

## **BRIEF HISTORY OF ECONOMIC NEXUS DOCTRINE LITIGATION INVOLVING DELAWARE PASSIVE INVESTMENT COMPANIES**

In this online supplement to Dyreng, Lindsey and Thornock (2011) “Exploring the Role Delaware Plays as a Domestic Tax Haven,” we provide a primer on the history of state economic nexus doctrine litigation over the past three decades. During that time period, the breadth of litigation covers hundreds of cases in many of the states in the United States, with many cases being tried (and re-tried) at different levels of the state court systems. As a result of the enormous breadth of the legal history, we limit our scope to several legal cases that we consider to be the most prominent. For more breadth of discussion, we refer the reader to academic and practitioner articles (Faber, 2003; Bauman and Schadewald, 2004; Bankman, 2007; Cline, 2008; Fox and Luna, 2011), textbooks (Swenson, Gupta, Karayan, and Neff, 2004) and legal primers (CCH, 2010).

Central to the legal issues surrounding the multi-state taxation of businesses are the due process and commerce clauses of the U.S. Constitution. The due process clause of the 14th Amendment prohibits a state from taxing a corporation unless there is a definite link or minimum connection between the company and the state. With respect to the commerce clause, states may not enact laws that unduly burden or inhibit the free flow of commerce between the states.<sup>1</sup> The Supreme Court has interpreted this to mean the business must have a substantial nexus in a state.<sup>2</sup> While similar, the due process clause focuses on the fundamental fairness to the taxpayer of being subject to tax by a state while the purpose and intent of the commerce clause addresses the effects of state regulation on a national economy. For a business to be subject to taxation by a state, the state must both have the authority to tax under the due process clause while not

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<sup>1</sup> Article 1, Section 8 of the U.S. Constitution

<sup>2</sup> *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)

violating the commerce clause that is intended to maintain the free flow of commerce between states.

In 1992, the Supreme Court handed down a highly influential decision in *Quill Corp. v. North Dakota* that revisited the due process and commerce clause requirements for a multi-state business.<sup>3</sup> Quill Corporation, a mail order business that sells office supplies and equipment, had failed to collect use tax from its North Dakota customers and remit the tax to the state. The company argued it had not established substantial nexus in North Dakota under the commerce clause because it had no physical presence in the state which is generally understood to mean no property or payroll. North Dakota disagreed and maintained that because Quill Corporation met the minimal connection due process standard with the state via the existence of North Dakota customers that the substantial nexus commerce clause standard had also been met. The Supreme Court sided with Quill Corporation and found that while the due process clause had been satisfied with the existence of North Dakota customers that substantial nexus under the commerce clause had not been met because Quill Corporation had no physical presence in the state.

The state of South Carolina was quick to use the *Quill* decision to its benefit. Toys R Us, Inc. established a wholly-owned Delaware subsidiary named Geoffrey LLC that held trademarks and trade names while having no presence in South Carolina, a separate filing state. Toys R Us subsidiaries in South Carolina and certain other states (subsidiaries in five states were specifically excluded from the licensing agreement) paid a royalty to Geoffrey for use of the trademarks and trade names equal to one percent of sales totaling \$55 million during the 1990 tax year. In South Carolina, Toys R Us claimed a portion of the \$55 million royalty deduction on its 1990 South Carolina return corresponding to the untaxed royalty income earned by and

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<sup>3</sup> *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992)

paid to the Toys R Us Delaware PIC Geoffrey. At first, South Carolina disallowed the deduction. In time, South Carolina changed its position and allowed the deduction but claimed “economic nexus” had been established with Delaware-based PIC Geoffrey because of the licensing agreement between Geoffrey and Toys R Us entities in South Carolina. Most notably, South Carolina argued that the applicability of the *Quill* decision did not extend beyond sales and use tax nexus to income tax nexus. Thus, the state of South Carolina argument hinged on the position that the substantial nexus requirement under the commerce clause did not mandate that the physical presence requirement be satisfied for income tax nexus. In July 1993, the South Carolina Supreme Court issued the *Geoffrey* decision and sided with the state of South Carolina.<sup>4</sup> The court agreed with the state’s economic nexus doctrine argument that the commerce clause had not been violated and that the Supreme Court *Quill* decision only had precedent over sales and use tax nexus. Importantly, the Supreme Court chose not to hear the case and has not heard any state income tax nexus case related to the commerce clause since the *Quill* decision in 1992. Several other states have tried the *Geoffrey* case in the past few years including Oklahoma, Massachusetts, and Louisiana.

In contrast to how the state of South Carolina acted quickly and successfully, the legal process played out more slowly and less decisively in other states. In time, the state of Maryland Department of Revenue developed a different legal argument to combat the Delaware passive investment company strategy. Based on precedent in Maryland corporate law, the way to tax an out-of-state corporation was to argue that the out-of-state corporation is a phantom corporation with no economic substance. In the late 1990s, the Maryland Department of Revenue claimed economic nexus with two different Delaware passive investment companies; Crown, Cork, and Seal, a subsidiary of Crow, Cork, & Seal Company that produces of metal cans and lids, and

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<sup>4</sup> *Geoffrey, Inc. v. South Carolina*, 437 S.E.2d 13 (1993)

SYL, a subsidiary of Syms, a retailer who both received royalty payments from corporations operating in Maryland. The Maryland Department of Revenue asserted that both Delaware passive investment companies were phantom corporations lacking economic substance so they could be taxed by Maryland. In 1999, the Maryland Tax Court disagreed with the Maryland Department of Revenue finding that the Delaware passive investment companies had economic substance by holding intangible assets among other things and ruled Maryland could not tax them.<sup>5</sup> Ten years after *Geoffrey* was issued in 2003, the Maryland Court of Appeals issued a joint ruling to both companies reversing the Maryland Tax Court decision finding that both Delaware passive investment companies lacked economic substance and were phantom corporations that could be taxed by the state of Maryland.<sup>6</sup>

With the trend beginning to shift towards states successfully taxing the income of passive investment companies, the Delaware passive investment company strategy scored a significant legal victory in New Jersey in 2003. Lanco Inc, a Delaware passive investment company established to hold the intangibles of a related corporation, Lane Bryant Inc, prevailed in 2003 against the New Jersey Division of Taxation when the New Jersey Tax Court found that New Jersey could not tax Delaware passive investment companies that had no physical presence in New Jersey.<sup>7</sup> Thus, even though Lanco held trademarks and trade names used by Lane Bryant stores in New Jersey, the New Jersey Tax Court found that New Jersey could not use the *Geoffrey* economic nexus doctrine to tax Lanco. In 2005, the Superior Court of New Jersey reversed the tax court's decision in *Lanco* and the New Jersey Supreme Court upheld the

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<sup>5</sup> *SYL, Inc. v. Comptroller, M.T.C. No. C-96-0154-01 (1999)*; *Crown Cork & Seal v. Comptroller, M.T. C. No. C-97-0028-01 (1999)*

<sup>6</sup> *Comptroller of the Treasury v. SYL, Inc., Comptroller of the Treasury v. Crown Cork & Seal (Delaware) Inc., 375 Md. 78, 825 A.2d 399 (2003)*

<sup>7</sup> *Lanco, Inc. v. Director, Division of Taxation, 21 N.J. Tax 200 (2003)*

Superior Court decision in 2006.<sup>8</sup> The New Jersey Supreme Court represented the second state supreme court to rule in favor of the states' position that income tax nexus could be established without a physical presence via the economic nexus doctrine, more than 13 years after the South Carolina Supreme Court issued the *Geoffrey* ruling.

The next landmark case came down in North Carolina in 2004 related to a Delaware passive investment company established by Abercrombie and Fitch named A&F Trademark, Inc. Note that both Lane Bryant and Abercrombie and Fitch are affiliated with the clothing retailer The Limited. The North Carolina Court of Appeals relied on the *Geoffrey* decision finding that North Carolina and A&F Trademark had substantial nexus. The court also followed the finding in *Geoffrey* that *Quill* required a physical presence for sales and use taxes only, not income taxes. In addition, the appellate court reasoned that companies must remit sales and use taxes to numerous taxing authorities multiple times during the year which imposes unique administrative burdens whereas income taxes are reported only annually to each state thereby justifying a lower standard for establishing income tax nexus in a state as compared to sales tax nexus.<sup>9</sup>

While many other passive investment company cases move through the litigation process with various states, these cases are generally viewed as the most influential in establishing the legal arguments used by states. In addition, with the exception of South Carolina enjoying immediate success with the *Geoffrey* decision, taxpayers scored initial victories in most states with the pendulum now shifting back more in the states' favor.

Returning to the Supreme Court *Quill* decision in 1992, the Court made it clear that Congress had the power granted to it under the Constitution to regulate commerce which may explain why the Supreme Court has not granted a *writ of certiorari* to hear an income tax nexus

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<sup>8</sup> *Lanco, Inc. v. Director, Division of Taxation*, 379 N.J. Super. 562 (2005); *Lanco, Inc. v. Director, Division of Taxation*, 188 N.J. 380, 908 A.2d 176 (2006)

<sup>9</sup> *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004)

case since the *Quill* sales and use tax nexus decision. Congress appears to recognize this constitutional power. Both the Senate and the House have issued bills in virtually every Congress since 2000 including a 2011 bill sponsored by Virginia House members Bob Goodlatte, a Virginia Republican, and Bobby Scott, a Democrat, requiring a physical presence to establish state income tax nexus. In fact, the bill allowed for property and employees to be in a state up to a 14 day safe harbor each year without establishing state income tax nexus. To this point, each bill has failed to make it out of committee.