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New Jersey Supreme Court Adopts Economic Presence Theory for Corporate Nexus

In Lanco, Inc. v. Director, Division of Taxation, No. A-89, 2006 WL 2883340, at *1 (N.J. Oct. 12, 2006) (per curiam), the Supreme Court of New Jersey affirmed the Appellate Division's decision that corporations with no physical presence in New Jersey may be subject to the New Jersey corporation business tax if they derive income from licensing intangibles to licensees within New Jersey. Lanco, 2006 WL 2883340, at *1 (affirming Lanco, Inc. v. Dir., Div. of Taxation, 879 A.2d 1234, 1242 (2005)). By doing so, New Jersey treated the physical presence test in Quill Corp. v. North Dakota, 504 U.S. 298, 314-18 (1992), as limited to sales and use taxes.

In Quill, the U.S. Supreme Court determined that corporations with no physical presence within a taxing state have no responsibility to collect such state's use tax. The Court based this physical presence test on the Commerce Clause requirement for substantial nexus but did not indicate whether the same test applies to both sales and income taxes. Since the Court decided Quill, state courts have varied in their interpretation of whether Quill applies to income taxes, with the recent trend favoring the limitation of Quill's applicability to sales and use taxes. In Lanco, New Jersey followed that trend and expressly determined that Quill's physical presence requirement is limited to sales and use taxes.

The Lanco decision allows New Jersey to adopt an "economic nexus" standard under which foreign (nondomiciled) corporations with no physical presence in New Jersey may find themselves subject to the New Jersey corporation business (income) tax merely because they license intangible property (e.g., trademarks, tradenames, copyrights, and patents) for use in New Jersey. Moreover, because New Jersey specifically allocates "royalties from the use in New Jersey of patents or copyrights" to New Jersey, such royalties would be treated as New Jersey sales for apportionment purposes. N.J. Admin. Code § 18:7-8.8(a)(4) (2006).

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Companies that *license* intangible property should evaluate their potential state tax exposure, whether such licenses are to affiliates or third parties. In addition, companies that *sell* intangible property to buyers who use the intangibles in New Jersey or other states that have adopted an economic nexus standard should ensure that such sales are properly structured and immune from re-characterization as licenses that would create economic nexus between the taxing state and the would-be seller. Acquiring companies should be sensitive to economic nexus when evaluating the liabilities of potential acquisition targets. Finally, companies should consider how the analysis in Lanco might be extended to assert nexus based on such non-licensing activities as related-party lending, which also creates revenue through intangible property.

Continuing the trend of the economic nexus standard for corporate income taxation, the Massachusetts Appellate Tax Board has recently rendered decisions for the Commissioner in a pair of cases that may have involved an economic nexus issue. In Capital One Bank v. Comm’r of Revenue, ATB Docket No. C262391 (decided Oct. 13, 2006), and Capital One FSB v. Comm’r of Revenue, ATB Docket No. C262598 (decided Oct. 13, 2006), the taxpayers asserted that they had no physical presence in Massachusetts, though this assertion has yet to be confirmed in a findings of fact and report. The parties in both cases have requested that the Board issue findings of fact and report. The Board has presumably concluded that financial institutions with no physical presence in Massachusetts may be subject to the Massachusetts corporation excise if they derive income from Massachusetts sources, but companies and their advisors need to await the Board’s opinions to learn its reasoning.

It remains to be seen whether the Lanco decision will prompt the U.S. Supreme Court to settle the question of whether physical presence is a prerequisite to jurisdiction with respect to levies other than sales and use

taxes. In the meantime, Congress has considered legislation that would create a bright-line physical presence nexus requirement in order for states to collect net income taxes or other business activity taxes on multistate enterprises, but it did not act on such legislation during the last session. See Business Activity Tax Simplification Act of 2006, H.R. 1956, 109th Congress (2d Sess. 2006); see *also* H.R. Rep. No. 109-575 (2006).