Holding Intellectual Property

by Xuan-Thao N. Nguyen

Xuan-Thao N. Nguyen is a professor of law at SMU Dedman School of Law, Dallas. She was an intellectual property associate with Fried, Frank, Harris, Shriver & Jackson and with Pryor Cashman, Sherman & Flynn, LLP, both in New York City.

A version of this article was presented at the SMU Intellectual Property Law Conference and at the Intellectual Property and Technology Conference at the Center for International and American Law, Plano, Texas, September 2004.

The author thanks Sandra Salas and Jonathan Wilson of the SMU Dedman School of Law 2005 Class for their exceptional research assistance. The author also thanks Profs. Merrill and Bertil Hille of the University of Washington for their invaluable support.

This report was originally published in 39 Georgia Law Review 1155 (2005). It is reprinted with permission.

I. Introduction

The collapse of WorldCom Inc. exposed a complex web of accounting irregularities. 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. Further scrutiny of the scheme reveals that WorldCom and its tax advisers, KPMG Peat Marwick LLP, devised a tax avoidance scheme through the creation of an intellectual property (IP) holding company. This type of scheme has been widely and quietly used in the last 20 years by many corporations with substantial intellectual property.

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, more and more states have directed their attention to intercorporate transactions and income-shifting schemes. In doing so, many states unearthed handsome amounts of royalty income generated by the licensing of intellectual 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 IIIA.


According to the Multistate Tax Commission, which represents state revenue agencies, the state income tax rate for corporations for 2002 was 5.2 percent, compared with 9.6 percent 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 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”).
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 that 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?

**What are the constitutional challenges states may face in their efforts to tax royalty income? What are their alternatives?**

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

Part V advocates balancing the interests of states and the 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 protection7 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 be traced to antiquity,10 the

---


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


impact of intellectual property on the economy, workplace, culture, society, and daily life is a more recent phenomenon.\textsuperscript{12}

The globalization of commerce has facilitated the movement of goods, including patented, copyrighted, and trademarked goods, to all corners of the world.\textsuperscript{13} Indeed, the monetary value of copyrighted goods exported from the United States to other countries has led all other exported goods.\textsuperscript{14} Moreover, the emergence of digital technology and the Internet has transformed the protection and dissemination of copyrighted materials.\textsuperscript{15} Commercial success based on invention and innovation has exploded in recent years.\textsuperscript{16} Perceiving patents as highly valuable assets, corporations and individual inventors actively seek them — so actively that the number granted by the U.S. Patent Office has increased approximately threefold in the last 20 years.\textsuperscript{17} Similarly, during fiscal 2003 alone, the U.S. Copyright Office registered 534,122 copyrightable works.\textsuperscript{18}

In short, intellectual property today has become so enormously important\textsuperscript{19} that the legal protection and enforcement of intellectual property rights


\textsuperscript{16}See generally Congressional 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


\textsuperscript{19}Indeed, intellectual property has become so significant that the Federal Bureau of Investigation has admitted: 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 $433 billion, or 5.68 percent, of the U.S. Gross National Product, which is more than any other single manufacturing sector. The Bureau of Labor Statistics reports that between 1977 and 1996 the growth in the IP segment of the economy was nearly twice that of the U.S. economy as a whole. It is also estimated that the software industry alone will employ more than one million people in the U.S. by the year 2005. Fed. Bureau of Investigation, “About the Financial Institution Fraud Unit: Intellectual Property Crimes,” at http://www.fbi.gov/hq/cid/fc/fifu/about/about$ipc.htm (last visited February 16, 2005).
occupies a central role in international trade and relations.

Not surprisingly, major companies today accumulate and possess large intellectual property portfolios. For the last 10 years, IBM has led all companies in the number of patents received each year, including 3,411 patents issued in 2001. Canon, Sony, and General Electric each received more than 1,000 issued patents during 2001. 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. 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.

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. Income derived from licensing intellectual property assets is subject to federal and state taxation as ordinary income. In recent years, companies have devised a scheme to minimize state taxation of royalty income.

Under such a scheme, a company with a large intellectual property portfolio forms a wholly owned subsidiary to hold its intellectual property assets. The parent company selects a state jurisdiction that does not tax royalty income received from licensing intellectual property assets and then forms its sub-


21See Daniel Kalderimis, “Problems of WTO Harmonization and the Virtues of Shields Over Swords,” 13 Minn. J. Global Trade 305, 329 (2004) (explaining the 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.”).


24Id.

25See Darch, supra note 14, at 489-490 (stating that in 1997, the U.S. exported copyright products totaled $414 billion).


29E.g., Comptroller of the Treasury v. Syl Inc., 825 A.2d 399, 400, 407 (Md. 2003) (noting, in consolidated opinion, that parent company Symms 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 the parent company, Sherwin-Williams, assigned all of its domestic trademarks to its two subsidiaries, DICM and SWIMC). (For the Maryland Court of Appeals’ decision in Syl, see Doc 2003-14066 or 2003 STT 112-8.)
sidiary, the IP holding company, there.\footnote{E.g., Syl Inc., 825 A.2d at 401, 407 (noting that subsidiaries Syl and Crown Delaware were incorporated in Delaware for the purpose of managing and controlling intellectual property assets); Sherwin-Williams Co., 778 N.E.2d at 509 (stating that the parent company selected Delaware for incorporation of subsidiary because the state afforded tax advantages to corporations confining their activities to holding, maintaining, and managing intangible assets).} The parent company transfers all of its intellectual property assets to the IP holding company in exchange for ownership of 80 percent or more of stock in the IP holding company.\footnote{E.g., Sherwin-Williams Co., 778 N.E.2d at 507-508 (noting that the parent company paid $47 million in royalty payments to two IP holding companies for tax year 1991).} 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\footnote{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 a 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 expenses because license of intellectual property rights had valid business purpose and economic substance). (For the Massachusetts Appellate Tax Board’s decision in Cambridge Brands, see Doc 2003-17023 or 2003 STT 140-41.)} and in some instances to sister companies that need to use the intellectual property assets.\footnote{E.g., Sherwin-Williams Co., 778 N.E.2d at 520-521 (allowing the parent company to deduct reasonable royalty payments to its subsidiaries as ordinary and necessary expenses). But see Syma Corp. v. Comm’r, 765 N.E.2d 758, 765 (Mass. 2002) (denying the parent company’s deduction of royalty payments to subsidiary because transfer and license-back arrangement was a sham).} Those 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.\footnote{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 508. Under Delaware law, “royalties and other income earned by” IP holding companies are “exempt from State taxation.” Id. (citing Del. Code Ann. tit. 30, section 1902(b)(8) (1997 and Supp. 2004)).} The IP holding company then uses the royalties for loans to the operating companies and receives interest from those loans.\footnote{The operating companies will deduct the interest payment on such loans as ordinary expense. E.g., id. at 522-523 (allowing parent company to deduct interest payment on short-term loan of $7 million from subsidiary).} The IP holding company may then pay dividends to the parent company.\footnote{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”).} 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.\footnote{See id. (stating that Kmart Corp. paid KPI royalty payments based on 1.1 percent of Kmart Corp.’s gross sales throughout United States). See generally Little Caesar Enter. Inc. v. Department 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 (Footnote continued on next page.)} 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 owned by the parent company but exchanged for stock ownership in the subsidiaries.\footnote{See id. (holding that rainfall is not a taxable event because no gains are recognized.)} The IP holding companies then licensed the trademarks to the related retail companies in exchange for royalty payments.\footnote{Id. at 11,041.} For tax year 1994, those same IP holding companies recorded $301,067,619 in royalty income and $122,031,344 in interest income from the related retail companies.\footnote{Id. at 11,042.} Those amounts accounted for 100 percent of the IP holding companies’ income.\footnote{Id. (noting that IP holding companies accumulated no other source of income, except royalty income).} These IP holding companies enjoy tax-exempt status as passive holding entities in Delaware, their state of incorporation.\footnote{Id. at 11,055.} KPI, another example, is the IP holding company for the well-known Kmart Corp.\footnote{E.g., id. at 11,054.} Its related trademarks, which are worth between $2.7 and $4.1 billion.\footnote{Kmart Props. Inc. v. Taxation & Revenue Department, [N.M.] St. Tax Rep. (CCH) para. 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).} KPI was incorporated in Michigan, which does not tax income from royalty payments that KPI receives from its exclusive license arrangement with the Kmart Corp.\footnote{See id. (detailing assignment and license-back arrangement involving well-known retail clothing trademarks).} Kmart Corp. established 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.\(^{51}\) Under 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 also retained outside attorneys to conduct patent prosecution work.\(^{53}\) Over a three-year period, the holding company received about $120 million in royalty payments from the parent company.\(^{54}\) The subsidiary filed no state income tax returns, but filed information returns with Delaware, the subsidiary’s state of incorporation.\(^{55}\) Not surprisingly, Delaware does not tax royalty payments.\(^{56}\)

Essentially, under the intellectual property tax scheme, companies with large intellectual property portfolios can legitimately avoid paying state taxes on income derived from royalties.\(^{57}\) Some states have attempted to reach and tax this income based on the licensing of intellectual property assets.\(^{58}\) These states face constitutional obstacles in light of the U.S. Supreme Court’s decision in Quill Corp. v. North Dakota.\(^{59}\)

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 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.\(^{60}\) Quill was a Delaware

---


\(^{48}\)See id. (noting that creation of KPI dramatically affected the 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). (For the Missouri Supreme Court’s consolidated decision in ACME and Gore, see Doc-2002-27171 or 2002 STT 241-22.)

\(^{50}\)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 the parent company, which did not receive reimbursement).

\(^{55}\)Id.

\(^{56}\)Id.
corporation with offices and warehouses in Illinois, California, and Georgia. Quill engaged in the business of selling office equipment and supplies via mail-order catalogs. It estimated that $1 million in sales were made annually to 3,000 customers residing in North Dakota. Quill delivered merchandise to customers by mail or common carrier from out-of-state locations. The state of North Dakota required Quill to collect a use tax from North Dakota consumers who purchased Quill products via mail-order catalogs and to remit the collected tax to the state.

North Dakota essentially tried to tap into the remarkable growth of the mail-order business, which grew from a relatively inconsequential market niche to a “goliath” with annual sales that reached “the staggering figure of $183.3 billion” within a short period of 20 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. 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. In the balance, the state believed there was a constitutionally sufficient nexus to justify imposing the purely administrative duty of collecting and remitting the use tax.

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. 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 of the U.S. Constitution. The Court uncoupled the two clauses and explained that each clause poses different and distinct limits on the states’ taxing power. A state may be 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.

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. For tax purposes, the Due Process Clause requires some catalogs and flyers mailed by Quill into the State every year” (quoting Heitkamp, 470 N.W.2d at 218-19).

Quill, 504 U.S. at 301-302. (“We 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.”) 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 must be satisfied). The Due Process Clause 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, section 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, section 8, cl. 3.

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. Rev. 1405, 1425-1426 (1993) (analyzing Quill on the distinction between Due Process and Commerce Clauses and critiquing Quill on its potential impact on state’s ability to impose taxation on foreign companies).

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.”) The Court, in uncoupling the Due Process and Commerce clauses, succinctly stated: (Footnote continued on next page.)
minimum connection between a state and the person, property, or transaction it seeks to tax. 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 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 prohibits 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.\(^{87}\)

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 for state revenue because a state’s reach to outside sellers is no longer expansive.\(^{88}\)

### B. Post-Quill Chaos for Intellectual Property

Because 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.

---

86\(^{\text{E.g.}}, \) 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\(^{\text{Id. at 313-319. Specifically, the Court said:}}\)

88\(^{\text{Id. at 313 n.6. The Court explicitly rejected the finding of nexus based on Quill’s contact with North Dakota:}}\)

In addition to its common-carrier contacts with the State, Quill also licensed software to some of its North Dakota clients. The State “concedes 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, \(^{\text{In National Geographic Society v. California Bd. of Equalization, 430 U.S. 551, 556 (1977),}}\) we expressly rejected a “‘slightest presence’ standard of constitutional nexus.” \(^{\text{We therefore conclude that Quill’s licensing of software in this case does not meet the ‘substantial nexus’ requirement of the Commerce Clause.}}\)

---

86\(^{\text{Quill, 504 U.S. at 313.}}\)

87\(^{\text{Id.}}\)

88\(^{\text{See Diehl, supra note 5, at 44 (discussing decline in state income tax rate for corporations from 9.6 percent in 1980 to about 5.2 percent in 2002).}}\)
Clause extends to state power to tax income received from out-of-state companies. 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. Further, the assertion suggests that *Quill* permits state taxation of such income “by virtue of an intentional exploitation of the state’s market without physical presence in the state.”

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.

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. 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.

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. 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.

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 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.

A. Business Situs

Under the business situs theory, intangibles acquire situs for taxation purposes if they have become an integral part of local business. Under this premise, intangibles are assigned a tax situs in a state where the owner or holder of the intangibles is

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. (For the Alabama administrative law judge’s decision in *Cerro Copper*, see 95 STN 242-1.)

See John E. Gaggini, “State Taxation of Passive Income Subsidiaries,” 473 PLI/TAX 779, 793-796 (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.*

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

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

not physically present. 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. 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.

The extension of the business situs rule to IP holding companies appeared 20 years ago in an administrative decision, In re Addax Music Co. In that case, the New York Department of Taxation and Finance 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 state income tax in the form of a franchise tax. 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. Addax Music received its royalty payments via its membership in ASCAP, a nonprofit membership association of composers, lyricists, and music publishers. ASCAP collected fees from nonexclusive blanket licenses and distributed them to its members. The department asserted that although Addax Music was not based in New York, its copyrighted compositions nevertheless had a taxable situs there because the copyrighted compositions were integrated in the local New York business through the licensing arrangements. The department found that Addax Music, through ASCAP, monitored and licensed its music composition in New York. Essentially, Addax Music obtained its royalty income through the copyrights used in the local New York business market. Therefore Addax Music, a copyright holding company, was subject to the imposition of a New York franchise tax on business corporations. 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. The leading case in

---

98 See Paull Mines, “Commentary Conversing With Professor Hellerstein: Electronic Commerce and Nexus Propel Sales and Use Tax Reform,” 52 Tax L. Rev. 581, 606-607 (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 situs in South Carolina); see also Patale, 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") (For the South Carolina Supreme Court’s decision in Geoffrey, see 93 STN 133-12.)

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 many 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 the 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’s 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.
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

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 that 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 Clause119 was established because the intellectual property was present through the licensing arrangement, and the royalty income was derived from that license.120

Further support for the business situs rule was offered in Kmart Properties Inc. v. Taxation and Revenue Department, in which 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 Corp.’s activities in New Mexico, together with the tangible presence of KPI’s marks, constitute[d] the functional

trademarks in New Mexico market for purpose of generating substantial income); Geoffrey v. S.C. Tax Comm’n, 437 S.E.2d 13, 19 (S.C. 1993) (holding that a 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. McLaughlin, “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

Id. at 17. Geoffrey, in exchange for the license grant, received 1 percent 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 (“Intangibles 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).
equivalent of physical presence,” even though KPI did not have any of its own employees, operations, offices, or facilities physically located within New Mexico.\textsuperscript{128} KPI was subject to New Mexico income taxation.\textsuperscript{124} Likewise, in a 2002 ruling, \textit{Secretary of Revenue v. A & F Trademark Inc.}, the North Carolina Tax Review 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.\textsuperscript{125} The subsidiaries were Delaware corporations, holding trademarks previously owned by The Limited and related retail companies.\textsuperscript{126} Those same retail companies transferred their trademarks to the IP holding companies and obtained the license rights to use those same trademarks in exchange for royalty fees from the subsidiaries.\textsuperscript{127} The Limited and the related retail companies deducted royalty payments from their income for North Carolina.\textsuperscript{128} The Tax Review Board found that the subsidiaries’ trademarks exist in North Carolina because trademarks are the kind of property that “exist[s] only where it is used.”\textsuperscript{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.\textsuperscript{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.\textsuperscript{131} 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 is overreaching. 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 companies.\textsuperscript{132} The decisions reflect a desperate attempt by local taxing authorities to address the need to raise revenue in the post-\textit{Quill} era since the \textit{Quill} Court mandated a bright-line approach to state taxation wherein the physical presence of a foreign company in the taxing jurisdiction is required.\textsuperscript{133} The attempt to distinguish \textit{Quill} as applicable only to sales and use tax cases, not income tax cases, Notes, November 21, 2005
leads to 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.\textsuperscript{134}

\textbf{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.\textsuperscript{135} They enjoy state-tax-free status 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.\textsuperscript{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\textsuperscript{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.\textsuperscript{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\textsuperscript{139} — have already been the subject of a license arrangement between the book publisher and the author.\textsuperscript{140} Like many national authors, Grisham has appeared on book tours to promote his novels.\textsuperscript{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.\textsuperscript{142} National authors most likely receive their income from royalty payments, whether in the form of an advance, lump sum, or periodic installments.\textsuperscript{143}

\textsuperscript{134}\textsuperscript{See Lanco, 21 N.J. Tax at 210-211 (critiquing thesis of business situs subsequent to Quill).}

\textsuperscript{135}The frustration with “nowhere” income has been forcefully expressed in a dissenting opinion in \textit{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 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.

\textit{Id.}

\textsuperscript{136}\textsuperscript{See id. (noting corporations’ avoidance of state and federal taxes).}

\textsuperscript{137}\textsuperscript{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 the state where the 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).}

\textsuperscript{138}\textsuperscript{See http://www.randomhouse.com/features/grisham/author.html (last visited February 18, 2005) (providing listing and ranking of Grisham’s books).}

\textsuperscript{139}Copyright law grants the author ownership of a copyright, as well as the exclusive rights due and to authorize any of the following:

(1) to reproduce the copyrighted work in copies or phonorecords;
(2) to prepare derivative works based on 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.


\textsuperscript{140}The arrangement between publishers and authors was noted by the U.S. Supreme Court in \textit{Mills Music Inc. v. Snyder}, 469 U.S. 153, 175 n.43 (1985) (noting the usual practice in the 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).


\textsuperscript{142}\textit{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).

\textsuperscript{143}\textsuperscript{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, (Footnote continued on next page.)
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.\textsuperscript{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.\textsuperscript{145}

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.\textsuperscript{146} That means Grisham may still receive royalty payments for the books in print while his intellectual property rights have already terminated.\textsuperscript{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’s books at various locations within a statevanishes, 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 pre-
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 sales 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 sales and use 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

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.

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.”)

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.

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 those things 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 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.\textsuperscript{161} Further, trade secrets have a situs in their state of origin.\textsuperscript{162} Indeed, numerous courts have held that regarding intellectual property protected under state law, the holder’s state residence is the situs of the intellectual property interests.\textsuperscript{163}

Federal trademarks, copyrights, and patents, on the other hand, are not protected under state law;\textsuperscript{164} they are protected under federal law.\textsuperscript{165} Trademarks, copyrights, and patents, therefore, do not have situs in their state of origin; they instead have no real situs,\textsuperscript{166} apart from the domicile of the holder.\textsuperscript{167} In other words, the state in which the owner of intellectual property resides is the situs of the intangible property interest.\textsuperscript{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.\textsuperscript{169} That is so because the “economic loss occurs to the patent holder at the place where the infringing sale is made because the patent owner loses business there.”\textsuperscript{170} Likewise, in trademark and copyright infringement cases, the situs of the infringement is the place where the infringing sales are made.\textsuperscript{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 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.\textsuperscript{172} The focus instead is on the place of the infringing harm and on the conduct of the defendants.\textsuperscript{173}


\textsuperscript{163}E.g., Paolino v. Channel Home Ctrs., 668 F.2d 721, 724 n.2 (3d Cir. 1981) (noting that “[i]ntellectual 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).


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

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. A successful claimant then can enjoy the remedies available, thereby enjoining the infringing conduct nationwide. 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 the situs for infringement of intellectual property rights seems to reside in any state where the infringing conduct occurs? 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. 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. 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.

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

174See N. Am. Philips Corp. v. Am. Vending Sales Inc., 35 F.3d 1576, 1579 (Fed. Cir. 1994) (holding that the 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 485, 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”).

175See Bebe Stores Inc. v. May Dept’l Stores Int’l, 313 F.3d 1056, 1057-1058 (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 section 26:17 at 26-27 (4th ed. 2003) (noting that federal trademark registration presumptively establishes nationwide protection and that federal trademark law under Lanham Act permits injunction against party when that party’s use of similar mark is likely to cause confusion).

176This 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.”)

177See Quill Corp. v. Heitkamp, 504 U.S. 298, 307 (1992) (emphasizing that 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 307-308 (quoting Burger King, 471 U.S. at 476).

178See Quill, 504 U.S. 305-309 (affirming that a state may establish sufficient nexus under Due Process Clause, but fail to establish physical, substantial nexus under Commerce Clause).

179See Acme, 96 S.W.3d at 79-80 (Wolf, 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).
reasons to establish subsidiaries for holding intellectual property assets. These business reasons have compelling rationales that should not be ignored by taxing authorities and courts. The efficiency of having centralized control of intellectual property assets is paramount. 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. Moreover, the centralized management of intellectual property assets provides a platform for comprehensive monitoring, protection, and enforcement of intellectual property rights. This minimizes the risks of having those rights expire due to administrative 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 unpolicing use by a third party. Further, the IP holding company has control over royalty payments and discretion to invest them for future earnings and significant additional income. 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. Utilizing legitimate means to minimize taxation is the prerogative of any entity that is doing business and facing competition in the marketplace. As long as there are jurisdictions that do not tax royalty income, 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.

185See 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”).

186See Sherwin-Williams Co. v. Comm’r of Revenue, 778 N.E.2d 504, 510 (Mass. 2002) (holding that the evidence supported conclusion that transfer and license-back of intellectual property between parent and wholly owned subsidiary were for economic substance and business purposes).

187See id. at 518 (stating that establishment of IP holding companies to hold various trademarks have “legal, practical, and economic effects” on the parent company as well as result in “new, viable business enterprises”).

188See id. at 518 (noting that IP holding companies with exclusive control of intellectual property had the power to license assets to parent company and third-party companies).

189See id. (stating that IP holding companies assumed and paid expenses of maintaining and defending their trademark assets).

190See id. at 517 (stating that IP holding companies “incurred and paid the substantial liabilities to unrelated third parties and [the parent company] to maintain, manage, and defend the marks”).

191See id. (noting that “illegal title and physical possession of the marks passed from Sherwin-Williams to the subsidiaries, as did the benefits and burdens of owning the marks”).
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 under the license arrangement to deduct the royalty amounts paid to IP holding companies. 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. 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. Evidence of a sham arrangement may include the 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.

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. 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. The taxing authority reaches the apportioned royalty income by directing its attention to the operating company within the state. This is possible because the transactions between the operating company and the IP holding company should not be acknowledged since they serve no economic substance, serve no legitimate business purpose, fail to reflect an

\[191\] 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 an 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).


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

[The 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 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.]

\[194\] 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 when 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).


\[196\] 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. Department 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 and 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”).
arm’s-length charge, and were formed solely as a means to avoid taxation. 197

It is time for a bright-line rule in this pressing area of the law.

In the proposed approaches, though the taxing authority does not directly pursue the out-of-state IP holding company, the result is the same: Appor tioned royalty income is subject to state taxation. 198 Those 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 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.

199 See Syms Corp. v. Comm’r of Revenue, 765 N.E.2d 758, 764 (Mass. 2002) (holding that evidence sufficiently supports finding that the assignment and license-back arrangement between parent company and the Delaware IP holding company was sham and royalty payments resulted from the 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 the 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 a phantom company that lacked any economic substance).
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”).