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ECONOMIC PRESENCE SEEN AS TAXABLE OPPORTUNITY THROUGH EYES OF STATES

The U.S. Supreme Court denied *certiorari* in two important cases where individual states taxed out-of-state businesses that have no physical presence in the taxing jurisdiction. The failure of the Supreme Court to review these two cases – *Lanco, Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006), cert. denied, No. 06-1236 (6/18/07) and *FIA Card Services, N.A. fka MBNA America Bank v. Tax Commissioner, State of West Virginia,* 640 S.E.2d 226 (W. Va. 2006), cert. denied, No. 06-1228 (6/18/07) – will now likely lead many states to aggressively seek to impose taxes upon businesses without a tangible "physical presence" (*e.g.*, offices, employees, agents, property) within the state but which have a so-called "economic presence" in the state.

Individual states now may feel free to "push the envelope" when interpreting what constitutes a sufficient "economic presence" to tax an out-of-state business. In *FIA*, the West Virginia Supreme Court of Appeals held that the state could assess business franchise and corporate net income taxes upon MBNA, whose only contact with West Virginia was by telephone, mail, and advertising to its current and potential West Virginia resident credit card holders. While the Court recognized that FIA did not have any physical presence in West Virginia, the Court explained its "economic presence" analysis in a far from formulaic manner: "an examination of both the quality and quantity of the company's economic presence." *FIA*, 640 S.E.2d at 234. This broad, nearly amorphous standard arguably would permit the imposition of income and similar taxes merely upon evidence of customers for a business' services, the derivation of income in any form, or even advertising directed at a state where the business has no tangible physical presence.

In *Lanco*, the Supreme Court of New Jersey held that corporations with no physical presence in the state (other than their intangible trademark) are now subject to New Jersey's Corporation Business Tax, *N.J.S.A.* 54:10A-1 to -41. The Court based its decision upon the fact that Lanco derives its income from a New Jersey source pursuant to a license agreement for the use of its trademark by another corporation that conducts retail business in New Jersey. Lanco, incorporated in Delaware, is a Delaware investment holding company that licenses its intellectual property *(e.g.*, trademarks) to its parent corporation, clothing retailer Lane Bryant. While Lanco has no physical presence in New Jersey, New Jersey argued it earns money in New Jersey, which the Court held subjects it to taxation upon that income.

Two examples illustrate the impact a nationwide adoption of the "economic presence" standard could yield:

(1) A small businessperson in New Jersey owns a car wash ("Car Wash") that advertises on Philadelphia radio and television stations and in Philadelphia newspapers that its rates for a car wash, detailing, and many other services are the lowest in the region. Car Wash has no physical

presence in Pennsylvania. Thousands of Pennsylvania motorists pass Car Wash each weekend when headed east to the New Jersey beaches and Atlantic City, and it earns significant income each year from these Pennsylvania residents. Based upon an amorphous "economic presence" standard, such as the one adopted by the Court in *FIA*, Pennsylvania could reasonably argue that Car Wash's "systematic" and "purposeful" efforts directed at enticing Pennsylvania residents to purchase its services provide a sufficient nexus for Pennsylvania to tax the income derived from them.

(2) A neurology practice at a leading hospital in Wilmington, Delaware ("Doctors") regularly engages in remote "telemedical" examinations of stroke patients who are brought into emergency rooms in rural hospitals throughout the mid-Atlantic United States. The emergency room physicians electronically transfer patient CT scans and other data to Doctors' computer for review in Delaware. Doctors and the emergency room physicians then confer by telephone or by videoconferencing link regarding diagnosis and treatment. Despite Doctors' lack of physical presence in any state other than Delaware, all of the states where Doctors' "telepatients" are located could reasonably argue based upon an "economic presence" standard that Doctors' "systematic" and "purposeful" direction toward those states provides a sufficient nexus for income tax liability.

These are merely two of the many business situations now left open for the individual states to tax. The U.S. Supreme Court has already determined that, at least for sales and use taxes, a corporation must have a physical presence in the state in order to establish the constitutionally required "substantial nexus." *See Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Since the Court's decision in Quill, many courts throughout the country have been asked to review the question of whether *Quill* is limited to sales and use taxes or whether it also applies to income/franchise taxes. The U.S. Supreme Court has yet to address this question.

As states boldly attempt to expand the reach of their state taxing jurisdiction well beyond the traditional physical bounds, the burden upon businesses of all sizes will only increase through the costs of compliance with taxation in states where they have no physical presence and the payment of such taxes.

> The burden on business is both the cost of compliance and the increased tax costs from the cumulative affect of the taxes.

If you have any questions concerning these decisions, their tax implications, or combining the burdens associated with business expansion to other taxing jurisdictions with the risks associated with taxing jurisdictions expanding their taxing authority, Schnader Harrison Segal & Lewis LLP lawyers can guide you through the "traps for the unwary."

Stewart M. Weintraub, Esquire
36th Floor, 1600 Market Street
Philadelphia, PA 19103

Telephone: (215) 751-2296
Telefax: (215) 972-7412
E-mail: sweintraub@schnader.com

Harris N. Feldman, Esquire
Woodland Falls Corporate Park,
220 Lake Drive, Suite 200
Cherry Hill, NJ 08002
Telephone: (856) 482-5734
Telefax: (856) 482-6980
E-mail: hfeldman@schnader.com