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Sales Factor Presence After *J. McIntyre Machinery*

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In December 2000 professor Charles McLure, senior fellow with the Hoover Institution at Stanford University, opined that the stream of commerce theory makes it possible to design a nexus test tied entirely to apportionment that can be applied across the board to foreign persons without need for case-by-case constitutional analysis.[1] Dubbing that approach "source-based taxation," McLure argued that a foreign person that makes substantial sales sourced to a state for sales factor purposes should have nexus with that state.[2] Unsurprisingly, the Multistate Tax Commission embraced that concept as the panacea for nexus uncertainty, and on October 17, 2002, it issued a policy statement and uniformity proposal establishing a model bright-line sales factor presence test under which a foreign person has nexus with a state if it has $500,000 or more in sales sourced to the state.[3] And in an accelerating trend, states have opted to implement that approach.[4] However, as a direct consequence of the U.S. Supreme Court's rejection of stream of commerce theory in *J. McIntyre Machinery*,[5] it is uncertain whether sales factor presence is constitutional in application under the U.S. Constitution's due process clause.

The Due Process Nexus Standard Under *J. McIntyre Machinery*

Under the due process clause, a state lacks the jurisdiction to subject a foreign person to tax in the absence of "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[6] The Supreme Court, preferring to avoid formalism in favor of striking a balance between the principles of interstate federalism, reasonable notice, and fundamental fairness and the realities of the modern economy, has adopted a flexible case-by-case approach to determining whether the requisite minimum connection exists.[7] At its core, this approach requires an examination of the nature and quality of a foreign person's contacts with a state to determine whether the

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[1]Charles E. McLure Jr., "Implementing State Corporate Income Taxes in the Digital Age," 53 *National Tax Journal* 1287, 1295-1297 (Dec. 2000).

[2]*Id.* at 1293.

[3]MTC Policy Statement 02-02, "Ensuring the Equity, Integrity, and Viability of State Income Tax Systems" (amended Oct. 17, 2002); MTC Uniformity Proposal, "Factor Presence Nexus Standard for Business Activity Taxes" (Oct. 17, 2002).

[4]Some variation of that test has been adopted by California (Calif. Revenue and Taxation Code section 23101(b)), Colorado (Colo. Code Regs. section 39-22-301.1(2)(b)), Connecticut (General Statutes of Connecticut section 12-216a(a);

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Connecticut Department of Revenue, Informational Publication 2010(29.1)), Michigan (Michigan Code of Laws section 206.621), Ohio (Ohio Rev. Code Ann. section 5751.01(H)(3) and (I)), Oklahoma (Okla. Stat. tit. 68, section 1218(H)), and Washington (Wash. Rev. Code sections 82.04.066 and 82.04.067). Ohio's adoption of sales factor presence is for commercial activity tax purposes only, Oklahoma's is for its business activity tax, and Washington's is for its business and occupation tax. Note that the application of factor presence in Ohio for commercial activity tax purposes is under challenge. At the administrative level, the Ohio Department of Taxation upheld factor presence under the commerce clause of the U.S. Constitution, but offered no due process analysis. *See*, *In re L.L. Bean*, Ohio Department of Taxation, Final Determination No. 0000000198 (Aug. 10, 2010).

[5]*J. McIntyre Machinery Ltd. v. Nicastro*, 131 S.Ct. 2780 (2011).

[6]*Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954). *See also Quill Corp. v. North Dakota*, 504 U.S. 298, 307 (1992).

[7]*International Shoe Co. v. State of Wash.*, 326 U.S. 310 (1945). *See also Hanson v. Denckla*, 357 U.S. 235 (1958); *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985).

person has "purposefully avail[ed] itself of the benefits of an economic market in the forum state."[8] As a standard for analysis, "purposeful availment" has long suffered from ambiguity because of the Court's reluctance to decide whether a foreign person has purposefully availed itself of a state's market merely by putting goods in the stream of commerce with the expectation that the goods would be sold to consumers in that state.[9] However, in its 2011 decision in *J. McIntyre Machinery*, the Court took a strong step in favor of resolving that question.

In *J. McIntyre Machinery*, the Court held that a British manufacturer that sold machinery on consignment to a U.S. distributor that engaged in advertising and sales efforts throughout the United States and actually sold at least one machine in New Jersey did not have the minimum connection with New Jersey required under the due process clause to subject the manufacturer to personal jurisdiction in the state.[10] Writing the opinion for the Court, Justice Anthony Kennedy rejected the theory that the requisite minimum connection could be established by placing goods in the stream of commerce with the expectation that the goods would be sold to consumers in that state, saying, "it is the defendant's actions, not his expectations, that empower a State's courts to subject him to judgment."[11] Instead, Kennedy enumerated three core principles to be used in determining whether a foreign person had purposefully directed its activities at a state. First, the foreign person must engage in some action, beyond placing goods in the stream of commerce that is specifically directed at building or enhancing the market for its goods in the state.[12] Second, nexus determinations must be made using "a forum-by-forum, or sovereign-by-sovereign, analysis,"[13] so that the activities of a foreign person directed at the market of the United States in general do not in and of themselves support a finding of nexus in a particular state. Third, even if nexus would be established under the first two principles, a finding of nexus must "not offend 'traditional notions of fair play and substantial justice.'"[14] Although Kennedy's opinion was a plurality, a majority of the Court supported the first of those principles, a separate majority found that the second could be reasonable subject to further exploration, and the third principle received general acceptance.[15]

Since the Supreme Court's holding in *J. McIntyre Machinery*, the Oklahoma Supreme Court and the West Virginia Supreme Court of Appeals have weighed in on this question.[16] Both state courts previously had found that the requisite minimum connection under the due process clause could be established by placing goods in the stream of commerce with the expectation that the goods would be sold to consumers in that state,[17] making these

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[8] *Id.* at 304, 307-308, *citing Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985). *See also Hanson v. Denckla*, 357 U.S. 235 (1958).

[9] *See, e.g.*, *World-Wide Volkswagen Corp. v. Woodson*, 585 P.2d 351 (Okla. 1978), *rev'd*, 444 U.S. 286 (1980); *Asahi Metals Indus. Co. v. Superior Ct. of Cal.*, 480 U.S. 102 (1987). Following the Supreme Court's indecision, the federal circuits and state courts have split on this issue. *Compare, e.g.*, *State ex rel. Circus Circus Reno Inc. v. Pope*, 854 P.2d 461, 159 (Or. 1993) ("Thus, the forum State does not exceed its powers under the Due Process Clause if it asserts personal jurisdiction over a corporation that delivers its products into the stream of commerce with the expectation that they will be purchased by consumers in the forum State."); *Pohlmann v. Bil-Jax Inc.* 954 S.W.2d 371, 373 (Mo. Ct. App. 1997) ("The placement of a product into the stream of commerce without more is not an action of defendant purposefully directed toward the forum state.").

[10] *J. McIntyre Machinery*, 131 S.Ct. 2780 (2011).

[11] *Id.* at 2789.

[12] *Id.* at 2789-2790. *See also Asahi Metals*, 480 U.S. at 112, 117, arguing that additional conduct is necessary to show that a foreign person intended to serve the market in a state, such as "designing the product for the market in the forum State, advertising in the forum State, establishing channels for providing regular advice to customers in the forum State, or marketing the product through a distributor who has agreed to service as the sales agent in the forum State."

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[13] *J. McIntyre Machinery*, 131 S.Ct. 2789 ("Because the United States is a distinct sovereign, a defendant may in principle be subject to the jurisdiction of the courts of the United States but not of any particular State.").

[14] *Id.* at 2787.

[15] In her dissent, Justice Ruth Bader Ginsburg, joined by Justices Sonia Sotomayor and Elena Kagan, argued that activities directed at the United States as a whole are directed at all the states jointly and separately, and the British manufacturer's activities in relation to the United States gave it New Jersey nexus because those activities exceeded merely putting goods in the stream of commerce with the knowledge that they could be sold in New Jersey. *J. McIntyre Machinery* at 2797-2804. The concurrence by Justice Stephen Breyer, joined in by Justice Samuel A. Alito Jr., arrived at the same conclusion as Kennedy by applying a pragmatic approach, but would have reserved the question whether activities directed at the United States as a whole are directed at all the states jointly and separately for another case. *J. McIntyre Machinery* at 2792-2794.

[16] *Scioto Ins. Co. v. Oklahoma Tax Com'n*, 279 P.3d 782 (2012); *Griffith v. ConAgra Brands, Inc.*, 728 S.E.2d 74 (2012). Also, the Tennessee Department of Revenue weighed in on this question in Rev. Rul. 12-27 (Jan. 8, 2013), holding that the due process clause barred taxation of an intangible management company with no contacts with the state other than that it licensed patents to a related-party manufacturer that used those patents to produce goods outside Tennessee, which the manufacturer then sold to customers in Tennessee. (For the decision in *Scioto*, see *Doc 2012-9384* or *2012 STT 86-28*; for the decision in *ConAgra*, see *Doc 2012-11406* or *2012 STT 103-33*.)

[17] *See, e.g.*, *Winston Indus. Inc. v. Dist. Court of Seventh Judicial Dist.*, 560 P.2d 572 (Okla. 1977) ("We conclude that under the Oklahoma long-arm statutes Oklahoma may acquire jurisdiction over a foreign manufacturer of a product which it reasonably may expect to enter interstate commerce,

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cases the perfect test bed for how states would apply the core principles laid out by Kennedy. In *Scioto Insurance*, the Oklahoma Supreme Court held that a Vermont captive insurance company that licensed intangibles to a related party that was subject to Oklahoma tax, which in turn sublicensed those intangibles to Wendy's restaurants throughout the United States, could not be subject to Oklahoma corporate income tax under the due process clause. That was because the insurance company's only contact with Oklahoma was that it received "payments from an Oklahoma taxpayer [that had] a bona fide obligation to do so under a contract not made in Oklahoma."[18] In *ConAgra Brands*, the West Virginia court held that a foreign licensor's placement of trademarks and trade names in the stream of commerce through licensees' products was insufficient to support the imposition of corporate income tax on the licensor under the due process clause, because the licensor did not purposefully direct its business activities at West Virginia through its nationwide licensing of the intangibles in question.[19]

Accordingly, the courts of two states that staunchly adhered to the theory that placing goods in the state's stream of commerce for consumer purchase constituted the requisite minimum connection under the due process clause have rejected that approach following *J. McIntyre Machinery*, and applied rules that effectuate Kennedy's approach to due process analysis.

Reassessing Sales Factor Presence

For sales factor presence to operate as a bright-line test, it must be constitutional in application in all circumstances without any analysis beyond its own terms. Therefore, if a state's sales factor presence rule provides that a foreign person has substantial nexus if that person makes more than $500,000 in sales sourced to the state, every instance in which a foreign person meets that threshold must pass muster under the due process clause. Otherwise, the sales factor presence rule must be modified to cure it of its constitutional infirmity.

When it was arguable that stream of commerce theory controlled due process analysis, it was clear the above sales factor presence rule would be valid under the due process clause for all foreign persons with sufficient sales sourced to the state because the only evidence necessary to support a finding of nexus was the sales themselves. However, after *J. McIntyre Machinery*, the determining factor is whether a foreign person engaged in some act, beyond placing goods in the stream of commerce with the expectation that they will be purchased by consumers in the state, that is directed at building or enhancing the market for the foreign person's goods in the state. Further, it is arguable that this rule is narrower based on the principle that a foreign person's activities are not directed at a specific state's market merely because the foreign person directs its acts at the market of the United States in general. Either way, it is relatively simple to imagine fact patterns in which a sales factor presence rule is constitutionally infirm in application under Kennedy's analysis in *J. McIntyre Machinery*, particularly regarding foreign persons dealing in intangibles or services, the very activities that sales factor presence was most intended to reach. In fact, imagination is unnecessary, because the authors have seen the following examples on audit.

> **Example 1:** Assume that Company 1 is a State X corporation that provides national advertising campaign development services to companies located throughout the United States. Company 1 does not actively solicit sales in State Y, has no property or payroll in State Y, does not develop advertising campaigns specifically tailored for State Y's market, has no customers located in State Y, and, outside the indirect benefit its customers receive in State Y from its services, has no contact with State Y. State Y has enacted a sales factor presence rule that asserts that any foreign person with more than $500,000 in sales sourced to State Y has nexus in the state and is subject to State Y's corporate income tax. State Y has also enacted a market sourcing rule for services, under which sales of services are sourced based on where the customer receives the benefit thereof. Under the internal policy of the State Y Department of Revenue, State Y's benefit of the service sourcing rule is applied to sales of national advertising services by dividing State Y's population by U.S. population. Under that sourcing

which does enter interstate commerce, and because the alleged defect causes damage to the plaintiff in Oklahoma."); *Hill v. Showa Denko, K.K.*, 425 S.E.2d 609 (W.Va. 1992) ("We conclude that personal jurisdiction 'premised on the placement of a product into the Stream of Commerce is consistent with the Due Process Clause,' and can be exercised without the need to show additional conduct by the defendant aimed at the forum state.").

[18] *Scioto Ins.*, 279 P.3d at 783-784. Of particular import in the Supreme Court of Oklahoma's decision were the following facts: (1) the insurance company has no say on where a Wendy's restaurant could be located, (2) the payments made to the insurance company were independent of performance by the sublessors, and (3) the license agreements were executed outside Oklahoma and were not specifically directed at the use of the intangibles within Oklahoma.

[19] *ConAgra Brands*, 728 S.E.2d at 82-84. The West Virginia Supreme Court of Appeals relied on the following facts in making this decision: (1) the products bearing the trademarks and trade names were manufactured by unrelated or affiliated licensees located outside West Virginia, (2) the licensor did not direct or dictate how its licensees distributed the products, and (3) the licensees sold the products to wholesalers and retailers throughout the United States and did not themselves operate stores within West Virginia.

rule, Company 1 is deemed to have more than $500,000 in sales sourced to State Y, and State Y asserts that under its sales factor presence rule, Company 1 has State Y nexus and is subject to tax. Company 1 can challenge that application of State Y's bright-line nexus standard and argue that it violates the due process clause because Company 1 has not purposefully availed itself of the market of State Y within the meaning of *J. McIntyre Machinery*. Here, given facts substantially similar to those in *ConAgra Brands*, the operative bar to nexus is that Company 1 has not directed any activities specifically at building or enhancing its market in State Y. Further, Company 1's national advertising campaign design services are targeted at the United States as a whole, and there is no evidence to show that Company 1 directed its activities at State Y.

Example 2: Assume the same law as in Example 1 above. Company 2 is a State X corporation that sells local-interest magazines in State X and has other business activities in State Y. Company 3 is a State X corporation that licenses trademarks to Company 2 that are necessary for Company 2 to produce the local-interest magazines it produces and sells in State X. Company 3 engages in no other business activities, and has no contact with State Y. Company 3 was formed for valid business purposes and has economic substance; license fees paid by Company 2 to Company 3 are not subject to State Y's addback statute because they qualify for an addback exception. State Y has alternative apportionment powers, but cannot force combination. The State Y DOR asserts that allowing the deduction to Company 2 without taxing Company 3 results in distortion, and uses its alternative apportionment powers to assert that Company 3 must source its license fees to State Y using Company 2's sales factor. That sourcing rule causes Company 3 to have greater than $500,000 in State Y sales, and State Y asserts that under its bright-line nexus test, Company 1 has State Y nexus and is subject to tax. In this situation, Company 3 can argue that its being subject to State Y's bright-line nexus standard violates the due process clause because the company directs none of its activities at State Y; its trademarks have business value, and are used, solely in State X; and although it is feasible that one or more of the State X local-interest magazines bearing its trademarks could be transported by Company 2's customers into State Y, Company 3's awareness of that possibility did not rise to the level of purposeful availment of State Y's market under *J. McIntyre Machinery*.

Because there are facts and circumstances under which the application of sales factor presence as a bright-line rule violates the due process clause, it is arguable that a state cannot apply a sales factor presence rule to a foreign person without first determining whether that person has purposely availed itself of a market in the state as interpreted by Kennedy in *J. McIntyre Machinery*. This kind of case-by-case analysis defeats one of the main purposes of sales factor presence, which is to eliminate the complexities and uncertainties of constitutional analysis by implementing a bright-line, purely numeric test that in and of itself passes constitutional muster. In the absence of that assumption of constitutionality, sales factor presence rules effectively exempt foreign persons that could rightly be subject to tax under constitutional nexus principles but do not have the requisite in-state sales, without ensuring that all foreign persons with the requisite in-state sales are subject to tax.

Conclusion

In the wake of *Scioto Insurance* and *ConAgra Brands*, an argument can be made that the U.S. Supreme Court's rejection of stream of commerce theory in *J. McIntyre Machinery* has infused life into the due process clause of the U.S. Constitution as an effective bar to state taxation. That rejection of stream of commerce theory combined with Kennedy's purposeful availment formulation potentially invalidates sales factor presence as a bright-line test. ✰

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