No. 10-1340

IN THE

Supreme Court of the United States

KFC CORPORATION,
Petitioner,

v.

IOWA DEPARTMENT OF REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of Iowa

BRIEF *AMICUS CURIAE* OF COUNCIL ON STATE TAXATION IN SUPPORT OF PETITIONER

FREDRICK J. NICELY
Counsel of Record
DOUGLAS L. LINDHOLM
TODD A. LARD
BOBBY L. BURGNER
COUNCIL ON STATE TAXATION
122 C St. N.W., Suite 330
Washington, D.C. 20001
(202) 484-5222
FNicely@cost.org

Counsel for Amicus Curiae

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20002

TABLE OF CONTENTS

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

INTEREST OF *AMICUS CURIAE*

This brief *amicus curiae* in support of the petitioner is filed on behalf of the Council On State Taxation ("COST"). COST is a non-profit trade association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. COST represents nearly 600 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."

Amicus represents many of the largest businesses in our nation's state and local economies.[1] Interstate businesses are in dire need of this Court to clarify whether in-state physical presence remains the standard by which a business becomes subject to a state's income tax jurisdiction. COST's members continue to face substantial difficulties, which equates to tremendous costs, in determining their state and local tax liabilities. This uncertainty regarding tax compliance obligations is creating significant and impermissible burdens on interstate commerce.

SUMMARY OF THE ARGUMENT

Once again, a taxpayer is petitioning this Court to set forth the constitutional boundaries for a state to impose its corporate income tax or other business activity tax. This case raises concerns similar to that

---

[1] No counsel for a party authored this brief in whole or in part, and no person or entity other than *amicus curiae* has made a monetary contribution to the preparation or submission of this brief. The parties received timely notice of *amicus*' 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.

of another taxpayer who recently filed for a writ of certiorari before this Court, *Lamtec Corporation v. Department of Rev. of the State of Washington*, 246 P.3d 788 (Wash. 2011), *petition for cert. filed*, 79 U.S.L.W. 3629 (U.S. April 19, 2011) (No. 10-1289).

Historically, a corporation's physical presence in a state served as the prerequisite for any type of tax, including a corporate income 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 assert tax jurisdiction over the corporate income of out-of-state businesses with no physical presence in the taxing state under an "economic presence" theory. 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 and impose significant compliance costs for taxpayers doing business in multiple state and local tax jurisdictions. The result creates an enormous burden on interstate commerce.

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 such as Michigan, Texas, and Tennessee have held the opposite.

The importance of this Court's review of the Supreme Court of Iowa's decision extends well beyond the direct conflict among state courts

regarding the meaning of the Commerce Clause. This Court's review is urgently needed because it is the first case from a state's highest court to assert a business has a taxable "economic presence" in the state based solely on the receipt of royalty and licensing income from *unrelated* third-party franchisees located in the state. This is insufficient for a finding of "substantial nexus" as required by this Court in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977), and subsequently addressed by this Court in *Quill*. The decision from the Supreme Court of Iowa vastly increases the uncertainty over when the states have the authority to subject an out-of-state business to a state's taxing powers. Allowing states to impose taxes on a business with a mere economic presence in a state, without any physical presence, creates an impermissible burden on interstate commerce.

The states' attempt to abandon the traditional "physical presence" rule forces multijurisdictional businesses to allocate more resources (*i.e.,* costs) to comply with the states', and their local jurisdictions', tax laws. This lowers business productivity, slows economic growth, results in fewer jobs, and otherwise imposes significant burdens on interstate commerce. The same reasons that animated this Court's grant of review in *Quill* speak 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. THE DECISION BELOW FAR EXCEEDS PRIOR STATE DECISIONS, AS "SUBSTANTIAL NEXUS" IS ATTRIBUTED THROUGH ENTIRELY UNRELATED ENTITIES.

A. This Court Has Never Sustained A State Tax In The Absence Of An In-State Physical Presence By The Taxpayer

This Court has never distinguished what constitutes "substantial nexus" for state and local sales and use taxes from "substantial nexus" for state and local corporate income taxes. The four-prong test pronounced by this Court in *Complete Auto* applies to all Commerce Clause challenges of a state or local tax. To survive a Commerce Clause challenge a tax must: 1) be applied to an activity with a substantial nexus with the taxing state, 2) be fairly apportioned, 3) not discriminate against interstate commerce, and 4) be fairly related to the services provided by the State. *Id.* at 279. This Court has expressly stated that the Commerce Clause requires a "substantial nexus" between a State and an out-of-state business as a necessary predicate "before *any* tax may be levied" by a State. *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 626 (1981).

Subsequent to *Complete Auto*, this Court recognized in *Quill* that its prior cases upholding state taxes all "involved taxpayers who had a physical presence in the taxing State." *Id.* at 314. However, because this Court did not expressly explain the reach of its holding beyond the sales and use tax context in *Quill*, state courts have concluded they are

free to limit the application of the *Bellas Hess* and *Quill* "physical presence" requirement so that it does not apply to other taxes. Absent this Court's intervention and clarification, the widespread confusion that has occurred will persist and continue to impose significant burdens on the free flow of interstate commerce.

B. The Iowa Supreme Court Decision Impermissibly And Excessively Expands Prior State Court Decisions

The Supreme Court of Iowa has stated that nothing more than an arm's-length contract with an unrelated party is sufficient to create constitutional nexus. Left unchecked, such a "nexus-by-customer" ruling will create additional layers of unpredictability and uncertainty in an area already lacking in guidance and clarity. Indeed, the Supreme Court of Iowa's ruling does not comport with even the most liberal state court interpretation of the substantial nexus requirement.

Three state appellate courts in Tennessee, Michigan, and Texas have concluded that a state cannot impose an income or franchise tax on any out-of-state business, unless that corporation maintains a physical presence through property or employees in the taxing state. *See J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *Guardian Industries Corp. v. Department of Treasury*, 499 N.W.2d 349, 377 (Mich. Ct. App. 1993); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. Ct. App. 2000). In fact, these courts have held that there is no basis for establishing a different test for sales/use and income/franchise taxes.

As referenced by the Supreme Court of Iowa, several state courts that have addressed income derived from royalty and interest payments was enough of a presence to require a *related* entity, such as a subsidiary, to be subject to a state's income tax. *See, e.g., Comptroller of the Treasury v. Syl, Inc.*, 825 A.2d 399 (Md.), *cert. denied*, 540 U.S. 984 (2003); *Syms Corp. v. Commissioner of Rev.,* 765 N.E.2d 758 (Mass. 2002); *Lanco, Inc. v. Director of Div. of Tax*, 908 A.2d 176 (N.J. 2006) *cert. denied*, 551 U.S. 1131 (2007); 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. South Carolina Tax Comm'n,* 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993). Other states have also attacked such royalty and licensing payment schemes as lacking economic substance, e.g., see *Nordstrom, Inc. v. Comptroller*, No. 07-IN-OO-0317, 07-IN-OO-0318, 07-IN-OO-0319, 2008 WL 4754842 (Md. Tax Oct. 25, 2008).

However, this case does not deal with a related entity. By allowing an *unrelated* entity to be taxed on receipts from a mere licensing agreement, the decision below will lead inevitably to a slippery slope: states will feel no constraints against taxing those who receive dividends and interest from in-state businesses, and other similar intangible sources within the state, to which the taxpayer bears no relationship other than an arm's-length third-party contractual agreement. Taken to the extreme, some states will argue the taxpayers' use of a third party to advertise their products in a state is sufficient to create nexus. It is entirely expected that states will argue that the use of a third party to advertise in the state, by means of a telephone book, radio, newspaper or television ad, or an Internet based information

service is sufficient to create "substantial nexus." While this Court has rejected mere advertising in a state as sufficient to subject a business to a state's taxing authority over 50 years ago in *Miller Bros. Co. v. State of Maryland*, 347 U.S. 340 (1954), that case arose when the State of Maryland sought to impose its sales and use tax on an out-of-state business, and not in the context of corporate income taxes or other business activity taxes.

II. THE PHYSICAL PRESENCE TEST SHOULD BE THE APPLICABLE TEST FOR ALL STATE TAXES.

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."[2]

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, "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* (citing *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-58 (1959)).

Such 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 to this case. Indeed, it may be more applicable in this case 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

---

[2] Laurence H. Tribe, American Constitutional Law 1125 (3d ed. 2000).

applicable tax rate? The burdens uniquely associated with uncertainty are few with respect to sales and use taxes, because compliance is more straightforward.

In contrast, state and local corporate income taxes are demonstrably more complex because there are multitudes 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 jurisdiction by jurisdiction, corporate entity by entity, and year by year. 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.

The following is an abbreviated description of the issues businesses face in filing corporate income and franchise taxes with a state and its local jurisdictions.

1. Return Filing Methods.

States have numerous types of income tax returns with inconsistent and overlapping names and frequently opaque rules. The lack of any uniformity in this area creates an enormous burden on any taxpayer seeking to comply. A partial list of the issues a taxpayer faces when filing a 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, or restricted stock?
- Does the state require only that the affiliates be unitary?
- What is the definition of a "unitary business" in any given state?
- 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 ownership 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 business may or must be included in a combined return and which must be excluded?

2. Filing Requirements and Mechanics.

Once the type of return and which entities should be 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?

3. Tax Base Computations and Adjustments.

Multi-jurisdictional taxpayers also face differing state definitions of the tax base. Five states do not use federal taxable income as a starting point. 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." 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 period?
- 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.

Over the years, states (and local jurisdictions) have adopted an increasingly varied set of rules for allocating and apportioning a multijurisdictional business's income. 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, following this Court's decision in *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978), twenty states currently utilize one factor, the sales factor, to apportion income.[3] The

[3] The following states use or allow certain taxpayers to elect to use a single sales factor: California (election), Colorado, Connecticut, Georgia, Iowa, Illinois, Indiana, Kentucky (election), Maine, Michigan, Mississippi, Nebraska, New Jersey (phase-in), New York, Ohio (Commercial Activity Tax), Oregon, South Carolina, Texas, Utah (phase-in) and Wisconsin.

irony to this is that such states acknowledge pursuant to *Quill* that they cannot impose their sales and use tax on an out-of-state seller's sales with no physical presence, yet those states assert they can use those same sales to apportion the seller's income to the state. The states' argue "economic presence" is sufficient for "substantial nexus" under the Commerce Clause. A potential business income taxpayer could conceivably have an economic nexus in over 12,600 jurisdictions that impose a business activity tax. This is 5,000 jurisdictions more than the estimated 7,000 tax jurisdictions in the United States that impose sales and use taxes.[4]

Without the physical presence rule, businesses have to 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. Studies show that state income tax compliance costs are already significant, amounting to double the costs of federal tax compliance, when computed relative to respective tax liabilities.[5] The states' departure from the "physical presence" rule to an "economic presence" rule exacerbates this problem and significantly hinders busi-

---

[4] Even more troubling is that many local business taxes are administered locally. In contrast, excluding Alabama, Alaska, Arizona, Colorado, and Louisiana, the states centrally administer the local jurisdictions' sales and use taxes.

[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%.

nesses' ability to engage in interstate commerce. It effectively allows the states to impose, impermissibly, their taxes under the Due Process Clause standard addressed by this Court in *Quill*, and not the "substantial nexus" requirement imposed by the Commerce Clause. *Id.* at 313. This will eviscerate the independent "substantial nexus" review that this Court required in *Quill* to sustain a tax under a Commerce Clause challenge. If this trend continues unchecked by this Court, many states will likely look to only the Due Process Clause's standard of "minimum contacts" to impose their corporate income and other business activity taxes. Given this Court's acceptance of several cases involving the Due Process Clause, it is quite clear the two clauses should remain distinct: *see e.g., Goodyear Lux. Tires v. Brown*, 695 S.E.2d 757 (N.C. Ct. App. 2009), *cert. granted*, 131 S. Ct. 858 (U.S. Sept. 28, 2010) (No. 10-76) and *J. McIntyre Mach., Ltd. v. Nicastro*, 987 A.2d 575 (N.J. 2010), *cert. granted*, 131 S. Ct. 62 (U.S. Sept. 28, 2010) (No. 09-1343).

Absent the Court's review, businesses engaged in interstate commerce face an unbearable burden of applying a multitude of inconsistent state laws concerning the scope of state tax jurisdiction under the Commerce Clause.

C. Physical Presence Is The Cornerstone For The Other Three Prongs of *Complete Auto*.

"Substantial nexus" is just one of the four prongs of the *Complete Auto* test that must be met to sustain a Commerce Clause challenge to a state tax. *Complete Auto* requires a tax to 1) be applied to an activity with a substantial nexus with the taxing state, 2) be fairly apportioned, 3) not discriminate against inter-

state commerce, and 4) be fairly related to the services provided by the State. As stated above, many states apportion a business's income to the state solely based upon the percentage of sales by that business in the state. When a taxpayer lacks physical presence in the state but is subject to tax the second prong of the *Complete Auto* test becomes an increasingly important factor to ensure that interstate commerce is protected from undue burdens. While a tax may be fairly apportioned so as to not violate the internal consistency test, the tax must also be applied in an externally consistent manner. *See Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995).

This case is similar to *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948), where the Court struck down a New York gross receipts tax because the taxpayer could be exposed to taxation on the same receipts in New Jersey and Pennsylvania that New York taxed in its entirety. *See also Jefferson Lines* at 190. The taxpayer in this case, KFC Corporation, principally conducts its franchise activity in Louisville, Kentucky. The locations where KFC Corporation's franchisees are sitused are not the *exclusive* locations where KFC Corporation is conducting its business activity (*i.e.,* by the very nature of KFC Corporation's business in Iowa, with no physical presence, its activity is nonexistent or very limited). However, Iowa's use of 100% of the revenue it receives from KFC Corporation's franchisees in Iowa to apportion its income subject to Iowa's corporate income tax raises serious issues about the amount of income Iowa is subjecting to its corporate income tax. This far exceeds the "appropriate portion to the business transacted by the [business] in that state." *Hans Rees' Sons v. State of North Carolina ex*

rel. Maxwell, 283 U.S. 123, 135 (1931). A physical presence requirement for a state to impose its taxes prevents this impermissible result.

The other two prongs of the *Complete Auto* test, *i.e.,* a tax shall not discriminate against interstate commerce and must be fairly related to the services provided by the state, are also at issue. States are increasingly providing preferential credits that reward business activity in a state that are not applicable to out-of-state businesses that could discriminate against interstate commerce. Further, related to whether a tax is externally consistent, how can a state which imposes a tax on a business without any physical presence be imposing a tax that is fairly related to the services provided by the State? This Court has made it clear the relationship of services provided by the state to the taxpayer does not have to be a one-to-one ratio; however, it is irrational, and constitutionally impermissible, for a business with no property or payroll in the state to be subject to tax in a state that provides no or very limited services to the business. (*See Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 629 (1981)). Thus, a state that imposes its tax on a business without a physical presence in the state may also easily violate the third and fourth prongs of the *Complete Auto* test.

The cornerstone of all four prongs of the *Complete Auto* test is that before a state can impose its taxing authority on a business such business needs some form of physical presence in the taxing state.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

FREDRICK J. NICELY
Counsel of Record
DOUGLAS L. LINDHOLM
TODD A. LARD
BOBBY L. BURGNER
COUNCIL ON STATE TAXATION
122 C St. N.W., Suite 330
Washington, D.C. 20001
(202) 484-5222
FNicely@cost.org

Counsel for Amicus Curiae