ECONOMIC NEXUS THROUGH OWNERSHIP AND USE OF INTELLECTUAL PROPERTY

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INTRODUCTION

The key issue in determining whether a corporation is subject to income tax in a particular state is whether nexus exists to that state. It is often prudent for a corporation to be proactive and diligent in in this analysis because each mistake with regard to a state in which some form of activity or connection exists could prove costly. If a corporation is found by state tax authorities to have the requisite nexus to that state and it has failed to file a tax return, the corporation will be exposed to additional taxes and penalties for noncompliance. That is why corporations that are subject to disclosure of high risk tax positions in their financial statements under ASC 740 -10 (the codification to FIN 48 in the accounting world) find that issues of possible nexus are closely monitored by the financial statement auditors.

However, managing nexus as part of annual or quarterly tax planning can also serve as a state and local tax saving opportunity. Under certain circumstances, a corporation may be able to use nexus statutes to shift profits from a high-tax state to a low-tax state.

DOING BUSINESS

An out-of-state corporation is subject to tax in a particular state only if the corporation engages in business in the state and the business activities are sufficient to establish nexus. The definition of "doing business" varies from state to state, but typically includes buying or selling services or property, executing contracts, enforcing contract rights, maintaining a place of business, and hiring employees in the state. However, nexus can also arise from less obvious transactions.

Public Law 86-272 limited the rights of states to tax out-of-state corporations with respect to the solicitation of sales within the state. Its application is limited to sales of tangible personal property. This limitation benefits out-of-state retailers of hard goods but provides little benefit to companies selling a digital product that is delivered over the internet.

Under Public Law 86-272, if an out-of-state corporation merely solicits orders in a state, and nothing more, the corporation does not have nexus with the state for tax purposes. Solicitation includes actual requests for purchases and ancillary activities that have no independent business purpose apart from the solicitation of orders. Examples of solicitations and ancillary activities that do not give rise to nexus include minor or incidental advertising, the display of free samples of a product, or the training or meeting of sales representatives on a periodic basis.

Nonetheless, the scope of nexus is broad, and some states and courts have expanded the definition of nexus to include "economic nexus," including nexus arising

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from the ownership and use of intellectual property ("I.P.") within a state.[1]

WHAT IS ECONOMIC NEXUS?

States have increasingly extended the definition of nexus to include an out-of-state corporation's ownership and use of I.P. within the state. I.P. typically includes copyrights, patents, trademarks, trade names, trade secrets, service marks, and know-how that are used within a state.

Thus, a corporation can have economic nexus with a state solely by executing a licensing agreement that earns the corporation royalties from that state, even if the corporation itself has no presence in the state. This greatly expands the concept of nexus for state tax purposes, and can be a trap for out-of-state corporations that are unaware of such provisions. It is important that any corporation leasing I.P. outside of its home state becomes familiar with the nexus laws of any state in which it enters into a licensing agreement.

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This is particularly important for non-U.S. corporations (frequently referred to by state law as "alien corporations") that do not otherwise engage in business in the U.S. As with their domestic counterparts, alien corporations can be swept up in a state's broad nexus provisions. Because tax treaties between the U.S. and foreign countries are not necessarily binding on states, a foreign corporation could be subject to tax in a particular state despite being exempt from income tax on the Federal level due to reliance on a tax treaty.

From the viewpoint of a state tax administration, a corporation formed and headquartered in another state is considered to be a "foreign corporation" but not an "alien corporation." Alien corporations and foreign corporations are afforded similar treatment. Hence, income tax treaties are often ignored for state income tax purposes.

For example, the Massachusetts Department of Revenue issued a directive in 1996[2] (the "Directive") advising that a foreign corporation's I.P. used within the state subjects that corporation to income tax if (i) the I.P. generates or is otherwise a source of gross receipts within Massachusetts for the corporation, including through a license or franchise; (ii) the activity is purposeful (such as through a contract with a company in the state); and (iii) the corporation's presence in Massachusetts is more than *de minimis*.

The Directive provided several examples of I.P. giving rise to nexus in Massachusetts:

- A dress shop in Wisconsin licenses its name to a Massachusetts company for use in connection with the sale of the Massachusetts company's clothing line in the state, pursuant to which the dress shop receives royalties from the Massachusetts company's sales in the state.
- A Delaware company located in Alabama develops and patents technology

[1] Revenue earned from the performance of services is not protected by P.L. 86-272 and may form the basis for nexus. This article, however, is limited to a discussion of I.P. that does not have a physical presence within the state.

[2] D.O.R. Directive No. 96-2.

for a motor scooter, then licenses the patent to a Massachusetts company for use in its manufacture and sale of scooters in Massachusetts, pursuant to which the Alabama company receives an upfront fee for the right to use the patented technology and a royalty on the sale of scooters.

- A Delaware fast food franchiser located in New Jersey franchises the rights to one of its restaurants to a New Hampshire resident for a location in Massachusetts, and the terms of the franchise agreement require the franchisee to use various items of I.P. owned by the franchiser, pay a monthly franchise fee, and pay a royalty charge based on sales proceeds.

These examples illustrate that nexus exists in Massachusetts whenever an out-of-state corporation enters an agreement to license certain I.P. and receives a royalty payment based on in-state sales of the licensee. Even a Japanese corporation licensing trade secrets and know-how on automobile radar devices would have a corporate income tax liability in Massachusetts.

In 2011, New Jersey issued Technical Advisory Memorandum 2011-6, which provided that taxpayers performing services and domiciled outside the state who solicit business within the state or derive receipts from sources within the state may have corporate nexus with the state.

While taxpayers have attempted to claim that economic nexus violates the due process clause and the commerce clause, courts have largely rejected these arguments and have found economic nexus properly exists based on the use of intangibles in the state.

"Unlike nexus for sales and use tax, which requires physical presence, courts have consistently held that such actual presence is not required for states to tax corporate income generated from the use of I.P."

ECONOMIC NEXUS REPLACES PHYSICAL PRESENCE

Unlike nexus for sales and use tax, which requires physical presence,[3] courts have consistently held that such actual presence is not required for states to tax corporate income generated from the use of I.P. Courts have emphasized that physical presence is not required if the corporation has an economic connection to the state.

For example, in *Geoffrey, Inc. v. Commr. of Revenue*,[4] the Massachusetts Supreme Judicial Court rejected the taxpayer's claim that it lacked nexus with Massachusetts because it did not have physical presence in the state. The court upheld the state's authority to tax out-of-state corporations due to their ownership and use of I.P. in the state because Geoffrey made "purposeful efforts to reap economic benefits" from Massachusetts' retail marketplace. The court held that collecting royalties based on net sales pursuant to a licensing agreement gave rise to "substantial nexus" in the state and that the imposition of tax upon a foreign corporation without a physical presence in Massachusetts did not violate the commerce clause.

In the case, Geoffrey was engaged in the business of licensing trademarks for the Toys "R" Us logo that were used in retail stores throughout the U.S. It had no employees and owned no tangible property in Massachusetts, and its sole activity in

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3 See *National Bellas Hess v. Department of Revenue of I.L.*, 386 U.S. 753 (1967).

4 *Geoffrey, Inc. v. Commr. of Revenue*, 899 N.E. 2d 87 (M.A. Sup. Jud. Ct. 2009).

the state was its licensing of trademarks to stores in the state in exchange for royalty payments on net sales. Nonetheless, the court emphasized the fact that the agreements afforded Geoffrey the continued right to regulate use of the trademarks and access to courts in Massachusetts to protect its I.P. rights. Interestingly, Geoffrey did not exercise the latter privilege.

The Massachusetts court's decision closely resembled the holdings of courts in several other jurisdictions, including South Carolina, which had also determined that Geoffrey's receipt of royalties in the state gave rise to economic nexus.[5] The Supreme Court of South Carolina held that since Geoffrey was engaged in the business of owning and licensing I.P., its decision to license trademarks for use in many states evidenced a purposeful intent to seek the benefit of economic contact with those states. The court also noted that Geoffrey could have prohibited the use of its intangibles in the state, and it did not elect to do so.

In both cases, Geoffrey relied on the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota*,[6] which held that personal presence was required to subject a company to sales tax in a state. However, both courts limited the holding of *Quill* to sales and use tax and held it inapplicable to corporate income tax.

In yet another case brought by Geoffrey,[7] a court in Oklahoma upheld the existence of economic nexus. Geoffrey received income that was derived from Oklahoma customers. Consequently, a sufficient economic connection to Oklahoma was established.

Likewise, in *Lanco, Inc. v. Division of Taxation*,[8] the New Jersey Supreme Court, reversing the decision of the New Jersey Tax Court, held that the license of I.P. to a New Jersey company gave rise to royalty income that was taxable in New Jersey, based on the Division of Taxation's argument that the royalty income was from New Jersey sources. The court, like those in the *Geoffrey* cases, distinguished the bright-line nexus rule set forth in *Quill*, holding that the physical presence requirement for nexus applies only in the sales and use tax context. Subsequent New Jersey decisions have confirmed this treatment, permitting the state to tax income generated by I.P. even if the corporate recipient lacks physical presence in the state.[9]

PURPOSEFUL INTENT IS REQUIRED

The precise facts that give rise to economic nexus in a given state are not always clear. While taxpayers have argued that the commerce clause and the due process clause of the U.S. Constitution prevent a state from imposing tax in the absence of physical presence, state courts have largely rejected these claims.

Nonetheless, it seems clear that purposeful intent is required so that the use of I.P. in a state alone is not sufficient to give rise to nexus if the taxpayer does not have a purposeful intent to engage in activity in the state. For example, intangible income

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5 *Geoffrey, Inc. v. S.C. Tax Commission*, 437 S.E.2d 13 (1993).

6 *Id.*

7 *Geoffrey Inc. v. O.K. Tax Commission*, No. 99,938 (O.K. Civ. App. 2005).

8 *Lanco, Inc. v. Division of Taxation*, 188 N.J. 380 (N.J. S. Ct. 2006).

9 See *Praxair Tech., Inc. v. Division of Taxation*, 988 A.2d 92 (N.J. S. Ct. 2009).

from transactions taking place outside New Jersey will not give rise to nexus in New Jersey.[10]

Further, in *Griffith v. ConAgra Brands, Inc.*,[11] the Supreme Court of West Virginia refused to find economic nexus on the receipt of royalties from trademarks used in the state, holding that the taxpayer did not meet the "purposeful direction" test under the due process clause or the "significant economic presence" test under the commerce clause. The holding in that case was contingent upon the fact that the taxpayer did not provide services to licensees in West Virginia and did not dictate in any way how the licensees distributed products using the trademarks.

In *J.C. Penney Natl. Bank v. Johnson*,[12] the Tennessee Court of Appeals refused to uphold economic nexus where the taxpayer extended credit card lending services to residents in the state but did not issue credit cards in its Tennessee stores.

THE ROLE OF PASSIVE INVESTMENT COMPANIES

One common factor in many of the cases finding the presence of economic nexus, such as the *Geoffrey* cases and *Lanco*, was the existence of a passive investment company (also referred to as a Delaware holding company). In many cases, the taxpayer was a passive investment company formed by its parent company, and the parent company itself had physical nexus with the state in question. Thus, when the parent company transferred the intangible assets to the passive investment company, which then licensed it for use in the state, application of the economic nexus concept to the passive investment company allowed the state to maintain its tax base. Application of the physical presence test would have allowed a unitary group to shift income from the state by using a passive entity with no physical presence in the state to received deductible license fees.[13]

However, where the sole issue is the taxpayer's use of a passive investment company, rather than invoking economic nexus, states have instead sought to enact statutes prohibiting the parent companies from deducting royalties and licensing fees where the income of the passive investment company was not taxable in the state. This achieves the same revenue protection goal but does so in a less contentious way.

ADVANCED PLANNING IS NECESSARY

Ideally, a corporation should evaluate any potential state nexus issues prior to

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10 *Whirlpool Properties, Inc. v. Division of Taxation*, N.J. Tax Ct. No. 66-2007 (2013).

11 *Griffith v. ConAgra Brands, Inc.*, 2012 W.V. LEXIS 282 (W.V. May 24, 2012).

12 *J.C. Penney Natl. Bank v. Johnson*, 19 S.W.3d 831 (T.N. Ct. App. 1999).

13 To the same effect, see *Kmart Props. Inc. v. Tax and Rev. Dept. of N.M.*, No. 21, 140 (N.M. Ct. App. 2001) (upholding economic nexus based on use of intangibles in N.M.); *L.A. Dept. of Rev. v. Gap (Apparel) Inc.*, 886 So. 2d 459 (L.A. Ct. App. 2004) (upholding economic nexus based on use of intangibles in L.A.); and *A&F Trademark Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004) (upholding economic nexus based on use of intangibles in N.C.). In each of these cases, the taxpayer was an out-of-state passive investment company whose parent company had physical presence in the state.

entering into a licensing or other agreement governing the use of I.P. with any in-state corporation. If the corporation engages in advanced planning, there are tax planning opportunities that can give rise to savings for the corporation, given the differences in tax rates between states.[14] Thus, if a corporation's home state is a high-tax state, the corporation may benefit from having economic nexus in a lower-tax jurisdiction.

"It is critical for a corporation to evaluate nexus prior to entering into a contract in a state and to continue to review potential nexus issues on an ongoing basis."

If a corporation is unsure whether its activities are sufficient to give rise to nexus in a particular state, it should seek to determine its level of exposure prior to engaging in activities in the state. Some states permit ruling requests so a taxpayer may identify whether the state considers it to have nexus based on its activities in the state.[15]

REMEDYING PAST MISTAKES

If the corporation discovers that it has economic nexus in a state after entering into an agreement and after having failed to file a tax return in the state, but prior to being contacted by that state in connection with asserted noncompliance, the corporation may benefit from entering the state's voluntary disclosure program, if one is available. Typically, doing so would enable the corporation to avoid penalties on the failure to file a return and pay tax, and it may limit the number of years for which a filing is required. Many states have initiated voluntary disclosure programs as an easy revenue fix.

These states rely on disclosures of uncertain tax positions in the published financial statements of corporations having publicly traded shares. However, the states act at their own pace. As a result, it may be possible to enter a program even if the financial statement disclosure is publicly available.

If a voluntary disclosure program is not available, the corporation should still consider coming forward voluntarily, as penalties for late filing and payment may be abatable for reasonable cause. If the corporation waits for the state to assess taxes, the corporation's argument for abatement of penalties is substantially weaker.

Thus, it is critical for a corporation to evaluate nexus prior to entering into a contract in a state and to continue to review potential nexus issues on an ongoing basis. Keeping up-to-date with changing laws in different states is the best way to avoid what could be a costly mistake.

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14 See, *e.g.*, O.H. Rev. Code Ann. §5733.042.

15 See, *e.g.*, 830 Code M.A. Regs. §63.39.1(9), outlining the procedures for requesting nexus determination from the Department.