No. 83579-9

SUPREME COURT
OF THE STATE OF WASHINGTON

LAMTEC CORPORATION,

Petitioner,

v.

DEPARTMENT OF REVENUE,
STATE OF WASHINGTON,

Respondent.

LAMTEC CORPORATION'S SUPPLEMENTAL BRIEF

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Constitutional Provisions

I. SUMMARY OF ARGUMENT

The Court of Appeals decision is contrary to the dormant Commerce Clause of the Constitution of the United States because Lamtec Corporation ("Lamtec") does not have a substantial nexus to Washington. Under controlling United States Supreme Court precedent, to satisfy the substantial nexus requirement, a taxpayer must have a physical presence in a state like Washington. Lamtec had no physical presence in Washington or any contact with Washington other than shipping its products into the state and occasionally visiting its existing customers. It had no office or sales staff here. Lamtec's activities were not reasonably related to sales within the state because it has directed no advertising to Washington, has mailed no catalogues or other business solicitation to potential customers in Washington, and has neither solicited nor accepted any orders for its products from existing customers in Washington. Imposing a tax on an out-of-state business, based on nothing more than occasional visits to Washington, violates the dormant Commerce Clause.

Lamtec requests that this Court reverse the Court of Appeals and award Lamtec a refund of the taxes it has paid to the Department of Revenue (the "Department").

II. ARGUMENT

A. The Commerce Clause Prohibits Taxing Lamtec.

States may not interfere with interstate commerce under the dormant Commerce Clause. However, the Department has done exactly that by extending its reach and imposing a tax on Lamtec, a corporation headquartered in New Jersey, only because it sent occasional visitors to Washington. The Commerce Clause expressly authorizes Congress to "regulate Commerce with foreign Nations, and among the several States." U.S. CONST. art. I, § 8, cl. 3. The Commerce Clause also contains a "negative" or "dormant" component that prohibits state actions that interfere with interstate commerce. *See Quill Corp. v. North Dakota*, 504 U.S. 298, 309, 112 S. Ct. 1904, 119 L. Ed. 2d 91 (1992), *citing South Carolina State Highway Dept. v. Barnwell Bros., Inc.*, 303 U.S. 177, 185, 58 S. Ct. 510, 514, 82 L. Ed. 734 (1938). The fact that Congress has the ability under the Commerce Clause to regulate interstate commerce also means that states cannot interfere with interstate commerce.

1. A physical presence in the taxing jurisdiction is constitutionally required for the imposition of a tax on an out-of-state entity.

The primary issue here is whether Lamtec has a sufficient nexus with Washington State for the Department to impose B&O tax on Lamtec.

Washington's B&O tax is a fee for the privilege of doing business in the state. RCW 82.04.220 (2009).[1] However, Lamtec's only contact with Washington was to ship its products to customers in this state by common carrier and to occasionally visit its existing customers, without taking orders or soliciting business from new customers.

The United States Supreme Court holds that a business must have a physical presence in a state in order to be subject to tax by that state. *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753, 758, 87 S. Ct. 1389, 18 L. Ed. 2d 505 (1967) (Illinois could not tax a mail order company with no physical presence in the state). The United States Supreme Court affirmed this holding in *Quill*, 504 U.S. at 309.

2. <u>*Quill* is still good law</u>.

The Department is wrong that the United States Supreme Court has overruled the physical presence requirement. In fact, *Quill* was based in large part on the value of *stare decisis* and was a reaction to the North Dakota Supreme Court taking it upon itself to overrule the United States Supreme Court in *Bellas Hess*:

[1] The legislature amended this statute in the 2010 1st Special Session, adding the term "substantial nexus" and newly defining that term. 2010 Laws ch. 23 (S.S.S.B. No. 6143). Whether the new definition is constitutional is not before the Court in the present case.

> In this case, the Supreme Court of North Dakota declined to follow *Bellas Hess* because "the tremendous social, economic, commercial, and legal innovations" of the past quarter-century have rendered its holding "obsole[te]." 470 N.W.2d 203, 208 (1991). . . . [W]e must either reverse the State Supreme Court or overrule *Bellas Hess*. While we agree with much of the state court's reasoning, we take the former course.

Quill, 504 U.S. at 301-02. This statement makes clear that only the United States Supreme Court or Congress can change prior rulings under the Commerce Clause. Justice Scalia, in his concurrence in *Quill*, which was joined by Justices Kennedy and Thomas, saw fit to emphasize this point:

> "If a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, the Court of Appeals should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions."

Quill, 504 U.S. at 320 (Scalia, J. concurring) (quoting *Rodriguez de Quijas v. Shearson/American Exp., Inc.*, 490 U.S. 477, 484, 109 S. Ct. 1917 (1989)).

Before *Quill*, the United States Supreme Court held that the "crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales."[2] *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 250, 107 S. Ct. 2810, 97 L. Ed. 2d 1999 (1987). The Department wrongly argues that a physical presence is not required for the nexus requirement under *Tyler Pipe* as long as there is some contact with the taxing state that is "significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales" under *Tyler Pipe*. 483 U.S. at 250. This reasoning ignores *Quill*, and in any event, *Tyler Pipe* is not inconsistent with the physical presence requirement later affirmed in *Quill*. *Tyler Pipe* did not address whether a physical presence was required to meet the "substantial nexus" requirement. The issue did not arise because Tyler Pipe had an independent contractor located in Seattle who solicited business. *Tyler Pipe*, 483 U.S. at 249. Tyler Pipe therefore met the physical presence test, unlike Lamtec which had no employees or independent contractors located in the state. In any event, *Quill* affirmed that the dormant Commerce Clause nexus analysis requires

[2] The U.S. Supreme Court has outlined a four-pronged test to determine whether a state tax can withstand a challenge under the Commerce Clause. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S. Ct. 1076, 51 L.Ed.2d 326 (1977). For the imposition of a tax on an out-of-state corporation not to violate the Commerce Clause the tax (1) must be applied to an activity with a substantial nexus with the taxing state; (2) must be fairly apportioned; (3) must not discriminate against interstate commerce; and (4) must be fairly related to the services provided by the State. *Complete Auto Transit, Inc.*, 430 U.S. at 279. The first prong is at issue here.

a taxpayer to have a physical presence to be subject to a state's tax since *Tyler Pipe*. *Quill Corp.*, 504 U.S. at 317-318.

The Department has acknowledged that the physical presence test constitutes a bright line, but argues that Lamtec's occasional visits to Washington constitute a physical presence. The Department has not cited any authority for this. In fact, case law supports precisely the opposite: occasional visits to a jurisdiction, without a constant local presence does not create a substantial nexus for imposing a state tax on an out-of-state business. *See e.g., Quill*, 504 U.S. at 315 (requiring a "small sales force, plant, or office"); *Scripto v. Carson*, 362 U.S. 207, 211, 80 S. Ct. 619, 621, 4 L. Ed. 2d 660 (1960) (requiring a "continuous local solicitation").

The United States Supreme Court has repeatedly focused on whether a continuous physical presence in the state existed to meet the "substantial nexus" requirement. For example, in *National Geographic v. California Equalization Bd.*, the Supreme Court held that California's imposition of a use tax liability on the Society's mail-order operation. A substantial nexus was present because the Society had two offices in the State of California. *National Geographic v. California Equalization Bd.*, 430 U.S. 551, 556, 97 S. Ct. 1386, 51 L. Ed.2d 631 (1977). Similarly, in *Standard Steel Co. v. Washington Revenue Dept.*, one of Standard's employees maintained an office in Washington. *Standard Steel Co. v. Washington Revenue Dept.*, 419 U.S. 560, 95 S. Ct. 706, 42 L. Ed. 2d 719 (1975). In contrast, Lamtec does not have any offices in Washington.

In the absence of an in-state plant or office, substantial nexus has been found to exist only when the foreign vendor maintains "continuous local solicitation" within the state. *Scripto*, 362 U.S. at 211; *National Geographic*, 430 U.S. at 557; *Bellas Hess*, 386 U.S. at 757. In *Scripto*, a Georgia corporation sold certain mechanical writing instruments to Florida residents. Scripto did not own or lease any office or plant in Florida. However, the corporation had written contracts with 10 sales "brokers," who were residents of Florida. The detailed contracts described the brokers as representatives of "Scripto for the purpose of attracting, soliciting and obtaining Florida customers." Although the salespeople were independent contractors, they provided Scripto with "continuous local solicitations in Florida," which satisfied the substantial nexus requirement. *Scripto*, 362 U.S. at 211. This sharply contrasts with Lamtec's activities in Washington, which did not involve local solicitations or any local sales people.

The holding of *Quill* still stands. Lamtec anticipates that the Department will contend that *Quill* is limited to sales and use taxes. That argument is unsupported. Since *Quill*, the United States Supreme Court has declined opportunities to revise the physical presence requirement by denying certiorari for cases that sought to clarify whether *Quill*'s holding extends to taxes other than sales and use taxes.[3] Other courts have determined that *Quill*'s physical presence requirement extends to state taxes other than sales and use taxes. *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 838 (Tenn. Ct. App. 1999) (holding that *Quill*'s physical presence test applies to all Commerce Clause evaluations) (set forth as Appendix B)[4] In *J.C. Penney*, the taxpayer was an out-of-state corporation with no offices or agents in Tennessee and did not engage in any activities within the state. *J.C. Penney Nat'l Bank*, 19 S.W.3d at 839. The court rejected the argument that *Quill* was distinguishable:

> Both *Bellas Hess* and *Quill* are clear in their holding that in the context of a use tax, physical presence is required in order to satisfy the substantial nexus requirement of *Complete Auto*.
>
> The only real issue is whether there is any reason to distinguish the present case from

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[3] *See, e.g. Lanco, Inc. v. Dir., Div. of Taxation (Lanco II)*, 908 A.2d 176 (N.J. 2006) *cert. denied*, 127 S. Ct. 2973 (2007); *A & F Trademark*, 605 S.E.2d 187, *cert. denied*, 126 S. Ct. 353 (2005); *Geoffrey Inc.*, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993); *Tax Comm'r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226 (W.Va. 2006), *cert. denied*, 127 S. Ct. 2997 (2007).

[4] *But see Geoffrey, Inc. v. South Carolina*, 313 S.C. 15, 437 S.E.2d 13 (S.C. 1993) (limiting *Quill* to tax and use cases).

> *Bellas Hess* and *Quill*. The Commissioner argues that those cases are distinguishable because they involved use taxes, whereas the present case involves franchise and excise taxes. We must reject the Commissioner's argument. While it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case. In fact, the Commissioner is unable to provide any authority as to why the analysis should be different for franchise and excise taxes.

Id. at 839.

This Court should follow the sound reasoning of *J.C. Penney Nat'l Bank* and hold that a physical presence is required for constitutional nexus, regardless of whether the tax is a use tax or another excise tax, such as a B&O tax. For a tax to survive dormant Commerce Clause analysis, the taxpayer must have a substantial nexus to the taxing jurisdiction, which requires a physical presence in Washington.

3. <u>The Court of Appeals erred by not applying the physical presence test.</u>

The Court of Appeals was wrong not to apply the physical presence test to the facts in the present case, and erred in its reading of this issue in earlier Washington decisions. Notably, in *General Motors*, when Division I declined to extend the "physical presence" test, the holding was limited to the factual context of that case where the automakers were exploiting the market, regardless of where they were physically located. *General Motors v. City of Seattle*, 107 Wn. App. 42, 55, 25 P.3d 1022 (2001).

General Motors owned property in Seattle.[5] *Id.* at 47. Significantly, General Motors had relationships with numerous dealerships in Seattle. *Id.* General Motors' numerous direct contacts with Seattle involved aggressive direct marketing, including direct advertising "in the sum of just under $6 million annually" and "approximately 500 contacts per year to Seattle dealerships." *Id.* at 46. General Motors also sold warranties on new cars through its Seattle dealers to Seattle customers. *Id.*

Here, there is no evidence that Lamtec was "exploiting the market" in any way equivalent to General Motors' exploitation of the Seattle market. Instead, Lamtec's only contact with Washington was through its representatives who very occasionally met with its customers. CP 25. None of the other factors, such as owning property, having employees or contractors within the State, targeted advertising, or placing or accepting orders occurred in Washington. CP 24-25.

The "physical presence" test requires the presence of a "small sales force, plant, or office" within the taxing state. *Quill*, 504 U.S. at 315.

[5] Although "it was not established that the property factored into the sales or marketing of GM products in any way." *General Motors*, 107 Wn. App. at 47.

Here, Lamtec had no sales force, plant, or office. CP 24-25. Lamtec did not advertise by radio, television, or direct mail in Washington. Its only "presence" was through the brief social meetings its representatives had with existing customers. CP 25. At those meetings, no sales orders were solicited or accepted. CP 25. Under the reasoning in *Quill* and *J.C. Penney*, Lamtec would not have a "physical presence" in the state to establish a substantial nexus between its activities and Washington. Thus, Washington would not be permitted to tax it based on its very minimal contacts.

The Court of Appeals misinterpreted Lamtec's contacts with Washington and failed to apply the United States Supreme Court's "physical presence test" to those facts. The Department's imposition of tax on Lamtec fails under this test because it is undisputed that Lamtec does not have a physical presence in the state.

4. <u>Lamtec does not have a substantial nexus with Washington, because its activities did not bear a reasonable relationship to sales in Washington</u>.

Lamtec's activities also do not meet the threshold of a substantial nexus with Washington. The analysis in *City of Tacoma v. Fiberchem, Inc.*, 44 Wn. App. 538, 722 P.2d 1357 (1986) is instructive. Like the present case the taxpayer in *Fiberchem* did not advertise, had no office, took no orders, and made no deliveries to Tacoma. *Fiberchem, Inc.*, 44 Wn. App. at 540. Its sole contact was with a representative who made visits to Tacoma approximately 12 hours per month. *Fiberchem, Inc.*, 44 Wn. App. at 540. The few activities that Fiberchem performed in Tacoma did not "bear any fair and reasonable relation to the proceeds of sales to Tacoma customers." *Fiberchem, Inc.*, 44 Wn. App. at 545. Further, "the sales activity that directly generated proceeds was almost entirely conducted by telephone communication to Tukwila initiated by Tacoma customers" and "the major portion of the little time spent by salespeople in Tacoma as they passed through the city was spent with a very small segment of its Tacoma customers." *Fiberchem, Inc.*, 44 Wn. App. at 545. The court ultimately held that "Fiberchem's activities in Tacoma were so minimal that a taxation of those activities for 'engaging in business' there could not be justified consistently with due process." *Fiberchem, Inc.*, 44 Wn. App. at 545.

In *Fiberchem*, the Court of Appeals stated that it based its holding on a Due Process analysis. However, contrary to the Court of Appeals' decision in the present matter, the *Fiberchem* analysis is highly relevant to the present situation because "[t]he Commerce Clause requires a greater relationship than does the Due Process Clause." *J.C. Penney Nat. Bank*, 19 S.W.3d 831, *see also Quill Corp.*, 504 U.S. at 313. While the analysis here is under the Commerce Clause, not the Due Process Clause as in *Fiberchem*, if a Due Process violation was found, it is highly likely that a Commerce Clause violation would also be found because the Commerce Clause requires a greater relationship with the jurisdiction than does the Due Process Clause.

Each of the cases relied upon by the Court of Appeals is inapposite because the taxpayer had significantly more contact and a much more substantial nexus with the taxing jurisdiction than Lamtec does to Washington. In each of these cases, the taxpayer engaged in activities that would reasonably lead to sales in the taxing jurisdiction, unlike the present case.

For example, in *Ford Motor Co. v. City of Seattle Exec. Svcs. Dep't*, 160 Wn.2d 32, 156 P.2d 185 (2007), this Court held that a B&O tax could be imposed on Ford by the cities of Seattle and Tacoma. However, Ford's contacts with the state were substantially greater than Lamtec's contacts. Ford had an office in Bellevue, Washington. *Ford Motor Co.*, 160 Wn.2d at 38. Lamtec neither owns nor leases any property in Washington. CP 24-25. Ford sold cars, parts, and accessories to independent dealers in Seattle and Tacoma. It also, sent "representatives to meet with its dealers and their part managers, imparting information about new products, discussing problems and customer satisfaction concerns, and marketing and selling warranties on its automobiles." *Ford Motor Co.*, 160 Wn.2d at 38. Most critically, Ford spent huge resources on national advertising designed to impact the Washington market.

Aside from the three Lamtec representatives and their periodic social-type visits to the state, who sold nothing in Washington and only met with existing customers, Lamtec has not engaged in any of the other activities used as bases to establish a substantial nexus with Ford. CP 24-25. Lamtec is hardly in Ford's league in terms of advertising its products in Washington.

In *General Motors*, the Court of Appeals, upheld Seattle's B&O tax when GM "exploited" the market in the city. *General Motors*, 107 Wn. App. at 55. The court held that GM's business activities were intended to maintain a share of the Seattle market. *General Motors*, 107 Wn. App. at 46-47. GM's activities included the expenditure of huge national advertising dollars directed at Seattle, marketing and selling warranties, sending sales, service, and parts representatives on a monthly basis to visit Seattle dealers, and requiring dealers to use large, permanent signage. *General Motors*, 107 Wn. App. at 46-47. The dealers also marketed GM's warranties and made service repairs at the dealerships on behalf of the automaker. *General Motors*, 107 Wn. App. at 52. Lamtec has engaged in none of these activities, other than having its representatives pay occasional visits to its existing customers. CP 24-25.

In *Tyler Pipe*, the taxpayer was an out-of-state manufacturer that made wholesale sales to Washington companies. *Tyler Pipe Industries, Inc.* 483 U.S. at 249. It solicited business through an independent contractor located within Washington and through out-of-state executives. *Tyler Pipe Industries, Inc.* 483 U.S. at 249. The Court held that by soliciting business through a contractor located in Washington, Tyler Pipe improved its name recognition, goodwill, and individual customer relations. *Tyler Pipe Industries, Inc.* 483 U.S. at 249-250. Its independent contractor "acted daily on behalf of Tyler Pipe in calling on its customers and soliciting orders." *Tyler Pipe Industries, Inc.* 483 U.S. at 249-250.

Lamtec's contacts were far more minimal. The three Lamtec representatives that met with customers in Washington never solicited orders. CP 25. Lamtec directed no advertising to Washington. Moreover, Lamtec's representatives' contact with Lamtec's customers were occasional, not the daily contact that Tyler Pipe's representatives had with its customers. The Court found that the crucial factor supporting

Washington's jurisdiction to impose taxes was that the sales representatives' activities, allowing the taxpayer to establish and maintain a market, actually took place in Washington. *Tyler Pipe Industries, Inc.* 483 U.S. at 250-51. Lamtec's contacts with Washington did not.

The distinction between *Ford*, *General Motors*, *Tyler Pipe* and *Fiberchem*, is that in the first three cases, the activities within the taxing jurisdiction had an actual relationship to sales within that jurisdiction, but in *Fiberchem*, as in the present case, the activities did not "bear any fair and reasonable relation" to making sales within the taxing jurisdiction. *Fiberchem, Inc.*, 44 Wn. App. at 545. In an almost identical fact pattern to *Fiberchem*, Lamtec does not advertise, has no office, takes no orders, and makes no deliveries while in Washington. CP 24-25. It has representatives who spend minimal time in the state. CP 25. This distinction is a helpful one for this Court to look to when fashioning a rule in this case, in the event it rejects the physical presence test.

B. <u>Public Policy Supports Drawing Reasonable Limits on the State's Taxation Power.</u>

The facts of the present case demonstrate the absurd results from imposing B&O tax on an out-of-state corporation with minimal contacts with the taxing state: a $71,566.12 tax liability for occasional visits to existing customers. There is a constitutionally insufficient nexus between

Lamtec's activities and the State of Washington for the imposition of Washington's B&O tax. The Court of Appeals' decision distorts the "substantial nexus" test into an "any possible nexus" test because even the most minimal contact would seemingly allow an out-of-state entity to be taxed by Washington. If the Department's assessment of B&O taxes is adopted and applied throughout the United States, Lamtec and other corporations like it, would be subject to business taxation in virtually every state. There would be few, if any circumstances, where the states would not be allowed to impose B&O tax.

III. CONCLUSION

For the reasons explained above, Lamtec requests that this Court reverse the Court of Appeals' and trial court's decisions, and hold that Lamtec's contacts with Washington do not establish a substantial nexus with the State to allow imposition of the B&O tax on it. The dormant Commerce Clause requires a physical presence in the state in order for there to be substantial nexus between an out-of-state entity like Lamtec and Washington. In the alternative, at a minimum, the out-of-state entity must have engaged in activities within Washington that bear a fair and reasonable relation to the proceeds of sales to Washington customers, for the out-of-state business to be considered to be "engaging in business" for the purposes of imposing B&O tax. Lamtec does not meet either threshold for a substantial nexus with Washington, and this Court should reverse the Court of Appeals and costs on appeal should be awarded to Lamtec.

RESPECTFULLY SUBMITTED this 6th day of May, 2010.

Respectfully submitted,

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APPENDIX

A. *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (2000).

CERTIFICATE OF SERVICE

The undersigned declares under penalty of perjury, under the laws of the State of Washington, that the following is true and correct: on May 7, 2010, I caused to be delivered by email and U.S. Mail, a true and correct copy of Lamtec Corporation's Supplemental Brief addressed to:

Peter B. Gonick Attorney General's Office/ Revenue Division P.O. box 40123 Olympia, WA 98504-0123 mailto:peterg@atg.wa.gov	Philip Albert Talmadge Talmadge/Fitzpatrick 18010 Southcenter Parkway Tukwila, WA 98188-4630

DATED this 7 day of May, 2010, at Seattle, Washington.

E. Ross Farr

APPENDIX

FILED AS
ATTACHMENT TO EMAIL

Westlaw.

Court of Appeals of Tennessee,
Western Section, at Nashville.
J.C. PENNEY NATIONAL BANK, Plaintiff/Appellant,
v.
Ruth E. JOHNSON, Commissioner of Revenue, State of Tennessee, Defendant/Appellee.
Dec. 17, 1999.
Application for Permission to Appeal Denied by Supreme Court May 8, 2000.

Out-of-state bank brought action against the Commissioner of Revenue to challenge the constitutionality of franchise and excise taxes on its credit card business. The Chancery Court, Davidson County, Ernest Pellegrin, Special Chancellor, upheld the taxes. Bank appealed. The Court of Appeals, Highers, J., held that: (1) the bank was not physically present in the state and, thus, lacked a substantial nexus necessary for the taxes to satisfy the Commerce Clause, and (2) the taxes satisfied the Due Process Clause.

Reversed.

West Headnotes

[1] Commerce 83 ⚷62.71

83 Commerce
83II Application to Particular Subjects and Methods of Regulation
83II(E) Licenses and Taxes
83k62.70 Taxation in General
83k62.71 k. In General. Most Cited Cases

Constitutional Law 92 ⚷4135

92 Constitutional Law
92XXVII Due Process
92XXVII(G) Particular Issues and Applications
92XXVII(G)6 Taxation
92k4135 k. In General. Most Cited Cases
(Formerly 92k281.5)
A state's power to tax may be sustained under the Due Process Clause, but imposition of the tax may nonetheless violate the Commerce Clause. U.S.C.A. Const. Art. 1, § 8, cl. 3; U.S.C.A. Const.Amend. 14.

[2] Constitutional Law 92 ⚷4135

92 Constitutional Law
92XXVII Due Process
92XXVII(G) Particular Issues and Applications
92XXVII(G)6 Taxation
92k4135 k. In General. Most Cited Cases
(Formerly 92k281.5)

Constitutional Law 92 ⚷4137

92 Constitutional Law
92XXVII Due Process
92XXVII(G) Particular Issues and Applications
92XXVII(G)6 Taxation
92k4136 Property Taxes
92k4137 k. In General. Most Cited Cases
(Formerly 92k281.5)
The Due Process Clause requires some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax. U.S.C.A. Const.Amend. 14.

[3] Constitutional Law 92 ⚷4140

92 Constitutional Law
92XXVII Due Process
92XXVII(G) Particular Issues and Applications
92XXVII(G)6 Taxation
92k4140 k. Franchise Taxes. Most Cited Cases

(Formerly 92k283)

Constitutional Law 92 ⚷4141

92 Constitutional Law
92XXVII Due Process
92XXVII(G) Particular Issues and Applications
92XXVII(G)6 Taxation
92k4141 k. Excise Taxes. Most Cited Cases
(Formerly 92k283)

Taxation 371 ⚷2242

371 Taxation
371III Property Taxes
371III(D) Corporations and Corporate Stock and Property
371k2242 k. Financial Institutions. Most Cited Cases
(Formerly 371k165)

Taxation 371 ⚷3486

371 Taxation
371VIII Income Taxes
371VIII(D) Persons Liable
371k3486 k. Foreign Corporations. Most Cited Cases
(Formerly 371k165)
Imposing franchise and excise taxes on out-of-state bank did not violate due process despite the bank's lack of a physical presence in the state. U.S.C.A. Const.Amend. 14.

[4] Commerce 83 ⚷12

83 Commerce
83I Power to Regulate in General
83k11 Powers Remaining in States, and Limitations Thereon
83k12 k. In General. Most Cited Cases
Under the negative or dormant Commerce Clause, the grant of specific power to Congress to regulate interstate commerce necessarily carries the negative implication that the states may not act to interfere with interstate commerce. U.S.C.A. Const. Art. 1, § 8, cl. 3.

[5] Constitutional Law 92 ⚷4145

92 Constitutional Law
92XXVII Due Process
92XXVII(G) Particular Issues and Applications
92XXVII(G)6 Taxation
92k4145 k. Sales and Use Taxes. Most Cited Cases
(Formerly 92k281.5)
An out-of-state seller's substantial nexus with a taxing state under the Commerce Clause is not the same as minimum contacts under the Due Process Clause. U.S.C.A. Const. Art. 1, § 8, cl. 3; U.S.C.A. Const.Amend. 14.

[6] Commerce 83 ⚷62.71

83 Commerce
83II Application to Particular Subjects and Methods of Regulation
83II(E) Licenses and Taxes
83k62.70 Taxation in General
83k62.71 k. In General. Most Cited Cases

Constitutional Law 92 ⚷4145

92 Constitutional Law
92XXVII Due Process
92XXVII(G) Particular Issues and Applications
92XXVII(G)6 Taxation
92k4145 k. Sales and Use Taxes. Most Cited Cases
(Formerly 92k281.5)
The Commerce Clause imposes a greater limitation on a state's right to tax an out-of-state seller than does the Due Process Clause. U.S.C.A. Const. Art. 1, § 8, cl. 3; U.S.C.A. Const.Amend. 14.

[7] Commerce 83 ⚷63.10

83 Commerce

83II Application to Particular Subjects and Methods of Regulation
83II(E) Licenses and Taxes
83k63 Licenses and Privilege Taxes
83k63.10 k. Particular Subjects and Taxes. Most Cited Cases

Taxation 371 ⟹2242

371 Taxation
371III Property Taxes
371III(D) Corporations and Corporate Stock and Property
371k2242 k. Financial Institutions. Most Cited Cases
(Formerly 371k165)

Taxation 371 ⟹3486

371 Taxation
371VIII Income Taxes
371VIII(D) Persons Liable
371k3486 k. Foreign Corporations. Most Cited Cases
(Formerly 371k165)
Out-of-state bank's presence had to be more than merely doing business in the state in order for franchise and excise taxes to satisfy the Commerce Clause. U.S.C.A. Const. Art. 1, § 8, cl. 3; T.C.A. §§ 67-4-806(d)(2), 67-4-903(f)(2) (Repealed).

[8] Commerce 83 ⟹63.10

83 Commerce
83II Application to Particular Subjects and Methods of Regulation
83II(E) Licenses and Taxes
83k63 Licenses and Privilege Taxes
83k63.10 k. Particular Subjects and Taxes. Most Cited Cases

Taxation 371 ⟹2242

371 Taxation
371III Property Taxes
371III(D) Corporations and Corporate Stock and Property
371k2242 k. Financial Institutions. Most Cited Cases
(Formerly 371k165)

Taxation 371 ⟹3486

371 Taxation
371VIII Income Taxes
371VIII(D) Persons Liable
371k3486 k. Foreign Corporations. Most Cited Cases
(Formerly 371k165)
Out-of-state bank that issued credit cards to state residents was not physically present in the state and, thus, lacked a substantial nexus necessary for franchise and excise taxes to satisfy the Commerce Clause, even though the bank owned the cards, its parent corporation owned retail stores in the state, and affiliates solicited business through the mail; the accounts in another state, not the cards, were the real assets, the stores were not affiliated with the credit card operations, and the bank had no offices or agents in the state. U.S.C.A. Const. Art. 1, §8 , cl. 3.
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John Robert Jacobson, Bowen, Riley, Warnock & Jacobson, Nashville, TN, Linda Arnsbarger, Paul H. Frankel, Neil I. Pomerantz, Thomas H. Steele, Morris & Foerster, LLP, Washington, DC, for Amicus Curiae Visa U.S.A. Inc. and MasterCard International, Inc.

HIGHERS, J.

The J.C. Penney National Bank appeals from the Chancery Court of Davidson County, which upheld the imposition of franchise and excise taxes against the Bank by the Tennessee Department of Revenue. For the reasons stated herein, we reverse the decision of the trial court.

Facts and Procedural History

At all relevant times, the J.C. Penney National Bank [FN1] ("the National Bank" or "JCPNB") was a federally chartered national banking association incorporated under the laws of Delaware with its principal place of business and commercial domicile in Harrington, Delaware. Ruth E. Johnson ("Commissioner") was the Commissioner of Revenue for the State of Tennessee and was named in this case in her official capacity. The present appeal arises from the Commissioner's imposition of franchise and excise taxes against JCPNB on income allegedly generated by JCPNB's credit card activities in the State of Tennessee. In order to clarify the positions of the respective parties, we find it necessary briefly to describe, perhaps to the point of oversimplification, the various entities and procedures involved in JCPNB's credit card business.

FN1. The National Bank was acquired by the J.C. Penney Company, Inc. in 1983.

Through its Delaware offices, JCPNB offers consumer banking services such as deposit accounts, home mortgage lending, general consumer loans, and automated teller machine ("ATM") services. In addition to the normal banking services which it provides, JCPNB engages in credit card lending through the issuance of Visa and MasterCard credit cards.[FN2] JCPNB has ***833** been issuing Visa credit cards since 1983, and MasterCard credit cards since 1984.

FN2. We stress, as does the appellant, that JCPNB's Visa and MasterCard credit card business exists independent of the J.C. Penney Company's "proprietary card business." Visa and MasterCard are membership corporations consisting of member banks throughout the United States and the world, formed to facilitate the use of credit cards. While the Visa and MasterCard cards issued by JCPNB may be used at many locations, the proprietary card issued by J.C. Penney may only be used at J.C. Penney retail stores.

JCPNB contracted with the J.C. Penney Company, its parent company, to perform various marketing and processing services that were necessary to create and maintain JCPNB's credit card business. Under that contract, the J.C. Penney Company agreed to provide services such as credit card solicitation, marketing, statement and payment processing, customer service, and collection. The J.C. Penny Company, in turn, contracted with other companies to provide many of these services.

The J.C. Penney Company contracted with Maryland Bank National Association ("MBNA"), an unrelated corporation domiciled in Texas, to provide the data processing related to the National Bank's credit card business. MBNA is a company that offers credit card processing services to a variety of banks. As transactions were received through the Visa or MasterCard network, MBNA posted them to the appropriate cardholder account. MBNA was also responsible for sending out account statements each month.

The J.C. Penney Company also contracted with Business Services, Inc. ("BSI"), a wholly owned subsidiary, to provide general marketing and payment processing services.[FN3] After MBNA sent monthly statements to the cardholders, the cardholders would send their payments to a BSI payment processing center in San Antonio, Texas. Also, as part of its marketing responsibilities, BSI solicited credit card accounts on behalf of JCPNB. These solicitations were sent via U.S. Mail to potential customers throughout the United States, including Tennessee.[FN4] As the first step in the solicitation process, BSI obtained the names of possible customers. Some names were obtained from a list of people who had a prior credit history with the J.C. Penney Company. BSI also obtained potential customer names through the use of mailing lists from various credit bureaus.[FN5] BSI would then submit the list of potential cardholders to a national credit bureau who would select those people having a credit profile consistent with the criteria established by JCPNB. The selected people would then receive an offer to apply for a credit account with the National Bank.

FN3. In 1996, BSI was sold to an unrelated third party and became Alliance Data Systems, Inc. After the sale, Alliance continued to provide the same services for JCPNB at the same prices and on the same terms.

FN4. There was, however, no solicitation which specifically targeted Tennessee residents.

FN5. Local credit bureaus in Tennessee are operated as for-profit corporations or as non-profit corporations formed by local merchants for the purpose of assembling necessary credit information for the merchants to engage in credit transactions. Local merchants who are members of a credit bureau provide their credit files to the local credit bureau of which they are a member. The local bureau is usually an affiliate of one of the three national automated consumer reporting agencies (Transunion, TRW, or Equifax). The local credit bureau forwards the local creditors' account information to its national consumer reporting affiliate. The national agency incorporates this credit information into its existing credit files. When JCPNB contracted with national credit reporting agencies, it did so through contracts negotiated with the agencies' national offices, which were outside of Tennessee.

None of the activities described above occurred in the State of Tennessee, other than the solicitations being mailed to Tennessee residents. Also, all of the entities involved in the National Bank's credit card operation were located outside the State of Tennessee.[FN6] JCPNB itself maintained no offices or places of business in Tennessee, nor did it have any employees in the State.

FN6. The J.C. Penney Company does own and operate the J.C. Penney retail stores that are located in Tennessee. However, as will be dealt with in more detail later, those stores were not involved in the National Bank's credit card business.

The Visa and MasterCard credit cards issued by the National Bank were "universal cards." This name derives from the ***834** fact that these cards could be used to purchase goods and services throughout the world from any retailer who displayed the Visa or MasterCard logo.[FN7] A credit card purchase may be made in two ways. The most common transaction occurs when the cardholder presents the card to a merchant and the merchant swipes the card through a point of sale terminal. The terminal reads the magnetic strip on the back of the card and transmits a request for authorization to the issuing bank. Another type of transaction can occur when the cardholder provides a merchant with his or her account number and expiration date, but does not physically present the card to the merchant. This type of transaction generally occurs when purchases are being made over the telephone or, in today's world, via the internet. In either case, a sales slip is generated which the merchant submits to a merchant bank with whom the merchant has a contract.[FN8] The merchant bank will then remit the transaction amount to the merchant minus a discount. The merchant bank may be located inside or outside Tennessee.

FN7. The cards may also be used to secure cash advances at participating Automated Teller Machines ("ATM's").

FN8. Merchant banks can be divided into two groups. One group is comprised of those banks which have entered into national contracts which cover all locations of a merchant throughout the United States. The other group of merchant banks is comprised of banks which have entered into contracts with individual Tennessee merchants to accept charge slips from Visa and MasterCard credit card transactions. JCPNB serves as a merchant bank for some merchants with store locations throughout the United States, including Tennessee. Under these agreements, each merchant has agreed to accept the Visa or MasterCard credit cards for purchases and JCPNB has agreed to accept the charge slips from these transactions for payment to the merchant's account. These agreements were negotiated between JCPNB and the merchant's corporate headquarters, rather than with a local outlet of a merchant. No such merchant had their corporate headquarters in Tennessee.

The merchant bank records the information from the sales slip and transmits the information to a VISA (USA) Inc. or MasterCard International, Inc. interchange center for the purpose of obtaining payment of the face amount of the slip, less an interchange fee, from the bank that issued the credit card, which, in this case, was JCPNB. Visa and MasterCard regularly inform JCPNB of the amount owed by it with respect to sales slips which have been submitted by all merchant banks. From Delaware, the National Bank transfers funds to pay these amounts.

The J.C. Penney National Bank charged an annual fee on most Visa and MasterCard credit card accounts, as well as interest and other fees in connection with the account. The National Bank then paid an income tax to the State of Delaware based upon 100% of the National Bank's net income. JCPNB had never filed a franchise or excise tax return with the Tennessee Department of Revenue, nor had it ever paid any franchise or excise taxes to the State of Tennessee. However, the Field Audit Division of the Tennessee Department of Revenue audited JCPNB in 1995 for the period of February 1990 through January 1994. On November 1, 1995, the Department of Revenue issued an assessment to the National Bank in the amount of $178,314, which included: $111,725 in franchise and excise taxes, $27,932 in penalties, and $38,657 in interest. The assessment was based on the determination that JCPNB was a "financial institution" as defined in T.C.A. § 67-4-804(a)(8) and was subject to franchise and excise taxation under T.C.A. §§ 67-4-806 and 67-4-903. In calculating the taxes, the Department of Revenue applied the single-factor, gross receipts apportionment formula applicable to financial institutions found in T.C.A. §§ 67-4-815 and 67-4-919.

In accordance with T.C.A. § 67-1-1801, the National Bank filed this action contesting the assessment of the franchise and excise taxes on three grounds: (1) the assessment violated the Commerce Clause *835 of the United States Constitution; (2) the assessment violated the Due Process Clause of the United States Constitution; and (3) basing the assessment upon the single receipts factor apportionment formula violated the Due Process Clause of the United States Constitution. The case was tried in the Chancery Court of Davidson County on February 9 and 10, 1998. The chancellor issued a memorandum opinion on October 16, 1998 upholding the assessment. The chancellor concluded that the assessment was not violative of the requirements of the Due Process Clause of the United States Constitution, and a sufficient nexus existed between the State of Tennessee and JCPNB to satisfy the requirements of the Commerce Clause. The Commissioner filed a motion to alter or amend the order because it did not provide for a judgment against JCPNB for the disputed tax liability and did not provide for an award of attorney's fees and expenses pursuant to T.C.A. § 67-1-1803(d). The chancellor entered a final order on December 7, 1998, awarding judgment in favor of the Commissioner in the amount of $178,314, as well as awarding attorney's fees and expenses to the Commissioner as the prevailing party. This appeal followed.

On appeal, JCPNB presents a single question for review. That question is whether JCPNB's relationship with the State of Tennessee satisfies the "substantial nexus" requirement of the Commerce Clause.

Law and Analysis

Financial institutions "doing business" in the State of Tennessee are subject to excise and franchise taxes pursuant to T.C.A. §§ 67-4-806(d)(2) [FN9] and 67-4-903(f)(2) [FN10]. The Commissioner contends that JCPNB's credit card activities come within the terms of the statutory provisions because JCPNB: (1) regularly solicits business from customers in Tennessee; (2) provides credit card services to its customers; (3) engages in transactions in which it extends credit to these customers; and (4) receives interest income and fee income from these transactions and loans. Appellee's Brief at p. 10. JCPNB, however, does not challenge the statutes pursuant to which the taxes were imposed. Rather, JCPNB contends that its contacts with the State of Tennessee, even if sufficient under the Tennessee statutory scheme, do not provide a sufficient nexus under the Commerce Clause of the United States Constitution to uphold the assessment.

FN9. (2) Additionally, a financial institution shall be deemed to be doing business in this state if the institution:

(A) Maintains an office in this state;

(B) Has an employee, representative or independent contractor conducting business in this state;

(C) Regularly sells products or services of any kind or nature to customers in this state that receive the product or service in this state;

(D) Regularly solicits business from potential customers in this state;

(E) Regularly performs services outside this state which are consumed in this state;

(F) Regularly engages in transactions with customers in this state that involve intangible property, including loans, and result in receipts flowing to the taxpayer from within this state;

(G) Owns or leases property located in this state; or

(H) Regularly solicits and receives deposits from customers in this state.

FN10. The language of this section is identical to T.C.A. § 67-4-806(d)(2).

I.

This case presents a question regarding the limits of Tennessee's power to tax out-of-state sellers. Constitutional limitations on this power are found in both the Due Process Clause of the Fourteenth Amendment and the Commerce Clause of article 1, § 8. In the trial court, JCPNB challenged the franchise and excise taxes as a violation of both constitutional provisions. On this appeal, JCPNB has limited its question presented to consideration of whether the taxes imposed by the State of Tennessee violates the Commerce Clause. ***836** However, JCPNB also claims that the Commissioner has "blurred the line" between Due Process and Commerce Clause analysis.

Some of the Commissioner's arguments do, in fact, confuse the analysis between the Commerce Clause and the Due Process Clause. For example, in arguing that JCPNB has a substantial nexus with the State of Tennessee, the Appellee's brief states:

"[JCPNB] is exercising the substantial privilege of doing business in Tennessee. On this basis, sufficient nexus exists and JCPNB is receiving the protections which establish a basis for finding of nexus." The Commissioner makes this statement after quoting a passage from *Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* 445 U.S. 425, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980).[FN11] However, the phrase "substantial privilege of doing business" is traditionally used in the area of due process. Additionally, the *Mobil Oil* case specifically used the language which Appellee quotes in the context of a Due Process analysis.[FN12] Therefore, recognizing the confusion that may exist between the parties, we find it necessary to clarify the specific limitations imposed by both Due Process and the Commerce Clause.

FN11. The quote, as it appears in Appellee's Brief, states:

> The requisite "nexus" is supplied if the corporation avails itself of the "substantial privilege of carrying on business" within the State; and "[t]he fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus with such a tax and transactions within a state for which the tax is an exaction.

FN12. The section in which the quoted language appears begins with the following statement: "For a state to tax income generated in interstate commerce, the Due Process Clause of the Fourteenth Amendment imposes two requirements: ..." *Mobil Oil,* 445 U.S. at 436, 100 S.Ct. 1223.

[1] In *Quill Corp. v. North Dakota,* the United States Supreme Court considered the constitutional limitations on a state's power to tax imposed by both the Due Process Clause and the Commerce Clause. 504 U.S. 298, 112 S.Ct. 1904, 119 L.Ed.2d 91 (1992). The Court began by noting that the "two claims are closely related." *Id.* (quoting *National Bellas Hess, Inc. v. Department of Revenue of Ill.,* 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d 505 (1967)). However, the Court also pointed out that the two Clauses each pose distinct limits on the taxing power of the States. *Quill,* 504 U.S. at 305, 112 S.Ct. 1904. Therefore, a State's power to tax may be sustained under the Due Process Clause, but imposition of the tax may nonetheless violate the Commerce Clause.[FN13] *Id.* (citing *Tyler Pipe Indus., Inc. v. Washington State Dept. of Revenue,* 483 U.S. 232, 107 S.Ct. 2810, 97 L.Ed.2d 199 (1987)).

FN13. In fact, the tax in *Quill* was struck down as violative of the Commerce Clause even though the Court found that the tax did not violate the requirements of the Due Process Clause.

II.

The due process analysis in the area of state taxation of interstate commerce derives from the rules for *in personam* jurisdiction expressed in *International Shoe Co. v. Washington,* and its progeny. 326 U.S. 310, 66 S.Ct. 154, 90 L.Ed. 95 (1945). *International Shoe,* the seminal case in the modern due process era, allows a state to assert personal jurisdiction if the defendant has minimum contacts with the jurisdiction "such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice." ' *International Shoe,* 326 U.S. at 316, 66 S.Ct. 154 (quoting *Milliken v. Meyer,* 311 U.S. 457, 463, 61 S.Ct. 339, 343, 85 L.Ed. 278 (1940)). Subsequent cases made clear the point that physical presence in the jurisdiction is not necessary for "minimum contacts" to exist. *See, e.g., Burger King Corp. v. Rudzewicz,* 471 U.S. 462, 105 S.Ct. 2174, 85 L.Ed.2d 528 (1985).

*837 [2] In the context of state taxation, the Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Quill,* 504 U.S. at 306, 112 S.Ct. 1904 (quoting *Miller*

Brothers Co. v. Maryland, 347 U.S. 340, 344-345, 74 S.Ct. 535, 539, 98 L.Ed. 744 (1954)). Prior to the 1967 decision in *National Bellas Hess, Inc. v. Department of Revenue. of Ill.,* 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d 505 (1967), the Supreme Court had found that "definite link" to exist in several cases involving state use taxes. However, the taxpayer in all those cases had some type of physical presence in the taxing state. *Quill* 504 U.S. at 306, 112 S.Ct. 1904. The *Quill* Court noted that the *Bellas Hess* decision suggested that physical presence in the State was *necessary* to sustain jurisdiction under the Due Process Clause. *See Quill* 504 U.S. at 306-307, 112 S.Ct. 1904. Applying the reasoning from the *International Shoe* and *Burger King* decisions, the *Quill* court rejected the notion that due process mandated the physical presence of an out-of-state seller before a state could tax that seller. The Court held that the Due Process Clause does not operate to bar enforcement of a use tax against a mail-order house "that is engaged in continuous and widespread solicitation of business within a state." *Quill,* 504 U.S. at 308, 112 S.Ct. 1904. In other words, if the contacts were sufficient to subject the corporation to personal jurisdiction in the forum state, then imposition of a use tax on the corporation's business in the state would be sustained in the face of a Due Process challenge. Physical presence in the state is not necessary. In so holding, the *Quill* Court noted the policy concerns that drive due process analysis. Specifically, the Court stated:

> Due process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him. We have, therefore, often identified "notice" or "fair warning" as the analytic touchstone of due process nexus analysis.

Quill, 504 U.S. at 312, 112 S.Ct. 1904.

[3] In the present case, the National Bank's relationship with the State of Tennessee was such that the imposition of the franchise and excise taxes was not precluded by due process considerations. The lack of a physical presence in Tennessee does not mandate a finding to the contrary. The following passage from *Burger King Corp. v. Rudzewicz,* cited by the *Quill* Court, is equally applicable in the present case:

> Jurisdiction in these circumstances may not be avoided merely because the defendant did not physically enter the forum State. Although territorial presence frequently will enhance a potential defendant's affiliation with a State and reinforce the reasonable foreseeability of suit there, it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted. So long as a commercial actor's efforts are 'purposefully directed' toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there.

Burger King, 471 U.S. at 476, 105 S.Ct. 2174. JCPNB has reached out to the citizens of the State of Tennessee through the solicitations for credit cards that were sent on its behalf. Moreover, JCPNB has purposefully availed itself of the substantial privilege of doing business in the State of Tennessee. *See id.* Clearly, the franchise and excise taxes assessed against JCPNB are not violative of the rights guaranteed under the Due Process Clause.

The Due Process Clause, however, is only the first consideration in determining ***838** whether a state may tax an out-of-state seller. Having recognized that the Due Process Clause does not preclude imposition of the franchise and excise taxes on JCPNB, we must consider the limitations imposed by the Commerce Clause.

III.

[4] The Commerce Clause expressly authorizes Congress to "regulate Commerce with foreign Nations, and among the several States." U.S. CONST. art. I, § 8, cl. 3. In addition to this affirmative grant of power, the "negative" or "dormant" Commerce Clause also serves to prohibit state actions that interfere with interstate commerce. *See Quill,* 504 U.S. at 309, 112 S.Ct. 1904 (citing *South Carolina State Highway Dept. v. Barnwell Bros., Inc.* 303 U.S. 177, 185, 58 S.Ct. 510, 514, 82 L.Ed. 734 (1938)). Simply stated, the fact that the Commerce Clause grants Congress the specific power to regulate interstate commerce necessarily carries the negative implication that the states may not act to interfere with interstate commerce.

The earliest cases in this area strictly limited the state's rights to tax interstate sales. *See, e.g., Leloup v. Port of Mobile,* 127 U.S. 640, 648, 8 S.Ct. 1380, 1384, 32 L.Ed. 311 (1888)("no state has the right to lay a tax on interstate commerce in any form"). Subsequent decisions by the Court moved away from the absolute limits imposed on state taxation and began to distinguish between "direct" and "indirect" burdens on interstate commerce. This line of cases culminated with the decision in *Freeman v. Hewit,* 329 U.S. 249, 67 S.Ct. 274, 91 L.Ed. 265 (1946), in which the Court formally embraced the distinction and struck down an Indiana tax as a direct tax on interstate sales.

Dormant Commerce Clause jurisprudence in the area of state taxation changed dramatically with the decision in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977). The *Complete Auto* decision rejected the line of cases which had held impermissible the direct taxation of interstate commerce by the states. [FN14] *Complete Auto* enunciated a four-part test, which provided that a state tax on an out-of-state seller will be sustained so long as the "tax (1) is applied to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the state." *Complete Auto Transit, Inc.* 430 U.S. at 279, 97 S.Ct. 1076.

FN14. As stated in *Quill,* the *Complete Auto* decision "renounced the *Freeman* approach as 'attaching constitutional significance to a semantic difference.'" *Quill,* 504 U.S. at 310, 112 S.Ct. 1904.

[5][6] The question in the present case is whether JCPNB's relationship with the State of Tennessee satisfies the "substantial nexus" requirement found in the first prong of the *Complete Auto* test. That question, in turn, raises the question of what is meant by the term "substantial nexus." As an initial matter, we can say that substantial nexus under the Commerce Clause is not the same as minimum contacts under the Due Process Clause. *See Quill,* 504 U .S. at 313, 112 S.Ct. 1904 ("Thus, the 'substantial nexus' requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce"). Although stating that proposition in the abstract seems to be simple enough, the actual analysis can be much more confusing. The problem is that phrases such as "minimum contacts" and "substantial nexus" do not really mean anything. There is no definitive line that marks a minimum contact, nor is there a specific point at which a substantial nexus exists. The analysis in this area is necessarily done on a case-by-case basis. However, we are guided by the recognition that the Commerce Clause imposes a greater limitation on Tennessee's right to tax JCPNB than does the Due Process Clause. *839 With the distinctions between the two clauses in mind, we turn to the question of whether a substantial nexus exists to sustain the franchise and excise taxes imposed by the Commissioner.

IV.

[7] We do not consider the fact that JCPNB was "doing business" in Tennessee to be dispositive of the present issue. If that were the case, we would

have obliterated the distinction between the Due Process Clause and the Commerce Clause. Instead, we must attempt to delineate that level of "presence" in the State of Tennessee that will justify the imposition of the types of taxes that are the subject of this appeal. This "presence" must, in order to satisfy the Commerce Clause, be more than merely "doing business" in the State of Tennessee. JCPNB relies on *Bellas Hess* and *Quill* to argue that physical presence is required. The Commissioner, on the other hand, argues that physical presence is not a formal requirement and the validity of a state tax should be determined under the *Complete Auto* test. The Commissioner refers to this as "contemporary Commerce Clause jurisprudence." The fundamental flaw in the Commissioner's argument is that *Complete Auto* does not set a different standard than that contemplated in *Bellas Hess* and *Quill*. Rather, *Bellas Hess* and *Quill* specifically address the first prong, or the substantial nexus requirement, of the *Complete Auto* test. *See Quill,* 504 U.S. at 311, 112 S.Ct. 1904. In that regard, the *Bellas Hess/ Quill* decisions are entirely consistent with the *Complete Auto* test. Both *Bellas Hess* and *Quill* are clear in their holding that in the context of a use tax, physical presence is required in order to satisfy the substantial nexus requirement of *Complete Auto*.

The only real issue is whether there is any reason to distinguish the present case from *Bellas Hess* and *Quill*. The Commissioner argues that those cases are distinguishable because they involved use taxes, whereas the present case involves franchise and excise taxes. We must reject the Commissioner's argument. While it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case. In fact, the Commissioner is unable to provide any authority as to why the analysis should be different for franchise and excise taxes.[FN15] It is certainly true that the *Quill* Court expressed some reservations about the vitality of the *Bellas Hess* decision. *See Quill,* 504 U.S. at 311, 112 S.Ct. 1904 (stating that the *Bellas Hess* decision might be different were the issue to arise for the first time today). However, we are not in a position to speculate as to how the Supreme Court might decide future cases. We are only able to rely on past decisions. Any constitutional distinctions between the franchise and excise taxes presented here and the use taxes contemplated in *Bellas Hess* and *Quill* are not within the purview of this court to discern. As such, we feel that the outcome of this case is governed by *Bellas Hess* and *Quill,* as those decisions interpret the first prong of the *Complete Auto* test.

FN15. The Commissioner's brief merely states that it is JCPNB's burden to show why the *Bellas Hess* rule should be followed in the present case and that they have failed to meet that burden.

[8] JCPNB argues that the present case is "almost identical" to the facts in *Quill*. In many respects, that assertion is correct. JCPNB is a Delaware corporation with no offices or agents in Tennessee, just as the taxpayer in *Quill* had no offices or employees in North Dakota. *See Quill,* 504 U.S. at 302, 112 S.Ct. 1904. Also, JCPNB did not physically engage in any activities in Tennessee connected with its credit card business. Similarly, Quill solicited business in North Dakota through catalogs, flyers, and other advertisements and delivered those goods via mail or common-carrier, thereby having no physical presence in North Dakota. *Id.*

***840** In response to JCPNB, the Commissioner asserts several arguments in support of finding that JCPNB does, in fact, have a substantial nexus with Tennessee. First, she argues that the credit cards which JCPNB issued were tangible physical property over which JCPNB maintained ownership, thereby giving JCPNB a physical presence in Tennessee through those cards.[FN16] Additionally, she argues that the presence of the J.C. Penney retail stores in Tennessee provides the requisite substantial nexus. We will deal with each of these arguments in turn.

FN16. In making this argument, we do not understand the Commissioner to concede that physical presence is *necessary* for a finding of substantial nexus.

During the tax years in question, JCPNB had between 11,000 and 17,000 accounts with Tennessee residents. The chancellor found that the actual credit cards constituted "tangible property for substantial nexus purposes." In reaching that decision, the chancellor found it persuasive that the cards remained the property of JCPNB. While we agree that a credit card is tangible in that it can be seen and touched, we do not agree that the presence of the credit cards in Tennessee is constitutionally significant. Additionally, we do not find it relevant that JCPNB retained ownership of the cards.

Credit cards, in and of themselves, are virtually worthless. The "value" of these cards is found in the right which the card represents, namely the credit account. The card is merely representative of the customer's right to charge goods and services. The actual card is not even necessary to the transaction.[FN17] It merely serves as a convenient article on which to record the necessary information regarding the customer's account. As the chancellor correctly determined, the real asset is the intangible account which the card represents. Those accounts were located, for tax purposes, in the State of Delaware and not subject to a Tennessee tax. Therefore, we do not agree with the chancellor's determination that the physical presence of the JCPNB credit cards constituted a basis for finding substantial nexus.[FN18]

FN17. While it may be common practice to physically present the card when making a purchase, that fact seems to be more of a practical requirement than anything else. The card contains information which identifies the account-holder. Perhaps, it would be much simpler and cost-effective to assign a card-holder his or her account number and allow purchases to be made simply by the verbal recitation of that account number. However, such a procedure would beg problems. There would be no way to determine whether the person presenting the account number is, in fact, the authorized user. It is certainly conceivable that the cards exist merely to prevent fraud or unauthorized usage.

FN18. Contrary to the chancellor's decision, we find it constitutionally insignificant that the credit cards remained the property of JCPNB. It seems entirely reasonable that the retained ownership merely gave JCPNB the right to end the credit relationship with a customer. After the relationship ended, the actual cards were of little or no value to JCPNB, therefore making ownership of no consequence. In fact, evidence in the record indicates that cards that have been returned by customers are destroyed.

The Commissioner also argues that JCPNB had a physical presence in Tennessee by virtue of the fact the J.C. Penney Company, JCPNB's parent, owned and operated the J.C. Penney retail stores in Tennessee. This argument lacks merit because the retail stores were not affiliated with JCPNB's Visa and MasterCard credit card operations.[FN19] The retail stores *841 conducted no activities which assisted JCPNB in maintaining its credit card business in Tennessee. The record shows that one could not apply for the JCPNB credit cards at the J.C. Penney retail stores, nor could individuals make a payment on their Visa or MasterCard account at the retail stores. Therefore, we reject the Commissioner's arguments which contend that a substantial nexus exists based on the presence of the J.C. Penney retail stores in Tennessee.

FN19. We note that many of the potential customers for JCPNB credit cards were identified through a list of individuals who had a previous credit history with the J.C. Penney Company. We summarily reject the argument that this was sufficient to

> provide a substantial nexus. There is no evidence to show that the retail stores had anything to do with this information. Every indication is that the J.C. Penney company conducted all of these activities from its corporate offices in Texas. Moreover, JCPNB also obtained the names of potential customers through independent credit reporting agencies. We find no basis for concluding that the use of credit information subjects the user of that information to a tax in the provider's home state. Under this theory, JCPNB would be subject to a tax in any state in which a credit reporting agency with whom JCPNB dealt was located. We believe this theory exemplifies the very sort of state taxation of interstate commerce that the Commerce Clause serves to prevent.

Finally, the chancellor concluded that a substantial nexus existed based on "the activities of the affiliates and third parties working on JCPNB's behalf." In reaching this conclusion, the chancellor relied on *Tyler Pipe Indus. v. Washington State Dep't of Rev.,* 483 U.S. 232, 107 S.Ct. 2810, 97 L.Ed.2d 199 (1987) and *Scripto v. Carson,* 362 U.S. 207, 80 S.Ct. 619, 4 L.Ed.2d 660 (1960). We are unable to agree with the chancellor's reasoning. Both *Tyler Pipe* and *Scripto* involved one crucial element which is absent in the present case. In those cases, activities were being conducted in the taxing state that substantially contributed to the taxpayer's ability to maintain operations in the taxing state. Simply put, the taxpayer in those cases had a physical presence in the taxing state that is lacking in the present case.

In *Scripto,* the Georgia taxpayer employed independent contractors who solicited business in the State of Florida, the taxing state. *See Scripto,* 362 U.S. at 211, 80 S.Ct. 619 ("Each salesman ... is actively engaged in Florida as a representative of Scripto for the purpose of attracting, soliciting and obtaining Florida customers"). The real issue in *Scripto* was whether it made any constitutional difference that the individuals hired to solicit business were employed as "independent contractors" rather than as regular employees. The court refused to find any meaningful difference between the labels used to describe the employees. *See id.* at 211, 80 S.Ct. 619 (holding the distinction between regular employees and independent contractors to be without constitutional significance).

Similarly, in *Tyler Pipe,* the Supreme Court found that a substantial nexus existed to justify the imposition of a business and occupation tax by the State of Washington.[FN20] In *Tyler,* the solicitation was "directed by executives who maintain their offices out-of-state and by an *independent contractor located in Seattle.*" *Tyler Pipe,* 483 U.S. at 249, 107 S.Ct. 2810 (emphasis added). The Court, agreeing with the Washington Supreme Court, found the crucial factor to be the fact that the activities which allowed the taxpayer to establish and maintain a market actually took place *in the State of Washington. Id.* at 250, 107 S.Ct. 2810 (emphasis added). The Court concluded by stating, "the activities of Tyler's sales representatives adequately support the State's jurisdiction to impose its wholesale tax on Tyler." *Id.* at 251, 107 S.Ct. 2810. Here, as in *Scripto,* the distinguishing factor was the physical presence of the taxpayer in the taxing state.

> FN20. The Supreme Court actually vacated the judgment and remanded the case to the state court based on an issue unrelated to the question of substantial nexus.

A review of the facts of the present case convinces this court that JCPNB did not have a physical presence in Tennessee through its affiliates. Neither BSI nor MBNA actually performed any services on behalf of JCPNB in the State of Tennessee. The solicitation, which was the most important function in allowing JCPNB to maintain its business, took place through the U.S. Mail, which, under the holding in *Quill,* does not allow a finding of substantial nexus. In short, the activities which allowed JCPNB to conduct its credit card operation did not occur in the State of *842 Tennessee.[FN21] As such, we believe the chancellor's reliance on *Scripto* and *Tyler Pipe* was misplaced as those cases are clearly distinguishable.

FN21. There is an indication in the record that one of JCPNB's affiliates used a Tennessee collection agency in order to recover moneys owed to JCPNB. Apparently, these collection efforts were aided through the use of the Tennessee court system. This may be the closest that JCPNB comes to having a physical presence in Tennessee. However, we do not believe that the actions of a party so far removed from JCPNB are sufficient to allow the State of Tennessee to levy taxes on JCPNB. The relationship is far too attenuated to confer a physical presence on JCPNB.

It is not our purpose to decide whether "physical presence" is required under the Commerce Clause. However, the Commissioner has pointed to no case in which the Supreme Court of the United States has upheld a state tax where the out-of-state taxpayer had absolutely no physical presence in the taxing state. The Commerce Clause requires a greater relationship than does the Due Process Clause. If we were to uphold the tax assessment against JCPNB, we believe that we would be unjustifiably overlapping the two clauses. While we are confident that the tax assessment satisfies due process, we fail to see the substantial nexus necessary to sustain the tax under the Commerce Clause. *Scripto, Inc. v. Carson,* is, by the Supreme Court's own words, the furthest extension of a state's right to tax an out-of-state seller. However, *Scripto* involved facts that are not present in this case. Specifically, the Georgia company in *Scripto* employed individuals in the State of Florida, the taxing state, to solicit business. Therefore, if *Scripto* is the furthest reach of a state's power to tax, and there is even less of a relationship in this case than was present in *Scripto,* we conclude that a substantial nexus is lacking to uphold the tax assessment against JCPNB.

Conclusion

For the reasons stated herein, we reverse and dismiss the decision of the trial court, which upheld the imposition of franchise and excise taxes against JCPNB. Costs of this appeal are taxed to the appellee, Ruth E. Johnson, Commissioner of Revenue, State of Tennessee, for which execution may issue if necessary.

FARMER and LILLARD, JJ., concur.
Tenn.Ct.App.,1999.
J.C. Penney Nat. Bank v. Johnson
19 S.W.3d 831

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