No. 06-1236

IN THE

Supreme Court of the United States

LANCO, INC.,

Petitioner,

v.

DIRECTOR, DIVISION OF TAXATION,

Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of New Jersey

REPLY BRIEF FOR PETITIONER

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Respondent urges adoption of a constitutional interpretation that would permit a State to impose franchise and excise taxes on any corporation that "reach[es] into" the State "for business." Br. in Opp. 18. Respondent candidly urges that the Commerce Clause's physical presence requirement should be abandoned to allow a tax that substantially burdens businesses precisely because they engage in interstate commerce. This Court rejected that argument in both *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), and in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

The state courts are deeply divided on this recurring question of the applicability of *Bellas Hess* and *Quill*. That disagreement and its nationwide importance require resolution of the question by this Court.

I. THE NEW JERSEY SUPREME COURT'S RULING BRINGS IT INTO DIRECT CONFLICT WITH OTHER STATE COURTS

A. The court below broadly rejected the *Bellas Hess/Quill* physical presence test as a general requirement for state taxes

Respondent attempts to portray the New Jersey Supreme Court's opinion below as a fact-specific holding that is somehow limited to a particular corporate structure involving inter-affiliate licensing of intellectual property. Br. in Opp. 1-6, 7 n.1. That is contrary to respondent's sweeping argument below, *see* Resp. N.J. App. Div. Br. 39 (respondent urging court below to hold that "*Quill* quite plainly does not apply to taxes other than sales and use taxes."), and respondent's own request that the New Jersey Supreme Court hear the case, *see* Pet. 7 (quoting respondent's assertion that this case involves a "substantial question under the United States Constitution on which there is a divergence of precedent").

Respondent's bait-and-switch tactics do not alter the fact that the decision below imposes an expansive rule that the Commerce Clause's physical presence requirement does not apply to *any* state taxes (other than sales and use taxes) for *any* business. The court expressly "agree[d] with the [respondent] Director that *Quill* does not apply to taxes other than sales and use taxes," and that New Jersey's Corporation Business Tax may be constitutionally applied to impose a tax on a company's income from licensing fees attributable to New Jersey, notwithstanding the company's "lack of a physical presence in New Jersey." Pet. App. 11a, 3a (citation omitted)

Respondent needed the courts below to reject the *Quill* physical presence test because, as the New Jersey Tax Court determined based on stipulated facts, petitioner Lanco is a Delaware corporation that has no physical presence in New Jersey. *Id*. at 22a. Lanco's customer, Lane Bryant, Inc., is a retailer who has clothing stores in New Jersey. Lanco licenses its intellectual property to Lane Bryant in exchange for royalties. There is no dispute that Lane Bryant has a physical presence in, and may be taxed by, New Jersey.

B. The ruling below widened a conflict among state appellate courts

The New Jersey Supreme Court acknowledged that its ruling widened "a split of authority" that has "developed regarding whether the Supreme Court's holding [in *Quill*] was limited to sales and use taxes." Pet. App. 2a. Indeed, respondent below recognized the split. *See* Resp. N.J. App. Div. Br. 49 (respondent arguing that "State court authority is split on whether the physical-presence test of *Quill* applies outside the sales and use tax context"); Pet. 7.

The court below pointed to *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *appeal denied*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000) (per curiam), *cert. denied*, 531 U.S. 927 (2000), as a ruling in

conflict with its own, but respondent contends (Br. in Opp. 7-8) that it is merely an intermediate state court decision without broad precedential value. That understanding of the precedential effect of the decision is wrong. Under settled state procedures (which are different from those followed by this Court), the Tennessee Supreme Court has affirmed the decision by denying an appeal and allowing the decision to be published. *See* Pet. 10.[1]

Also, as already demonstrated (Pet. 11-12), state appellate courts in Michigan and Texas have adopted a reading of *Quill* that cannot be reconciled with the decision below. Respondent's contention that the "factual paradigm" of those cases differs from this one (Br. in Opp. 8) is irrelevant. Importantly, respondent does not dispute that those cases hold "that *Quill* established a physical presence requirement for the imposition of all State taxes." *Id*. at 9. Indeed, each of those decisions announced a broad rule about the test to determine whether there is the constitutionally required "substantial nexus" to support state taxation jurisdiction, none is limited in any way suggested by respondent, and each is now binding law in the State in which it was issued.

The fact that state courts in New Jersey and elsewhere have increasingly misread *Quill* in recent cases may be explained, at least in part, by the difficulty that a state court faces in invalidating its own State's claims of tax jurisdiction

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[1] The subsequent unpublished opinion in *America Online, Inc. v. Johnson*, 2002 WL 1751434 (Tenn. Ct. App. July 30, 2002), did not call *J.C. Penney* into doubt. *America Online* does not have the force that *J.C. Penney* has because *America Online* was not appealed to the Tennessee Supreme Court and because it is not published, which means that, under Tennessee law, it has no force as precedent. *See* Tenn. S. Ct. R. 4(G)(1). In any event, *America Online* addressed only whether particular conduct met the "physical presence test," which, as described in the petition, includes certain activities performed in state on behalf of the taxpayer. *See* 2002 WL 1751434, at *3; Pet. 2 n. 1.

over out-of-state entities in light of actions already taken by sister States that allow such taxation in comparable circumstances in that other State. Because the Tax Injunction Act precludes the lower federal courts, which are designed to ensure attention to federal interests in such instances, from passing on the significant constitutional question presented here, this Court is the only federal forum in which this important federal issue can be resolved.

C. Petitioner is only one of the many types of companies that lack a physical presence in New Jersey that the respondent seeks to tax

Respondent goes to great lengths to insinuate that petitioner engaged in an improper tax avoidance mechanism. That attack is both irrelevant and without merit. The parties stipulated that transactions between petitioner and its licensee were made at "arm's length rates," Pet. App. 53a, respondent never questioned the *bona fides* of Lanco, and no argument about tax planning was ever addressed below. In separate tax litigation in New York, petitioner Lanco was found to be a "viable corporation[]" formed for numerous legitimate business reasons apart from tax planning and that it engaged in "extensive activities" regarding "the registration and protection of the trademarks it owned." *In re Express, Inc.*, 1995 WL 561501, at *33 ¶F, *3 ¶9-11, *4 ¶22 (N.Y. Div. Tax App., Sept. 14, 1995). Indeed, if Lanco were not distinct from Lane Bryant, then respondent New Jersey already has the constitutional authority to attribute Lanco's income to Lane Bryant, Inc., the in-state taxpayer. *See* Pet. 23 n.9.

Respondent also argues that the New Jersey Supreme Court decision is limited to the licensing of intellectual property between related companies, but the court's decision does not so indicate. And respondent does not provide any principle that could legally distinguish, for purposes of state taxation, the licensing of intellectual property to an out-of-

state customer from, for example, the sale of tangible goods through the mail or the provision of credit card services at issue in *MBNA America Bank, N.A. v. Tax Commissioner*, No. 06-1228, pet. for *cert.* pending. The Commerce Clause is neither industry nor tax specific; it applies to all manner of commerce and taxes.

Indeed, New Jersey's statements and actions reflect this understanding through its practice of asserting jurisdiction to tax all types of corporations, without regard to the physical presence requirement of *Bellas Hess/Quill*. For example, New Jersey has attempted to tax a software development company with no physical presence in New Jersey based solely on the fact that it sold seven software licenses in the State. *See Business Activity Tax Simplification Act of 2003: Hearing Before the Subcomm. on Commercial & Administrative Law of the House Comm. on the Judiciary*, 108th Cong., 2d Sess., at 85 (2004) (statement of Rep. Goodlatte); Pet. 4 n.2. Also, respondent's counsel expressly represented that the outcome of this case would determine, for example, whether New Jersey could tax "companies that conduct seminars for people in New Jersey without actually sending an instructor to the State," but use the television or the internet instead.[2]

Finally, as discussed in the petition (at 17) and the brief of the Clearing House Association *et al*. as *amicus curiae* (at 12-13) in the pending petition in *MBNA America Bank, N.A. v. Tax Commissioner*, No. 06-1228, New Jersey already has begun circulating "nexus surveys" to foreign affiliates of corporations incorporated in the United States. That action suggests that New Jersey also intends to apply the ruling

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[2] *See* video of N.J. Sup. Ct. Oral Argument (Sept. 12, 2006), at 30:20-30:55, *available at* http://njlegallib.rutgers.edu/supct/args/A_89_05.php.

below to companies that lack a physical presence in *any* of the States.

Such aggressive efforts are not limited to New Jersey. Congress has documented efforts by States across the country to tax companies that lack any physical presence within that State. *See* H.R. Rep. No. 109-575, at 7-8 (2006) (banks who issue credit cards to state residents); House Hearing, *supra*, at 65, 85 (media corporations that broadcast programs into the State); *id*. at 85 (health care providers performing services for state residents); *ibid*. (corporations registering to do business in State); *id*. at 86 (corporations listing phone number in in-state phone book).

This persistent danger of overreaching States disrupts settled expectations of businesses that seek to serve customers across state lines. Respondent asserts, astoundingly, that "there are no 'settled expectations' in business." Br. in Opp. 17. But the brief of the Greater Philadelphia Chamber of Commerce and the Chamber of Commerce Southern New Jersey as *amicus curiae* emphasizes that a recent ABA draft white paper explains that "most interested parties" understood this Court's cases in *Bellas Hess* and *Quill* "to mean that physical presence was required" in a State to support the State's imposition of "income-type taxes" as well as "sales and use type taxes," and "business decisions were made accordingly." *Id*. at 5 (citing American Bar Association, Section of Taxation, *Draft White Paper on Business Activity Taxes and Nexus* 25 (Jan. 15, 2007)). It is for this reason that *amici* correctly state with great conviction that New Jersey's current post-*Quill* effort to tax companies that lack a physical presence in the State disrupts the expectations of entire industries. *See id*. at 5-11; Brief of The Sherwin-Williams Co. as *amicus curiae* ("Sherwin-Williams *Amicus* Br."), at 1, 3, 11-12.

II. THE STATE LAWS CITED BY NEW JERSEY INCREASE, RATHER THAN DIMINISH, THE NEED FOR IMMEDIATE REVIEW OF THE DECISION BELOW

Respondent suggests (Br. in Opp. 9-12) that legislative changes in some States make the question of whether respondent has the authority to tax petitioner less relevant. That is wrong. In fact, those statutes make this Court's review even more critical.

Respondent notes (*id*. at 9-10) that New Jersey, and other States, have enacted legislation to preclude taxpayers with a physical presence in the State, such as Lane Bryant, Inc., from deducting from their income any payments for the use of intangible property that they make to a related company, such as petitioner, that lacks a physical presence in the State. Thus, Lane Bryant, Inc., the retailer who was petitioner Lanco's licensee and was undisputedly subject to tax in New Jersey because it is physically present there, would, under that law, be required to pay tax on the very same money that constituted petitioner's income. Such legislation demonstrates that there are alternate mechanisms available to States to address their perceived problem without violating the Commerce Clause's physical presence requirement.

But respondent New Jersey is not satisfied with taxing corporations that have a physical presence in the State. Respondent insists that it can *also* tax petitioner Lanco for the very same income received from Lane Bryant, Inc. Thus, it is New Jersey's position that under the New Jersey Supreme Court's holding, it may tax Lanco's income twice, first as Lane Bryant's nondeductible payment to Lanco and then as Lanco's revenue. Respondent already has taken such a position against other companies that lack a physical presence in New Jersey but license intellectual property to related companies with such a physical presence. *See, e.g.*, *Federated Brands Inc. v. Director*, N.J. Tax Ct. No. 008806-2006, complaint filed December 7, 2006 (challenging such

multiple state taxation). That hardly is a cure to the problems identified by the petition.[3]

III. INTERSTATE COMMERCE WILL BEAR ENORMOUS COMPLIANCE COSTS IF THE PHYSICAL PRESENCE REQUIREMENT IS ABANDONED

A. In *Quill*, this Court recognized the need for a bright-line test to determine the ability of States to tax businesses that offer goods or services to residents of multiple States. The easy applicability of the physical presence requirement explains why it has been adopted by the United States in many international tax treaties. Pet. 17-18.

Although respondent urges that income and franchise tax compliance is less burdensome than sales tax compliance (Br. in Opp. 15-16), *amici* demonstrate that the costs of complying with state income and franchise taxes are even greater than the compliance costs this Court found sufficient in *Quill* to retain the physical presence requirement. It is undisputed that more than 8,000 jurisdictions in the United States have the authority to impose an income, franchise, or gross-receipts tax. Pet. 21-22. Contrary to respondent's claim (Br. in Opp. 15), many income-taxing jurisdictions require multiple income tax filings each year. *See* Sherwin-Williams *Amicus* Br. at 7. Moreover, there is a vast array of differences across taxing jurisdictions in determining income, in procedural requirements, and in record-keeping. *See* Brief of Council on State Taxation, National Association

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[3] Respondent also ignores the fact that several States whose courts have abandoned the physical presence requirement of *Bellas Hess/Quill*, such as West Virginia, South Carolina, and Louisiana, have not enacted such statutes. *See* Br. in Opp. 4-6, 10. Also, respondent notes that some States require "combined reporting" for related corporate entities, Br. in Opp. 11, but that is merely another possible mechanism available to New Jersey to impose a tax on the income paid to Lanco. It does not legitimize the State's exercise of taxing authority over petitioner at issue here.

of Manufacturers, and National Marine Manufacturers Association as *amicus curiae*, at 11-12, 10, 15 n.11; Sherwin-Williams *Amicus* Br. at 8-10. Imposition upon businesses of income, franchise, and gross-receipts taxes by every jurisdiction in which they have customers would impose a serious burden on interstate commerce.

Respondent also asserts that *Quill* was only an application of *stare decisis* that should be limited to that case. Br. in Opp. 14-15. But this Court in *Quill* overruled the due process holding in *Bellas Hess*, *see* 504 U.S. 306-308, at the same time that it reaffirmed the Commerce Clause holding of *Bellas Hess*, making clear that each holding was examined in light of contemporary case law and *stare decisis* was not the only basis for the decision. The Justices concurring in judgment in *Quill* confirmed this reading. *Id*. at 320 (Scalia, J., concurring in judgment).

B. Finally, respondent argues that unless *Bellas Hess* and *Quill* are limited, income of out-of-state corporations will "escape[] State taxation entirely." Br. in Opp. 5. That is wrong. Petitioner is subject to the taxing authority of Delaware, in which it has a physical presence.

New Jersey implicitly criticizes Delaware's decision not to impose the taxes on petitioner that New Jersey now seeks to impose (*id*. at 1-3), but one State's tax laws are not a loophole that another is allowed to close. This is the essence of our federalism that this Court's Commerce Clause decisions protect. *Cf. BMW of North Am., Inc. v. Gore*, 517 U.S. 559, 571 (1996) (State is "constrained" under the Commerce Clause "by the need to respect the interests of other States" and cannot "impose its own policy choice on neighboring States"). The constitutional protection that Delaware's tax policy is due does not vary based on whether the income is earned by the licensing of intellectual property for use out of state, or the sale of tangible items for use out of state. Respondent asserts that it would only be "fair" to allow it to tax petitioner, Br. in Opp. 18, thereby candidly

urging that state boundaries should no longer matter, but, of course, in our federal system, they matter very much.

Few issues are as unsettled and important to the business community as the question of the continuing applicability of the rule that a State has taxing jurisdiction over a company only if the company has a physical presence in the State. That question is presented by this case and by the *MBNA* case also currently pending on petition for *certiorari*. As urged in our petition (at 30), both cases should be granted review and heard in tandem. If this Court grants *certiorari* only in *MBNA*, then the instant case must be held pending the resolution of *MBNA* and then disposed of accordingly.

CONCLUSION

For the reasons set forth above and in the petition for a writ of *certiorari*, the petition should be granted.

Respectfully submitted,

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