federalism, the burden on the defendant, and the plaintiff's interest in having a day in court were held to be not separate tests but rather outgrowths of the "minimum contacts" question. Further, purposeful availment was defined not as earning revenue from a state or knowing that one's products will end up in the state, but rather whether it would be reasonable to anticipate a court case within the state.

The defendant's due process concerns and the forum state's interest in the litigation became separate concerns again in *Burger King Co. v. Rudzewicz*.[18] There, the Court held that purposeful availment was not decisive, but that it created a presumption about minimum contacts that the defendant could rebut if he demonstrated *fundamental unfairness*. Unable to define that term, the Court seemed exasperated by its generality: "We . . . reject any talismanic jurisdictional formulas; the facts of each case must always be weighed in determining whether personal jurisdiction would comport with fair play and substantial justice." The opinion was also unclear regarding "whether the critical mental state in minimum contacts is one of purpose, awareness, or inadvertence."[19] Two justices dissented.

The rules became muddled further by *Calder v. Jones*[20] and by a divided Court in *Asahi Metal Ind. Co. v. Superior Court*.[21] In *Calder*, the Court held that the national sale of a magazine provided sufficient minimum contacts for jurisdiction in a libel case. In contrast, in *Asahi*, the main opinion of four justices held when a company reasonably expected that its product would reach the forum state, it was not purposeful availment, although it was a sufficient minimum contact. However, jurisdiction could *not* be exercised if it was unreasonable and unfair to do so, taking into account the burden on the defendant, the forum state's interests, the plaintiff's interest in obtaining relief, efficient resolution of the controversy, and the states' interest in furthering social policies.[22] Four other justices agreed that the factors were relevant, but rejected a balancing test in favor of an absolute rule that placing products in the stream of commerce was purposeful availment sufficient for the exercise of jurisdiction. A ninth justice would have decided the case simply on fairness grounds. Five justices thus valued fairness over minimum contacts.

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Some but not all remnants of the physical presence rule have been swept away. Although a court seizing in-state property of a defendant without minimum contacts violates due process,[23] in-state service on a nonresident individual does not.[24] The latter rule has been criticized as a return to territorial lines, from which the doctrine was supposedly moving away. "After 110 years as a nonissue, the

[12]Perdue, *supra* note 4, at 529-30.
[13]*McGee v. Int'l Life Ins. Co.*, 355 U.S. 220 (1957).
[14]McMunigal, *supra* note 2, at 196-97 (emphasis added).
[15]*Id.*
[16]*Hanson v. Deckla*, 357 U.S. 235 (1958).
[17]*World-Wide Volkswagen v. Woodson*, 444 U.S. 286 (1980).
[18]*Burger King Co. v. Rudzewicz*, 471 U.S. 462 (1985).
[19]McMunigal, *supra* note 2, at 217.
[20]*Calder v. Jones*, 465 U.S. 783 (1984).
[21]*Asahi Metal Ind. Co. v. Superior Court*, 480 U.S. 102 (1987).
[22]*Id.* at 113-14.
[23]*Shaffer v. Heitner*, 433 U.S. 186 (1977).
[24]*Burnham v. Superior Court*, 495 U.S. 604 (1990).

defendant's ability to foresee suit in the forum state grew in less than ten years to become the sine qua non of jurisdiction."[25]

However, the Court's use of defendant-specific factors has also been heavily criticized. "The fact-intensive nature of the foreseeability inquiry and the uncertainty of its outcome, paradoxically, leave defendants unable to predict whether they can afford to default, while raising the barriers of entry to the courthouse for plaintiffs unable to afford multistate litigation."[26] Cases switch results multiple times during appeals, and that fact encourages appeals in other cases.[27] Business and litigation become more costly because potential defendants cannot foresee what will happen. "Unstable and unpredictable legal doctrine inhibits the convergence of the parties' estimates of the case value, thus inhibiting settlement."[28] That uncertainty has inhibited the growth of e-commerce. "The justices' utter lack of agreement . . . makes the doctrine exceedingly difficult to apply to new and unforeseen situations, such as transactions occurring in whole or in part in cyberspace."[29] Seemingly reluctant to make a bad situation worse, the Court has absented itself from personal jurisdiction law since 1990.

The early hopes that *International Shoe* and its progeny would replace a "mechanical, formalistic" rule with a "modern, realistic" rule have been dashed by 62 years of "split opinions, loaded footnotes, and convoluted opinions. . . . [T]he applause and admiration for the Court's forays into the field of jurisdiction have long ago given way to a distinct disenchantment."[30] From that experience, commentators, legislators, and judges should be wary of calls for upheaval in another area of law based solely on the argument that the rule is arcane or formalistic, particularly if there is no consensus on a replacement.

III. The *Quill* Physical Presence Nexus Rule and Criticism of It

"In its opinion finding tax liability for an out-of-state corporation with no presence, tangible or intangible, in West Virginia on income realized out-of-state by that corporation for accounts kept out-of-state, the majority, in its opinion, boldly goes where no court has gone before." So writes Justice Brent Benjamin of the West Virginia Supreme Court of Appeals, dissenting from a ruling to uphold the levy of over a quarter million dollars in state taxes on a company whose only connection to West Virginia is that some of its customers now live there.

In June 2007 the U.S. Supreme Court declined to review the case, which involved FIA Card Services (formerly MBNA America Bank and now owned by Bank of America). Although a quarter-million dollars may not be considered much for a company whose profits that year were over $1 billion, MBNA has paid taxes on all that income to the state where it was headquartered: Delaware. If every state were to impose similar taxes on every company, the negative impact on the economy would be serious. And although MBNA had property, offices, and 28,000 employees around the world, none of them were in West Virginia.

> ***Legislators and judges should be wary of calls for upheaval in another area of law based solely on the argument that the rule is arcane or formalistic, particularly if there is no consensus on a replacement.***

MBNA America Bank N.A. v. Tax Commissioner of the State of West Virginia is only the latest attempt to undermine a constitutional rule that states cannot impose taxing obligations on companies that are not physically present in the state. Those obligations can include paying corporate income tax (as is disputed in *MBNA*), or being forced to collect sales or use taxes for a state from out-of-state consumers (struck down as unconstitutional in *Quill*[31]). State officials are eager to tax out-of-state companies, to increase government spending by shifting tax burdens to faceless businesses and out-of-towners with no ballot box recourse. Consequently, the states have embraced a concept that would allow them to do it. West Virginia's bold and extreme action is part of the natural progression of an academic concept called economic nexus.

A. From Complete Bar to *Complete Auto*

The U.S. Constitution came about in large part because the federal government initially had no power to stop states from setting up trade barriers between each other. States' power over commerce, "guided by inexperience and jealousy, began to show itself in iniquitous laws and impolitic measures . . ., destructive to the harmony of the States, and fatal to

[25]Katherine C. Sheehan, "Predicting the Future: Personal Jurisdiction for the Twenty-First Century," 66 *U. Cin. L. Rev.* 385, 403 (1998).
[26]*Id.* at 386.
[27]*See* Patrick J. Borchers, "Jurisdictional Pragmatism: International Shoe's Half-Buried Legacy," 28 *U.C. Davis L. Rev.* 561, 583 (1995).
[28]*Id.*, at 585.
[29]Sheehan, *supra* note 25, at 393.
[30]Frederick K. Juenger, "A Shoe Unfit for Globetrotting," 28 *U.C. Davis L. Rev.* 1027, 1027 (1995).
[31]*Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

their commercial interests abroad. This was the immediate cause that led to the forming of a convention."[32] Among the powers granted to Congress in the new Constitution was that "to regulate Commerce . . . among the several States," a provision known as the commerce clause. Congress and the courts thus have the power to strike down laws that discriminate against interstate commerce.[33]

Nevertheless, states still have incentives to impede interstate commerce. "Perceived tax exportation is a valuable political tool for state legislators, permitting them to claim that they provide government services for free."[34] The critical question therefore is at what point permissible interstate competition becomes impermissible discrimination.

The Supreme Court began with a formal rule: States cannot tax or impede interstate commerce at all. "A State is . . . precluded from taking any action which may fairly be deemed to have the effect of impeding the free flow of trade between States."[35] That blanket prohibition began to erode in the 1950s, when the Court treated essentially identical taxes differently based on "magic words" in the statute. For example, an annual license tax imposed on the in-state gross receipts of an out-of-state company was invalidated as discriminating against interstate commerce, but an identical tax imposed as a franchise tax on in-state going concern value, measured by in-state gross receipts, was upheld as valid.[36]

Justices and scholars became dissatisfied with a legal test that simply rewarded draftsmanship while missing the important question: "whether the challenged tax produced results forbidden by the commerce clause."[37] Consequently, the Court abandoned its formal rule in 1977 and announced the *Complete Auto* test to delineate when a tax on interstate commerce is valid:

- nexus: a sufficient connection between the taxpayer and the state;
- fair apportionment: the state cannot tax beyond its fair share of the taxpayer's income;
- nondiscrimination: the state must not impose burdens on out-of-state taxpayers but not in-state taxpayers; and
- related to services: the tax must be fairly related to services provided to the taxpayer by the state.

The nexus requirement — the first prong of *Complete Auto* — was discussed by the Court three weeks later, when it reaffirmed a rule from the earlier case of *National Bellas Hess*.[38] There, the Court had struck down an effort by Illinois to require an out-of-state company to collect compensating use taxes on all sales made to Illinois residents. "In order to uphold the power of Illinois to impose use tax burdens on National in this case, we would have to repudiate totally the sharp distinction . . . 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." Unless a company has offices, employees, or other property in a state, it does not have nexus under *Complete Auto* and cannot be subject to use tax obligations.

The Court's opinion in *National Bellas Hess* also discussed practical considerations:

> If Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose "a fair share of the cost of the local government."[39]

The Court seemed concerned not only about the danger that mail-order companies would be subject to multiple taxation and a heavy administrative burden, but that states had no legitimate power to impose taxation obligations on companies that were not physically present in the state in some way.

B. *Quill*

During the 1980s some academics criticized *Bellas Hess* and the physical presence rule as arcane, formalistic, and outmoded. Some state courts agreed and simply disregarded the decision. "The economic, social, and commercial landscape upon which *Bellas Hess* was premised no longer exists, save perhaps in the fertile imaginations of attorneys representing

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[32]*Gibbons v. Ogden*, 22 U.S. 1, 224 (opinion of Johnson, J.).

[33]The power of federal courts to act when Congress is silent was inferred as an implication of the commerce clause (the dormant, or negative, commerce clause). *See, e.g., Willson v. The Black Bird Creek Marsh Co.*, 27 U.S. 245 (1829).

[34]Daniel Shaviro, "An Economic and Political Look at Federalism in Taxation," 90 *Mich. L. Rev.* 895, 957 (1992).

[35]*Freeman v. Hewit*, 329 U.S. 249, 252-53 (1946). *See also Leloup v. Port of Mobile*, 127 U.S. 640, 648 (1888). ("No State has the right to lay a tax on interstate commerce in any form.")

[36]*See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 284 (1977) (comparing *Ry. Express Agency v. Virginia*, 347 U.S. 359 (1954) (*Railway Express I*) and *Ry. Express Agency v. Virginia*, 358 U.S. 434 (1959) (*Railway Express II*)).

[37]*Id.* at 285.

[38]*Nat'l Geographic Soc. v. Calif. Bd. of Equalization*, 430 U.S. 551, 559 (1977), *citing National Bellas Hess, Inc. v. Dep't of Revenue of State of Ill.*, 386 U.S. 753 (1967).

[39]*Id.* at 759-60.

mail order interests. . . . The burgeoning technological advances of the 1970s and 1980s have created revolutionary communications abilities and marketing methods which were undreamed of in 1967."[40] However, the number of jurisdictions imposing sales taxes had increased from 2,300 to more than 6,000, and an efficient and inexpensive way for small businesses to track sales tax rates, bases, and exemptions remained elusive, despite technological advances.

In 1992, in *Quill*, the Supreme Court took up those academic and state challenges, and reaffirmed the physical presence rule. The case involved a Delaware office supplies company with some $1 million in sales to 3,000 customers in North Dakota, but no employees or property in the state; all deliveries were made by mail or common carrier. North Dakota was one of 34 states that had enacted tax obligations on nonpresent companies, up from 11 at the time of *Bellas Hess*. *Quill* arrested that trend, with the Court giving several reasons for its decision.

First, the Court emphasized the nexus requirement of *Complete Auto*. By requiring a connection between a taxing state and a company, nexus "ensure[s] that state taxation does not unduly burden interstate commerce." In North Dakota, any company that advertised three times in the state became obligated to collect taxes for the state, and the Court described that obligation as a burden on interstate commerce.

Second, the Court discussed "the continuing value of a bright-line rule." The physical presence rule "firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes." One thinks of the personal jurisdiction mess, and perhaps the Court's desire to avoid repeating it in another area of law. "The continuing value of a bright-line rule in this area and the doctrine and principles of *stare decisis* indicate that the *Bellas Hess* rule remains good law." Justice Antonin Scalia separately wrote that the only litigation that seemed to arise in 25 years of applying *Bellas Hess* were state efforts to overrule it: "Concern that reaffirmance of *Bellas Hess* will lead to a flurry of litigation over the meaning of 'physical presence,' seems to me contradicted by 25 years of experience under the decision."

Third, the Court expressed concern about disrupting settled expectations. "A bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment by businesses and individuals." Justices Scalia, Anthony Kennedy, and Clarence Thomas wrote a separate opinion basing their decision on a refusal to upset those expectations: "Having affirmatively suggested that the 'physical presence' rule could be reconciled with our new jurisprudence, we ought not visit economic hardship upon those who took us at our word."

The Court also clarified that the physical presence rule is grounded in the commerce clause; due process clause arguments are governed by the minimum contacts rule of personal jurisdiction. "The requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State." While the Quill Corp. had sufficient minimum contacts to be within the *jurisdiction* of the state under the due process clause, its lack of physical presence was insufficient nexus to be within the *taxing power* of the state under the commerce clause.

Because the rule is grounded in the commerce clause, the Court noted that Congress has the power to alter it. "No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusion." Justice Scalia was even more direct: "Congress has the final say over regulation of interstate commerce, and it can change the rule of *Bellas Hess* by simply saying so."

Justice Byron White dissented, calling physical presence "anachronistic," "artificial," and not premised on "economic reality." He favored abandoning all nexus inquiry beyond the minimum contacts rule of personal jurisdiction. White had been in the *Bellas Hess* majority; his change of heart arose primarily out of a sense of injustice at the fact that some sales escape taxation, and the erroneous belief that technological change has made keeping track of thousands of tax laws, rates, and exemptions no longer burdensome. Citing the *states'* legal briefs as expert authority, White asserted that "the costs of compliance . . ., in light of today's modern computer and software technology, appear to be nominal." Although White indicated some concern about retroactive collection of taxes if the physical presence rule was abandoned, he did not even address the likelihood that multiple states will seek to tax the same companies and the same sales.

C. Post-*Quill*

Academics and states have criticized the physical presence rule reaffirmed in *Quill* and have sought to overturn it. For instance, scholar John Swain argues, "[S]ales tax equity can be fully achieved only if *Quill*'s anachronistic physical presence test is either

[40]*State v. Quill Corp.*, 470 N.W. 2d 203, 208 (N.D. 1991).

judicially or legislatively overruled."[41] Those criticisms echo the dissenters in *Bellas Hess* and *Quill*, and embrace a concept known as "economic nexus." "'Economic nexus' is an umbrella term that commonly refers to the assertion of jurisdiction based on something other than physical presence in the taxing state."[42] It first appeared in the *Bellas Hess* dissent, where Justice Abe Fortas argued that nexus exists if an "out-of-state company is engaged in exploiting the local market on a regular, systematic, large-scale basis."[43] That starting point has since been refined by commentators, using factors such as "the presence of intangible property or affiliates, or, in some cases, simply the derivation of economic benefit from the state's residents."[44] Other factors can include the "number of customers in the state, value of assets or deposits in the state, and receipts attributable to sources in the state."[45] Yet another idea is an *Asahi*-like inquiry into "the frequency, quantity and systematic nature of a taxpayer's economic contacts with a state"[46] to determine if there is sufficient nexus to subject the activity to that state's taxation. At least one academic would make the test circular: "Taxable activity should imply nexus."[47]

Some lower court cases have used economic nexus. In *Geoffrey, Inc. v. South Carolina Tax Commission*, South Carolina imposed a corporate income tax on Geoffrey Inc., a Delaware company with no employees, offices, or property in the state.[48] Geoffrey held the trademarks of its parent, Toys "R" Us Inc., to which it leased them back for a royalty. The result was that much of the profit earned in South Carolina Toys "R" Us stores was paid to the subsidiary, which paid (lower) taxes in Delaware. The South Carolina Supreme Court upheld the taxation of Geoffrey, ruling that it had accounts receivable in South Carolina — essentially, nexus exists wherever there is someone who owes Geoffrey money. Geoffrey thus had "contemplated and purposefully sought the benefit of economic contact with" South Carolina. The primary reason for finding nexus, however, was that Geoffrey had licensed intangibles in the state. "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." Other states have also used the in-state "presence" of intangibles to justify taxation of out-of-state companies.[49]

Affiliate nexus is another approach, albeit a less used one. "Under this theory, a nonresident corporation is subject to tax in a state based on the nexus of affiliated entities. Affiliated entities can include a parent, a subsidiary, or other affiliate."[50] For instance, had South Carolina adopted that approach, Geoffrey would be subject to state taxation because its parent company, Toys "R" Us, has physical presence in the state. New Jersey has upheld taxation of a subsidiary not physically present in the state on that basis. However, unless a state has chosen to disregard corporate forms and adopt combined reporting, which states are reluctant to do for fear of appearing antibusiness, courts have been reluctant to adopt affiliate-based economic nexus.

Broadest of all has been the approach taken by West Virginia in *MBNA* — that a nonpresent company is subject to taxation simply if it has customers present in the state. The state court had ruled, "MBNA's systematic and continuous business activity in this State produced significant gross receipts attributable to its West Virginia customers which indicate a significant economic presence sufficient to meet the substantial nexus prong of *Complete Auto*." The court controversially asserted that *Quill*'s physical presence rule applies narrowly only to sales and use taxes and not to taxation and interstate commerce generally. Prof. R. Todd Ervin has criticized that approach, arguing that imposing a *collection duty* should not receive greater scrutiny than imposing a *tax obligation*, and Justice Benjamin noted that *Complete Auto* mentions only sales and

[41] John A. Swain, "Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?" 75 *S. Cal. L. Rev.* 419, 473 (2002).

[42] Michael W. McLoughlin, "Constitutional Limits on State Tax Jurisdiction," 575 *PLI/Tax* 93, 103 (2003).

[43] *Bellas Hess*, 386 U.S. at 763 (Fortas, J., dissenting).

[44] Craig J. Langstraat and Emily S. Lemmon, "Economic Nexus: Legislative Presumption or Legitimate Proposition?" 14 *Akron Tax. J.* 1, 2 (1999).

[45] *Id., quoting* John Simons, "Shaking Down the Net: Local Governments Seek to Tax Internet Sales and Services," *U.S. News & World Report* (June 10, 1996) at 60-61.

[46] Christina R. Edson, "*Quill*'s Constitutional Jurisprudence and Tax Nexus Standards in an Age of Electronic Commerce," 49 *Tax Law.* 893, 945 (1996).

[47] Charles E. McLure Jr., "Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws," 52 *Tax L. Rev.* 269, 395 (1997).

[48] 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

[49] *E.g., Lanco, Inc. v. Director of Taxation*, 879 A.2d 1234 (N.J. 2005), *petition for cert. filed* 75 U.S.L.W. 3500 (U.S. Mar. 9, 2007); *A & F Trademark, Inc. v. Tolson,* 605 S.E.2d 187 (N.C. 2004), *cert. denied*, 126 S.Ct. 353 (U.S. 2005); *Secretary, Department of Revenue, State of La. v. Gap (Apparel), Inc.*, 886 So.2d 459 (La. App. 2004). (For the decision in *Lanco*, see *Doc 2006-21177* or *2006 STT 199-22*; for the decision in *A&F Trademark*, see *Doc 2004-23413* or *2004 STT 239-18*; for the decision in *Gap*, see *Doc 2004-13512* or *2004 128-10*.)

[50] Langstraat and Lemmon, *supra* note 43, at 6.

use taxes, but no one claims that its nexus rule is not applicable to all state taxation.[51] Other courts who have considered West Virginia's rule have rejected it.[52]

The Supreme Court's decision not to accept the *MBNA* appeal suggests that the Court prefers that Congress give the next word on the physical presence rule after *Quill*. Although the conflict between Tennessee's and West Virginia's rules may result in Supreme Court consideration, a congressional revision seems more likely at present.

Preferring that route, some scholars have been less confrontational about the *Quill* rule and instead have focused on pushing for greater uniformity in state tax codes. "If a more uniform sales and use tax regime were in place, or if the specter of thousands of local jurisdictions were removed, the commerce clause nexus standard would approach the due process standard, and the physical presence test would be obviated."[53] Frustrated by congressional inaction in overruling *Quill*, states set up the Streamlined Sales Tax Project in 1999 to "(1) significantly reduce, if not eliminate, the current compliance and administrative burdens imposed upon remote sellers; and (2) preserve state and local sovereignty."[54] The enormous task of attempting to simplify or eliminate differences in the 7,400-plus sales taxing jurisdictions in the United States has had some limited progress.

In 2003 the Council On State Taxation graded the SSTP's progress and found that it had done well in developing uniform base definitions (although some are still complex and counterintuitive; for instance, "candy" does not include licorice), uniform exemption rules, a central administration framework, rules protecting retailers from class-action liability in the event of erroneous tax overcharging, and governance.[55] However, COST criticized the SSTP for not linking tax jurisdictions to five-digit ZIP code boundaries, reimbursing vendors for collection duties, or prohibiting states from shifting tax complexity into other taxes (such as Minnesota's new "fur tax" on fur sales). As for the state corporate income tax, COST said that states are moving away from uniformity. "For several years, states have been trending away from uniformity, as more and more states moved from three-factor equally weighted [tax] formulas, to formulas that double weight the sales factor, and finally to single sales factor formulas. . . . [M]uch of this blame can be placed on state legislatures responding to parochial self-interests of in-state corporate taxpayers."

> ***If one advocates tax liability based on economic activity without regard to geography, the tax system should not be defined by geography.***

Simplification is not a foregone conclusion, and vague references to technological change as somehow eliminating the burden of reporting and paying discriminatory taxes do not justify abandoning the physical presence standard. That some transactions escape state taxation should not be a justification for imposing the onerous burden of a system forever defined by geography:

> What these commentators fail to take entirely into account, however, is the "skill of contemporary man and his machines" in designing and operating new forms of commerce that further complicate the remote collection burden. It is a fundamental truth that state tax systems will constantly be playing catch-up to technological improvements in the market place. Unless and until a new system of state taxation is devised that is not based entirely on geographic boundaries, we will continue to face the inherent conflict of "old economy" tax systems imposed upon "new economy" commerce.[56]

As long as state tax systems are defined by geographical lines, consistency requires that taxes be imposed only on individuals and businesses within those geographical lines. If one advocates tax liability based on economic activity without regard to geography, the tax system should not be defined

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[51] *See* R. Todd Ervin, "State Taxation of Financial Institutions: Will Physical Presence or Economic Presence Win the Day?" 19 *Va. Tax. Rev.* 515, 543-44 (2000); *MBNA*, 640 S.E.2d at 239 (Benjamin, J., dissenting) (for the decision, see *Doc 2006-23668* or *2006 STT 228-18*).

[52] *See J.C. Penney Nat. Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999) (finding insufficient nexus where an out-of- state bank had over 11,000 credit card accounts and a parent company physically in state) (for the decision, see *Doc 1999-39731* or *1999 STT 248-17*; *Cerro Copper Prods., Inc. v. State*, 1995 WL 800114, at *3 (Ala. Dep't Rev. Dec. 11, 1995). ("As a practical matter, the same benefits of a bright-line, physical presence test cited in *Quill* for sales and use tax purposes would also apply equally to other types of taxes.")

[53] John A. Swain, "State Sales and Use Tax Jurisdiction: An Economic Nexus Standard for the Twenty-First Century," 38 *Ga. L. Rev.* 343, 363-64 (2003).

[54] Brian S. Masterson, Note, "Collecting Sales and Use Tax on Electronic Commerce: E-Confusion or E-Collection," 79 *N.C. L. Rev.* 203, 226 (2000).

[55] *See* Douglas L. Lindholm, "'Old Economy' Tax Systems on a 'New Economy' Stage: The Continuing Vitality of the 'Physical Presence' Nexus Requirement," Council On State Taxation (Feb. 27, 2003), at 20-26.

[56] *Id.*, at 11.

by geography. But states prefer to raise taxes on individuals and businesses outside their territory as a way to export tax burdens to nonvoters and discriminate against out-of-state business activity. An economic nexus rule is therefore inherently discriminatory within the context of our state tax systems.

IV. The Virtues of *Quill* and the Dangers of Economic Nexus

Abandoning the physical presence rule in *International Shoe* led to confusion and uncertainty, resulting in an area of law in which no one is sure what the rules are. Abandoning the *Quill* physical presence rule would result in the same. By replacing the physical presence rule in personal jurisdiction, the Supreme Court had to confront the necessity of identifying which factors should henceforth be considered. Alarmingly, the Court has become less coherent over time, which does not bode well for the future coherence of economic nexus doctrine.

The reality is that courts are not well equipped to develop new rules of taxation. Courts may not, and in some cases cannot, obtain evidence from interested stakeholders and take political and economic factors into consideration when developing doctrine. "Congressional processes are more accommodative, affording the whole industry hearings and an opportunity to assist in the formulation of new legislation. . . . The whole scope of congressional action would be known long in advance and effective dates for the legislation could be set in the future without the injustices of retroactivity and surprise which might follow court action."[57] Because the *Quill* rule is premised on the commerce clause, it is subject to congressional change, which could be more comprehensive and accountable than any judicial pronouncement.

> ***Courts are not well equipped to develop new rules of taxation. Courts may not, and in some cases cannot, obtain evidence from interested stakeholders and take political and economic factors into consideration when developing doctrine.***

Doctrine is developed case by case, and the facts of a particular case may preclude completeness or coherence. "As we have seen, the Court's ability to fine-tune an economic nexus rule is limited, and the Court's ruling may also be limited by the particular facts of the case that arrives at its steps."[58] Combined with the fact that the Supreme Court is averse to tax cases in the first place, there is a high danger that any move away from the physical presence rule will do no good. There are five particular concerns regarding economic nexus.

First, applying geography-based income taxes or geography-based sales taxes with a standard unconstrained by geography risks multiple taxation and burdensome compliance costs. In personal jurisdiction, the location of an Internet transaction remains disputed. If a New York company sells a product on its Web site to a California purchaser via servers in Ohio and Colorado, the transaction can be described as being everywhere, nowhere, or always somewhere at a given point in time.[59] For the same reason, economic nexus threatens to tax transactions everywhere; even taxing transactions somewhere can be burdensome to figure out.

States have responded by trying to tax whatever they can reach — hardly the new and innovative development tax officials describe it as. "State tax systems . . . have not kept up with the e-commerce revolution — not through lack of effort by state tax administrators, but because the systems are inherently based on geographic borders, a concept that is simply ineffective in a borderless electronic economy."[60] The *MBNA* court took that to the extreme by suggesting the commerce clause itself is outdated: "The Framers' concept of commerce consisted of goods transported in horse-drawn, wooden-wheeled wagons or ships with sails. They lived in a world with no electricity, no indoor plumbing, . . . no iPods." While some constitutional principles surely must be revisited to apply them to new circumstances, the idea that parochial state interests cannot burden interstate commerce remains a timeless principle regardless how sophisticated technology may be.

Second, simply imposing the existing taxation regime on e-commerce would burden e-commerce more than bricks-and-mortar businesses:

> If Congress enacts legislation that essentially overturns *Quill*, such legislation would create an undue burden by requiring many e-retailers to collect use taxes from hundreds of thousands of consumers nationwide and comply with thousands of different tax codes. Main Street retailers, however, need comply only with the tax code of the jurisdiction in which they conduct business. To reduce costs, e-retailers

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[57]*Flood v. Kuhn*, 407 U.S. 258, 279 (1972).

[58]Swain, *supra* note 40, at 369.

[59]*See, e.g.*, Shane Padgett Morris, Note, "Interstate Commerce and the Future of State Sales and Use Taxes," 54 *Ala. L. Rev.* 1393, 1397-98 (2003) (discussing three views of Internet presence).

[60]Lindholm, *supra* note 54, at 28.

would likely shift the burden to consumers by increasing prices. Moreover, imposing those administrative and financial burdens may force smaller online companies out of business or discourage businesses from engaging in e-commerce.[61]

Under either nexus rule, a bricks-and-mortar store needs to worry only about the tax system where it is physically present.[62] Economic nexus imposes additional obligations for each jurisdiction into which an item is sold; it is "effectively . . . an export duty on outbound commerce."[63] Those burdens become excessive when one accounts for the vastly different state rules as to what is or is not taxed. Support for economic nexus is usually justified as a way to end inequity between electronic and physical retailers.[64] But without enormous advances in simplification, states using an economic nexus rule will burden electronic commerce more than bricks-and-mortar businesses, and courts should be suspicious of a standard that allows states to do so. "Congress must strike a delicate balance between fostering an emerging Internet market and protecting states' powers to tax. . . . If it is determined that additional state taxes cannot be imposed on the Internet without significantly damaging the market, then no new taxes should be allowed."[65]

> ***The idea that parochial state interests cannot burden interstate commerce remains a timeless principle regardless how sophisticated technology may be.***

Third, there is a high likelihood that e-commerce would become subject to multiple taxation under an economic nexus standard. "Under any nexus analysis, multiple taxing jurisdictions may have power over a remote seller. To avoid multiple taxation, only one state may actually exercise that power."[66] A physical presence rule makes that easy; an economic nexus rule complicates matters. In *MBNA*, West Virginia sought to tax income that is already subject to Delaware income tax. Even though the second prong of *Complete Auto* is meant to prevent a state from taxing beyond its fair share, multiple states will nevertheless assert that they are entitled to tax the income. States are unlikely to smooth out such agreements for the same reasons that rules for divvying up state corporate income taxes have become less uniform. "Because of the tension in interests between money market states (states that are importers of financial services) and money center states (states that are net exporters of such services), any future agreement on a single method of allocating and apportioning income among financial institutions seems unlikely."[67] Absent such an agreement, a judicial endorsement of economic nexus would invite multiple taxation and substantial litigation involving multiple states.

Fourth, how far in space and time economic nexus can go remains undetermined. One infamous personal jurisdiction case upheld service of process on an airplane flying over the state. "It cannot seriously be contended that a person moving in interstate commerce is on that account exempt from service of process while in transit, and we think it makes no practical difference whether he is traveling at the time on a plane, or on a bus or train, or in his own car."[68] Physical presence in state taxation imposes some limits on how far state taxation power can extend. If an economic nexus rule is adopted, there is a danger that geographical limits will be abandoned, resulting in states unfairly subjecting nonresidents to excessive taxation.

Temporal limits, also, could subject nonresident companies to uncertainty. "How long does nexus last? There is little guidance in this area, and states' responses vary widely. Three states have publicized twelve months as the duration of nexus for sales and use tax collection purposes, the State of Washington has a five year duration of nexus regulation, two states have ruled that nexus ends on the day the physical presence ends, and in Indiana, nexus apparently lasts forever."[69] If courts embrace state taxation of nonresident companies, it will be difficult to curtail such expansive rules in an orderly fashion;

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[61]Ryan J. Swartz, "The Imposition of Sales and Use Taxes on E-Commerce: A Taxing Dilemma for States and Remote Sellers," 2 J. *High Tech. L.* 143, 148 (2003).

[62]*Geoffrey* might imperil even bricks-and-mortar businesses. One rationale underlying that decision was that nexus exists in a state where customers are, so if a Virginia storeowner sells to a purchaser on credit and the purchaser moves to Montana, the storeowner may then have nexus with Montana.

[63]Masterson, *supra* note 53, at 217.

[64]*See, e.g.*, Swain, *supra* note 40, at 345 ("If consumer purchases are to be taxed, then they all should be taxed to avoid discrimination and keep a level playing field").

[65]S. Morris, *supra* note 59, at 1411.

[66]Masterson, *supra* note 53, at 215.

[67]*Id.* at 531.

[68]*Grace v. MacArthur*, 170 F. Supp. 442, 447 (E.D. Ark. 1959).

[69]H. Beau Beaz III, "The Rush to the Goblin Market: The Blurring of *Quill*'s Two Nexus Tests," 29 *Seattle U. L. Rev.* 581, 581 (2006).

determining how far is too far or how long is too long is a question of policy, not constitutional command.

Any judicial endorsement of economic nexus would involve curtailment of electronic commerce; indeed, that is probably why many bricks-and-mortar retailers are eager for it.

Fifth, adopting an economic nexus standard would unsettle expectations and threaten retroactive application of taxes, endangering economic investments. "Taxpayers, mail order and Internet alike, rely on [physical presence] for 'settled expectations' in tax planning and compliance, as do the states; any change in the standard would result in many taxpayers finding themselves liable in far more states than they planned for."[70] While the Internet has seen an increased amount of commerce, some seem to view it as a golden goose that can be squeezed without adverse effects. However, the availability of many items in electronic commerce could be affected if an economic nexus standard were adopted:

> Just as the mail-order catalog business had grown prior to *Quill*, so the financial services industry has expanded. . . . Without the availability of such credit, a great amount of which often crosses state lines, the growth of electronic commerce will be substantially hindered. An economic presence test would threaten income taxation in each state where credit was offered and, therefore, might tend to discourage creditors — especially smaller, less wealthy creditors — from extending credit in multiple states.[71]

Any judicial endorsement of economic nexus would involve curtailment of electronic commerce; indeed, that is probably why many bricks-and-mortar retailers are eager for it. Many proponents of economic nexus have recognized the problems of economic nexus by outlining model schemes that have several common mitigating features, the imposition of which are beyond the judicial power. Those include de minimis exemptions, simplified rates, and uniform bases. Until Congress and the states can hammer out national rules on those and other areas of concern, a physical presence rule is the only nexus rule that avoids burdening interstate commerce. It should be upheld by the Supreme Court and by Congress. Overturning the present standard without being sure about what replaces it will repeat the mistake made by the progeny of *International Shoe*.

V. Conclusion

At least one commentator has written that "*Quill*'s continued adherence to the 'physical presence' test is a relic from the pre-*International Shoe* era."[72] With the knowledge of the mess that *International Shoe* began when it abandoned a physical presence rule, courts, scholars, and businesses should be wary of calls to repeat it in another area of law. Commentators cannot agree on what shape economic nexus should take, and states cannot agree on how simplified their tax systems should be. Because they proceed case by case, courts are not well equipped to manage overhauling the U.S. taxation system with an economic nexus standard fraught with concerns. Attempting to do so would create confusion, unsettle expectations, and endanger the nation's economy — damage much worse than any harm suffered by bricks-and-mortar businesses at present, and far worse than the uncertainty caused in the area of personal jurisdiction. Preventing states from inflicting such damage as they pursue parochial interests is, after all, the reason we have the commerce clause. ☆

[70]Sidney S. Silhan, Note, "If It Ain't Broke Don't Fix It: An Argument for the Codification of the *Quill* Standard for Taxing Internet Commerce," 76 *Chi.-Kent L. Rev.* 671, 688 (2000).

[71]Ervin, *supra* note 50, at 540-41.

[72]Swain, *supra* note 40, at 457.

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