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Potential New State Tax Liabilities for Financial Institutions – The Reasoning and Impact of the Bank of America Case

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A recent decision by the United States Supreme Court not to hear a case previously decided by the State of West Virginia could have a significant impact on the state tax liabilities of financial institutions with activity in multiple states. By refusing to rule on the decision made in *MBNA America Bank v Tax Commissioner of West Virginia*, 06-1228, the U.S. Supreme Court has allowed a state to impose its income tax on an out-of-state corporation using a standard of "significant economic presence" in place of the previous, long-standing standard of a physical presence requirement. Despite the fact that the U.S. Supreme Court's inaction specifically affects only West Virginia, the effect on the overall state tax environment is one that financial institutions will need to be aware of.

While the immediate impact is unclear, in the current environment, where states appear willing to fight for every possible tax dollar, states looking to increase their tax revenues by taxing businesses with no actual physical presence in the state now have a clear path to do so.

Background of the case

In 1998 and 1999, MBNA America Bank, a Delaware-based corporation, earned over $18 million from West Virginia customers through issuing and servicing credit cards. For those two years, MBNA paid over $460,000 in income and franchise taxes to West Virginia as an out-of-state corporation. MBNA had no employees and no real or tangible personal property located in West Virginia. After filing the West Virginia returns, MBNA filed for a refund of the taxes paid to that state. MBNA's basis for the refund was that since MBNA had no connection to West Virginia other than through promoting its business in that state via mail and telephone solicitation, West Virginia had no right to impose its income and franchise taxes. The request for the refund was denied by the West Virginia Tax Commissioner.

A series of appeals were filed, first by MBNA, which won a reversal by the West Virginia Office of Tax Appeals (OTA). The OTA based its ruling on the fact that, since MBNA had no physical presence in West Virginia, there was no substantial nexus with the state and, therefore, the tax could not be imposed.

West Virginia then appealed the OTA ruling and won a reversal by the Circuit Court. The Circuit Court ruled that the activity of MBNA in West Virginia constituted a significant business activity and this was sufficient for the state to tax MBNA. MBNA then appealed to the Supreme Court of Appeals of West Virginia (WV Supreme Court), which upheld the ruling. In 2006, Bank of America, which had subsequently acquired MBNA, appealed to the U.S. Supreme Court, which, in June, 2007, declined to rule on the case.

Reasoning for the decision

MBNA's original refund request was based, in large part, on a standard set by a previous

U.S. Supreme Court decision. In 1992, the Court ruled in *Quill Corp. v North Dakota,* 504 U.S. 298 (1992), that states may levy sales and use taxes only against corporations that had a physical presence--such as employees, stores, or offices--within that state. In order for a state to impose its tax on an out-of-state business, both the Due Process and the Commerce Clauses of the U.S. Constitution must be met. Both clauses require an out-of-state taxpayer to have a "meaningful nexus" with a given state to be subject to taxation. Basically, *Quill* established that in order for the Commerce Clause to be satisfied, a physical presence was required in order to impose sales and use taxes on an out-of-state business.

The decision of the WV Supreme Court to reject the standards set by *Quill*, was based on four main factors. One factor was that the ruling in *Quill* was, in part, a reaffirmation of the standards set by a previous case, *National Bellas Hess, Inc. v Department of Revenue,* 386 U.S. 753 (1967). *Bellas Hess* ruled that the state of Illinois could not require a mail-order business to collect and pay use taxes on goods purchased in Illinois. The U.S. Supreme Court held that Illinois had no power to impose its use tax on an out-of-state corporation with no physical presence in the state. The view of the WV Supreme Court was that *Quill* allowed the *Bellas Hess* ruling to stand, in part, because it had "become part of the basic framework of a sizable industry" and was in the interest of "stability and orderly development of the law." The WV Supreme Court stated that *Quill's* physical presence test for sales and use taxes was based in large part on a particular industry's reliance on established precedent, and therefore didn't apply in the current case.

The second factor was that the decision in *Quill* was specifically limited to the imposition of sales and use taxes. Since the MBNA case involved income and franchise taxes, *Quill* was not applicable.

The third factor was that the *Quill* decision was, in part, based on the fact that compliance with administrative regulations in the collection of sales and use taxes placed an undue burden on interstate commerce, violating the Commerce Clause. The WV Supreme Court ruled that the income and franchise taxes at issue in MBNA's case did not appear to cause the same burdens, since sales and use taxes must normally be remitted more frequently than income and franchise taxes. Further, the administrative burdens of income and franchise taxes were less stringent, given that businesses are required not only to remit sales and use taxes to a state but also to collect the tax from their customers.

The final factor was that the physical presence test of *Quill* did not make sense in the current business environment. Even though *Quill* was decided in 1992, the physical presence test it reaffirmed derived from *Bellas Hess*, which was decided in 1967. The Court noted that in the almost 40 years since that decision, the manner in which business is transacted has changed dramatically. Specifically, the Court stated that the current technology available made physical presence much less of a factor for taxation.

The WV Supreme Court ruled that a "significant economic presence" test was the better guideline to use when deciding whether substantial nexus necessary for a state to impose income and franchise taxes existed. This new test allowed for the "examination of both the quality and quantity" of a company's "economic presence" in a state and was a better measure of the "degree to which a company has exploited a local market." The fact that MBNA had such significant contact with so many West Virginia customers and earned millions of dollars from these customers was sufficient for the proper imposition of the West Virginia income and franchise taxes, at least in West Virginia's eyes.

Impact of the decision

What this means to financial institutions with financial activity in various states is unclear. While the facts of the MBNA case certainly could apply to the activities of many financial institutions, the U.S. Supreme Court's refusal to rule on the case contributes to an environment of uncertainty. The failure to rule means that the significant economic presence test can currently be relied on only in West Virginia. States are not bound by the rulings imposed by other states. In fact, in its appeal, MBNA unsuccessfully cited a case decided in the state of Tennessee, which required a physical presence test in order for income taxes to be imposed, *J.C. Penney Nat'l Bank v Johnson*, 19 S.W. 3d 831 (Tenn.Ct.App. 1999).

While it is possible that the U.S. Supreme Court may decide to hear a state tax case with similar facts in the future, for the present, it appears that states that wish to increase their tax revenues may be tempted to tax out-of-state companies with no physical presence using the West Virginia MBNA decision as guidance. Adding to this, the U.S. Supreme Court has also recently declined to hear another case that ruled favorably for an expanded definition of state nexus, *Lanco, Inc. v Director of Taxation,* No. A-89-05 (N.J. Supreme Ct. Oct 12, 2006), potentially giving states even more ammunition.

Financial institutions with any business activity in any state other than their home state will need to monitor state tax activity to remain abreast of the aggressiveness of states in taxing out-of-state businesses.

About the author

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