Supreme Court, U.S.
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In The
Supreme Court of the United States

GEOFFREY, INC.,

Petitioner,

v.

COMMISSIONER OF REVENUE,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Judicial Court Of Massachusetts

PETITION FOR A WRIT OF *CERTIORARI*

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QUESTION PRESENTED

Whether the decision of the Supreme Judicial Court of Massachusetts, in conflict with the decisions of other state courts and the precedent of this Court, violates the Commerce Clause by permitting a State to tax the income of an out-of-state corporation that does not maintain a physical presence in the taxing State.

PARTIES TO THE PROCEEDING

The parties are as stated in the caption.

RULE 29.6 CORPORATE DISCLOSURE STATEMENT

For the years at issue in this dispute (the fiscal years ending January 31, 1997 through January 31, 2001), petitioner Geoffrey, Inc. was wholly owned by TRU, Inc., which is a wholly owned subsidiary of Toys "R" Us, Inc.

In 2008, Geoffrey, Inc. was converted into a single member limited liability company. Geoffrey, LLC currently is a wholly owned subsidiary of Geoffrey Holdings, LLC. Geoffrey Holdings, LLC is a wholly owned subsidiary of Toys "R" Us-Delaware, Inc. Toys "R" Us-Delaware, Inc. is a wholly owned subsidiary of Toys "R" Us, Inc.

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PETITION FOR A WRIT OF *CERTIORARI*

Petitioner Geoffrey, Inc. respectfully petitions for a writ of *certiorari* to review the judgment of the Supreme Judicial Court of Massachusetts.

OPINIONS BELOW

The opinion of the Supreme Judicial Court for the Commonwealth of Massachusetts (App., *infra*, 1a-18a) is reported at 453 Mass. 17 (2009). The appeal was transferred from the Appeals Court by order (App., *infra*, 19a-20a) granting application for direct review. The decision, findings of fact, and report of the Massachusetts Appellate Tax Board (App., *infra*, 21a-46a), are unreported.

JURISDICTION

The Supreme Judicial Court of Massachusetts entered its judgment on January 8, 2009.

This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL, STATUTORY, AND REGULATORY PROVISIONS INVOLVED

Article I, Section 8, clause 3 of the United States Constitution provides: "The Congress shall have Power * * * [t]o regulate Commerce * * * among the several States * * *."

The relevant portions of the Massachusetts general laws and regulations are set forth at App., *infra,* 47a-124a.

INTRODUCTION

The question presented involves one of the most significant constitutional state tax issues currently being litigated in the state courts. It is an issue of great magnitude that has hopelessly divided state courts around the Nation, and it is worth billions of dollars annually to thousands of businesses worldwide, both large and small—from owners of intellectual property such as petitioner, to credit card companies, to authors earning royalties, to music publishers, to software companies, and to many more.

In these challenging financial times, States are mired in red ink and are, with alarming frequency, dramatically expanding their tax base without regard to constitutional limitations, in order to extract tax revenues from out-of-state corporations that do not have even the slimmest of reeds connecting them to the taxing State. Oftentimes, this tax revenue falls within the jurisdiction of another State. In the ruling below, Massachusetts has become the latest State to impose income-based taxes on out-of-state corporations even when they do not maintain a physical presence in the taxing State.

In order to uphold application of the Massachusetts tax against out-of-state corporations

without a physical in-state presence, the Massachusetts Supreme Judicial Court had to distinguish *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992), and hold that the prohibition of *Quill* against state taxation on out-of-state corporations unless they have an in-state physical presence applies only to sales and use tax collection, *i.e.*, taxes on buyers that are collected by the out-of-state corporation and remitted to the State. The Massachusetts court concluded that, notwithstanding *Quill*, Massachusetts may tax the income of an out-of-state corporation such as petitioner Geoffrey even though Geoffrey does not maintain a physical presence in the Commonwealth of Massachusetts, because the tax is based on royalties that Geoffrey receives from the use by others in Massachusetts of Geoffrey's intellectual property. This ruling by the Massachusetts court relied on the rationale set forth in its decision rendered the same day in *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76 (Mass. 2009), *petition for cert. filed,* (U.S. Mar. 18, 2009) (No. 08-1169), where the court upheld the validity of applying Massachusetts' financial institutions excise tax to out-of-state credit card businesses that similarly do not maintain any physical presence in Massachusetts, but receive income from in-state credit card customers. The state court adopted an "elastic" nexus test that allows State taxation of an out-of-state corporation when the out-of-state corporation receives income from an in-state entity. App., *infra*, 3a.

The ruling of the Massachusetts' court cannot be reconciled with *Quill*, where this Court reaffirmed the longstanding constitutional requirement in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), that the substantial nexus between a taxing State and an out-of-state corporation being taxed, which is required to satisfy the Commerce Clause, can be met only if the out-of-state corporation has a physical presence in the taxing State. Moreover, irrespective of whether this Court believes the instant dispute is governed by *Quill* and *Bellas Hess*, this significant constitutional question should not remain unanswered by this Court.

The recent twin rulings in this case and *Capital One* by the Supreme Judicial Court of Massachusetts join a growing list of state appellate court decisions that have reached divergent conclusions on this issue, in numerous contexts, because of the lack of a decision from this Court. Thus far, approximately *one-third* of all the States in the Nation, 16 in total, have examined *Quill* and *Bellas Hess* and have come to their own view of the federal constitutional question. Three of those States—Tennessee, Michigan, and Texas—have concluded (correctly, in our view) that a taxing State may not, consistent with the Commerce Clause, impose on an out-of-state corporation the State's income or franchise taxes—*i.e.*, direct taxes on the corporation—unless the out-of-state corporation maintains a physical presence in the taxing State. And the appellate courts of 13 other States—Illinois, Louisiana, Maryland, New Jersey,

New Mexico, North Carolina, Ohio, Oklahoma, South Carolina, Washington, West Virginia, Wyoming and now Massachusetts—have come to a different conclusion. Those courts have held that the constitutionally required substantial nexus between the taxing State and the out-of-state corporation can be satisfied by a mere and amorphous economic connection to the taxing jurisdiction, without any in-state physical presence.[1]

Regardless of which side of the dispute is correct, it is now clear that this entrenched conflict in the state courts will not resolve itself absent this Court's intervention. No state court we cite that has decided this issue, one way or the other, has revisited the question presented and switched sides in the dispute.

Moreover, Congress has given no indication in the nearly two decades since *Quill* was decided, that it intends to follow up on this Court's suggestion in *Quill* that this is a question "that Congress may be better qualified to resolve." *Quill*, 504 U.S. at 318.

Accordingly, corporations that engage in interstate commerce involving numerous States in which they do not maintain a physical presence are left with an intolerable patchwork of inconsistent state laws concerning the scope of state tax jurisdiction under the Commerce Clause. And state taxing authorities in

[1] In addition, many administrative, trial and tax court decisions on the question have been issued by other States, some of which are still subject to appellate review.

different States currently are bound by different interpretations of the federal constitutional limitations on state taxation of out-of-state corporations. This should not be the case, particularly for an issue as important as this. This constitutional question is worth billions of dollars annually. And absent this Court review, the state courts will continue to inconsistently decide who—the out-of-state corporation such as petitioner or the state taxing authority—is entitled to this money.

There is no reason for this Court to defer resolution of this conflict in the state courts. No better vehicles will present themselves than the twin rulings of the Supreme Judicial Court of Massachusetts in the instant case and the *Capital One* case. They provide this Court the opportunity to rule on the scope of the federal constitutional limitation on state taxation of the income of an out-of-state corporation in the context of different industries and different underlying factual scenarios. The petition for a writ of *certiorari* should be granted.

STATEMENT OF THE CASE

A. Constitutional, Statutory, And Regulatory Framework

1. More than forty years ago, this Court in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), confirmed the longstanding Commerce Clause doctrine that a State imposes an unconstitutional burden on interstate commerce

when it imposes tax collection and remittance responsibilities on an out-of-state corporation that lacks any physical presence in the taxing State. The *Bellas Hess* Court canvassed Supreme Court precedent back to 1939, and concluded that there is a "sharp distinction" between "sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier." *Bellas Hess*, 386 U.S. at 758. The Court explained that that distinction, which was the basis for those entities within the State being subject to State taxation and those outside of the State not being taxed, had "been generally recognized by the state taxing authorities," and "is a valid one." *Ibid.* The Court therefore "decline[d] to obliterate it." *Ibid.*

A decade after *Bellas Hess*, the Court set forth a general test for dormant Commerce Clause challenges to the exercise of state taxing power in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). Under *Complete Auto*, a state tax will be upheld against a Commerce Clause challenge if the state tax: (1) "is applied to an activity with a substantial nexus with the taxing State"; (2) "is fairly apportioned"; (3) "does not discriminate against interstate commerce"; and (4) "is fairly related to the services provided by the State." *Id.* at 279.

In the years that followed *Complete Auto*, a number of state courts concluded that the "substantial nexus" requirement of *Complete Auto* had replaced the need under *Bellas Hess* for an

out-of-state corporation to have a physical presence in the taxing State in order for the state tax to be constitutionally applied. But this Court rejected that argument in *Quill Corporation v. North Dakota*. In *Quill*, the Court addressed again the Commerce Clause issue in a case involving the imposition on an out-of-state corporation of a use tax—*i.e.*, a tax effectively levied on the buyer but collected by the seller and remitted to the State. The *Quill* Court reaffirmed the central holding of *Bellas Hess* and ruled that the *Complete Auto* requirement that there be a "substantial nexus" between the taxing State and an out-of-state corporation can be met only where the corporation maintains a "physical presence" in the taxing State. *Quill Corp. v. North Dakota*, 504 U.S. 298, 314 (1992).

These rulings by the Court reflect core principles that undergird the Constitution, and which are reflected in the Commerce Clause, that a State may not regulate beyond its geographic borders into the boundaries of its sister States. As this Court has explained, "[i]n a Union of 50 States, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777-778 (1992).

2. Respondent Massachusetts broadly taxes out-of-state corporations on income they derive from the in-state use by others of the out-of-state corporation's intangible property. And Massachusetts

does so regardless of whether the out-of-state corporation maintains a physical presence in Massachusetts.

The statutes of Massachusetts provide that "every foreign corporation, exercising its charter, or qualified to do business or actually doing business in the commonwealth, or owning or using any part or all of its capital, plant or any other property in the commonwealth, shall pay, on account of each taxable year" an excise tax. Mass. Gen. Laws ch. 63, § 39, 39(3)(a)(2), 39(3)(b). The stated purpose of that tax is "to require the payment of this excise to the commonwealth by foreign corporations for the enjoyment under the protection of the laws of the commonwealth, of the powers, rights, privileges and immunities derived by reason of the corporate form of existence and operation." *Id.* § 39(3).

Section 38(f) of the Massachusetts General Laws sets forth the rules for apportioning sales to Massachusetts in computing "net income determined to be taxable in accordance with the provisions of this chapter." That provision states that a sale is attributed to Massachusetts if it is derived from a sale "other than sales of tangible personal property" that occurs in Massachusetts "if 1. the income-producing activity is performed in this commonwealth; or 2. the income-producing activity is performed both in and outside this commonwealth and a greater portion of this income-producing activity is performed in this commonwealth than in

any other state, based on costs of performance." *Id.* § 38(f).

The Massachusetts Department of Revenue has promulgated regulations construing Section 38(f) that permit the apportionment to the State of the income received by an out-of-state corporation from its licensing of intangible property, such as trademarks, for use by licensees and rests on where and how much the licensee uses the property:

> Gross receipts from the licensing of intangible property are attributable to Massachusetts if the property is used by the licensee solely in Massachusetts. If the licensee uses the intangible property in more than one state, the gross receipts from the licensing are attributable to Massachusetts if the use of property by the licensee in Massachusetts exceeds its use of the property in any other one state.

830 Mass. Code Regs. § 63.38.1(9)(d)(3)(c) (2001).

The Massachusetts Department of Revenue has issued a directive addressing when use of intangible property by another in the State can subject to state taxation an out-of-state corporation who licensed the property. Directive 96-2 provides:

> A foreign corporation's intangible property used within Massachusetts will subject that corporation to corporate excise when:
>
> 1. The intangible property generates, or is otherwise a source of, gross receipts within

> the state for the corporation, including through a license or franchise; and
>
> 2. The activity through which the corporation obtains such gross receipts from its intangible property is purposeful (e.g., a contract with an in-state company); and
>
> 3. The corporation's presence within the state, as indicated by its intangible property and its activities with respect to that property, is more than de minimus.

Mass. Dep't of Revenue Directive 96-2.

B. Factual Background[2]

1. Petitioner Geoffrey, Inc. was a Delaware corporation formed in 1984 as a wholly-owned subsidiary of Toys "R" Us, Inc. Petitioner owned intellectual property in the form of trademarks, tradenames and service marks which it licensed to third parties and other legal entities, including to Toys "R" Us-Mass, Inc. (TRUMI) and Baby Superstore, Inc.

TRUMI operated Toys "R" Us retail toy stores and Kids "R" Us retail children's clothing stores in Massachusetts during the fiscal years at issue. App.,

[2] The facts recited in this Petition are taken primarily from the stipulated factual record; no material facts in this case were in dispute. Unless stated to the contrary, the facts relate to the tax years at issue, which are Geoffrey's fiscal years that ended January 31, 1997 through January 31, 2001.

infra, 26a. Baby Superstore, Inc., beginning with the fiscal year ended January 31, 1998, operated Babies "R" Us retail stores throughout the country, including three in Massachusetts, through its Babies "R" Us division. App., *infra*, 28a. Neither TRUMI nor Baby Superstore, Inc., are parties in the instant matter.

2. Respondent did not dispute that petitioner was formed for valid business purposes and had economic substance. Petitioner had no physical presence in Massachusetts. Petitioner does not own or maintain any offices, employees, or real or tangible personal property in Massachusetts. App., *infra*, 28a.

Petitioner's business activities were carried out through its board of directors which met annually outside of Massachusetts, and by support services performed in New Jersey, not Massachusetts, by Toys "R" Us for which petitioner paid arm's length rates,[3]

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[3] Respondent does not dispute that the payments made between the related companies, including royalties, were at arm's length rates. An independent tax tribunal held that the license between Geoffrey and another one of its licensees was at arm's length rates. *In re Toys "R" Us-NYTEX, Inc.*, No. TAT(E) 93-1039 (GC), 2004 N.Y. City Tax LEXIS 11 (N.Y.C. Tax App. Trib., Jan. 14, 2004), *aff'g*, No. TAT(H) 93-1039 (GC), 1999 N.Y. City Tax LEXIS 31 (N.Y.C. Tax App. Trib., Aug. 4, 1999). Further, in that case, the administrative law judge concluded that: "Geoffrey was created for several valid business purposes, including but not limited to owning and protecting the existing Toys 'R' Us trademarks and trade names; establishing and registering new trademarks and trade names; licensing those trademarks and trade names to both related and unrelated entities; and defending the integrity of the trademarks in

(Continued on following page)

and with the advice of New York-based trademark counsel. App., *infra*, 26a-28a. The license agreement between petitioner and TRUMI was executed outside of Massachusetts and during the years at issue petitioner did not use any state or federal courts in Massachusetts. App., *infra*, 27a-28a, 8a n.7.

3. TRUMI and Baby Superstore, Inc., conducted business in Massachusetts and filed Massachusetts corporation excise tax returns. Both TRUMI and Baby Superstore, Inc., claimed deductions for the royalties paid to Geoffrey.

Based on its audit of TRUMI, respondent began a nexus investigation of petitioner. On January 28, 2003, relying on its Directive 96-2, which provides that an out-of-state corporation is subject to Massachusetts' corporate excise tax in almost any circumstance where the out-of-state corporation's intangible property is used by another in Massachusetts with profit-seeking intent, respondent issued a Notice of Assessment against petitioner which, as revised by stipulation, imposes a tax of $1,257,793 with interest of $567,101. App., *infra*, 24a, 7a n.6. The notice also imposed late filing, late

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litigation with third parties. Geoffrey paid its own expenses, including fees to unrelated law firms and accounting firms. The credible testimony and evidence demonstrate not only that it was anticipated that Geoffrey would realize a profit from its licensing activities, apart from any tax benefit, but that in fact Geoffrey did realize such a profit." 1999 N.Y. City Tax LEXIS 31.

payment, and underpayment penalties of an additional $631,541. App., *infra*, 7a n.6.

C. Proceedings Below

1. Petitioner sought review of the assessment to the Massachusetts Appellate Tax Board, which rejected the appeal. The Tax Board concluded that Geoffrey's reading of *Quill* was too "broad" and that "neither * * * Supreme Court nor Massachusetts precedent supports the proposition that physical presence is required to impose an income-based tax." App., *infra*, 40a (citation omitted).

2. Petitioner filed an appeal with the Massachusetts Appeals Court and an application for direct appellate review with the Supreme Judicial Court of Massachusetts. App., *infra*, 1a. The Supreme Judicial Court granted the application and transferred the case to its jurisdiction. App., *infra*, 19a-20a. The court also granted a direct application for review in *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76 (Mass. 2009), *petition for cert. filed*, (U.S. Mar. 18, 2009) (No. 08-1169), to address the same question of whether the State's imposition of the financial institution excise tax on out-of-state corporations is constitutionally limited to those corporations that maintain a physical presence in the State and, therefore, meet the constitutional nexus requirement. Both the instant case and the *Capital One* case were argued before the Supreme Judicial Court on October 7, 2008.

3. The Massachusetts Supreme Judicial Court affirmed the Tax Board in both cases.

In the instant case, the court relied heavily on its ruling issued the same day in *Capital One.* The court held that "substantial nexus can be established where a taxpayer domiciled in one State carries on business in another State through the licensing of its intangible property that generates income for the taxpayer." App., *infra*, 11a. The court explained it was "join[ing] other jurisdictions that have considered the physical presence issue in the context of intangible property and have upheld the imposition of income-based tax assessments." *Ibid.* Even though the court acknowledged that the licenses with TRUMI and Baby Superstore, Inc., "permitted *those* entities to use the trademarks exclusively in Massachusetts," the court suggested that the licensee's activities were attributable to petitioner due to (1) the purported "encourage[ment to] Massachusetts customers to shop at Toys 'R' Us, Kids 'R' Us, and Babies 'R' Us through an *implicit* promise, manifested by the trademarks, that the products at those stores would be of good quality and value"; (2) petitioner's purported reliance on employees of TRUMI to "maintain a positive retail environment"; and (3) petitioner's quality control of licensed products to "maintain its positive reputation with Massachusetts customers." App., *infra*, 13a (emphasis added). But the court's conclusion that petitioner had a substantial nexus to Massachusetts due to its alleged "business activities" which resulted in "substantial

profits," was based at bottom on petitioner's out-of-state licensing of intangible property that generated income related to their use by the licensees in Massachusetts.

REASONS FOR GRANTING THE PETITION

REVIEW IS NECESSARY BECAUSE THE STATES ARE HOPELESSLY DIVIDED OVER WHETHER A STATE CAN TAX THE INCOME OF AN OUT-OF-STATE CORPORATION THAT DOES NOT MAINTAIN A PHYSICAL PRESENCE IN THE TAXING STATE

A. Sixteen State Courts Have Weighed In On The Conflict Regarding Whether This Court's Longstanding Requirement Of *Bellas Hess* And *Quill*, That A State May Tax An Out-Of-State Corporation Only If The Corporation Maintains A Physical Presence In The Taxing State, Applies To Income Taxes

There is a mature, well-recognized, and entrenched split of authority among the state courts on the question of whether the Commerce Clause prohibits the imposition by a State of income taxes on an out-of-state corporation that does not maintain any physical presence in the taxing State.

1. The decision below conflicts directly with the state appellate court rulings in Tennessee, Michigan and Texas.

The Tennessee court in *J.C. Penney National Bank v. Johnson*, held that Tennessee could not tax

the corporate earnings of out-of-state corporations that had no physical presence in Tennessee. The court explained that no valid distinction could be made for Commerce Clause purposes between such an income-based tax and the sales and use taxes at issue in *Bellas Hess* and *Quill*. The Tennessee court thus held that, "[w]hile it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case." *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 839 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000).

The Michigan court, in *Guardian Industries Corp. v. Department of Treasury*, 499 N.W.2d 349 (Mich. Ct. App. 1993), likewise stated, in a case involving a single business tax, that "after *Quill*, it is abundantly clear that" there must be "a physical presence within a target state to establish a substantial nexus to it." *Id.* at 377.

The Texas court, in *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. Ct. App. 2000), adhered to *Quill's* reasoning, and held that Texas cannot impose on an out-of-state corporation, that does not maintain a physical presence in the State, the State's franchise tax, *i.e.*, a tax on the privilege of doing business in the State. The Texas court explained that, "[w]hile the decisions in *Quill Corp.* and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause." *Id.* at 300. The Texas court held that, where a "corporation conducts its activity solely through

interstate commerce and lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax." *Ibid.*

2. On the other side of the legal divide, the Supreme Judicial Court of Massachusetts has joined the appellate courts of Illinois, Louisiana, Maryland, New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, South Carolina, Washington, West Virginia, and Wyoming in holding that States may impose income and franchise taxes on an out-of-state corporation even though the corporation does not maintain any physical presence in the State. Most of these courts have acknowledged that their decisions depart from the precedent in other States.

The New Jersey Supreme Court recently declared that "[s]ince the Court decided *Quill*, a split of authority has developed regarding whether the Supreme Court's holding was limited to sales and use taxes." *Lanco, Inc. v. Director, Div. of Taxation*, 908 A.2d 176, 177 (N.J. 2006), *cert. denied*, 127 S. Ct. 2974 (2007). The New Jersey court then concluded, erroneously in our view, that "the better interpretation of *Quill* is the one adopted by those states that limit the Supreme Court's holding to sales and use taxes." *Ibid.*

A divided West Virginia Supreme Court immediately followed the New Jersey court's *Lanco* ruling in *Tax Commissioner v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006). The West Virginia court also acknowledged the disagreement among the

state courts as to whether the physical presence requirement articulated in *Quill* applies to income and franchise taxes, and that that issue was a "major question left open by the Supreme Court's opinion." *Id.* at 231. In "reject[ing]" the Tennessee *J.C. Penney* court's reasoning requiring an out-of-state corporation to have a physical presence in the taxing State, the West Virginia court held that the "significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes." *Id.* at 234.[4]

Several other state appellate courts similarly acknowledge the conflict among the courts in express terms. *See Bridges v. Geoffrey, Inc.*, 984 So.2d 115, 127 (La. Ct. App. 2008) (rejecting *Quill's* physical presence requirement and describing the decisions of the Tennessee and Texas cases as not "persuasive"); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Ct. App. 2005) (rejecting *Quill's* physical presence requirement and attempting to distinguish the Tennessee and Texas decisions); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 196 n.9 (N.C. Ct. App. 2004) (rejecting *Quill's* physical presence requirement for income taxation and attempting to distinguish the

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[4] This conclusion by the West Virginia court was strongly disputed by the dissent. The dissent emphasized that "[t]he jurisprudential reality is that the United States Supreme Court has never held in any state tax case that the nexus requirements of the Commerce Clause can be satisfied in the absence of a taxpayer's physical presence in the taxing state." *Id.* at 239 (Benjamin, J., dissenting).

Tennessee court's *J.C. Penney* decision); *General Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1028 (Wash. Ct. App. 2001) (rejecting *Quill*'s physical presence requirement and noting that the taxpayers "correctly argue that some state courts have extended the physical presence rule").

In addition, a number of other state courts have held, without explicitly recognizing the conflict, that "the taxpayer need not have a tangible, physical presence in a state for income to be taxable there." *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13, 18 (S.C. 1993); *see also Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225, 1230 (Ohio 1996) ("There is no indication in *Quill* that the Supreme Court will extend the physical-presence requirement to cases involving taxation measured by income derived from the state."); *Buehner Block Co. v. Wyoming Dep't of Revenue*, 139 P.3d 1150, 1158 n.6 (Wyo. 2006) (noting that "*Bellas Hess* and *Quill* * * * created [a] specialized jurisprudence" applicable to "sales or use tax case[s]"); *Kmart Props., Inc. v. Taxation & Revenue Dep't*, 131 P.3d 27, 35 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22, 35-36 (N.M. 2005) (same); *Comptroller of the Treasury v. Syl, Inc.*, 825 A.2d 399, 415-416 (Md. 2003) (same); *Borden Chems. & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73, 80-81 (Ill. Ct. App. 2000) (same).

3. The fact that the Tennessee, Michigan, and Texas decisions do not come from state courts of last resort does not, in any way, lessen the adverse

consequences of the conflict in the state courts and does not undermine the need for review by this Court.

As a matter of state procedural law, the Tennessee Supreme Court's denial of further review in *J.C. Penney* approved and adopted the reasoning of the state appellate court when it denied review. *See State v. Cawood*, 134 S.W.3d 159, 164 n.6 (Tenn. 2004) (when the Tennessee Supreme Court "denies a writ of *certiorari*, the Court takes jurisdiction and makes a final disposition of the case by approving the final decree of the intermediate court").

Likewise, under state procedural law, the Michigan appellate decision is binding precedent throughout that State. *See Tebo v. Havlik*, 343 N.W.2d 181, 185 (Mich. 2004). In addition, the Michigan Department of Revenue has announced that it will adhere to the physical presence requirement in light of the *Guardian Industries* decision, *see J.W. Hobbs Corp. v. Revenue Div., Dep't of Treasury*, 706 N.W.2d 460, 463 (Mich. App. 2005).

Finally, Texas appellate procedure requires that Texas courts treat as binding precedent a decision such as the *Rylander* imposing the physical presence requirement. *See Messina v. State*, 904 S.W.2d 178, 181 (Tex. App. 1995).

Moreover, even if any of these decisions were subject to reconsideration by their own state courts, it is clear from the years that have passed from the dates of these rulings that these decisions are

entrenched. Not one of these state courts has revisited its prior conclusion.

B. The Decisions Of The Massachusetts Supreme Judicial Court Here And In *Capital One* Cannot Be Reconciled With This Court's Commerce Clause Precedent

Although the sheer breadth of the disagreement in the state courts alone should compel this Court to grant *certiorari* in the instant case, the petition also should be granted because the decision below cannot be reconciled with the Court's precedent.

1. This Court's Commerce Clause Holdings In *Quill* And *Bellas Hess* Govern This Case Because They Do Not Distinguish Between Different Types Of State Tax

a. Review is necessary here because, in attempting to avoid *Quill* and *Bellas Hess*, the court below and numerous other state courts have opined that this Court, and thus the Constitution, somehow distinguishes between sales and use taxes on the one hand and income and franchise taxes on the other. App., *infra*, 17a, 40a, 43a. But this Court's precedent does not support such a distinction because this Court has reasoned that the requirement under the Commerce Clause for a "substantial nexus" between a State and an out-of-state corporation is a necessary predicate "before *any* tax may be levied" by a State. *Commonwealth Edison Co. v. Montana*, 453 U.S. 609,

626 (1981). *Quill* itself recognized that this Court's prior cases upholding state taxes have all "involved taxpayers who had a physical presence in the taxing State." *Quill*, 504 U.S. at 314.

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977), is not to the contrary. In that decision, this Court included the "substantial nexus" requirement as part of the four-prong test to determine whether the imposition of a state tax is permissible under the Commerce Clause, but no distinction was made between the types of state tax at issue. As such, even though *Complete Auto* addressed the constitutionality of a state use tax, (where the physical presence requirement of *Bellas Hess* and *Quill* would unquestionably apply), this Court relied equally on its franchise tax precedent. *See id.* at 285-287 (citing *Colonial Pipeline Co. v. Traigle*, 421 U.S. 100, 101 (1975)).

In the years that have followed since *Complete Auto*, this Court has applied that four-prong analysis on several occasions to assess the constitutionality of state income taxes. *See, e.g. Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); *Amerada Hess Corp. v. Director, Div. of Taxation,* 490 U.S. 66 (1989); *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358 (1991); *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994). And this Court has rejected the argument, advanced by several States, that the "decision in *Complete Auto* undercut the *Bellas Hess* rule." *Quill*, 504 U.S. at 311-312.

The label that a State gives a tax cannot permit that tax to evade constitutional review. The *Complete Auto* Court recognized that redefining a tax one way or another will not result in a different analysis or result under the Constitution. "A tailored tax, *however accomplished*, must receive the careful scrutiny of the courts to determine whether it produces a forbidden effect on interstate commerce." *Complete Auto*, 430 U.S. at 288 n.15 (emphasis added). A court must "look[ ] past 'the formal language of the tax statute [to] its practical effect.'" *Quill*, 504 U.S. at 310 (quoting *Complete Auto*, 430 U.S. at 279) (second brackets in original). Accordingly, in discussing the Commerce Clause's substantial nexus requirement, this Court has routinely referred to cases involving sales and use taxes interchangeably with cases involving direct taxes such as income taxes, undermining the notion that respondent pressed below (and the state court adopted) that there are different substantial nexus requirements for different kinds of state taxes. *See, e.g.*, *National Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551, 555-559 (1977).

There is no logical reason that a State should be able to impose state income taxes on an out-of-state corporation that does not maintain a physical presence in that State when it cannot, under the Commerce Clause, impose state sales and use taxes on that out-of-state corporation.

b. Application of the physical presence requirement articulated in *Quill* and *Bellas Hess* to

state imposition of income taxes on out-of-state corporations is entirely consistent with the core principles that undergird the Commerce Clause. In declining to overrule *Bellas Hess*, the *Quill* Court reaffirmed that the Commerce Clause was intended to address "structural concerns about the effects of state regulation on the national economy" because, under the Articles of Confederation, "state taxes and duties [had] hindered and suppressed the interstate commerce." *Quill*, 504 U.S. at 312.

The economic nexus rationale set forth by the Massachusetts court below, as well as by some of the other state courts to have decided this issue, was plainly rejected by this Court in *Quill*. *See MBNA*, 640 S.E.2d at 241 (Benjamin, J., dissenting) (noting that this Court rejected the "economic exploitation nexus" arguments in *Bellas Hess* and *Quill*). In *Quill*, the State had argued that because the out-of-state corporation had derived significant revenues from in-state customers, the corporation should have paid tax to that State on that income. The State also argued that: (1) the out-of-state corporation received benefits from the taxing State; (2) such a corporation would be at a competitive advantage vis-à-vis in-state merchants who necessarily must collect the tax; and (3) the physical presence rule was rendered obsolete by the technological and economic changes of the late Twentieth Century. But this Court correctly concluded that none of these arguments in *Quill* justified a departure from the physical presence

requirement. And there is no reason why they should lead to a different result today merely because an income, rather than sales or use, tax is at issue.

Indeed, the ruling below, by cabining *Quill* and *Bellas Hess* to sales and use taxes only, has imposed a constitutional regime in which States can reach the very transactions the Constitution seeks to protect from state interference. As this Court has previously made clear, the economic burdens on interstate commerce posed by imposition of state income taxes on out-of-state corporations are actually greater than the consequences of sales and use tax collection obligations. *National Geographic*, 430 U.S. at 558. The state taxes invalidated in *Bella Hess* and *Quill* were not direct taxes on out-of-state corporations but, instead, were obligations to collect sales and use taxes from in-state customers. By contrast, income and franchise taxes are *direct* taxes imposed on the out-of-state corporation.

As such, it would make no sense for the administrative burden of a collection obligation for sales and use taxes to violate the Commerce Clause due to the absence of any physical presence by the out-of-state corporation, *see Quill*, 504 U.S. at 313 n.6, but for no such violation to occur where there is not only an administrative burden but also an immediate financial obligation of an income tax for what might amount to that same sale by the

out-of-state corporation that maintains no physical presence in the State.[5]

c. The physical presence requirement of *Bellas Hess* and *Quill* is supported not only in the context of sales and use taxes, but also with regard to income taxes, by basic federalism principles.

Although the modern economy may lack physical borders, States do not. In the years since *Quill*, this Court has consistently reaffirmed the constitutional limitations on a State's ability to regulate economic activity beyond its geographic border. *See, e.g.*, *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 421 (2003); *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 569-571 (1996); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 821-823 (1985); *see also Granholm v. Heald*, 544 U.S. 460, 472 (2005) (noting that the

[5] Congress has mandated in 15 U.S.C. § 381 that there is a minimum standard for State imposition of net income tax that provides that no State may impose such a tax "on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person" are based solely on solicitations of orders in the State for sales of tangible personal property that are approved or rejected outside the State, and/or solicitations of such orders for the benefit of a customer. 15 U.S.C. § 381(a). States thus have targeted out-of-state corporations that earn income from customers located in their State or from intangible property used in their State, *e.g.,* businesses owning intellectual property, computer software firms, credit card businesses, music publishers, and service providers. Of course, Congress's imposition of a minimum standard says nothing about the constitutionality of the reach of the state tax to the situation presented here.

Commerce Clause was intended to "minim[ize]" the potential for "[r]ivalries among the States").

If the physical presence of a taxpayer in the taxing State becomes irrelevant to a State's power over the taxpayer, and a State is allowed to exert broad taxing authority solely on the basis of activity in commercial markets, then state regulatory power becomes effectively unmoored from the very feature of the State that gives it constitutional status—*viz.*, its sovereignty over a specified geographical area and those who come within it. For that reason, this Court has explicitly held that "[i]n a Union of 50 States, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as business could be subjected to severe multiple taxation." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777-778 (1992).

2. Any Ambiguity In The Reach Of *Quill's* Constitutional Ruling Should Be Resolved By This Court And Not Left To A Disagreement Among The State Courts

a. Several state courts, including the court below, *see* App., *infra*, 43a; *Capital One*, 899 N.E.2d at 12, have limited *Quill* and *Bellas Hess* to sales and use taxes and have declined to apply that precedent to income taxes based upon the following observation in *Quill*:

> [A]lthough in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes.

Quill, 504 U.S. at 317; *see also id.* at 314 ("Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule.").

Those statements do not, however, provide States with a justification to exclude income-based taxes from this Court's physical presence requirement. That is particularly true in light of this Court's longstanding precedents which do not impose different Commerce Clause tests depending upon the state tax at issue. *See* pages 22-27, *supra*.

Nevertheless, the disparate decisions of 16 state courts demonstrate that this language in *Quill* has created ambiguity. That provides yet another reason for this Court to grant this petition and clarify the implications of this dictum.

b. Even if this Court were to view the state courts that have refused to apply *Bellas Hess* and *Quill* to income taxes to be correct, it is for this Court to rule on the question. As Justice Scalia explained in

his opinion concurring in part and concurring in the judgment in *Quill*, "if a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, [courts] should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions." *Quill*, 504 U.S. at 320 (Scalia, J., concurring in part and concurring in the judgment) (citation omitted).

Moreover, this Court's ruling on the question presented is necessary because the absence of this Court's intervention has led some state courts to believe that this Court has rejected the physical presence requirement for state income tax cases merely because the Court has denied *certiorari* in certain cases. *Praxair Technology, Inc. v. Director, Div. of Taxation*, No. 007445-05 (N.J. Tax Ct. June 27, 2007) (Order Granting Partial Summ. J.), *rev'd and remanded*, 404 N.J. Super. 287, 291 (N.J. Super. Ct. App. Div. 2008) (viewing this Court's denials of *certiorari* as "signaling" its decision on the merits of this issue).

3. A Bright-Line, Physical Presence Requirement Provides A Judicially Manageable Rule, Whereas An Economic Nexus Standard Would Be Unmanageable And Subject To Manipulation

The requirement that a State not impose state taxation on an out-of-state corporation unless that

corporation maintains a physical presence in the taxing State provides a principled and judicially manageable rule that "encourages settled expectations and, in doing so, fosters investment by businesses and individuals." *Quill*, 504 U.S. at 316.

One of the foremost experts in State taxation, Professor Richard D. Pomp, explained that the "physical presence is to be preferred to economic presence as a nexus standard" because it is "more likely to reduce litigation and foster interstate investment, less likely to discriminate against the service sector, less likely to lead to multiple taxation, more easily administered, and more compatible with the growth of electronic commerce." App., *infra*, 143a. An economic nexus standard, on the other hand, "is amorphous and easily malleable" and "is less a legal principle and more an invitation to chaos and multiple taxation." *Ibid.*

Indeed, the vagaries of the economic nexus test, as opposed to the physical presence test, are plainly demonstrated by the courts that have applied it. The Massachusetts court held that "substantial nexus" is an "elastic" test that purportedly "means a greater presence, both qualitatively and quantitatively, than the minimum connection between a State and a taxpayer that would satisfy a due process inquiry," yet in the State's view this elastic text can be satisfied by virtually any commercial arrangement with individuals or entities in the taxing State.

Capital One, 899 N.E.2d at 15; *see also* App., *infra*, 3a.[6]

West Virginia courts look to whether there is any significant "economic presence" in the State. *MBNA*, 640 S.E.2d at 234. And other state courts have similarly based their decisions on some amorphous threshold requirement of minimum economic or commercial activity directed at the taxing State. *General Motors*, 25 P.3d 1028-1029.

These nonstandards provide no guidance to the courts that must apply them or to the out-of-state corporations that must abide by them. And the flexible—*i.e.*, malleable—nature of these tests has been justified by the limitless rationale that those "who adopted the Commerce Clause lived in a world that is impossible for people living today to imagine" so that there must be "a fresh application of Commerce Clause principles tempered with healthy

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[6] The Massachusetts Department of Revenue Directive 96-2, on which the State relied in this case, finds a substantial nexus any time an out-of-state corporation's intangible property "generates gross receipts" through a "contract with an in-state company" and the presence of the "intangible property" and the out-of-state corporation's "activities with respect to that property" are "more than de minimis." Mass. Dep't of Revenue Directive 96-2. Under this standard, it is difficult to conceive of a circumstance where the use for profit in Massachusetts of intangible property owned by an out-of-state corporation would not in the State's view result in a substantial nexus that authorizes state taxation of the out-of-state corporation.

doses of fairness and common sense" to adapt to the modern world. *MBNA*, 640 S.E.2d at 236.

That rationale, rooted in the speed and scope of modern interstate commerce arrangements, is symptomatic of the problem with the economic nexus standard. It means that the Commerce Clause has become nugatory, because economic transactions no longer yield to State borders, so that a State can regulate any interstate commerce that involves a customer who lives within the taxing State, contrary to this Court's longstanding precedent.

C. The Continued Departure By State Courts And Taxing Authorities From The Physical Presence Requirement Has Severe Economic Implications

1. The Conflict In The State Courts Creates Economic Uncertainty On An Issue That Is Worth Billions Of Dollars Annually To Corporations Such As Petitioner And The States

The uncertainty caused by the continued proliferation of the now 16-State conflict in the state courts significantly hinders business planning and investment at a time our Nation can ill afford it. This issue affects all sorts of corporations—from petitioner, to the credit card companies in *Capital One*, to authors and music publishers, to software companies, and to many others. It is estimated to be worth billions of dollars annually. That means that until

this Court resolves this undecided constitutional issue, state courts will continue to divergently decide who—the State or the out-of-state corporation without a physical presence in the State—has a right to this money.

A corporation attempting to order its business affairs and determine in what States it can be subjected to state income and franchise tax currently is faced with the prospect of different conclusions in different States, depending not on any difference in the extent of the connection between the corporation and the State but, instead, on the difference in how the state courts may interpret the federal Constitution. Such uncertainty inhibits strategic business planning and investment and is extraordinarily costly. Reliance interests need to be respected and the clarity provided by *Quill* restored. Absent clear guidance from this Court, there is no reliable way for businesses to predict how far jurisdictions will assert taxation authority in the future, and whether such exercise of taxing authority will be upheld by the courts.

States have also begun to sustain the imposition of substantial, non-deductible and often unabateable penalties on out-of-state corporations that had relied (and continue to rely) on this Court's holdings in *Quill* and *Bellas Hess* that physical presence is a prerequisite for nexus under the Commerce Clause.

The need for clarity on this issue is particularly important in light of requirements for corporate

transparency. The Financial Accounting Standards Board Interpretation No. 48 (FIN 48), which is entitled Accounting for Uncertainty in Income Taxes, sets forth how a corporation must account for and disclose its income tax positions. In particular, FIN 48 requires a company to determine whether it is "more likely than not" that its positions would be upheld by the court of last resort. If it is not more likely than not that a position will be upheld, the corporation cannot recognize a benefit for such position in its financial statements. Financial Accounting Standards Board, *Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109*, App. A, A2 (2008). Although the court of last resort on constitutional questions is this Court, some auditors are requiring that no benefit be taken on economic nexus positions due solely to the conflict on this issue in the State courts that has not yet been resolved by Congress or this Court. That results in profound consequences for the publicly reported financial health of a corporation, for shareholder value, and the ability to raise capital in this particularly uncertain economic time.

Although a remarkably large number of States have litigated this issue to completion, two thirds of the States have not yet conclusively weighed in on this issue. The likely continued litigation of the issue in these other States will not resolve the entrenched disagreement in the state courts, and it will continue to generate enormous—and enormously wasteful—litigation costs. *Cf. Quill*, 504 U.S. at 315

(noting that a clear rule establishing the boundaries of state taxation authority would "reduc[e] litigation concerning those taxes").[7]

2. The Economic Nexus Standard Has Adverse Global Implications

Tax jurisdiction is not just a national issue. Under most international tax treaties to which the United States is a signatory, the United States has agreed to tax foreign corporations only if they have a "permanent establishment" in the United States, which is normally defined as a "fixed place of business through which the business of an enterprise is wholly or partly carried on." U.S. Model Income Tax Convention art. 5(1), Sept. 20, 1996. A foreign corporation thus is not subject to United States income tax unless it is physically present in this country. That "permanent establishment" requirement is widely used in the international arena because of its clarity, reliability, and fairness, which

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[7] In addition to statutory, regulatory, and other publicly announced economic nexus positions and cases pending before or decided by State administrative tribunals, there also is ongoing litigation in certain States that has not yet resulted in appellate court decisions. *See, e.g.*, *MBNA America Bank, N.A. v. Indiana Dep't of State Revenue*, 895 N.E.2d 140 (Ind. Tax Ct. 2008) (case presenting same issue that has recently come out of the tax court in Indiana and likely to proceed to higher state court).

all are principles of tax policy that apply equally in the State tax arena.[8]

These treaties also are of particular concern because they generally do not limit the power of States and localities to impose taxes on foreign corporations. *See Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 196-197 (1983). Consequently, if the decision below is permitted to stand, a foreign corporation without a permanent establishment in the United States could find itself subject to tax by States that reject a physical presence requirement, even though the foreign corporation would not be subject to federal income tax. *Cf. Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448 (1979) (noting that "a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential").

In addition to the practical problems that could arise (most State tax returns use federal income tax returns as their starting point in computing tax

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[8] The permanent establishment provision was introduced by the League of Nations in 1927 (*see Reports Presented by the Comm. of Technical Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.216M.85 1927 II (1927) (presenting Draft Bilateral Convention for the Prevention of Double Taxation)), and has been incorporated into virtually all international tax treaties ever since. *See generally* Gary D. Sprague & Rachel Hersey, *Permanent Establishments and Internet-Enabled Enterprises: The Physical Presence and Contract Concluding Dependent Agent Tests*, 38 Ga. L. Rev. 299 (2003).

liability), there would be an "enhanced risk of multiple taxation" and the United States would be prevented from "speak[ing] with one voice" with respect to international trade, which are considerations that must be addressed, in addition to the *Complete Auto Transit* tests, when foreign commerce is implicated. *See Container Corp.*, 463 U.S. at 185; *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 311 (1994) (citation omitted).

CONCLUSION

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

Respectfully submitted,

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