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ARTICLES

HOLDING INTELLECTUAL PROPERTY

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I. INTRODUCTION

The collapse of WorldCom, Inc., exposed a complex web of accounting irregularities.[1] Within that web, recent filings by Dick Thornburgh, WorldCom's Bankruptcy Court Examiner, reveal a different type of scheme that involves the holding of intellectual property.[2] Further scrutinizing the scheme reveals that WorldCom and its tax advisors, KPMG Peat Marwick LLP (KPMG), devised a tax avoidance scheme through the creation of an intellectual property holding company (IP holding company).[3] This type of scheme has been widely and quietly utilized in the last twenty years by many corporations with substantial intellectual property.[4]

Indeed, as state taxing authorities have become more aggressive in their auditing process, the spotlight is now on the IP holding company scheme. Due to numerous states' slow recovery from the economic downturn and the shrinkage of state tax revenues in the last few years,[5] more and more states have directed their attention

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[1] *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 302 (2004) (noting epidemic of accounting and related financial irregularities at companies, notably Enron, WorldCom, Global Crossing, and Tyco).

[2] *See generally* Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner, *In re* WorldCom, Inc., No. 02-13533, 2004 WL 353878 (S.D.N.Y. Jan. 26, 2004) (describing WorldCom's state minimizing tax program under advice of KPMG).

[3] The Bankruptcy Examiner in the WorldCom case asserted that due to KPMG's advice WorldCom may have potential claims against KPMG for being negligent in proposing the "highly aggressive intangible asset royalty programs" and for failure to warn WorldCom that "certain of [KPMG's] conclusions were highly aggressive and subject to challenge," particularly in light of KPMG's engagement letter with WorldCom in which KPMG "agreed to return fees it received if its tax advice proved incorrect." *Id.* at III.A.

[4] *See, e.g.*, Sherwin-Williams Co. v. Comm'r, 778 N.E.2d 504, 510 (Mass. 2002) (giving minutes of Jan. 23, 1991, board meeting, which provides reasons for creating subsidiaries); Kmart Props., Inc. v. Taxation & Revenue Dep't, [N.M.] St. Tax Rep. (CCH) ¶ 401-004, 21,176 (N.M. Ct. App. Nov. 27, 2001), *writ granted*, 40 P.3d 1008 (N.M. 2002) (table case); *In re* Toys "R" Us-NYTEX, Inc., No. TAT(E) 93-1039 (GC), 2004 WL 75386 (N.Y. Tax App. Trib. Jan. 14, 2004) (discussing Toys "R" Us and its holding company); *In re* Addax Music Co., No. 28376 TSB-H-85(1)C, 1984 WL 179619 (N.Y. Dep't Tax. & Fin. Dec. 14, 1984) (describing Addax as subsidiary of Paramount Pictures and Gulf & Western Industries, Inc., which has no assets except music copyrights and no income except royalties earned on such copyrights); Sec'y of Revenue v. A & F Trademark, Inc., [2 N.C.] St. Tax Rep. (CCH) ¶ 202-146, 11,041 (N.C. Tax Review Bd. May 7, 2002).

[5] According to the Multistate Tax Commission, which represents several state revenue agencies, the state income tax rate for corporations for 2002 was 5.2% compared to 9.6% in 1980. *See* Deborah Diehl, *Is the IP Holding Company Dead?*, 37 MD. B.J. 43, 44 (2004) (discussing shrinkage of state tax revenue in recent years, how shrinkage functions as factor

to intercorporate transactions and income shifting schemes. In doing so, many states unearthed handsome amounts of royalty income generated by the licensing of intellectual property that had never been taxed. Utilizing this taxing power, states are eager to reach the royalty income accumulated by companies holding intellectual property, but in taxing such income, states may encounter a potential constitutional stumbling block.

How does intellectual property become part of a tax avoidance scheme? What is an IP holding company? What are the tax and nontax reasons that facilitate the creation of this scheme? What are the constitutional challenges states may face in their efforts to tax royalty income? What are their alternatives?

This Article will address these questions and argue that the IP holding company scheme is a complex tax avoidance program requiring states to devise an approach to taxation that reflects an understanding of intellectual property rights and of the interests of intellectual property rights holders. In and of itself, a scheme that results in tax avoidance is not illegal. There are considerable business reasons behind the creation of an IP holding company for a major corporation's intellectual property assets. Part I discusses the transformation of intellectual property into valuable corporate assets.

Part II identifies and analyzes the IP holding company scheme. Notable examples illustrate the widespread use of this scheme by major U.S. corporations.

Part III focuses on the constitutional reach of state taxing power to royalty income received by out-of-state holding companies in light of the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota*.[6]

Part IV discusses how states attempted to evade constitutional requirements in their eagerness to tax the royalty income of out-of-state holding companies. This section analyzes the business situs approach to intellectual property rights as employed by states to justify their fulfillment of the constitutional requirements post-

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along "with the budget pressures many states are currently experiencing, and the recognition by the states of the 'income shifting' from the use of intellectual property holding companies").

[6] 504 U.S. 298 (1992).

Quill. This section critiques the business situs approach by providing illustrative examples of how the approach reaches beyond constitutional limits.

Part V advocates balancing the interests between states and holders of intellectual property. This section highlights some fundamental aspects of intellectual property rights that may assist states in their efforts to reach royalty income received by out-of-state holding companies that license intellectual property rights for use within states. This section also provides alternative approaches states may consider that pose less risk of constitutional challenges.

This Article concludes that as long as intellectual property assets are valuable corporate assets and holders of intellectual property continue to seek ways to maximize their return on such assets, uncertainties regarding states' power to tax an IP holding company's income reflect a need for guidance from Congress and a need for uniformity of state tax treatments. Regardless of these uncertainties, the potential migration of intellectual property assets offshore poses yet another problem.

II. THE RISE OF INTELLECTUAL PROPERTY ASSETS

Rapid change in science and technology, coupled with expansion of legal protection,[7] has created a new type of valuable intangible corporate asset.[8] That asset is intellectual property, which often includes patents, trade secrets, copyrights, and trademarks.[9] Although the existence of various forms of intellectual property can

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[7] The expansion of legal protection for intangible property is evidenced by the recognition of patent protection in the biotech, computer software, and Internet industries.

[8] *See* Joseph M. Manak, *The Law of Written Description in Pharmaceutical and Biotechnology Patents*, 23 BIOTECH. L. REP. 30, 31 (2004) ("[I]ntellectual property is in a constant state of boundless growth. It can arise at any time by virtue of almost any new creation or invention from any of the billions of minds on the planet engaged in multitudinous endeavors."); Richard G. Mason & Beth M. Polebaum, *Buying Intellectual Property from Troubled Companies*, 779 PLI/PAT 365, 373 (2004) ("In today's economy, a company's intellectual property may be among its most valuable assets.").

[9] *See* Robert P. Merges, *A New Dynamism in the Public Domain*, 71 U. CHI. L. REV. 183, 200 (2004) (noting "widespread consensus that intellectual property rights have become increasingly valuable since the 1970s"); Sherry Lynn Murphy, *Unlimited Congressional Power Under the Copyright Clause in Article I of the Constitution:* Eldred v. Ashcroft, 38 U.S.F. L. REV. 525, 531-33 (2004) (providing brief discussion of types of intellectual property).

be traced to antiquity,[10] the impact of intellectual property on the economy, workplace,[11] culture, society, and daily life is a more recent phenomenon.[12]

The globalization of commerce has facilitated the movement of goods, including patented, copyrighted, and trademarked goods, to all corners of the world.[13] Indeed, the monetary value of copyrighted goods exported from the United States to other countries has led all other exported goods.[14] Moreover, the emergence of digital technology and the Internet has transformed the protection and dissemina-

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[10] The history of various forms of intellectual property is rich. Trade secrets and legal protection against misappropriation of trade secrets have been traced to the Roman Empire. A. Arthur Schiller, *Trade Secrets and the Roman Law: The Actio Servi Corrupti*, 30 COLUM. L. REV. 837, 838-39 (1930) (arguing that action available in response to third party enticing slave-employee to disclose business secrets demonstrates that Roman law protected intellectual property). The earliest mention of a patent protection system is in Aristotle's *The Politics*. *See* Aristotle, THE POLITICS 36-39 (Stephen Everson ed., Cambridge Univ. Press 1988) (discussing law of Hippodamus "that those who discovered anything for the good of the state should be honoured"). Copyright protection emerged from the introduction of the printing press in England. *See* Shubha Ghosh, *Deprivatizing Copyright*, 54 CASE W. RES. L. REV. 387, 429 (2003) (detailing connection between printing press technology and emergence of copyright protection). The use of trademarks in commerce is also traced to antiquity. *See generally* Sidney A. Diamond, *The Historical Development of Trademarks*, 65 TRADEMARK REP. 265 (1975) (surveying history of trademark); F.D. Prager, *The Early Growth and Influence of Intellectual Property*, 34 J. PAT. & TRADEMARK OFF. SOC'Y. 106 (1952) (discussing early history of intellectual property in developed nations).

[11] *See generally* Catherine L. Fisk, *Working Knowledge: Trade Secrets, Restrictive Covenants in Employment, and the Rise of Corporate Intellectual Property, 1800-1920*, 52 HASTINGS L.J. 441 (2001) (tracing history of trade secrets law and how it affects employment relationships and social practices).

[12] *See* Laurence R. Helfer, *Regime Shifting: The TRIP Agreement and New Dynamics of International Intellectual Property Lawmaking*, 29 YALE J. INT'L L. 1, 27-52 (2004) (analyzing growth and impact of intellectual property in areas of international concern such as biodiversity, plant genetic resources, public health, and human rights); Peter K. Yu, *The Escalating Copyright Wars*, 32 HOFSTRA L. REV. 907, 909 (2004) (concluding that new digital copyright law and its challenges have become "a matter of public significance, affecting all of us in our daily lives").

[13] *See* Robert Bejesky, *Investing in the Dragon: Managing the Patent Versus Trade Secret Protection Decision for the Multinational Corporation in China*, 11 TULSA J. COMP. & INT'L L. 437, 438 n.6 (2004) (noting important role of intellectual property protection in transnational exports and economic development); *cf.* Ann Bartow, *Likelihood of Confusion*, 41 SAN DIEGO L. REV. 721, 733-37 (2004) (explaining complexity of source of trademarked goods in commerce, as such goods are manufactured by companies while trademarks associated with such goods convey different sources).

[14] *See* Colin Darch, *Digital Divide or Unequal Exchange? How the Northern Intellectual Property Rights Regime Threatens the South*, 32 INT'L. J. LEGAL INFO. 488, 489 (2004) (asserting that "the value of the export to the rest of the world of U.S. copyright products . . . exceeded the total for clothes, chemicals, cars, computers and airplanes combined").

tion of copyrighted materials.[15] Commercial success based on invention and innovation has exploded in recent years.[16] Perceiving patents as highly valuable assets, corporations and individual inventors actively seek them such that the number granted by the U.S. Patent Office has increased approximately threefold in the last twenty years.[17] Similarly, during the 2003 fiscal year alone, the U.S. Copyright Office registered 534,122 copyrightable works.[18]

In short, intellectual property today has become so enormously important[19] that the legal protection and enforcement of intellectual

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[15] *See* Gerard N. Magliocca, *From Ashes to Fire: Trademark and Copyright in Transition*, 82 N.C. L. REV. 1009, 1044-49 (2004) (discussing impact of Internet revolution on development of contemporary copyright law). *See generally* CONG. BUDGET OFFICE, COPYRIGHT ISSUES IN DIGITAL MEDIA (Aug. 2004) (detailing impact of expansion of digital technology on copyright), *available at* http://www.cbo.gov/showdoc.cfm?index=5738&sequence=0&from=0#anchor.

[16] *See* Robert P. Merges, *Commercial Success and Patent Standards: Economic Perspectives on Innovation*, 76 CAL. L. REV. 803, 876 (1988) (arguing that overemphasis on innovation without significant technical advances allows too many patents to be issued); Joshua A. Newberg & Richard L. Dunn, *Keeping Secrets in the Campus Lab: Law, Values and Rules of Engagement for Industry—University R&D Partnerships*, 39 AM. BUS. L.J. 187, 192-97 (2002) (detailing joint partnership between government, university, and industry and how such partnership impacted growth of intellectual property in recent years).

[17] *See* OFFICE OF ELECTRONIC INFO. PRODS./PATENT TECH. MONITORING DIV., U.S. PATENT AND TRADEMARKS OFFICE, U.S. PATENT STATISTICS, CALENDAR YEARS 1962-2003 (July 2004), *available at* http://www.uspto.gov/web/offices/ac/ido/oeip/taf/us_stat.pdf (reporting number of patents issued from 1967 to 2003); *see also* John R. Allison & Mark A. Lemley, *Who's Patenting What? An Empirical Exploration of Patent Prosecution*, 53 VAND. L. REV. 2099, 2118 (2000) (reporting dramatic increase of 39.1% in number of patent applications filed between 1993 and 1998 and 45.4% increase in number of patents issued between 1995 and 1998).

[18] COPYRIGHT LAW ADMIN., *Registration of Copyrighted Works*, *in* FISCAL YEAR 2003 REPORT (providing detailed annual report of activities for fiscal year 2003), *available at* http://www.copyright.gov/reports/annual/2003/Copyright_Law_Administration.pdf (last visited Feb. 18, 2005).

[19] Indeed, intellectual property has become so significant that the Federal Bureau of Investigation has admitted that:

> These valuable products, collectively known as "Intellectual Property" (IP), are the primary fuel of the U.S. economic engine. Currently, the U.S. leads the world in the creation and export of IP and IP-related products. The International Anti-Counterfeiting Coalition recently reported that the combined U.S. copyright industries and derivative businesses account for more than $433 billion, or 5.68%, of the U.S. Gross National Product, which is more than any other single manufacturing sector. The Bureau of Labor Statistics reports that between 1977 and 1996 the growth in the IP segment of the economy was nearly twice that of the U.S. economy as a whole. It is also estimated that the software industry alone will employ more than one million people in the U.S. by the year 2005.

FED. BUREAU OF INVESTIGATION, ABOUT THE FINANCIAL INSTITUTION FRAUD UNIT: INTELLECTUAL PROPERTY CRIMES, *at* http://www.fbi.gov/hq/cid/fc/fifu/about/about_ipc.htm (last visited

property rights occupies a central role in international trade[20] and relations.[21]

Not surprisingly, major companies today accumulate and possess large intellectual property portfolios.[22] For the last ten years, IBM has led all companies in the number of patents received each year, including 3,411 issued patents in 2001.[23] Canon, Sony, and General Electric each received more than 1,000 issued patents during 2001.[24] Companies with large copyright holdings in the publishing and entertainment areas enjoy the high export value of their copyrighted goods, as evidenced by one reported estimate placing the total value of these U.S. exports as higher than $400 billion annually.[25] The Coca-Cola trademark alone is valued at more than $67 billion, while the Microsoft brand is valued at $61 billion, IBM at $54 billion, GE at $44 billion, and Intel at $33 billion in 2004.[26]

Feb. 16, 2005).

[20] *See* U.S. PATENT AND TRADEMARK OFFICE, A NEW ORGANIZATION FOR A NEW MILLENNIUM: PERFORMANCE AND ACCOUNTABILITY REPORT FISCAL YEAR 2000, at 17 (discussing goals of U.S. Patent and Trademark Offices in protection and enforcement of intellectual property rights at home and abroad), *available at* http://www.uspto.gov/web/offices/com/annual/2000/00highlights.pdf (last modified Aug. 6, 2004); Michael R. Taylor & Jerry Cayford, *American Patent Policy, Biotechnology, and African Agriculture: The Case for Policy Change*, 17 HARV. J.L. & TECH. 321, 371-72 (2004) (analyzing how U.S. utilizes trade negotiations, trade sanctions, and tariff benefits to protect intellectual property rights abroad).

[21] *See* Daniel Kalderimis, *Problems of WTO Harmonization and the Virtues of Shields Over Swords*, 13 MINN. J. GLOBAL TRADE 305, 329 (2004) (explaining relationship between intellectual property protection and international trade regulations); F. Scott Kieff, *Property Rights and Property Rules for Commercializing Inventions*, 85 MINN. L. REV. 697, 699 n.4 (2001) ("Economic research over the past sixty years has amply established a causal link between the development of intellectual property and the growth of our national economy, while also showing that intellectual property is an increasingly critical component of United States capital and foreign trade.").

[22] *See* Michael J. Meurer, *Controlling Opportunistic and Anti-Competitive Intellectual Property Litigation,* 44 B.C. L. REV. 509, 519 (2003) ("[I]ntellectual property has become more valuable, and the number of patents, copyrights, and trademarks has increased rapidly." (citations omitted)).

[23] U.S. PATENT AND TRADEMARK OFFICE, PRELIMINARY LIST OF TOP PATENTING ORGANIZATIONS: CALENDAR YEAR 2001 (reporting top ten organizations receiving most number of patents, including IBM), *available at* http://www.uspto.gov/web/offices/ac/ido/oeip/taf/top01cos.htm (last visited Feb. 16, 2005).

[24] *Id.*

[25] *See* Darch, *supra* note 14, at 489-90 (stating that in 1997 U.S. exported copyright products totaled $414 billion).

[26] Diane Brady et al., *Cult Brands*, BUS. WK., Aug. 9, 2004, at 59 (ranking top 100 global trademarks).

III. THE SCHEME OF TAX AVOIDANCE: IP HOLDING COMPANY

As intellectual property becomes a more important corporate asset, many companies with large intellectual property portfolios search for ways to maximize revenues. A common way to expand market exposure is through the licensing of intellectual property assets for new fields of products and services in existing or new territories.[27] Income derived from licensing intellectual property assets is subject to federal and state taxation as ordinary income.[28] In recent years, companies have created a scheme to minimize state taxation of royalty income.[29]

Under such a scheme, a company with a large intellectual property portfolio forms a wholly owned subsidiary to hold its intellectual property assets.[30] The parent company selects a state jurisdiction that does not tax royalty income received from licensing intellectual property assets and then forms its subsidiary, the IP holding company, there.[31] The parent company transfers all of its

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[27] *See* Mary M. Squyres, *Global Licensing: A License to Use*, *in* HANDLING INTELLECTUAL PROPERTY ISSUES IN BUSINESS TRANSACTIONS at 491-92 (PLI Pats., Copyrights, Trademarks, & Literary Prop. Course, Handbook Series No. 779, 2004) (listing purposes of licensing intellectual property assets, including greater profitability by licensing to unrelated third party and by capitalizing on reputation of established trademark).

[28] Companies avoided federal taxation by transferring intellectual property to subsidiaries in Bermuda. *See* Glenn R. Simpson, *A New Twist in Tax Avoidance: Firms Send Best Ideas Abroad*, WALL ST. J., June 24, 2002, at A1 ("The transfer of intellectual property—such as trademarks and patents—has become so widespread that it has prompted an aggressive crackdown by the Internal Revenue Service on alleged abuses that one IRS consultant says could eventually involve tax claims in the tens of billions of dollars.").

[29] *See* Tun-Jen Chiang, Comment, *State Income Taxation of Out-of-State Trademark Holding Companies*, 70 U. CHI. L. REV. 1533, 1553 (2003) (describing trademark holding company as tax avoidance scheme); Ashley B. Howard, Comment, *Does the Internal Revenue Code Provide a Solution to a Common State Taxation Problem?: Proposing State Adoption of § 367(d) to Tax Intangibles Holding Subsidiaries*, 53 EMORY L.J. 561, 566-67 (2004) (discussing tax benefits of IP holding company).

[30] *E.g.*, Comptroller of the Treasury v. Syl, Inc., 825 A.2d 399, 400, 407 (Md. 2003) (noting, in consolidated opinion, that parent company Syms assigned all trademarks, trade names, and advertising slogans to its subsidiary Syl and that parent company, Crown Parent, assigned its patents and trademarks to its subsidiary, Crown Delaware); Sherwin-Williams Co. v. Commissioner, 778 N.E.2d 504, 509-10 (Mass. 2002) (noting that parent company Sherwin-Williams assigned all of its domestic trademarks to its two subsidiaries, DIMC and SWIMC).

[31] *E.g.*, *Syl, Inc.*, 825 A.2d at 401, 407 (noting that subsidiaries Syl and Crown Delaware were incorporated in Delaware for purpose of managing and controlling intellectual property

intellectual property assets to the IP holding company in exchange for ownership of 80% or more of stock in the IP holding company.[32] Such a transfer and exchange is not a taxable event because no gains are recognized. The IP holding company then licenses the intellectual property assets back to the parent company[33] and in some instances to sister companies that need to use the intellectual property assets.[34] These sister companies, which are also operating companies, conduct business in numerous or all states and are generally allowed to deduct, as business expenses, royalties paid to the IP holding company.[35] The IP holding company, on the other hand, receives royalties from the operating companies and does not have to pay state taxes on that royalty income in the jurisdiction where the IP holding company was formed.[36] The IP holding company then uses the royalties for loans to the operating compa-

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assets); *Sherwin-Williams Co.*, 778 N.E.2d at 509 (stating that parent company selected Delaware for incorporation of subsidiary because state afforded tax advantages to corporations confining their activities to holding, maintaining, and managing intangible assets).

[32] *E.g.*, *Sherwin-Williams Co.*, 778 N.E.2d. at 510 (stating that parent company and another of its subsidiaries received 100% of both IP holding companies' stock); *In re* Toys "R" Us-NYTEX, Inc., No. TAT(E) 93-1039 (GC), 2004 WL 75386 (N.Y. Tax App. Trib. Jan. 14, 2004) (noting that parent company wholly owned subsidiary).

[33] *E.g.*, *Sherwin-Williams Co.*, 778 N.E.2d at 507-08 (noting that parent company paid $47 million in royalty payments to two IP holding companies for tax year 1991).

[34] *E.g.*, Cambridge Brands, Inc. v. Comm'r, No. C259013, 2003 WL 21665241, at *1 (Mass. App. Tax Bd. July 16, 2003) (holding that royalties paid by Massachusetts candy manufacturing company to sister Delaware IP holding company for right to use certain trademarks and formulas were properly deductible as ordinary and necessary business expense because license of intellectual property rights had valid business purpose and economic substance).

[35] *E.g.*, *Sherwin-Williams Co.*, 778 N.E.2d at 520-21 (allowing parent company to deduct reasonable royalty payments to its subsidiaries as ordinary and necessary expenses). *But see* Syms Corp. v. Comm'r, 765 N.E.2d 758, 765 (Mass. 2002) (denying parent company's deduction of royalty payments to subsidiary because transfer and license-back arrangement was sham).

[36] As Delaware corporations, IP holding companies enjoy significant legal and tax advantages as long as they confine "their activities to holding, maintaining, and managing intangible assets." *Sherwin-Williams Co.*, 778 N.E.2d at 509. Under Delaware law, "royalties and other income earned by" IP holding companies are "exempt from State taxation." *Id.* (citing DEL. CODE ANN. tit. 30, § 1902(b)(8) (1997 & Supp. 2004)).

nies and receives interest from those loans.[37] The IP holding company may then pay dividends to the parent company.[38]

Examples of these tax avoidance schemes are everywhere. The Limited Stores, Inc., an Ohio corporation, owns numerous retailing companies that operate stores throughout the United States.[39] The parent company has also created wholly owned IP holding companies in Delaware to hold well-known trademarks in the clothing industry, such as "The Limited," "Victoria's Secret," "Express," "Abercrombie & Fitch," "Lane Bryant," and "Lerner," which were all once owned by the parent company but exchanged for stock ownership in the subsidiaries.[40] The IP holding companies then licensed the trademarks to the related retail companies in exchange for royalty payments.[41] For tax year 1994, these same IP holding companies recorded $301,067,619 in royalty income and $122,031,344 in interest income from the related retail companies.[42] These amounts accounted for 100% of the IP holding companies' income.[43] These IP holding companies enjoy tax exempt status as passive holding entities in Delaware, their state of incorporation.[44]

KPI, another example, is the IP holding company for the well-known Kmart Corporation and its related trademarks, which are worth between $2.7 and $4.1 billion.[45] KPI was incorporated in Michigan, which does not tax income from royalty payments that KPI receives from its exclusive license arrangement with the Kmart

[37] The operating companies will deduct the interest payment on such loans as ordinary expense. *E.g.*, *id.* at 522-23 (allowing parent company to deduct interest payment on short-term loan of $7 million from subsidiary).

[38] *See* Michael T. Fatale, *State Tax Jurisdiction and the Mythical "Physical Presence" Constitutional Standard*, 54 TAX LAW. 105, 135 (2000) (stating that transfer and license-back scheme is "fairly common tax avoidance technique").

[39] Sec'y of Revenue v. A & F Trademark, Inc., [2 N.C.] St. Tax Rep. (CCH) ¶ 202-146, 11,041 (N.C. Tax Review Bd. May 7, 2002), *aff'd*, 2003 WL 21665022 (N.C. Super. Ct. 2003), *aff'd*, 605 S.E.2d 187 (N.C. Ct. App. 2004).

[40] *Id.* (detailing assignment and license-back arrangement involving well-known retail clothing trademarks).

[41] *Id.* at 11,041.

[42] *Id.* at 11,042.

[43] *Id.* (noting that IP holding companies accumulated no other source of income, except royalty income).

[44] *Id.* at 11,043, 11,055.

[45] Kmart Props., Inc. v. Taxation & Revenue Dep't, [N.M.] St. Tax Rep. (CCH) ¶ 401-004, 21,176 (N.M. Ct. App. Nov. 27, 2001), *writ granted*, 40 P.3d 1008 (N.M. 2002) (table case).

Corporation.[46] Kmart Corporation created KPI and infused it with assets by transferring ownership of all Kmart's domestic trademarks in exchange for all of KPI's stock.[47] KPI's office is one block away from the parent company's headquarters and all of KPI's five employees, including two intellectual property attorneys and their respective support staff, came from the parent company.[48]

Intellectual property tax schemes are not limited to trademarks. Indeed, such schemes include patents and other intellectual property assets. For example, Gore Enterprise Holdings, Inc., owns more than 300 patents related to the process and manufacture of Gore-Tex products.[49] The Gore parent company transferred all of its patents to Holdings in exchange for all of Holdings' stock.[50] The holding company and the parent company entered into a licensing arrangement for the patents.[51] Pursuant to the assignment and license-back arrangement, the holding company manages the patent portfolio, collects royalties from the use of the patents, and invests the proceeds in investment vehicles.[52] The holding company had not had any employees or office space for some years, and its activities were conducted by employees at the parent company.[53] The holding company later hired one paralegal, who monitored and administered the patent portfolio.[54] The holding company also retained outside

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[46] *See id.* (stating that Kmart Corporation paid KPI royalty payments based on 1.1% of Kmart Corporation's gross sales throughout United States). *See generally* Little Caesar Enters. Inc. v. Dep't of the Treasury, 575 N.W.2d 562 (Mich. Ct. App. 1997) (holding that Single Business Tax Act's franchise fee exception did not preclude franchisor from deducting monthly percentage payments it received from its single business tax base); Zenith Data Sys. v. Dep't of the Treasury, 555 N.W.2d 264, 267 (Mich. Ct. App. 1996) (holding that payments taxpayer received from consumers pursuant to license agreement for use of computer software were royalties that could be deducted from taxpayer's single business tax base).

[47] *Kmart Props., Inc.*, [N.M.] St. Tax Rep. (CCH) ¶ 401-004, 21,176.

[48] *See id.* (noting that creation of KPI dramatically affected parent company's tax liability and that KPI, "a corporation with no formal operations in" New Mexico, did not pay state income taxes on royalty payment income).

[49] Gore Enter. Holdings, Inc. v. Dir. of Revenue, No. 99-2856 RI, 2002 WL 200918, at *2 (Mo. Tax Comm'n Jan. 3, 2002), *rev'd and remanded subnom*, ACME Royalty Co. v. Dir. of Holdings, Inc., 96 S.W.3d 72 (Mo. 2003) (consolidated opinion).

[50] *Id.* at *1.

[51] *Id.* at *1-*2.

[52] *Id.*

[53] *Id.* at *3.

[54] *Id.* (stating that some patent prosecution work was performed by parent company, which did not receive reimbursement).

attorneys to conduct patent prosecution work.[55] Over a three-year period, the holding company received about $120 million in royalty payments from the parent company.[56] The subsidiary filed no state income tax returns but filed information returns with Delaware, the subsidiary's state of incorporation.[57] Not surprisingly, Delaware does not tax royalty payments.[58]

Essentially, under the intellectual property tax scheme, companies with large intellectual property portfolios can legitimately avoid paying state taxes on income derived from royalties.[59] Some states have attempted to reach and tax this income based on the licensing of intellectual property assets.[60] These states face constitutional obstacles in light of the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota*.[61]

IV. CONSTITUTIONAL REQUIREMENT OF NEXUS PHYSICAL PRESENCE

Whether a state can tax an out-of-state or foreign company, such as an IP holding company, is a controversial and complex issue. What are the constitutional requirements a state must satisfy in order to tax an out-of-state company? There is no clear authority directly addressing the issue. Worse, the last attempt by the U.S. Supreme Court to shed light on the constitutional requirements for state taxation of an out-of-state company led to more speculation

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[55] *Id.*

[56] *Id.*

[57] *Id.* at *4.

[58] *See* DEL. CODE ANN. tit. 30, § 1902(b)(8) (1997 & Supp. 2004) (exempting corporations from state tax whose activities within Delaware "are confined to the maintenance and management of their intangible investments," which include "patents, patent applications, trademarks, trade names and similar types of intangible assets").

[59] Lanco, Inc. v. Dir., Div. of Taxation, 21 N.J. Tax 200, 219 (N.J. Tax Ct. Oct. 23, 2003) (recognizing that transfer and license-back arrangement is tax avoidance scheme). The *Lanco* court noted that "[l]egitimate means to minimize taxation are, of course, the prerogative of any business and perhaps the dictate of market-place competition." *Id.*

[60] *See* Prentiss Willson, *Recent State Corporate Income and Franchise Tax Developments*, 491 PLI/TAX 9, 18-29 (2001) (surveying taxations of in-state use of licensed intellectual property rights).

[61] 504 U.S. 298 (1992).

and confusion about the limitations on state authority to tax royalty income received by out-of-state IP holding companies.

A. THE *QUILL* MANDATE

The U.S. Supreme Court imposed a physical presence nexus requirement on states that impose a taxation burden on out-of-state companies in *Quill Corp. v. North Dakota*.[62] Quill was a Delaware corporation with offices and warehouses in Illinois, California, and Georgia.[63] It had neither tangible property nor employees in North Dakota.[64] Quill engaged in the business of selling office equipment and supplies via mail-order catalogs.[65] It estimated that $1 million in sales were made annually to 3,000 customers residing in North Dakota.[66] Quill delivered merchandise to customers by mail or common carrier from out-of-state locations.[67] The State of North Dakota required Quill to collect a use tax[68] from North Dakota consumers who purchased Quill products via mail-order catalogs and to remit the collected tax to the State.[69]

North Dakota essentially seized the remarkable growth of the mail-order business, which grew from a relatively inconsequential

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[62] *Id.* Prior to the *Quill* decision, it was "generally considered that the requirement of the Due Process Clause that an entity have certain minimum contacts with a taxing jurisdiction to support the imposition of a tax was not different from the substantial nexus component of the Commerce Clause standard." *Lanco*, 21 N.J. Tax at 204.

[63] *Quill*, 504 U.S. at 302.

[64] *Id.*

[65] *Id.*

[66] *Id.*

[67] *Id.*

[68] "Use tax" is a tax levied on the use of property purchased. Lanco, Inc. v. Dir., Div. of Taxation, 21 N.J. Tax 200, 205 n.2 (N.J. Tax Ct. Oct. 23, 2003). A sales tax is "[a] tax imposed on the sale of goods and services, [usually] measured as a percentage of their price." BLACK'S LAW DICTIONARY 1498-99 (8th ed. 2004).

[69] *Quill*, 504 U.S. at 302-03. The North Dakota use tax statute and regulation, as amended in 1987, required mail-order companies that engaged in solicitation to collect and remit use tax, even if those companies maintained no property or personnel in North Dakota. N.D. CENT. CODE § 57-40.2-07 (Supp. 1991) (requiring "retailer maintaining a place of business in" North Dakota to collect use tax from consumers and remit it to State). The term "retailer" included "every person who engages in regular or systematic solicitation of a consumer market in th[e] state." *Id.* § 57-40.2-01(6). The term "regular or systematic solicitation" meant three or more advertisements within a twelve-month period. N.D. ADMIN. CODE § 81-04.1-01-03.1 (1988).

market niche to a "goliath" with annual sales that reached " 'the staggering figure of $183.3 billion' " within a short period of twenty years, by imposing on out-of-state companies the obligation to collect a use tax on property purchased by in-state consumers and to remit that tax to the State.[70] The rationale for imposing the use tax was the economic benefit, legal infrastructure, support, and opportunities provided by the State to out-of-state companies that facilitate the demand for those companies' products and, consequently, the growth of such companies and their respective markets.[71] In the balance, the State believed there was a constitutionally sufficient nexus[72] to justify imposing the purely administrative duty of collecting and remitting the use tax.[73]

The U.S. Supreme Court agreed with much of North Dakota's reasoning, but declined to overrule its own precedent on the constitutional limitations of the taxing power of states on out-of-state companies.[74] The Court reemphasized and clarified that state taxing statutes on out-of-state companies must satisfy both the Due Process Clause and the Commerce Clause.[75] The Court uncoupled the two Clauses and explained that each Clause poses different and distinct limits on the states' taxing power.[76] A state may be

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[70] *Quill*, 504 U.S. at 303 (quoting Heitkamp v. Quill Corp., 470 N.W.2d 203, 208-09 (N.D. 1991)).

[71] *See id.* at 304 (noting North Dakota court's reasoning that State had created " 'an economic climate that fosters demand for' Quill's products, maintained a legal infrastructure that protected that market, and disposed of 24 tons of catalogs and flyers mailed by Quill into the State every year" (quoting *Heitkamp*, 470 N.W.2d at 218-19)).

[72] *Id.*

[73] *Id.* at 303 (noting North Dakota court observed that "advances in computer technology greatly eased the burden of compliance with a 'welter of complicated obligations' imposed by state and local taxing authorities").

[74] *Id.* at 301-02 ("[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.").

[75] *Id.* at 305 (emphasizing that in cases involving application of state taxing statutes to out-of-state sellers, precedents dictate that both Due Process and Commerce Clauses be satisfied). The Due Process Clause of the U.S. Constitution states: "No person shall . . . be deprived of life, liberty, or property, without due process of law. . . ." U.S. CONST. amend. V. "[N]or shall any State deprive any person of life, liberty, or property, without due process of law. . . ." U.S. CONST. amend. XIV, § 1. The Commerce Clause of the U.S. Constitution provides that: "The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." U.S. CONST. art. I, § 8, cl. 3.

[76] *Quill*, 504 U.S. at 302; *see also* Pamela M. Krill, Note, Quill Corp. v. North Dakota: *Tax Nexus Under the Due Process and Commerce Clauses No Longer the Same*, 1993 WIS. L.

consistent with the Due Process Clause and have the authority to tax a particular out-of-state company, but imposition of that tax may nonetheless stand in violation of the Commerce Clause.[77]

Indeed, the Court explained in great detail that due process mainly concerns the fundamental fairness of governmental activity and that the constitutional inquiry often focuses on "notice" and "fair warning" as the touchstone of nexus analysis.[78] For tax purposes, the Due Process Clause requires some minimum connection between a state and the person, property, or transaction it seeks to tax.[79] In light of Quill's purposeful direction of its advertising and selling activities toward North Dakota consumers, the Due Process Clause does not bar the State from enforcing its use tax against Quill.[80]

The Commerce Clause and its nexus requirement, in contrast, focus on structural concerns about the effects of state regulation on the national economy.[81] For tax purposes, the analysis centers on

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REV. 1405, 1425-26 (1993) (analyzing *Quill* on distinction between Due Process and Commerce Clauses and critiquing *Quill* on its potential impact on state's ability to impose taxation on foreign companies).

[77] *See Quill*, 504 U.S. at 305 ("Although the [Due Process and Commerce Clauses are closely related, they] pose distinct limits on the taxing powers of the States. Accordingly, while a State may, consistent with the Due Process Clause, have the authority to tax a particular taxpayer, imposition of the tax may nonetheless violate the Commerce Clause.").

[78] The Court, in uncoupling the Due Process and Commerce Clauses, succinctly stated that:

> 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.

Id. at 312. The Court noted that due process jurisprudence has evolved in the preceding twenty-five years, primarily in the area of in personam jurisdiction. *Id.* at 307.

Due process jurisprudence, as now applied to state taxation on out-of-state sellers, suggests that such a seller or corporation "clearly has fair warning that [its] activity may subject [it] to the jurisdiction of a foreign sovereign." *Id.* at 308 (quoting Shaffer v. Heitner, 433 U.S. 186, 218 (1977)).

[79] *Id.* (stating that solicitation through "a deluge of catalogs" alone met due process requirement for state use tax purpose because "requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State").

[80] *Id.*

[81] *Id.* at 312. Moreover, the Court noted that as the Commerce Clause jurisprudence has evolved, "no State has the right to lay a tax on interstate commerce" that causes direct burdens on interstate commerce. *Id.* at 309.

whether a tax is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state.[82] The fair apportionment and nondiscrimination inquiry prohibit taxes that pass an unfair share of the tax burden onto interstate commerce.[83] The substantial nexus and the relationship between the tax and the state-provided services inquiries seek to limit the reach of the state taxing authority, ensuring that state taxation does not unduly burden interstate commerce.[84] Accordingly, the substantial nexus requirement is not similar to the due process minimum contacts requirement, which is a proxy for notice and fair warning, "but [is] rather a means for limiting state burdens on interstate commerce."[85] A company may have the minimum contacts with a taxing state required by the Due Process Clause, yet lack the substantial nexus required by the Commerce Clause.[86] Since Quill neither owned property in North Dakota nor had employees in North Dakota, the Court reversed the state court's decision and remanded the case for further proceedings consistent with the Court's opinion on the substantial nexus requirement of the Commerce Clause.[87]

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[82] *Id.* at 311. The Court reapplied the four-part test first developed in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

[83] *Quill*, 504 U.S. at 313.

[84] *Id.*

[85] *Id.*

[86] *E.g.*, *id.* (stating that contrary to North Carolina's suggestion, "a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause").

[87] *Id.* at 313-19. Specifically, the Court noted that:

> North Dakota's use tax illustrates well how a state tax might unduly burden interstate commerce. On its face, North Dakota law imposes a collection duty on every vendor who advertises in the State three times in a single year. Thus, absent the *Bellas Hess* rule, a publisher who included a subscription card in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, all would be subject to the collection duty. What is more significant, similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions.

Id. at 313 n.6. The Court explicitly rejected the finding of nexus based on Quill's contact with North Dakota:

> In addition to its common-carrier contacts with the State, Quill also licensed software to some of its North Dakota clients. The State "concedes

The *Quill* decision sent a clear message to states that the Commerce Clause limits the taxing power of states regarding out-of-state companies. A taxing state must establish the physical presence of out-of-state companies within its jurisdiction in order for a state's sales or use taxing statute to pass constitutional muster. The constitutional requirement as dictated by *Quill* has direct consequences on state revenue since a state's reach to outside sellers is no longer expansive.[88]

B. POST-*QUILL* CHAOS FOR INTELLECTUAL PROPERTY

Since *Quill* directly limits state power to impose sales and use taxes on out-of-state companies, a major question in the post-*Quill* era is whether the physical presence requirement of the Commerce Clause extends to state power to tax income received from out-of-state companies.[89] Some commentators asserted that the physical presence constitutional standard is a myth with respect to limiting state power to tax income received by out-of-state companies.[90] Further, the assertion suggests that *Quill* permits state taxation of

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> that the existence in North Dakota of a few floppy diskettes to which Quill holds title seems a slender thread upon which to base nexus." We agree. Although title to "a few floppy diskettes" present in a State might constitute some minimal nexus, in *National Geographic Society v. California Bd. of Equalization*, 430 U.S. 551, 556 (1977), we expressly rejected a " 'slightest presence' standard of constitutional nexus." We therefore conclude that Quill's licensing of software in this case does not meet the "substantial nexus" requirement of the Commerce Clause.

Id. at 315 n.8 (citations omitted).

[88] *See* Diehl, *supra* note 5, at 44 (discussing decline in state income tax rate for corporations from 9.6% in 1980 to about 5.2% in 2002).

[89] This question has no clear answer because *Quill* has left many uncertainties. *See* Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425, 460 (1997) ("At the end of the analytical day, one is once again faced with uncertainties in the income tax arena similar to those confronted in the sales and use tax context.").

[90] *See generally* Michael T. Fatale, Geoffrey *Sidesteps* Quill*: Constitutional Nexus, Intangible Property and the State Taxation of Income*, 23 HOFSTRA L. REV. 407 (1994) (claiming *Quill* physical presence requirement is insufficient to clear up issues regarding taxing power of states under Due Process and Commerce Clauses and discussing South Carolina case that answered question of whether state can tax income of corporation outside state where income is derived from intangible property used within state); Fatale, *supra* note 38, at 105 (reviewing U.S. Supreme Court's physical presence requirement, examining how state courts have applied this requirement, and concluding that physical presence requirement is not requirement in fact).

such income "by virtue of an intentional exploitation of the state's market without physical presence in the state."[91]

Others, however, interpreted *Quill* as dictating a bright-line approach not only for sales and use taxes, but also for state income taxation of out-of-state companies, which requires physical presence for substantial nexus in order to satisfy the Commerce Clause mandate.[92] To read *Quill* otherwise would render an incongruity: Out-of-state companies would not have a sufficient nexus with the taxing state for sales and use tax purposes, but would have a substantial nexus with the taxing state for income tax purposes.[93]

As a result, a number of states tried taxing the income received by out-of-state IP holding companies that are separate entities, have no tangible assets, and hire no employees in the taxing state.[94] Meanwhile, other states have failed to reach IP holding companies for lack of physical presence in the taxing state, even though the IP holding companies license their intellectual property assets to affiliates or parent companies for use within that state.[95]

V. SITUS OF INTELLECTUAL PROPERTY INQUIRY

In desperate attempts to reach income generated by the licensing of intellectual property assets, states will flex their taxing power in order to subject out-of-state IP holding companies to state income

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[91] Lanco, Inc. v. Dir., Div. of Taxation, 21 N.J. Tax 200, 208 (N.J. Tax Ct. Oct. 23, 2003) (analyzing commentator's discussion of *Quill*).

[92] *See* Chiang, *supra* note 29, at 1542 ("A physical presence requirement for income taxes is necessary to prevent states from shifting their tax burdens onto out-of-state companies. It is not as necessary for use taxes, because the taxing state's own consumers will end up bearing part of the burden of the use tax.").

[93] *See* Cerro Copper Prods., Inc. v. State, No. F. 94-444, 1995 WL 800114, at *3 (Ala. Dep't Rev. Dec. 11, 1995)

> If the Taxpayer does not have sufficient nexus with Alabama for sales and use tax purposes, which it clearly does not have under *Quill*, then it is incongruous that the taxpayer would have 'substantial nexus' to be subject to Alabama's franchise tax. As a practical matter, the same benefits of a bright-line, physical presence test cited in *Quill*, at page 1915, for sales and use tax purposes would also apply equally to other types of taxes.

[94] *See* John E. Gaggini, *State Taxation of Passive Income Subsidiaries*, 473 PLI/TAX 779, 793-96 (2000) (surveying states that tax income received by out-of-state companies). Notably, South Carolina, New Mexico, and North Carolina are the leading states in such taxation. *Id.*

[95] *See id.* at 797-801 (surveying states that declined to tax income received by out-of-state companies).

taxation. These states circumvent *Quill* by adopting an approach centered on the belief that intellectual property has a business situs where the goods associated with those intellectual property rights are offered for sale at locales within the state.[96]

A. BUSINESS SITUS

Under the business situs theory, intangibles acquire situs for taxation purposes if they have become an integral part of local business.[97] Under this premise, intangibles are assigned a tax situs in a state where the owner or holder of the intangibles is not physically present.[98] The business situs of intellectual property goods—whether trademarked, copyrighted, or patented—allows the taxing jurisdiction to have a substantial nexus with the out-of-state company.[99] Thus, applying the business situs theory, a state can tax royalty income derived from the intellectual property rights used in connection with the sale of goods or services within the state, even though the holder of the intellectual property is incorporated, owns tangible property, or has employees conducting business in a different jurisdiction.[100]

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[96] Business situs is also referred to as the "economic presence" approach. *See id.* at 793 (stating that South Carolina adopted "economic presence" approach where "taxable nexus may be established through economic benefits derived from the taxing state" in royalty income cases).

[97] *See* Megan E. Groves, *Where There's a Will, There's a Way: State Sales and Use Taxation of Electronic Commerce*, 74 IND. L.J. 293, 305 (1998) (noting that intangibles transferred into state acquired business situs within that state because they had become part of local business conducted within state); John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 347 (2003) (noting that "business situs" was first used in Due Process case where New York successfully attempted to tax nonresident on gain from sale of membership in New York Stock Exchange).

[98] *See* Paull Mines, *Commentary Conversing with Professor Hellerstein: Electronic Commerce and Nexus Propel Sales and Use Tax Reform*, 52 TAX L. REV. 581, 606-07 (1997)

> Business situs presence satisfies the due process requirement that property must be within the taxing state before it can be made subject to a property tax. . . . Ownership of an intangible with a business situs in the taxing state creates jurisdiction for the state to impose an income tax on the gain realized by a nonresident from the sale of the intangible. The state has sufficient jurisdiction even though the nonresident exclusively operated from a point outside of the taxing state.

[99] *Id.* at 607.

[100] *See* Geoffrey, Inc. v. S.C. Tax Comm'n, 437 S.E.2d 13, 17 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993) (applying business situs and concluding that intangibles acquired business

The extension of the business situs rule to IP holding companies appeared twenty years ago in an administrative decision, *In re Addax Music Co.*[101] In this case, the New York Department of Taxation and Finance (Department) ruled that petitioner Addax Music, a wholly owned subsidiary of Paramount Pictures that only held copyrights to musical compositions and received royalties through its membership in an intermediary, was subject to New York income tax in the form of a franchise tax.[102] Addax Music was a California corporation and had no employees, and all of its accounting and administrative functions were performed by employees of Paramount Pictures in California.[103] Addax Music received its royalty payments via its membership in ASCAP, a nonprofit membership association of composers, lyricists, and music publishers.[104] ASCAP collected fees from nonexclusive blanket licenses and distributed them to its members.[105] The Department asserted that although Addax Music was not based in New York, its copyrighted compositions nevertheless had a taxable situs there[106] because the copyrighted compositions were integrated in the local

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situs in South Carolina); *see also* Fatale, *supra* note 90, at 411 ("The business situs rule . . . states generally that an item of intangible property requires a taxable situs in a state when it is used in that state in a local business.").

[101] No. 28376 TSB-H-85(1)(C), 1984 WL 179619 (N.Y. Dep't Tax. & Fin. Dec. 14, 1984). The doctrine of business situs, however, has been applied in much earlier cases that did not involve intellectual property. *E.g.*, Farmers' Loan & Trust Co. v. Minnesota, 280 U.S. 204, 213 (1929) (citations of cases omitted) (holding that decedent's bonds and certificates "had acquired permanent situs for taxation in New York," not in state of owner's domicile, because they had become integral parts of local businesses).

[102] The Audit Division issued a Notice of Estimated Deficiency for the tax years from 1971 through 1977 for the franchise taxes due under New York Tax Law. *Addax Music Co.*, 1984 WL 179619, at *1. The Department held a hearing and subsequently decided that Addax Music was subject to the franchise tax on business corporations for the years at issue. *Id.* at *4.

[103] *Id.* at *1.

[104] *Id.* at *1-*2. ASCAP is the American Society of Composers, Authors and Publishers. Generally, ASCAP holds the repertory of all the copyrighted works of its members. On behalf of its members, ASCAP grants nonexclusive blanket licenses to users. *Id.*

[105] *Id.* at *2. ASCAP could not, however, determine from its records how much of a member's royalty for a particular composition is derived from a particular state. *Id.* It could only ascertain the amount of fees collected from licensees in a particular state, such as New York. *Id.*

[106] *Id.* at *3. The Department stated that "intangibles . . . have a taxable situs of their own which may be away from the domicile of the owner if they have become integral parts of some local business." *Id.* (citations omitted).

New York business through the licensing arrangements.[107] The Department found that Addax Music, through ASCAP, monitored and licensed its music composition in New York.[108] Essentially, Addax Music obtained its royalty income through the copyrights used in the local New York business market.[109] Therefore Addax Music, a copyright holding company, was subject to the imposition of a New York franchise tax on business corporations.[110] The *Addax Music* case did not advance any further and has since remained an obscure administrative decision.

Facing the stringent *Quill* mandate of physical presence for substantial nexus and the subsequent shrinkage of state tax dollars, states have aggressively resurrected the business situs rule and applied it with vigor in cases involving significant intellectual property rights.[111] The leading case in the revival effort was *Geoffrey, Inc. v. South Carolina Tax Commission*, which applied the business situs theory to that state's taxation of income in order to reach an IP holding company that had no physical contact in South Carolina.[112]

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[107] *Id.* The Department framed the issue as "whether the copyrights were an integral part of some local business activity" of Addax Music. *Id.* The Department affirmatively answered this inquiry. *Id.*

[108] *Id.* (noting that petitioner through ASCAP licensed use of its copyrighted music and collected its royalties based on user fee distribution formula).

[109] *Id.* at *4 ("[P]etitioner's means of continued efforts in the pursuit of profit and gain as well as the local business into which petitioner's intangibles were, of necessity, integrated." (internal punctuation omitted)).

[110] *Id.*

[111] *See* Kmart Props., Inc. v. Taxation & Revenue Dep't, [N.M.] St. Tax Rep. (CCH) ¶ 401-004, 21,181 (N.M. Ct. App. Nov. 27, 2001), *writ granted*, 40 P.3d 1008 (N.M. 2002) (table case) (regarding Commerce Clause test, court observed that whatever test is, Kmart's trademark subsidiary has sufficient nexus by virtue of Kmart's use of its trademarks in New Mexico market for purpose of generating substantial income); Geoffrey v. S.C. Tax Comm'n, 437 S.E.2d 13, 18 (S.C. 1993) (holding that Delaware company receiving royalty income from use of intangible trademark in South Carolina had sufficient nexus with South Carolina for purposes of tax liability despite lacking physical presence or tangible property within state). An example of a recent application of business situs is a July 1, 2002, Letter of Findings issued by Indiana, wherein the Department of Revenue ruled that the taxpayer's intellectual property had acquired an Indiana "business situs because all of the value derived from this property was attributable entirely to activities occurring in Indiana." Michael W. McLoughlin, *Jurisdiction and Nexus*, *in* 575 STATE & LOCAL TAXATION: WHAT EVERY LAWYER NEEDS TO KNOW 93, 109 (PLI Tax Lawyer & Estate Planning Course, Handbook Series No. J0-008V, 2003).

[112] 437 S.E.2d at 19-20.

In *Geoffrey*, Toys "R" Us, Inc., created Geoffrey, Inc., a wholly-owned subsidiary, in Delaware.[113] Geoffrey owned all trademarks and know-how and licensed this intellectual property to the parent company in exchange for royalty payments.[114] In 1985, Toys "R" Us began doing business in South Carolina and since then had made royalty payments to Geoffrey based on South Carolina sales.[115] The South Carolina Supreme Court applied the business situs theory to the intellectual property licensed for use in South Carolina and found that the intellectual property was located in South Carolina.[116] That subjected Geoffrey, the intellectual property holder, to South Carolina taxation.[117] The court rejected Geoffrey's argument that its intellectual property assets were held at its corporate headquarters in Delaware, not in South Carolina.[118] Without analysis, the court summarily ruled that the constitutional requirement of substantial nexus under the Commerce Clause[119] was established because the intellectual property was present

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[113] *Id.* at 15.

[114] *Id.* (describing transactions between Geoffrey and parent company with respect to trademarks and trade names). The parent company transferred all trademarks and trade names to Geoffrey, and Geoffrey granted an exclusive license to the parent company to use the trademarks and trade names in the United States, except New York, Texas, Pennsylvania, Massachusetts, and New Jersey. *Id.* In addition, Geoffrey granted an exclusive right to the parent company to use Geoffrey's know-how in connection with the advertising, marketing, and sales of products associated with the trademarks. *Id.* at 17. Geoffrey, in exchange for the license grant, received 1% of the net sales by the parent company or its affiliates or subsidiaries. *Id.* The royalty payments were transferred via wire from a Toys "R" Us account in Pennsylvania to a Geoffrey account in New York. *Id.*

[115] *Id.* at 15. Toys "R" Us subsequently deducted the royalty payments made to Geoffrey from its South Carolina taxable income. *Id.* The South Carolina tax commission allowed this deduction despite its initial opposition. *Id.*

[116] *Id.* at 17 ("[I]ntangibles may acquire a situs for taxation other than at the domicile of the owner if they have become integral parts of some local business." (citations omitted)).

[117] *Id.* (finding that "Geoffrey's purposeful direction of activity toward South Carolina as well as its possessing intangible property here provide a definite link between South Carolina and the income derived by Geoffrey from the use of its trademarks and trade names in this State").

[118] *Id.*

[119] Although the U.S. Supreme Court in *Quill* specifically stated that the Due Process requirement is distinct from the Commerce Clause standard, the South Carolina court took a contrary position, importing its Due Process analysis into its Commerce Clause analysis. *Id.* at 18 n.5 ("Further discussion of the remaining requirements of the Commerce Clause is unnecessary. Our Due Process analysis of the benefits conferred upon Geoffrey applied with equal force here and need not be repeated.").

through the licensing arrangement, and the royalty income was derived from such license.[120]

Further support for the business situs rule was offered in *Kmart Properties, Inc. v. Taxation & Revenue Department*, wherein the New Mexico Court of Appeals held that KPI, Kmart's Michigan trademark holding company, was subject to New Mexico income taxation.[121] The New Mexico Court of Appeals followed *Geoffrey*, reasoning that KPI had a substantial nexus with New Mexico through its trademark licensing activity with Kmart stores within New Mexico's economic market for the purpose of generating income for KPI.[122] The court concluded that the "combination of Kmart Corporation's activities in New Mexico, together with the tangible presence of KPI's marks, constitute[d] the functional equivalent of physical presence," even though KPI did not have any of its own employees, operations, offices, or facilities physically located within New Mexico.[123] KPI was subject to New Mexico income taxation.[124]

Likewise, in a 2002 case, *Secretary of Revenue v. A & F Trademark, Inc.*, the North Carolina Tax Board held that IP holding companies were subject to North Carolina taxation because the subsidiaries' trademarks and their associated goodwill were used in North Carolina at numerous retail stores.[125] The subsidiaries were

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[120] *Id.* at 18 ("The presence of intangible property alone is sufficient to establish nexus. . . . We hold that by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a 'substantial nexus' with South Carolina.").

Recently, the South Carolina Tax Commission issued a revenue ruling that claims the licensing of trademarks or trade names to either related or unrelated entities with locations in South Carolina constitutes a sufficient nexus to subject the out-of-state licensor to South Carolina income tax. *Nexus Creating Activities for Income Taxes*, S.C. Revenue Ruling No. 03-4, at 6 (Dec. 9, 2003), *available at* http://www.sctax.org/NR/rdonlyres/D07DB5A7-82F8-4AEE-9241-F680FE81F93E/0/RR034.pdf.

[121] [N.M.] St. Tax Rep. (CCH) ¶ 401-004, 21,176 (N.M. Ct. App. Nov. 27, 2001), *writ granted*, 40 P.3d 1008 (N.M. 2002) (table case).

[122] *Id.* Pursuant to the license agreement executed in Michigan, KPI licensed trademarks to Kmart Corporation and received royalty payments based on 1.1% of Kmart Corporation's gross sales throughout the United States. *Id.*

[123] *Id.* KPI protested that the imposition of state income tax violated the Commerce Clause due to KPI's lack of physical presence in New Mexico. *Id.* The court, however, ruled that the physical presence does not extend to state income taxation. *Id.*

[124] *Id.*

[125] [2 N.C.] St. Tax Rep. (CCH) ¶ 202-146, 11,041 (N.Y. Tax Rev. Bd. May 7, 2002). The Board noted that the IP holding companies own and license trademarks to nine retail companies that have more than 130 stores located in North Carolina. *Id.*

Delaware corporations, holding trademarks previously owned by The Limited and related retail companies.[126] These same retail companies transferred their trademarks to the IP holding companies and obtained the license rights to use these same trademarks in exchange for royalty fees from the subsidiaries.[127] The Limited and the related retail companies deducted royalty payments from their income for North Carolina.[128] The Tax Board found that the subsidiaries' trademarks exist in North Carolina since trademarks are the kind of property that "exist[s] only where it is used."[129] Further, the use of trademarks permanently affixed to retail locations and appearing on the labels of merchandise sold at such stores renders the marks in use each time employees at the locations sell the merchandise.[130] Therefore, such use of the trademarks occurs in North Carolina and preserves the existence of the subsidiaries' trademarks. Accordingly, the IP holding companies are subject to North Carolina taxation.[131]

These court and administrative decisions illustrate that the business situs theory has been revived by local taxing authorities to extend the state's taxing power to reach out-of-state IP holding

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[126] *Id.* The IP holding companies are Lanco, Inc., for Lane Bryant and related trademarks; Lernco, Inc., for Lerner and related trademarks; A & F Trademark, Inc., for Abercrombie & Fitch and related trademarks; V. Secret Stores, Inc., for Victoria's Secret and related trademarks; Expressco for Limited Express or "Express" related trademarks; Caciqueco, Inc., for Cacique and related trademarks; Structureco, Inc., for Structure and related trademarks; Limtoo, Inc., for Limited Too and related trademarks; and Limco Investments, Inc., for The Limited, Inc., and related trademarks. *Id.*

[127] *Id.* at 11,055-56 (stating that IP holding companies received $301,067,619 in royalty income and $122,031,344 in interest income from related retail companies in 1994 tax year).

[128] *Id.* at 11,055.

[129] *Id.* at 11,056 (adopting Assistant Secretary's reasoning).

> [P]rinciples of trademark law . . . property cannot exist apart from an established business in which it is used; if the property is not used, the property is considered abandoned and ceases to exist. The Taxpayers' property therefore exists only where it is used. The Taxpayers' property is used extensively in North Carolina in connection with established businesses. These established businesses are the 130 plus North Carolina retail locations of the Taxpayers' related retail companies.

Id.

[130] *Id.*

[131] *Id.* (affirming findings by Assistant Secretary that IP holding companies own "income-producing property in North Carolina" and license "income-producing property in North Carolina," and therefore, IP holding companies were "doing business" under applicable North Carolina statutes and administrative rules).

companies.[132] The decisions reflect a desperate attempt by local taxing authorities to address the need to raise revenue in the post-*Quill* era since the *Quill* Court mandated a bright-line approach to state taxation wherein the physical presence of a foreign company in the taxing jurisdiction is required.[133] The attempt to distinguish *Quill* as applicable only to use and sales tax cases, not income tax cases, propels adoption of the business situs theory wherein the presence of intellectual property is sufficient to justify the substantial nexus between the taxing jurisdiction and the foreign IP holding company.[134]

B. PROBLEMS WITH BUSINESS SITUS FOR INTELLECTUAL PROPERTY

A state's desire to reach royalty payments received by foreign IP holding companies is understandable since foreign IP holding companies are not subject to any state taxation because their royalty payments are "nowhere" income.[135] They enjoy state tax-free status

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[132] *See* Sec'y, Dep't of Revenue v. GAP (Apparel), Inc., 886 So. 2d 459, 462 (La. Ct. App. 2004) (holding that trademarks licensed by California corporation for use in Louisiana are integral part of Louisiana licensee's businesses and thus California corporation's trademarks had acquired business situs in Louisiana for corporate income tax purpose); Lanco, Inc. v. Dir., Div. of Taxation, 21 N.J. Tax 200, 210-12 (N.J. Tax Ct. Oct. 23, 2003) (critiquing *Geoffrey* and "New Mexico state court decision" for their proposition that physical nexus is required for state income taxation and noting that *Geoffrey* both failed to engage in Commerce Clause inquiry and cited to precedents on due process analysis for support); Indiana Letter of Finding, 26 Ind. Reg. 959, 959-60 (2002) (finding trademarks of Delaware IP holding company had business situs in Indiana for both adjusted gross income tax and gross income tax purposes).

[133] *See* Howard, *supra* note 29, at 574-79 (noting that because *Quill* left question open as to physical presence requirement for state income taxation, some states have sidestepped *Quill* by asserting economic nexus theory and attributional nexus theory, among others).

[134] *See Lanco*, 21 N.J. Tax at 210-11 (critiquing thesis of business situs subsequent to *Quill*).

[135] The frustration with "nowhere" income has been forcefully expressed in a dissenting opinion in *Acme Royalty Co. v. Director of Revenue*, 96 S.W.3d 72, 78 (Mo. 2002) (Wolff, J., dissenting) (citation omitted):

> [T]hese corporations shifted income taxable in Missouri to Delaware, where income from patents and trademarks is tax-free. . . . [A] bare corporate change can make income that is taxable today not taxable tomorrow. The result is the creation of so-called nowhere income—income that is taxed in no state.
>
> Nowhere income, it might be noted, is not just affecting individual states. . . . Companies set up offshore subsidiaries so they can transfer royalties from sales of products made outside the United States to places

due to the resultant shifting of intellectual property asset ownership within the corporate structure. The "nowhere" income has become a frustration to states futilely trying to extend their reach to tax such income.[136] However, categorically assigning intellectual property like patents, copyrights, trade secrets, and trademarks a business situs wherever the products associated with such intellectual property rights are offered for sale[137] is overreaching.

Indeed, under the business situs theory, national book authors have much to fear from a state's taxation reach. For example, John Grisham, a national author of legal thrillers, has his books sold in major bookstores across the United States.[138] In order for the legitimate sale of his books to occur, both the John Grisham name and the associated bundle of copyrights—such as derivative, reproduction, distribution, public display, and performance rights[139]—have already been the subject of a license arrangement between the book publisher and the author.[140] Like many national

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> like Bermuda. . . . By moving their profits to places where such income is not taxable, companies are avoiding taxation in places such as Missouri where those profits were derived.

Id.

[136] *See id.* (noting corporations' avoidance of state and federal taxes).

[137] *Id.* at 79-80 (Wolff, J., dissenting) (asserting that "intellectual properties, the patent and trademark rights, are part of the products that are sold," and thus holders of such intellectual property benefit from state where products are sold, and that benefit should subject such holders to state income taxation); *see also GAP*, 886 So. 2d at 462 (finding that licensed trademarks provide connection with Louisiana for corporate income tax purposes).

[138] *See* http://www.randomhouse.com/features/grisham/author.html (last visited Feb. 18, 2005) (providing listing and ranking of Grisham's books).

[139] Copyright law grants the author ownership of a copyright, as well as the exclusive rights to do and to authorize any of the following:

> (1) to reproduce the copyrighted work in copies or phonorecords;
> (2) to prepare derivative works based upon the copyrighted work;
> (3) to distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending;
> (4) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly; [and]
> (5) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work, to display the copyrighted work publicly.

17 U.S.C. § 106 (2000).

[140] The arrangement between publishers and authors was noted by the U.S. Supreme

authors, Grisham has appeared on book tours to promote his novels.[141] Thus, he may be deemed actively involved at the macro level in the local business of selling books. Book authors generally receive their royalty payments based on the number of copies sold.[142] National authors most likely receive their income from royalty payments, whether in the form of an advance, lump sum, or periodic installments.[143] Since the copyrights and author's name are integral to the business of selling books at the local level, state taxing authorities would argue that Grisham's intellectual property has acquired business situs in each state where the books are sold.[144] Therefore, according to the business situs rule, a state may tax Grisham on the royalty income that he receives from his publisher. Grisham potentially faces such taxation in all states, except those few states that do not impose a tax on royalty income, such as Michigan and Delaware. That certainly leads to multiple taxation problems as well as an administrative impossibility for authors as taxpayers.[145]

Court in *Mills Music, Inc. v. Snyder*, 469 U.S. 153, 175 n.43 (1985) (noting usual practice in publishing industry that "book authors usually contract with book publishers for the publication of their works, the publisher taking title to all rights in the work subject to the provisions of the contract" (citation omitted)).

[141] Grisham signed books at independent bookstores before he became an internationally known author. *See* Bob Summer, *Grisham's Southern Loyalists*, PUBLISHERS WKLY., Mar. 3, 2003 (noting Grisham's return to five independent bookstores for signings), *available at* http://www.keepmedia.com/ShowItemDetails.do?itemID=119968&extID=10032&oliID=213 (last visited Feb. 18, 2005).

[142] *Mills Music, Inc.*, 469 U.S. at 175 n.43 ("The author usually receives a royalty computed as a percentage of the price at which each book is sold or as a percentage of the total volume of sales." (citation omitted)).

[143] *See* Comm'r v. Wodehouse, 337 U.S. 369, 385 n.8 (1949) (noting for tax purposes "that a payment in the nature of a rent or royalty is in a lump sum rather than so much per annum, per unit of property, per performance, per book sold, or a certain percentage of the receipts or profits, does not alter the character of the payment as rent or royalty" (citations omitted)).

[144] *See* Acme Royalty Co. v. Dir. of Revenue, 96 S.W.3d 72, 72 (Mo. 2002) (holding that sufficient business within state merits paying state income tax on royalty income); Kmart Props., Inc. v. Taxation & Revenue Dep't, [N.M.] St. Tax Rep. (CCH) § 401-004, 21,176 (N.M. Ct. App. Nov. 27, 2001), *writ granted*, 40 P.3d 1008 (N.M. 2002) (table case) (same); *In re* Addax Music Co., 1984 WL 179619, at *1 (N.Y. Dep't Tax & Fin. Dec. 14, 1984) (same); Geoffrey v. S.C. Tax Comm'n, 437 S.E.2d 13, 13 (S.C. 1993) (same).

[145] *See* Lanco, Inc. v. Dir., Div. of Taxation, 21 N.J. Tax 200, 216 (N.J. Tax Ct. Oct. 23, 2003) (noting tax expert's testimony that multiple taxation and administrative inefficiency are among potential problems if state taxation fails to adhere to Commerce Clause requirements).

Moreover, copyrights and other intellectual property do not exist in perpetuity, and Grisham's intellectual property rights in connection with his books may expire before all the physical copies of the books are sold.[146] This means Grisham may still receive royalty payments for the books in print while his intellectual property rights have already terminated.[147] Could states continue to assert that there is a substantial nexus between the state and Grisham, even though Grisham's intellectual property rights no longer exist? The link between Grisham and the state vis-à-vis the intellectual property rights previously used in the sale of Grisham books at various locations within a state vanishes as there are no longer intangible rights to form the business situs.

Constitutionally, the business situs theory has additional problems. Courts applying and commentators advocating the business situs rule often prematurely limit the business situs to the due process analysis.[148] They ignore the Commerce Clause nexus analysis.[149] This is in direct conflict with the established requirement that states may impose taxation to the extent constitutionally permissible, which ensures both Due Process and Commerce Clause requirements are satisfied.[150] Since the *Quill* Court interpreted the

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[146] *See* 17 U.S.C. § 302 (2000) (establishing term of copyright protection as life of author plus seventy years).

[147] A parallel example is the license of Listerine. Though the trade secret of the Listerine formula is known in the trade, the licensee continues to pay the licensor royalty payments pursuant to the contract. *See* Warner-Lambert Pharm. Co. v. John J. Reynolds, Inc., 178 F. Supp. 655, 667 (S.D.N.Y. 1959) (upholding contract between parties where trade secret became discoverable).

[148] *E.g.*, *Geoffrey*, 437 S.E.2d at 16-17 (analyzing business situs of intellectual property under due process and finding that "Geoffrey's purposeful direction of activity toward South Carolina as well as its possessing intangible property here provide a definite link between South Carolina and the income derived by Geoffrey from the use of its trademarks and trade names in this State").

[149] *See Lanco*, 21 N.J. Tax at 210 (noting that cases that applied business situs rule focused only on due process analysis). The *Lanco* court stated that such case authorities failed to lend support to the assertion that the "Commerce Clause nexus may be found absent physical presence ascribable to a taxpayer." *Id.* at 212. For example, a 2004 decision rendered by the Louisiana Court of Appeals limited its analysis to due process. Sec'y, Dep't of Revenue v. GAP (Apparel), Inc., 886 So. 2d 459, 461 (La. Ct. App. 2004) (concluding that "[i]f a foreign corporation purposefully avails itself of the benefits of an economic market in the forum state, it may subject itself to the state's personal jurisdiction even if it has no physical presence in the state").

[150] *See* Quill Corp. v. Heitkamp, 504 U.S. 298, 305 (1992) (stating that both Due Process and Commerce Clauses impose limits on states taxing interstate companies); *Lanco*, 21 N.J.

Commerce Clause to require tangible property or physical presence within a state for the establishment of a substantial nexus,[151] using the business situs of intellectual property as the required link between a state and the foreign holder of intellectual property rights cannot withstand constitutional muster.[152]

In addition, the business situs theory is incongruous, as illustrated in the next hypothetical. Imagine that Grisham decides to offer a few autographed copies of his books for sale via telephone. Now, Grisham has become a remote seller of those limited copies. Under the *Quill* mandate, a state cannot impose sale or use taxes on Grisham—the remote seller—due to the lack of a substantial nexus between the state and Grisham. If there is no substantial nexus under the Commerce Clause for use and sales taxes, how could a substantial nexus under the Commerce Clause be present for state income taxes? It would be incongruous to assert that there is nevertheless a substantial nexus between the state and Grisham for state taxation of royalty payments that Grisham receives based on the volume of his books sold at retailers across the state and yet no substantial nexus between the state and Grisham for sales or use taxes.[153]

Tax at 204 ("State taxation of entities engaged in interstate commerce must comport with the Due Process and Commerce Clauses of the United States Constitution.").

[151] *See Quill*, 504 U.S. at 311 (noting that Court, on several occasions, has affirmed sharp distinction between mail-order sellers with physical presence in taxing state and those who do no more than communicate with customers in state by mail or common carrier as part of general interstate business). The Court has also expressed " 'doubt that termination of an interstate telephone call, by itself, provides a substantial enough nexus for a State to tax a call.' " *Id.* (quoting Goldberg v. Sweet, 488 U.S. 252, 263 (1989)).

[152] The *Quill* Court adopted a bright-line approach in imposing the physical presence test for sales and use tax because such an approach "encourages settled expectations and, in doing so, fosters investment by businesses and individuals." *Id.* at 316. The Court noted that Congress adopted a similar approach for state taxation of net income. *Id.* at 316 n.9 ("It is worth noting that Congress has, at least on one occasion, followed a similar approach in its regulation of state taxation. . . . Congress enacted Pub. L. 86-272, codified at 15 U.S.C. § 381[, which forbids states from imposing] a net income tax on any person if that person's 'only business activities within such State [involve] the solicitation of orders [approved] outside the State [and] filled . . . outside the State.' ").

[153] *See* Cerro Copper Prods., Inc. v. State, No. F. 94-444, 1995 WL 800114, at *3 (Ala. Dep't Rev. Dec. 11, 1995) ("If the Taxpayer does not have sufficient nexus with Alabama for sales and use tax purposes, which it clearly does not have under *Quill*, then it is incongruous that the Taxpayer would have 'substantial nexus' to be subject to Alabama's franchise tax.").

VI. BALANCING INTERESTS IN HOLDING INTELLECTUAL PROPERTY

As intellectual property assets continue to be valuable corporate assets, holders of such assets will seek ways to legitimately minimize tax burdens in their quest to maximize overall corporate revenue and profit.[154] States that want to extend their taxing power to reach IP holding companies should first have some understanding of the nature of intellectual property rights.[155] Sound tax policies require considering the interests of intellectual property rights holders and then balancing those interests with local taxation.

A. CORPOREAL NATURE OF INTELLECTUAL PROPERTY, INFRINGEMENTS, AND REMEDIES

Intellectual property is a peculiar form of intangible property.[156] One cannot touch and feel a trademark, copyright, trade secret, or patent, and yet trademarks, copyrights, trade secrets, and patents seem to be everywhere.[157] A trademark affixed to a tangible product is present wherever the product is shipped, offered for sale, and consumed.[158] A copyright is intangible, yet has a presence wherever

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[154] *See Lanco*, 21 N.J. Tax at 219 (noting that "perhaps the decisive reason . . . for placing ownership of intangibles in a separate corporation . . . is the avoidance of taxation").

[155] The intellectual property rights holder understands its valuable intellectual property assets and the intangible nature of the rights embodied in the physical copies. Furthermore, the intellectual property rights holder will search different jurisdictions for favorable taxation results before conducting its business. That leaves the taxing authority "bound where the taxpayer has chosen shrewdly." *Id.*

[156] *See* Carole R. Klein et al., *Intellectual Property Issues*, 1431 PLI/CORP 703, 708 (2004) ("Although possession of tangible assets provides some evidence (if no adverse claims are made) of ownership, possession of many intangible assets is nearly meaningless as an indicator of ownership because a number of people can possess the same intellectual property in different ways and not necessarily have an ownership interest.").

[157] *See* Howard Siegel & Linda A. Newmark, *Music Publishing*, 782 PLI/PAT 855, 1078 (2004) ("[I]ntellectual property, practically speaking, means that it is intangible, something that can not be touched.").

[158] According to the federal trademark statute, a trademark is deemed to be used in commerce

> (1) on goods when—
>
> (A) it is placed in any manner on the goods or their containers or the displays associated therewith or on the tags or labels affixed thereto, or if the nature of the goods makes such placement impracticable, then on documents associated with the goods or their sale, and
>
> (B) the goods are sold or transported in commerce[.]

a tangible copy of the copyrighted work is transported and used.[159] A trade secret or a patent is embodied in the tangible, movable, and physical machinery, process, product, or method.[160]

Where is the situs of a trademark, copyright, trade secret, or patent? According to trade secret law, trade secrets have a fictional situs where the trade secret owner resides.[161] Further, trade secrets have a situs in their state of origin.[162] Indeed, numerous courts have held that with respect to intellectual property protected under state law, the holder's state residence is the situs of the intellectual property interests.[163]

Federal trademarks, copyrights, and patents, on the other hand, are not protected under state law;[164] they are protected under

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15 U.S.C. § 1127 (2000).

[159] The copyright of a work of authorship is present in the sense that the copyright is fixed in the tangible object such as a book or a CD ROM. *See* Advent Sys. v. Unisys Corp., 925 F.2d 670, 675 (3d Cir. 1991) (holding that computer program may be copyrightable as intangible intellectual property, but once it is copied onto floppy disc it becomes tangible physical good); Tyler T. Ochoa, *Copyright, Derivative Works and Fixation: Is Galoob a Mirage, or Does the Form(Gen) of the Alleged Derivative Work Matter?*, 20 SANTA CLARA COMP. & H. TECH. L.J. 991, 995-96 (2004) (stating that copyright law separates work of authorship—an intangible intellectual creation in which copyright subsists—from tangible object in which work is fixed).

[160] *E.g.*, Tarek N. Fahmi, *IP Due Diligence: Methodologies and Practices*, 779 PLI/PAT 841, 897 (2004) (describing process patents embodied in products); Corey B. Blake, Note, *Ghost of the Past: Does the USPTO's Scientific and Technical Background Requirement Still Make Sense?*, 82 TEX. L. REV. 735, 764 (2004) (describing method patents embodied in computer program).

[161] *See* MELVIN F. JONGER, TRADE SECRETS LAW § 4:03[1] (1988) (describing choice of law in trade secrets cases).

[162] *See* Harry Miller Co. v. Carr Chem Inc., 5 F. Supp. 2d 295, 298 n.1 (E.D. Penn. 1998) (distinguishing proper venue for trade secret actions as opposed to trademark actions).

[163] *E.g.*, Paolino v. Channel Home Ctrs., 668 F.2d 721, 724 n.2 (3d Cir. 1981) (noting that "[s]ince intellectual property cannot have a physical situs the law of the state of residence of the person who initially developed and protected the secret appears to be the obvious starting point for its protection"). When a nonresident interferes with intellectual property, it is foreseeable that the state creator would reach out through its courts to protect those rights it bestowed upon its citizens. Anderson v. Century Prods. Co., 943 F. Supp. 137, 144 (D.N.H. 1996).

[164] Trademarks are protected under both state and federal law. Rachel Clark Hughey, *The Impact of* Pro-Football, Inc. v. Harjo *on Trademark Protection of Other Marks*, 14 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 327, 336 (2004). Since the federal protection for trademarks is significantly broader than state protections, most trademark owners today seek federal protection for their trademarks. *See id.* (noting benefits provided federally registered trademark); Danielle Conway-Jones, *Remedying Trademark Infringement: The Role of Bad Faith in Awarding an Accounting of Defendant's Profits*, 42 SANTA CLARA L. REV. 863, 866-73 (2002) (discussing expansion of federal trademark protection); Lisa P. Ramsey, *Descriptive Trademarks and the First Amendment*, 70 TENN. L. REV. 1095, 1124 (2003) (discussing several

federal law.[165] Trademarks, copyrights, and patents, therefore, do not have situs in their state of origin; they instead have no real situs,[166] apart from the domicile of the holder.[167] In other words, the state in which the owner of intellectual property resides is the situs of the intangible property interest.[168]

In infringement jurisprudence, however, the situs of the injury in patent infringement actions is the location, or locations, where the infringing activity directly impacts the interests of the patentee.[169] This is so because the "[e]conomic loss occurs to the patent holder at the place where the infringing sale is made because the patent owner loses business there."[170] Likewise, in trademark and copyright infringement cases the situs of the infringement is the place where the infringing sales are made.[171] Because the focus in infringement actions is on long-arm jurisdiction over the defendant, neither a plaintiff's residence nor a plaintiff's contacts with the

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benefits provided under federal law).

165 Federal protection for trademarks is codified in 15 U.S.C. §§ 1111-1129, copyrights in 17 U.S.C. §§ 101-121, and patents in 35 U.S.C. §§ 100-105. *See also* Lateef Mtima, Tasini *and Its Progeny: The New Exclusive Right or Fair Use on the Electronic Publishing Frontier?*, 14 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 369, 396-97 (2004) (discussing source of copyright law and its purpose).

166 *See Harry Miller Co.*, 5 F. Supp. 21 at 298 n.1 (distinguishing patents, copyrights, and trademarks from trade secrets).

167 Educ. Testing Serv. v. Katzman, 631 F. Supp. 550, 564 (D.N.J. 1986) ("[B]ecause both patents and trade secrets would be deemed to have fictional situs at the residence of their owners, the cause of action arose in the plaintiff's home state."); London Film Prods. Ltd. v. Intercontinental Communications, Inc., 580 F. Supp. 47, 49 n.4 (D.N.J. 1984) (citing MELVILLE B. NIMMER, 3 NIMMER ON COPYRIGHT § 12.01[c] (1982) (noting that copyright is intangible incorporeal right with no situs apart from proprietor's domicile).

168 Beverly Hills Fan Co. v. Royal Sovereign Corp., 21 F.3d 1558, 1566 (Fed. Cir. 1994) (rejecting previous decision holding that situs of patent infringement injury is situs of intangible property interest, *i.e.*, where owner resides).

169 *Id.* at 1571.

170 *Id.* The court determined that the best methodology for defining the legal situs of an injury under patent law was to locate the place of sale of the infringing good. *Id.* The court reasoned:

> Analysis of long-arm jurisdiction has its focus on the conduct of the defendant. Plaintiff's contacts with the forum—such as where the plaintiff resides—as a general proposition are not considered a determinative consideration. Additionally, a focus on the place where the infringing sales are made is consistent with other areas of intellectual property law—it brings patent infringement actions into line with the rule applied in trademark and copyright cases.

Id. (footnotes omitted).

171 *Id.* at 1572.

forum state are considered determinative factors. Therefore, the fictional presence of intellectual property does not have any jurisdictional significance in a long-arm jurisdictional analysis.[172] The focus instead is on the place of the infringing harm and on the conduct of the defendants.[173]

Accordingly, a holder of a trademark, copyright, or patent may bring an infringement action against potential defendants in any federal district court where the infringing conduct occurs as long as the federal district court has personal jurisdiction over the defendants under the forum state's long-arm jurisdiction.[174] A successful claimant then can enjoy the remedies available, thereby enjoining the infringing conduct nationwide.[175] From the infringement and remedies perspective, intellectual property rights seem to be everywhere. Intellectual property rights holders seem to benefit from every state where the products and services associated with the rights reside.

Does it then follow that every state can tax one of the benefits, such as income derived from intellectual property rights, because

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[172] The U.S. Supreme Court has noted, however, that "intangible property has no actual situs," and the fictional presence accorded such property by law "can have no jurisdictional significance." Rush v. Savchuk, 444 U.S. 320, 330 (1980).

[173] *E.g.*, *Beverly Hills Fan Co.*, 21 F.3d at 1572 (holding defendants subject to personal jurisdiction under Virginia's long-arm statute). The finding for such situs in an infringement case analysis of long-arm jurisdiction has its focus on the conduct of the defendant. A plaintiff's contacts with the forum, such as where the plaintiff resides, as a general proposition are not considered a determinative consideration. *Id.* at 1571-72.

[174] *See* N. Am. Philips Corp. v. Am. Vending Sales, Inc., 35 F.3d 1576, 1579 (Fed. Cir. 1994) (holding that situs of patent infringement occurs where offending act is committed). In trademark infringement actions, two circuits have stated that the claim arises at the place of the "passing off," which is "where the deceived customer buys the defendant's product in the belief that he is buying the plaintiff's." Tefal, S.A. v. Prods. Int'l Co., 529 F.2d 495, 496 n.1 (3d Cir. 1976) ("It is undisputed that a cause of action for trademark infringement arises where the passing off occurs."); Vanity Fair Mills v. T. Eaton Co., 234 F.2d 633, 639 (2d Cir. 1956), *cert. denied*, 352 U.S. 871 (1956); *see also Beverly Hills Fan Co.*, 21 F.3d at 1570 ("[A] focus on the place where the infringing sales are made is consistent with other areas of intellectual property law—it brings patent infringement actions into line with the rule applied in trademark and copyright cases.").

[175] *See* Bebe Stores, Inc. v. May Dep't Stores Int'l, 313 F.3d 1056, 1057-58 (8th Cir. 2002) (affirming lower court's nationwide injunction in case where plaintiff's clothing store made sufficient showing that injunction should be issued against competitor); 4 J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 26:17 at 26-27 (4th ed. 2003) (noting that federal trademark registration presumptively creates nationwide protection and federal trademark law under Lanham Act permits injunction against party when that party's use of similar mark is likely to cause confusion).

the situs for infringement of intellectual property rights seems to reside in any state where the infringing conduct occurs?[176] The answer is a resounding "No." The jurisdictional focus in an infringement action involving intellectual property is the connection between the infringing defendant and the forum, not the physical, substantial nexus between the intellectual property holder and the forum. Further, the in personam jurisdictional inquiry is a due process analysis, not a Commerce Clause inquiry.[177] Thus, whether a particular forum has jurisdiction over an infringer may not establish that the forum also has a substantial nexus with the intellectual property owner.[178] Therefore, the fact that an out-of-state holder of intellectual property can petition the courts sitting in a particular state to protect its intellectual property rights in infringement cases does not mean that the state has a substantial nexus with the holder for state tax purposes.[179]

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[176] This argument was advanced by the dissenting opinion in *Acme Royalty Co. v. Dir. of Revenue*, 96 S.W.3d 72, 79 (Mo. 2002) ("Missouri not only creates a marketplace for these products, including their licenses, but also affords legal protections to these 'taxpayers.' For instance if a company were to sell 'Gore-Tex' products or 'Acme' bricks in Missouri without licenses from these 'taxpayers,' there is no doubt that these 'taxpayers' could use Missouri courts to enforce their rights to the intellectual property.").

[177] *See* Quill Corp. v. Heitkamp, 504 U.S. 298, 307 (1992) (emphasizing that state due process analysis was inquiry in cases addressing in personam and in rem jurisdiction). The *Quill* Court quoted the explanation the Court provided in *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985), to illustrate that the Due Process Clause, not the Commerce Clause, was the appropriate jurisdictional analysis. The *Quill* Court stated:

> 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.

Quill, 504 U.S. at 307-08 (quoting *Burger King*, 471 U.S. at 476).

[178] *See Quill*, 504 U.S. 305-09 (affirming that state may establish sufficient nexus under Due Process Clause, but fail to establish physical, substantial nexus under Commerce Clause).

[179] *See Acme*, 96 S.W.3d at 79-80 (Wolff, J., dissenting) (expressing frustration that while owners of intellectual property rights enjoy state benefits, including protection from courts, states cannot tax income produced by intellectual property assets).

B. HOLDING INTELLECTUAL PROPERTY OR A QUEST FOR TAX AVOIDANCE?

Companies with large intellectual property assets in their portfolios have business as well as tax reasons to establish subsidiaries for holding intellectual property assets.[180] These business reasons have compelling rationales that should not be ignored by taxing authorities and courts.[181] The efficiency of having centralized control of intellectual property assets is paramount.[182] The corporation with such control gains knowledge about the current value of its intellectual property assets, can decide which direction the corporation should chart with those assets, may expand its market through licensing certain intellectual property rights, and may develop new alliances or partnerships by using its intellectual property assets in joint-venture or cobranding arrangements.[183] With centralized management of intellectual property assets, the corporation has the information necessary to decide whether it should increase holdings in a certain area of intellectual property rights. It also understands which intellectual property assets are valuable and subsequently invests or divests in certain intellectual property assets over others.[184] Moreover, the centralized management of intellectual property assets provides a platform for comprehensive monitoring, protection, and enforcement of intellectual property rights.[185] This minimizes the risks of having those rights expire due to administra-

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[180] *See* Sherwin-Williams Co. v. Comm'r of Revenue, 778 N.E.2d 504, 510 (Mass. 2002) (holding that evidence supported conclusion that transfer and license-back of intellectual property between parent and wholly owned subsidiary were for economic substance and business purposes).

[181] *Id.* at 517 (assessing transactions between parent and subsidiary in broader context of operation of resultant businesses and concluding that transfer and licensing-back of trademarks were for substantial reasons beyond tax benefits).

[182] *Id.* at 518 (noting that creation of IP holding companies to hold various trademarks have "legal, practical, and economic effects" on parent company as well as result in "new, viable business enterprises").

[183] *See id.* (noting that IP holding companies with exclusive control of intellectual property had power to license assets to parent company and third-party companies).

[184] *See id.* (stating that IP holding companies assumed and paid expenses of maintaining and defending their trademark assets).

[185] *See id.* at 517 (stating that IP holding companies "incurred and paid substantial liabilities to unrelated third parties and [the parent company] to maintain, manage, and defend the marks").

tive errors, such as failing to renew intellectual property registrations or paying fees to appropriate governmental agencies. Also, it allows the corporation to initiate timely and appropriate action to deter the infringement of intellectual property assets and prevent losses of certain intellectual property rights through abandonment or through genericide via unpoliced use by a third party.[186] Further, the IP holding company has control over royalty payments and discretion to invest them for future earnings and significant additional income.[187] These business reasons should not be disregarded by states that think all IP holding companies are formed solely for tax avoidance purposes.

Even if the formation of an IP holding company is for tax avoidance purposes, such goals are not illegal.[188] Utilizing legitimate means to minimize taxation is the prerogative of any entity that is doing business and facing competition in the marketplace.[189] As long as there are jurisdictions that do not tax royalty income,

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[186] *See id.* (noting that "[l]egal title and physical possession of the marks passed from Sherwin-Williams to the subsidiaries, as did the benefits and burdens of owning the marks").

[187] *See id.* at 513 (stating that revenue earned by IP holding companies, including proceeds from royalty payments made by parent company, "was not returned to [the parent company] as a dividend but, rather, was retained and invested as part of their ongoing business operations, earning significant additional income").

[188] *Id.* at 513-14 ("There is no rule against taking advantage of opportunities created by [the Legislature or revenue service] for beating taxes." (quoting Yosha v. Comm'r of Internal Revenue, 861 F.2d 494, 497 (7th Cir. 1988)). Further, the transfer and license-back transaction "does not lose its [tax] immunity, because it is actuated by a desire to avoid, or, if one chooses, evade, taxation." *Id.* at 514.

[189] Therefore, the subjective motives that a business entity possesses when it creates an IP holding company do not serve as a basis for disregarding the transaction because the "tax system is a rule-based system, objective in nature, that places principal importance on what taxpayers do and the economic consequences attached to those actions, not on what may have subjectively motivated them to act in the first place." *Id.* Indeed, the court explained:

> [The parent company], on initially going into business, could have organized itself in such a way that its intangible assets (e.g., its marks) were held in a corporation separate from the corporations holding its production facilities and sales operations; the corporation owning the marks could have licensed those marks to its sister corporations; and this arrangement would have been respected by taxing authorities even if the structure were motivated entirely by a desire to minimize [the parent company's] over-all tax burdens. Although motivated by tax considerations, such a structure would not have been an uncommon way of doing business nor an artificial construct whose only possible effect was the avoidance of taxes.

Id.

individuals or corporations will form wholly owned subsidiary companies to hold intellectual property assets in such jurisdictions. As long as there are nonuniform tax laws and regulations among the states, the search for a better jurisdiction to minimize the state tax burden will continue. Each state has its own power to decide how it can reach the royalty income received by IP holding companies, as long as that reach is within constitutional confines.[190]

Instead of zealously pursuing IP holding companies and encountering myriad problems, states may consider different approaches that could strike a balance between the states' interests and those of intellectual property rights holders. For example, instead of seeking out IP holding companies, states should determine whether to allow in-state operating companies that use the intellectual property rights pursuant to the license arrangement to deduct the royalty amounts paid to IP holding companies.[191] If there is no direct relationship, such as parent–subsidiary, between the operating company and the IP holding company, the deduction is permissible because the license arrangement is for business reasons as long as the rate is at arm's length.[192] If the arrangement between the IP holding company and the operating company is a sham because it lacks business and economic substance, the deduction is impermissible.[193] Evidence of a sham arrangement may include the

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[190] *See* Christina R. Edson, Quill's *Constitutional Jurisprudence and Tax Nexus Standards in an Age of Electronic Commerce*, 49 TAX LAW. 893, 895 (1996) (stating that state taxing power is limited by Due Process Clause and interstate commerce concerns under Commerce Clause).

[191] This approach requires a fact-intensive inquiry as employed by a few jurisdictions such as Massachusetts. *See* Syms Corp. v. Comm'r of Revenue, 765 N.E.2d 758, 763 (Mass. 2002) (stating that whether creation of IP holding company and transfer and license-back arrangement constitutes sham is primarily factual inquiry, in which taxpayer bears burden of proof in abatement process).

[192] *See* Sherwin-Williams Co. v. Comm'r of Revenue, 778 N.E.2d 504, 504 (Mass. 2002) (allowing deduction of royalty payments by parent company to IP holding company); *Syms*, 765 N.E.2d at 760 (denying deduction under sham transaction doctrine and "ordinary and necessary expenses" doctrine); *see also* N.J. STAT. ANN. § 54:10A-4.4 (West 2002) (disallowing deductions for royalty payments made to related entity for use of intangible property).

[193] *See Syms*, 765 N.E.2d at 760 (affirming board's denial of deduction of royalty payments made by parent company because royalty payments were not ordinary and necessary business expense). The court in *Syms* adopted the board's findings that:

> [T]he value of the marks had been created entirely by [the parent company], and, even after their transfer and the payment of the royalties, [the parent company] continued to pay the expenses associated with

parent company holding majority control of the stock in an IP holding company, the relatively unchanged status of the intellectual property rights management and control before and after the transfer and license-back relationship, and the lack of a coherent business purpose behind the establishment of the IP holding company.[194]

Furthermore, instead of the deduction allowance approach, states may require combined reporting by all corporate components of an enterprise engaged in a unitary business conducted in part within the taxing state.[195] Under the combined reporting approach, states must establish that there is a unitary business between the parent company and its subsidiaries, including the IP holding company.[196] The taxing authority reaches the apportioned royalty income by directing its attention to the operating company within the state.

> owning them, including the legal expenses incurred in maintaining them. It concluded that, in such circumstances, [the parent company's] royalty payments to [the IP holding company] for the use of the marks was unnecessary. In effect, [the parent company] was paying twice for their use.

Id.

[194] *See id.* at 762 (noting that business operations of parent corporation did not change after transfer and license-back of marks to IP holding company where parent company continued to maintain and protect goodwill and value of trademarks, paid for all attorney fees associated with protection and enforcement of trademarks along with advertising expenditures, continued to choose which products would be sold under marks, and oversaw quality control of those products).

[195] Jurisdictions that have adopted such an approach include Illinois, New York, and Oregon. *See, e.g.*, Automatic Data Processing v. Ill. Dep't of Revenue, 729 N.E.2d 897, 903 (Ill. App. Ct. 2000) (noting that combined reporting is favored over separate reporting for state income tax purposes because combined reporting "is much less subject to manipulation by taxpayers than is separate reporting"); *In re* Burnham Corp., No. 814531, 1997 WL 413931, *13-*15 (N.Y. Div. Tax App. July 10, 1997) (interpreting New York statutes and regulations concerning combined tax reporting in case involving Delaware IP holding company and its parent company); Nabisco Brands, Inc. & Affiliates v. Dep't of Rev., No. TC-MD 010109A, 2003 WL 21246425, *1 (Or. T.C. Magis. Div. Apr. 3, 2003) (discussing Oregon statutes on combined tax reporting for unitary business).

[196] The unitary business principle establishes the constitutional basis for a state to reach the apportioned income of an out-of-state company and include such income with an in-state company. *See* Citizens Utils. Co. v. Dep't of Revenue, 488 N.E.2d 984, 987 (Ill. 1986) (stating that various entities deemed to constitute single business enterprise are combined into "unitary business group," which is treated as single taxpayer); Jerome B. Libin & Timothy H. Gillis, *It's a Small World After All: The Intersection of Tax Jurisdiction at International, National, and Subnational Levels*, 38 GA. L. REV. 197, 273 (2003) ("The unitary business principle simply establishes the constitutional basis for a state to include out-of-state income in an in-state taxpayer's tax base subject to apportionment.").

This is possible because the transactions between the operating company and the IP holding company should not be acknowledged since they have no economic substance, serve no legitimate business purpose, fail to reflect an arm's length charge, and were formed solely as a means to avoid taxation.[197]

In the proposed approaches, though the taxing authority does not directly pursue the out-of-state IP holding company, the result is the same: Apportioned royalty income is subject to state taxation.[198] These approaches, however, limit a state's reach to royalty income when the relationship between the operating company and the IP holding company is not a sham.[199] States cannot tax the royalty income when the IP holding company is a legitimately separate business entity.[200]

VII. CONCLUSION

Intellectual property will continue to enjoy its status as a valuable corporate asset in the economy. As enormous amounts of financial resources are devoted to the creation, protection, and enforcement of trademarks, copyrights, patents, and trade secrets, holders of such property will continue to look for ways to maximize the return from their valuable intellectual property. Many holders of such property have successfully devised and utilized the IP holding company model as a means of avoiding state taxation. Some state taxing authorities have desperately attempted to reach the handsome royalty "nowhere" income. As long as the ambiguity

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[197] *See* Maria T. Jones et al., *2002-2003 Survey of New York Law State and Local Taxation*, 54 SYRACUSE L. REV. 1379, 1388-94 (2004) (analyzing combined tax report method applied by New York in taxing trademark holding company).

[198] *See* Lanco, Inc. v. Dir., Div. of Taxation, 21 N.J. Tax 200, 219 (N.J. Tax Ct. Oct. 23, 2003) (stating that tax avoidance can be addressed by combined reporting or disallowance of deduction for royalty payments).

[199] *See* Syms Corp. v. Comm'r of Revenue, 765 N.E.2d 758, 764 (Mass. 2002) (holding that evidence sufficiently supports finding that assignment and license-back arrangement between parent company and Delaware IP holding company was sham and royalty payments resulted from sham transaction); *In re* Burnham, No. 814531, 1997 WL 413931, at *14 (N.Y. Div. of Tax App. July 10, 1997) (finding that taxing authority failed to demonstrate that relationship of New York petitioner with its affiliated Delaware IP holding companies was distortive).

[200] *See* Comptroller of the Treasury v. Syl, Inc., 825 A.2d 399, 401 (Md. 2003) (affirming Comptroller's finding that Delaware IP holding company was phantom company that lacked any economic substance).

caused by *Quill*, the lack of response from Congress,[201] and the nonuniform state taxing schemes remain the status quo, corporations with large intellectual property portfolios and state taxing authorities will continue to face the costly uncertainties associated with the constitutionally permissible reach of state taxing power to IP holding companies. It is time for a bright-line rule in this pressing area of the law.

[201] Even the *Quill* Court has suggested that Congress, with its commerce power, is the appropriate branch to address state taxation and the burden on interstate commerce. Quill Corp. v. Heitkamp, 504 U.S. 298, 318 (1992) (inviting Congress to address state taxation power in area involving multistate and interstate commerce because "Congress has the power to protect interstate commerce from intolerable or even undesirable burdens").