Nos. 08-1169, 08-1207

IN THE

Supreme Court of the United States

CAPITAL ONE BANK N.A., FKA CAPITAL ONE et al,
Petitioner,

v.

COMMISSIONER OF REVENUE OF MASSACHUSETTS,
Respondent.

GEOFFREY, INC.,
Petitioner,

v.

COMMISSIONER OF REVENUE OF MASSACHUSETTS,
Respondent.

On Petition for a Writ of Certiorari to the Commonwealth of Massachusetts Supreme Judicial Court

BRIEF OF *AMICI CURIAE* OF COUNCIL ON STATE TAXATION, NATIONAL ASSOCIATION OF MANUFACTURERS, AND NATIONAL MARINE MANUFACTURERS ASSOCIATION IN SUPPORT OF PETITIONER

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INTEREST OF *AMICI CURIAE*

This brief *amici curiae* in support of petitioners is filed on behalf of three trade associations representing the largest businesses in our nation's state and local economies.[1] Unless this Court clarifies whether in-state physical presence remains the standard by which a business becomes subject to a state's income and franchise tax jurisdiction, the thousands of members of *amici's* associations will face substantial costs in determining their tax liabilities and in some instances will not be able to ascertain those liabilities accurately at all. This uncertainty regarding tax compliance obligations increasingly creates significant and impermissible burdens on interstate commerce.

The Council On State Taxation ("COST") is a nonprofit trade association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. COST represents more than 600 of the largest multistate businesses in the United States, including companies in every industry. Many of COST's members have customers in states where the members have no property or employees—that is, in states where the members have no "physical presence."

The National Association of Manufacturers ("NAM") is the nation's largest industrial trade association, representing small and large manufac-

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity other than *amici curiae* has made a monetary contribution to the preparation or submission of this brief. The parties received timely notice of *amici's* intent to file this brief. Written consent of all parties to the filing of this brief has been filed with the Clerk of this Court.

turers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media, and the general public about the vital role of manufacturing to America's economic future and living standards.

The National Marine Manufacturers Association ("NMMA") is the nation's largest recreational marine industry association, representing more than 1,500 boat builders, engine manufacturers, and marine accessory manufacturers. The recreational boating industry is a substantial contributor to the nation's economy with sales of recreational marine products and services totaling more than $37.5 billion in 2007 alone. Because their business activities are typically multistate in nature, the NMMA's members have an important interest in the question presented. In addition, the majority of NMMA members are small businesses with limited resources to navigate complex state tax regimes.

SUMMARY OF THE ARGUMENT

Historically, a corporation's physical presence in a state served as the prerequisite for any type of tax, including income and franchise tax. In *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 754 (1967), and *Quill v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed the physical presence rule in the context of sales and use taxes. However, many states continue to expand aggressively their own tax revenues by asserting the power to tax the corporate income of out-of-state businesses that have no physical presence in the taxing state. States have adopted a variety of expanded "nexus" standards through judicial, legislative, and administrative action. These standards—which are unclear and vary widely from state to state—are highly burdensome for taxpayers doing business in multiple jurisdictions and thus place an enormous burden on interstate commerce. As the scope of these standards have been judicially tested, the highest courts of Massachusetts, West Virginia, New Jersey, and South Carolina have all held that the Commerce Clause does not prevent the imposition of income and franchise taxes upon out-of-state corporations with no physical presence in the state. While some state appellate courts have issued similar decisions, others have held the opposite.

The importance of the Court's review of the Massachusetts decisions extends well beyond the direct conflict among state courts regarding the meaning of the Commerce Clause. To be sure, this Court's review is urgently needed because departures from the physical presence rule and the resulting uncertainty over the jurisdictional grounds of state taxation have themselves generated an impermissible burden on interstate commerce. Thus, these cases present the special circumstance where divergent approaches by different states have produced the very constitutional evil that the Commerce Clause was meant to avoid.

The uncertainty in calculating a multistate business's state income or franchise tax liability stems both from (i) the divergent approaches taken by different states and (ii) the nebulous and unpredictable nature of alternatives to the physical presence rule. The uncertainty generates a considerable increase in compliance costs and administrative burdens, as well as problems in determining and reporting the business's tax liability for required financial statements.

A business that cannot accurately ascertain its tax liability, even internally, can hardly be expected to make meaningful disclosures to investors. As a result, there are real economic losses when a company decides not to exploit an otherwise profitable opportunity (such as expanding its business into a new state) because of the expense and uncertainty inherent in state tax jurisdiction rules. The abandonment of the traditional "physical presence" rule thus entails deadweight losses (in the form of unnecessary compliance costs), lower business productivity, slower growth, fewer jobs, and additional burdens on interstate commerce. The same reasons that animated this Court's grant of review in *Quill* militate strongly in favor of certiorari in these cases. In fact, this Court's review is much more compelling here than in *Quill* because state corporate income taxes are more burdensome than the collection of sales and use taxes. The costs of compliance are much greater, and the threat to interstate commerce is immediate.

ARGUMENT

I. UNCERTAINTY REGARDING STATE AND LOCAL TAX COMPLIANCE OBLIGATIONS CREATES AN IMPERMISSIBLE BURDEN ON INTERSTATE COMMERCE

A. The Physical Presence Rule Is Necessary To Provide Clarity and Predictability

Physical presence has traditionally served as the basis for the imposition of corporate income and franchise taxes. In *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967), this Court held that a systematic program of direct mail advertising was not sufficient to justify imposition of use tax on an out-of-state seller. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed the physical presence rule in the sales and use tax context as a limit "firmly establish[ing] the boundaries of legitimate state power." *Id*. at 315.

The physical presence rule is a bright-line rule that provides a business with an adequate understanding of when and where it will be subject to tax. As a leading constitutional scholar has observed, the rule "provides some measure of stability to parties engaged in commercial interchange and provides a more hospitable environment for the flourishing of nascent modes of free-floating interstate commerce, which might otherwise perish on the rocky shoals of overmuch state taxation." 1 Laurence H. Tribe, AMERICAN CONSTITUTIONAL LAW 1125 (3d ed. 2000).

However, some states have departed from the physical presence rule in the imposition of corporate income and franchise taxes. Massachusetts has adopted an "elastic" substantial nexus test, which would permit the State to tax the income of any business with *customers* in the taxing state, even if it lacked any real or tangible personal property, employees, or other contacts there. Other states have adopted their own "nexus" standards, whose nebulous nature and non-uniform definitions make it highly burdensome for multistate businesses to comply. *See, e.g., Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13, 18 (S.C.) *cert. denied*, 510 U.S. 992 (1993) ("by licensing intangibles for use in this State and deriving income from their use here, [taxpayer] has a 'substantial nexus'" with state); *see also Buehner Block Co. v. Wyo. Dep't of Revenue*, 139

P.3d 1150, 1158 n.6 (Wyo. 2006).[2] Still other states have made statutory or administrative changes asserting authority to tax corporations with no physical presence.[3]

As states adopt their own versions of a "nexus" test, multistate taxpayers face a variety of different standards and vague guidelines. Taxpayers are denied a clear understanding of their tax liabilities as states base their "determinations of whether nonresident corporations are subject to tax on a subjective facts and circumstances analysis". Megan A. Stombock, *Economic Nexus and Nonresident Corporate Taxpayers: How Far Will It Go?*, 61 THE TAX LAWYER 1225, 1238 (2008). It is often unclear to taxpayers whether they are even required to pay tax in a jurisdiction at all. As observed by commentators:

> [W]e are now in a world in which a business, remotely present in multiple states, is faced with a wide range of nexus standards regarding the

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[2] *See also Bridges v. Geoffrey, Inc.,* 984 So.2d 115 (La. Ct. App. 2008), *writ denied*, 978 So.2d (La. 2008); *Lanco, Inc. v. Director, Div. of Tax.*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S. Ct. 2974 (2007); Kmart *Props., Inc. v. Taxation & Revenue Dep't of N.M.,*131 P.3d 27 (N.M. Ct. App. 2001), *writ quashed,* 131 P.3d 22 (N.M. 2005); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 546 U.S. 821 (2005); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005); *Gen. Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. App.), *pet. rev. denied en banc*, 84 P.3d 1230 (Wash. 2001), *cert. denied*, 535 U.S. 1056 (2002); *Tax Comm'r v. MBNA America Bank*, 640 S.E.2d 226 (W. Va. 2006), *cert. denied*, 127 S. Ct. 2997 (2007).

[3] *See*, *e.g.*, Ark. Reg. 1996-3 (2009); Fla. Admin. Code Ann. r. 12C-1.011 (p)1 (2009); Iowa Admin. Code r. 701.52.1(422), 52.1(1)d (2009); Minn. Stat. § 290.015(1)(c)(3) (2009); Okla. Admin. Code § 710:50-17-3(a)(9) (2009).

> complex commercial transactions. The convergence of these trends, the blurring of nexus standards, and the increasing complex global economy call into question the ability to fairly administer the current state and local taxing system.

Giles Sutton, Eric de Moya, and Chuck Jones, *Attributional Nexus, Flash Title, And the Chaos in Nexus Standards*, 50 STATE TAX NOTES 491 (2008).

Two months ago, Wisconsin significantly changed its law pertaining to economic nexus without any hearings or public debate. The new law, which imposes tax on anyone "regularly soliciting business from potential customers in this state," raises many difficult questions taxpayers must address to determine precisely what activities give rise to economic nexus in the State. Wisc. Stat. § 71.22(1r) (2009).

The current confusion surrounding income tax nexus is not that different from the situation this Court faced in *Quill* when addressing sales and use taxes. The Court acknowledged then "our law in this area is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensible power of taxation." *Quill*, 504 U.S. at 315 citing *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-58 (1959)). The current uncertainty offends the core values protected by the Commerce Clause and amply warrants this Court's review.

B. Departures From The Physical Presence Rule Create Substantial Compliance Costs For Multistate Businesses

In *Quill*, this Court recognized that anything but a physical presence rule would be an undue burden on interstate commerce, because of the significant cost of compliance with sales and use tax laws in a multistate environment. The same conclusion applies *a fortiori* in these cases, because corporate income tax compliance is substantially more complex and burdensome than the sales and use tax compliance analyzed in *Quill*. In the sales and use tax context, only two broad questions must be asked and answered: Is the item taxable or non-taxable? If the item is taxable, what is the applicable tax rate? The burdens uniquely associated with uncertainty are few with respect to sales and use taxes, because compliance is straightforward.

In contrast, corporate income tax is demonstrably more complex because there are dozens of independent questions and judgments that must be made in calculating a corporate income tax liability. Without a physical presence rule, companies would need to examine these questions on a jurisdiction-by-jurisdiction, corporate-entity-by-entity, and year-by-year basis. Record-keeping in the corporate income tax context is also significantly more elaborate than in the area of sales and use taxes where only the records of sales need be retained. The number of potential taxing jurisdictions at the state and local level that can impose a business activity tax is dramatically higher than the number of jurisdictions imposing a sales and use tax. *See Quill*, 504 U.S. at 313 n.6. Multistate businesses face the prospect of taxation not only in 50 states, but also in thousands of localities authorized to impose corporate income, franchise and other business activity taxes.

In the absence of a physical presence rule, multistate businesses will face significant costs in trying to determine the jurisdictions in which they face potential tax liabilities and the applicable rules of those jurisdictions. Some may be unable to ascertain accurately their tax liabilities at all. Each multistate business—large and small—must analyze a long list of issues for every jurisdiction where it has a commercial profile. Listing all of the issues a taxpayer must address before complying with the numerous individual state income tax rules would easily exceed the maximum page count allowed for this brief. However, an abbreviated description of the archetypal issues can provide a hint of the task involved.

1. Return Filing Methods

States have numerous types of income tax returns with inconsistent and overlapping names and frequently opaque rules. While some states adopt standard federal consolidated reporting concepts, most do not. The lack of any uniformity in this area creates an enormous burden on any taxpayer seeking to comply. A passing list of the issues a taxpayer faces when choosing the appropriate type of return includes:

- Is combined reporting (a method where affiliated businesses file as one unit) allowed, prohibited, or elective?
- What are the requirements for an affiliate to be included or excluded from the combined report?

- What are the ownership rules for an affiliate to be eligible for inclusion in the combined report? Are there beneficial ownership rules? What types of stock are considered in the ownership test—preferred stock, convertible bonds, restricted stock?
- Does the state require only that the affiliates be unitary?
- What is the definition of a "unitary business" in any given state—the "contribution and/or dependency test," the test articulated in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), the test cited in *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), or a state-created test?
- Does the state have some type of additional test such as a requirement that the calculation of a company's income tax is distortive? If so, what is considered distortion?
- How are partnerships and other pass-through entities treated? Is the pass-through entity included in the combined report if its majority owner is the combined group? Is only its income allocated to the member included in the tax base or is its total income included?
- What types of entities and businesses may or must be included in a combined return and which must be excluded? For example, may an insurance company be included with its non-insurance affiliates? Are Puerto Rico affiliates included?

2. Filing Requirements and Mechanics

Once the type of return and which entities should be included on the return is determined, the taxpayer must determine how to file and pay the tax, obtain a refund, or seek an extension.

- When are estimated tax payments due? Are payments due ratably throughout the year, or are different percentages of tax due at different estimate dates? What happens to short tax years?
- Must the return be filed electronically? Must the payment be sent electronically?
- What are the procedures for amendments and adjustments? Some states piggy-back onto federal extension filings while others require separate applications for an extension of time to file a tax return.

3. Tax Base Computations and Adjustments

Multi-jurisdictional taxpayers also face differing state definitions of the tax base. Most states use federal taxable income as a starting point, but five states do not. Even among the states that use federal taxable income as the starting point, every state has unique addition and subtraction modifications that result in a substantial divergence in the ultimate state tax base from the federal base (and among the states' bases themselves). Corporations typically must keep numerous schedules for each state to track the differences in asset and liability basis, net operating losses (NOLs), depreciation, and other variations from the federal rules.

Typical issues that taxpayers face include:

- Does the state follow federal depreciation rules? Most states have departed from the federal bonus depreciation in recent years, but many departed in differing ways. This means taxpayers must keep multiple sets of depreciation calculations for the same business equipment.
- How does a state calculate NOLs? Does it follow the federal carryback and carryforward rules, or does it have its own time period? Taxpayers typically have many different NOL calculations in many different states, none of which matches the federal NOL amount.
- How does a state treat dividends from affiliates? Does it use the same percentages and stock ownership rules as the federal government? What percentage of ownership is required to obtain a dividend received deduction?

4. Income Apportionment and Allocation.

The concept of allocation and apportionment does not exist at the federal level and thus is a unique burden created by state tax laws. Over the years, states have adopted an increasingly varied set of rules for these issues. "Apportionment" generally means how the income from typical activities of a taxpayer is spread out among the taxing states. A formula is used to determine the percentage of income subject to tax in each state. Historically, an equally weighted three-factor formula consisting of property, payroll, and sales was used to determine the business activity, and thus the percentage of taxable income, that each state could claim. However, there is currently very little uniformity among states. Other apportionment and allocation issues include:

- What items are included in the "property" factor?
- How is property valued?
- What and who is included in the "payroll" factor? Are non-cash benefits included? Is deferred compensation included? Are the salaries of the officers and directors included? To what jurisdiction is an employee's salary assigned? What if the employee has no permanent office but telecommutes, or spends all of his or her time on the road traveling between clients in five different states? Is the compensation of a taxpayer's independent contractors included?
- What is included in the "sales" factor? To what jurisdiction are sales of services and intangible property assigned?
- Do certain industries, such as manufacturing, receive a special apportionment formula, such as a single sales factor formula, as an incentive to relocate, expand, or remain in the state, and if so, how is that industry defined? Are certain industries assigned apportionment formulas different from the standard formula because of a unique business model—such as financial institutions, trucking companies, or broadcasting companies?
- When is a taxpayer required to apportion its income among all of the states in which it does business (*i.e.*, business income)? When must it allocate its income from a certain

transaction to one state (*i.e.*, non-business income)? What is the definition of business income?

- If a taxpayer must allocate its income from a certain activity to one state, which state is it? Is it the taxpayer's state of legal domicile, or the state in which it has its headquarters?
- What are the statutory rules for applying an apportionment formula that differs from the statutory formula? How does a taxpayer apply for an alternative formula and what evidence must it present? Can the state impose an alternative formula under the same theory? What types of alternatives are available?[4]

By itself, this list of questions is burdensome. But the abandonment of the "physical presence" rule compounds the burden by multiplying the number of jurisdictions in which a multistate business must resolve the uncertainties. Technology alone cannot solve the problem, because the ambiguities require human analysis and judgment. A potential taxpayer

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[4] This list of issues is not exhaustive. Added burdens stem from the cost of maintaining adequate documentation, which is multiplied as the number of taxing states increases. Further issues arise when the state tax is based on something other than income—such as assets, paid-in-capital, or gross receipts. In addition, the complexity does not end when the return is filed. Large corporations are under almost continuous audit by many states. The more jurisdictions in which the company is required to file and pay tax, the more audits to which the company will be subject. Audits require answering numerous documentation requests, conducting interviews with employees, and entering into negotiations and potential litigation. All of these items carry significant direct costs and also reduce productivity.

must answer these questions in every state and locality in which it conceivably has an economic nexus—a truly daunting task in light of the 12,600 state and local jurisdictions that have the authority to impose a business activity tax.

Without the physical presence rule, businesses must monitor every state and locality in which they have any type of commercial profile. They will be required to track state tax legislation and regulatory developments constantly, become familiar with potential changes in tax law, and stand ready to implement those changes accordingly. Studies show that state income tax compliance costs are already significant, amounting to double the costs of federal tax compliance, when computed relative to the respective tax liabilities.[5] Departures from the physical presence rule will only make the problem worse and will trigger a significant impact on interstate commerce.

C. Uncertainty Leads To Substantial Opportunity Costs

The additional compliance burdens attributable to uncertainty have real and substantial opportunity costs as well, magnifying the harm to interstate commerce. For example, a company deciding whether to expand its operations in a multistate fashion will necessarily consider whether the additional cost and complexity of tax compliance outweigh the business benefits of expansion. At the margin, the uncertainty

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[5] Sanjay Gupta and Lillian Mills, *How Do Differences in State Corporate Income Tax Systems Affect Compliance Cost Burdens?* 56 NAT'L TAX J. 355, 363 (2002). For the largest 1,000 firms, the ratio of state compliance costs to state income tax expenses is 2.9%, or more than twice the federal ratio of 1.4%.

caused by departures from the physical presence rule will cause companies to choose business activities that avoid compliance costs but are of lesser value to the business, society and the economy. Such a choice, inherent in any system that requires taxation, is exacerbated as the costs of compliance increase.

Such market distortions are exactly what the Commerce Clause was meant to prevent. The national economy is artificially constricted when a company does not enter new jurisdictions even though there is demand for the company's product, or does not pursue a new line of business at all because it would subject the company to the jurisdiction of additional states under a vague "economic presence" standard. The inherent uncertainty caused by departures from the physical presence rule will aggravate the distortions in economic choice.

D. The Impact on Small Businesses Will Be Severe

Although these cases deal with large corporate taxpayers, the effects on small and mid-sized businesses of abandoning the physical presence rule will be severe. Smaller businesses do not have the resources or capability to comply with the multitude of state and local tax laws that are certain to be triggered by the economic nexus standard. For example, one study determined that for firms with $5 million or more in assets, the "average total compliance costs systematically increase with increasing firm size as measured by asset size."[6] "Consistent with all earlier

[6] Joel Slemrod and Varsha Venkatesh, *The Income Tax Compliance Cost of Large and Mid-Size Businesses: A Report to the IRS LMSB Division*, Univ. Mich. Bus. Sch. (Sept. 2002). Firms in the $5 million to $10 million asset category had an

research, compliance costs are regressive in the sense that those costs as a percentage of firm size are higher for smaller firms than they are for larger firms."[7] Thus, abandoning the physical presence rule will have a disproportionate impact on small and mid-sized corporate taxpayers.

II. ABANDONING THE PHYSICAL PRESENCE RULE FRUSTRATES THE GOAL OF ACCURATE FINANCIAL DISCLOSURE.

Departing from the physical presence rule will also create accounting difficulties and will frustrate the goal of accurate and transparent financial disclosures at the heart of the federal securities laws. A company that cannot accurately predict its state income tax liability, even internally, can scarcely be expected to provide meaningful information to investors.

The problem is made more acute by recent tightening of financial disclosure requirements. In 2006, the Financial Accounting Standards Board (FASB), adopted new rules on accounting for uncertain income tax positions. *FASB Increases Relevance and Comparability of Financial Reporting or Income Taxes: Final Interpretation Reduces Widespread Diversity in Practice*, News Release (FASB) (July 13, 2006) ("FIN 48"). FIN 48 provides uniform criteria

average of $35,443 in compliance costs; firms in the $10 million to $50 million category spent $93,876 on average; firms with assets from $50 million to $100 million spent $149,876 on average; firms ranging from $100 million to $250 million in asset size spent an average of $243,492; and firms with $250 million to $1 billion in assets had an average of $1,331,643 in compliance costs. *Id.* at 15.

[7] *Id.*

for the preparation of financial statements and expands the disclosure required regarding uncertainty in income taxes. FIN 48 mandates a "reserve" for 100% of tax items unless it is "more likely than not" that the company will prevail in litigation on those items. This reserve is of indefinite duration, with interest and penalties accruing annually.

The abandonment of the physical presence rule along with the adoption of varying "nexus" or "economic presence" standards by different states creates havoc for the financial statements of publicly traded companies. Under FIN 48, a company with customers but no physical presence in a state or locality is required to decide whether it is "more likely than not" that it will be deemed, after the fact, to lack a requisite nexus with that jurisdiction. The ambiguous and evolving nature of the concept of "nexus" makes it extremely difficult to decide, to a 50% certainty, whether a company will be deemed to have a nexus in a given state or locality. In fact, it may very well create a never-ending dilemma for many multistate companies.

If a business determines it does not have the requisite activity to create nexus in a state and thus does not file a return there, the statute of limitations for an assessment often never expires. Thus, a business may be in the awkward position of taking a reasonable position regarding its tax filing requirements in a given state, but because of the controversial and unsettled state of the law on nexus, the business may be unable to reach the required confidence level ("more likely than not") on the validity of its financial statement reporting position under FIN 48. As a result, this phantom tax liability to the state (plus accrued phantom penalties and interest) will never disappear from its financial statements unless the business is actually audited and the state determines it does not have nexus.

The varying and ill-defined "economic presence" standards adopted by the states will therefore frustrate the goal of providing investors with a realistic picture of a corporation's financial position. Hence, abandoning the physical presence rule disserves the purposes of the securities laws as well as the Commerce Clause.

CONCLUSION

The petitions for writ of certiorari should be granted.

Respectfully submitted,

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