No. 10-1340

In The Supreme Court of the United States

KFC CORPORATION,

Petitioner,

v.

IOWA DEPARTMENT OF REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The Supreme Court Of Iowa

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

Does the assessment of tax on income received by KFC from Iowa franchisees for their regular licensed uses of KFC's intangible Marks and System as an integral part of their Iowa businesses satisfy the "substantial nexus" requirement of the Commerce Clause, either because KFC's intangibles have a sufficient business situs in Iowa to amount to a "physical presence" for KFC or because KFC's physical presence is not required for taxing KFC's income from the licensed use of its intangibles in Iowa?

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STATEMENT OF THE CASE

The agency decision upheld on judicial review below was a ruling on the parties' motions for summary judgment. (Pet. App. 87a) The only constitutional issue raised in either party's motion for summary judgment was whether KFC had the "substantial nexus" with Iowa required under the Commerce Clause. No issue was raised or presented as to the fair apportionment, nondiscrimination, or fair relationship to state services prongs of the Commerce Clause test set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

Undisputed facts for purposes of the summary judgment motions can be found in the administrative law judge's ruling. (Pet. App. 88a-94a) Petitioner KFC granted to franchisees with restaurants located in Iowa the right and license to use KFC's trademarks, trade names, and service marks (Marks) and related unique system for preparing and marketing fried chicken and other food products (System) meeting KFC's quality standards through the use of processes and trade secrets communicated by KFC. (Pet. App. 88a-89a ¶¶ 2, 3, 10) Those franchisees paid to KFC monthly royalties of four percent of gross revenues for the right to use KFC's Marks and System. (Pet. App. 89a ¶11) In order to enhance the value of the KFC System and Marks, and the goodwill associated with them, the KFC franchise agreements placed detailed obligations on the franchisees that included strict adherence to KFC's requirements regarding menu items, marketing, and physical facilities. (Pet. App.

90a ¶15) The franchisees' Iowa outlets were required to be constructed and operated in strict compliance with KFC's standards and specifications for signs and menu boards, advertising and promotional material, equipment, supplies, uniforms, paper goods, packaging, furnishings, fixtures, recipes, and food ingredients. (Pet. App. 91a ¶17) KFC's Franchise Department tracked the compliance of the KFC franchisees with contractual obligations and determined the disciplinary actions to be taken for noncompliance. (Pet. App. 90a ¶16)

There has never been an issue in this (or decided in the other states' cases cited by KFC) as to "the power of state departments of revenue to tax the income" of out-of-state businesses (Pet. 2). There was no "non-legislative expansion of the state tax code" as alleged by KFC (Pet. 24). The standard applied by the Iowa Department of Revenue and upheld by the Iowa Supreme Court is that required by statute. Any "expansion" was done by the 1995 statutory change that added the word "intangible" to Iowa Code section 422.33(1). That *statute* imposes an income tax upon each corporation "doing business in this state, or deriving income from sources within this state," with "income from sources within this state" defined in the statute to mean "income from real, tangible, or intangible property located or having a situs in this state." (Pet. App. 103a) The Department's administrative regulations state that if intangible property "has become an integral part of some business activity occurring regularly in Iowa," then it is located in

or has a situs in Iowa. Iowa Admin. Code r. 701-52.1(1)"d" & r. 701-52.1(4) (Pet. App. 106a, 115a). The Iowa Supreme Court found that the tax at issue "falls squarely within the intended scope of Iowa Code section 422.33" regarding intangible property located or having a situs in the state. *KFC Corp. v. Iowa Dep't of Revenue*, 792 N.W.2d 308, 328-29 (Iowa 2010) (Pet. App. 47a). Also, the court stated that the Department's administrative regulations implementing section 422.33(1) "are simply a logical interpretation of the statute." *Id.* at 329 (Pet. App. 47a).

KFC and the *amici curiae* repeatedly misstate the holdings of the Iowa Supreme Court and of other states' courts. None of the cited courts decided that a state may tax the income of a business "that has done nothing more than enter into arms-length contracts with third parties within the State" (Pet. 2); nor have they held that the constitutionally required substantial nexus can be satisfied by a "mere" or "some" economic connection or economic nexus to the taxing state (Pet. 3, 20, 26). The Iowa Supreme Court did *not* make a "nexus-by-customer" ruling (COST 5; IPT 3,5; TEI 2,3), find constitutional nexus based solely on arm's-length contracts with unrelated in-state parties (COST 5,6; TEI 7), or apply an "economic presence" or "economic nexus" standard (COST 3,13; TEI 2,5,10,11,13; IFA 5,9,15; IPT 3-5,7,18-19,21-22). The decision below could be upheld by this Court without addressing the constitutionality of the "economic

presence" nexus standard that the petition and *amici curiae* briefs attack.

REASONS TO DENY THE PETITION

I. REVIEW BY THE COURT WILL NOT AFFECT THE ULTIMATE OUTCOME OF KFC'S CHALLENGE, BECAUSE THE INCOME TAX ASSESSMENT SHOULD BE UPHELD UNDER A "PHYSICAL PRESENCE" STANDARD IF LITIGATION OF ISSUES NOT RAISED IN THE MOTIONS FOR SUMMARY JUDGMENT BECOMES NECESSARY.

Any review and reversal by this Court of the decision of the Iowa Supreme Court will be academic, because it will not change the ultimate outcome of KFC's challenge to the Department's income tax assessment. KFC's Iowa income tax liability will still be in dispute due to an additional issue not raised in the motions for summary judgment. The Department will be entitled to an evidentiary hearing and arguments on the issue raised in the Department's administrative pleading of whether KFC had a physical presence in Iowa.

Even without considering additional facts to be presented at the evidentiary hearing that will be necessary if the ruling on the parties' motions for summary judgment is reversed, the Department will be able to show that KFC had a constitutional

"physical presence" in Iowa based on undisputed facts. For example, quality assurance activities for the Marks were performed in Iowa "on behalf of KFC" by employees of KFC affiliates, and KFC National Management Company performed activities in Iowa associated with KFC's Marks in compliance with its Service Agreement with KFC. (Pet. App. 92a ¶¶ 23, 24). The franchise agreements noted that "the continuing services that might be performed by KFC or an affiliate of KFC includ[ed] operating advice and training, informing franchisees of proven methods of quality control, and such other services as KFC deemed necessary or advisable in connection with furthering the businesses of the franchisees and the System and protecting the Marks and goodwill of KFC." (Pet. App. 92a ¶25) KFC's Iowa franchisees "were required to immediately inform KFC of any suspected or known infringement of or challenge to KFC's Marks and System by others" and assist KFC in taking whatever action KFC deemed appropriate. (Pet. App. 92a ¶ 22) Iowa activities done for KFC by others give KFC as much of a "nexus" with Iowa as if done by KFC's own employees. *See Tyler Pipe Industries, Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232, 251 (1987) (activities of independent sales representatives supported the state's jurisdiction to impose wholesale tax); *Scripto, Inc. v. Carson*, 362 U.S. 207, 211 (1960) (each independent sales representative was engaged as a representative of Scripto, with his label or technical legal status being "without constitutional significance"). In addition, KFC owned the tangible six-volume sets of operating manuals

located at Iowa franchisees' restaurants. (Pet. App. 91a ¶¶ 19, 20)

Quality control activities had to be done in Iowa by KFC, either directly or by others on its behalf, in order to protect and enhance the goodwill associated with its Marks and System. "Control of the trade-mark is crucial in the licensing context because a licensor who fails to monitor its mark risks a later determination that it has been abandoned." *Church of Scientology Int'l v. Elmira Mission of The Church of Scientology*, 794 F.2d 38, 43 (2d Cir. 1986). "[O]nce a trademark owner loses control of its mark by failing zealously to watch over its use by others – or by not objecting to its unauthorized use – the reputation associated with the mark is reduced." *Id.* at 44.

The goodwill associated with KFC's Marks is the exclusive property of KFC. (Pet. App. 90a ¶ 13) That goodwill, which leads consumers to purchase the licensed KFC products, was *used and protected by KFC in Iowa* to maintain the value of its intangibles, as well as to receive royalty income. If KFC's Marks and System were not used in association with some product, service, or business, they would soon lose all of their value. There is "no such thing as property in a trade-mark except as a right appurtenant to an established business or trade in connection with which the mark is employed." *United Drug Co. v. Theodore Rectanus Co.*, 248 U.S. 90, 97 (1918). The "right to a particular mark grows out of its use, not its mere adoption," and the "owner of a trade-mark may not, like the proprietor of a patented invention,

make a negative and merely prohibitive use of it as a monopoly." *Id.* at 97-98.

II. THERE IS NO SIGNIFICANT CONFLICT IN STATES' APPELLATE COURT DECISIONS ON THE QUESTION PRESENTED.

The "question presented" in KFC's petition is whether the Commerce Clause is violated by a "holding that a State may tax the income of an out-of-state business that maintains no physical presence in the taxing State." Contrary to KFC's claims (Pet. 2, 18), there is no "entrenched divide" or "deep conflict" among the state courts on that question. For over ten years, the states' highest courts that have considered the issue have agreed that physical presence is not a prerequisite for liability for a tax based on income.[1]

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[1] *See, e.g., Borden Chems. & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73, 80 (Ill. App. Ct. 2000); *MBNA America Bank, N.A. v. Indiana Dep't of State Revenue*, 895 N.E.2d 140, 144 (Ind. Tax Ct. 2008); *Bridges, Sec'y of Dep't of Revenue v. Geoffrey, Inc.*, 984 So. 2d 115 (La. Ct. App. 2008); *Kmart Properties, Inc. v. Taxation & Revenue Dep't of N.M.*, 131 P.3d 27, 37 (N.M. Ct. App. 2001), *rev'd on other issues*, 131 P.3d 22 (N.M. 2005); *Geoffrey, Inc. v. Okla. Tax Comm'n*, 132 P.3d 632, 639 (Okla. Ct. Civ. App. 2005). These are consistent with earlier decisions. *See, e.g., Allied-Signal Inc. v. Comm'r of Fin.*, 588 N.E.2d 731, 735-36 (N.Y. 1991) (upholding a New York City tax against a nondomiciliary corporation on dividend and capital gain income it received from an unaffiliated corporation that was doing business in New York City); *Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225, 1230 (Ohio 1996) (stating as dictum that "physical-presence requirement of *Quill* is not applicable" to case involving income tax on nonresident's lottery winnings), *cert. denied*, 519 U.S. 810

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Those decisions include several for which this Court has previously denied petitions for a writ of certiorari.[2] The three court decisions that KFC claims show a "deep conflict among the state courts" were issued from eleven to eighteen years ago by state intermediate appellate courts and do not address the issue of substantial nexus for an income tax on a company's income from in-state franchisees or licensees for their use of the company's intangibles as an integral part of regular in-state business activity.

In *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. Ct. App. 2000), the Texas court repeatedly stressed that the State had assessed its franchise tax "solely" on the basis of the taxpayer's passive possession of a "certificate of authority" to do business in Texas. *Id.* at 298-300. During the period at issue, it was the Texas Comptroller's "policy" that

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(1996); *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).

[2] *See, e.g., Capital One Bank v. Comm'r of Revenue*, 899 N.E.2d 76 (Mass. 2009), *cert. denied*, 129 S. Ct. 2827 (2009); *Geoffrey, Inc. v. Comm'r of Revenue*, 899 N.E.2d 87, 92 (Mass. 2009), *cert. denied*, 129 S. Ct. 2853 (2009); *Lanco, Inc. v. Dir., Div. of Taxation*, 879 A.2d 1234, 1242 (N.J. Super. Ct. App. Div. 2005), *aff'd*, 908 A.2d 176 (N.J. 2006) (per curiam), *cert. denied*, 551 U.S. 1131 (2007); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 195 (N.C. App. 2004), *cert. denied*, 546 U.S. 821 (2005); *General Motors Corp. v. Seattle*, 25 P.3d 1022, 1029 (Wash. Ct. App. 2001), *cert. denied*, 535 U.S. 1056 (2002); *Tax Comm'r v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 234 (W. Va. 2006), *cert. denied sub nom., FIA Card Services, N.A. v. Tax Comm'r of W. Va.*, 551 U.S. 1141 (2007).

"the licensing of intangibles, including patents, in Texas did not create franchise tax nexus." *Id.* at 298, 302. Despite its dicta quoted by KFC, *Bandag Licensing* does not strike an income or franchise tax where the taxing State actually relied on extensive transactions in the State using a taxpayer's intangibles and resulting in the taxed income. The Texas court did not consider the Comptroller's argument that the receipt of royalty income under a licensing agreement used in the State satisfies the "substantial nexus" requirement, because the issue had not been argued in the trial court and the trial court's findings of fact furnished "no factual foundation" for the new argument. *Id.* at 302.

In *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000), the Commissioner presented arguments attempting to show that the taxpayer had a physical presence and did not "provide any authority" to the court as to why the Commerce Clause analysis should be different from that used for sales and use taxes. *Id.* at 839-40, 842. The court ultimately stated, "It is not our purpose to decide whether 'physical presence' is required under the Commerce Clause." *Id.* at 842. Also, in the more recent intermediate appellate court decision in *America Online, Inc. v. Johnson*, 2002 WL 1751434 (Tenn. Ct. App. 2002),[3] the court cautioned

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[3] *America Online* is unpublished, but has been relied upon in a published decision of the Tennessee intermediate appellate

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against too strong a reading of *J.C. Penney*, stating, "We think, however, [the chancellor's] reading of *J.C. Penney* would simply substitute 'physical presence' for 'nexus' as the first prong of the *Complete Auto Transit* test. As we read the cases, neither court has made that suggestion." *America Online* at *2 (footnote omitted).

Guardian Industries Corp. v. Department of Treasury, 499 N.W.2d 349 (Mich. Ct. App. 1993), did not strike down any tax. At issue was Michigan's single business tax, which is "a consumption type value-added tax." *Id.* at 353. "One factor in determining the tax base is the percentage of the taxpayer's total sales made [in Michigan]," with sales considered to have been made in Michigan "if the taxpayer is not taxable for them in the purchaser's state." *Id.* at 353. The case involved whether the "taxpayer's solicitation of business in foreign states, alone" allowed those states to tax the sales made in those states, thereby allowing the taxpayer to pay less tax to Michigan. *Id.* at 353. The State of Michigan, relying in part on 15 U.S.C. § 381 (P.L. 86-272), argued *against* a finding of sufficient nexus with the target states. The taxing authorities in those other states were not involved in the case. The court reversed the trial court's summary disposition for Guardian Industries "because a genuine issue of fact exist[ed] regarding the extent of

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court. *See Arco Bldg. Sys., Inc. v. Chumley*, 209 S.W.3d 63, 74 (Tenn. Ct. App. 2006).

Guardian's solicitation activities within each target state." *Id.* at 357. The record was "unclear whether Guardian's employees were present in each target state" and "mere solicitation of sales, standing alone," was said by the court to be "insufficient to establish the substantial nexus required" by the Commerce Clause. *Id.* The court remanded, "finding that a record might be developed which would leave open an issue upon which reasonable minds might differ." *Id.*

KFC and the *amici curiae* have not shown *any conflict* between state courts that addressed the question presented by KFC where similar arguments were made based on similar connections between the states and income in dispute.

III. THE DECISION OF THE IOWA SUPREME COURT IS CORRECT.

A. The Decision below Is Consistent with *Quill*.

Before it determined that a physical presence was not required, the Iowa Supreme Court decided that the "intangibles owned by KFC, but utilized in a fast-food business by its franchisees that are firmly anchored within the state, would be regarded as having a sufficient connection to Iowa to amount to the functional equivalent of 'physical presence' under *Quill*." 792 N.W.2d at 324 (Pet. App. 36a). KFC's intangibles were sufficiently "localized" to provide a "business situs" supporting an income tax on revenue

generated by the use of the intangibles within Iowa. *Id.* at 323 (Pet. App. 34a).

It is apparent based on their briefs that KFC and the *amici curiae* consider the presence of tangible property to be a "physical presence" for the property's owner, but they never explain why the presence of a corporation's intangible property with a "business situs" in the state does not also constitute "physical presence." In a Commerce Clause property tax case, this Court stated:

> It is not the character of the property that makes it subject to such a tax, but the fact that the *property has its situs within the state* and that the owner should give appropriate support to the government that protects it. *That duty is not less when the property is intangible than when it is tangible.* Nor are we able to perceive any sound reason for holding that the owner must have real estate or tangible property within the state in order to subject its intangible property within the state to taxation.

Virginia v. Imperial Coal Sales Co., 293 U.S. 15, 20 (1934) (emphases added). For purposes of taxation, intangibles have a "situs" in a state (other than that of their owner's domicile) if they have become "integral parts of some local business." *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 210 (1936). Because KFC's intangible Marks and System used by franchisees in Iowa had a business situs in Iowa, they did "amount

to the functional equivalent of 'physical presence' under *Quill*." 792 N.W.2d at 324 (Pet. App. 36a).

"In the alternative, even if the use of intangibles within the state in a franchised business does not amount to 'physical presence' under *Quill*," a physical presence is not required in order to impose "an income tax based on revenue generated from the use of intangibles within the taxing jurisdiction." *KFC*, 792 N.W.2d at 324 (Pet. App. 36a). In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), this Court retained the physical presence test set forth in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967), for the requirement to collect a state's use tax. In doing so, the Court relied on the "doctrine and principles of *stare decisis*" and the need to retain a "bright-line, physical-presence requirement" for the benefit of a sizable interstate mail-order industry that had relied upon such a test for sales and use taxes. *See Quill*, 504 U.S. at 317-18. Nothing in *Quill* suggested that physical presence is required for the imposition of other types of taxes. In fact, the Court observed that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today," that its "Commerce Clause jurisprudence now favors more flexible balancing analyses," and that the physical-presence test "appears artificial at its edges." 504 U.S. at 311, 314-15. It twice noted that in reviewing "other types of taxes" it had never adopted the physical-presence requirement established in *Bellas Hess*. *See Quill*, 504 U.S. at 314, 317. An *amicus curiae*

misleadingly states, "Although the Court did not expressly extend its holding in *Quill* beyond the sales and use tax area, it said that its narrow holding did not 'imply repudiation of the *Bellas Hess* rule' in respect of other taxes. [*Quill*] at 314." (TEI 9) The concluding language "in respect of other taxes" was added by the *amicus curiae*. Also, rather than referring to its narrow holding in *Quill*, the Court was referring to the fact that it had "not, in [its] review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes." *Quill*, 504 U.S. at 314.

KFC and an *amicus curiae* misrepresent *Quill* when they state that in *Quill* this Court recognized that its "prior cases upholding state taxes all 'involved taxpayers who had a physical presence in the taxing State.' [*Quill*] at 314." (Pet. 20, COST 4) The Court's quoted comment actually referred only to two specific cases that had been reviewed and cited by the North Dakota Supreme Court, those being *Standard Pressed Steel Co. v. Department of Revenue of Wash.*, 419 U.S. 560 (1975), and *Tyler Pipe Industries, Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232 (1987). *See Quill*, 504 U.S. at 314. The Court's comment did not apply to its decisions discussed below.

B. The Decision below Is Also Consistent with Other Decisions of this Court.

The Court has upheld state taxes on a nonresident's income if the income has a "source" in the

taxing state, even if the taxpayer is not physically there. *See, e.g., Shaffer v. Carter*, 252 U.S. 37, 53 (1920) (income of nonresident from oil-producing land, oil and gas mining leaseholds, and other business-related property managed from outside the state); *New York ex rel. Whitney v. Graves*, 299 U.S. 366, 373-74 (1937) (nonresident's income from sale of intangible membership right on New York Stock Exchange); *Wisconsin v. J.C. Penney*, 311 U.S. 435, 442 (1940) (dividend income of nonresident shareholders).

> That the state, from whose laws property and business and industry derive the protection and security without which production and gainful occupation would be impossible, is debarred from exacting a share of those gains in the form of income taxes for the support of the government, is a proposition so wholly inconsistent with fundamental principles as to be refuted by its mere statement. . . .
>
> Income taxes are a recognized method of distributing the burdens of government, favored because requiring contributions from those who realize current pecuniary benefits under the protection of the government, and because the tax may be readily proportioned to their ability to pay.

Shaffer, 252 U.S. at 50-51.

Again in *International Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435 (1944), Wisconsin had taxing jurisdiction over dividends received by

nonresident shareholders from a company doing business in Wisconsin, with the Court stating:

> A state may tax such part of the income of a non-resident as is fairly attributable either to *property located in* the state *or* to events or *transactions* which, *occurring there*, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers. [Citations omitted.] And the privilege of receiving dividends derived from corporate activities within the state can have no greater immunity than the privilege of receiving any other income from sources located there.
>
> We think that Wisconsin may constitutionally tax the Wisconsin earnings distributed as dividends to the stockholders. It has afforded protection and benefits to appellants' corporate activities and transactions within the state. These activities have given rise to the dividend income of appellants' stockholders and *this income fairly measures the benefits they have derived from these Wisconsin activities.*

322 U.S. at 441-42 (emphases added). Iowa may constitutionally tax franchisees' Iowa earnings distributed to KFC, just as Wisconsin could "constitutionally tax the Wisconsin earnings distributed as dividends to the stockholders." *See id.* at 442. And just as the stockholders were "the ultimate beneficiaries of the corporation's activities within the state,"

KFC is a beneficiary of its franchisees' activities within Iowa. *See id.* at 441.

International Harvester and *Whitney* "were decided at a time when the nexus requirements of the Due Process Clause and the dormant Commerce Clause were thought to be interchangeable." *KFC*, 792 N.W.2d at 325 (Pet. App. 38a).

> [G]rounded as it was in *stare decisis*, *Quill* did not raise the Commerce Clause nexus bar. Instead, *Quill* lowered the due process bar to the level that the Court's nontax due process jurisprudence had reached long before. Until *Quill*, the Due Process and Commerce Clause tax nexus standards were essentially identical, and many cases treated them as interchangeable, even failing to precisely identify which standard was being applied. . . .
>
> > . . . Because pre-*International Shoe* [*Co. v. Washington*, 326 U.S. 310 (1945),] due process tax nexus cases were decided when the focus of jurisdictional inquiry was on corporate presence, these cases would seem to have special relevance to a Commerce Clause standard that also demands presence for sales and use taxes. . . .

John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 Wm. & Mary L. Rev. 319, 346 (2003) (footnotes omitted). "If today's Commerce Clause nexus standard is today's due process standard 'plus something,' the due

process standard at the time of *International Harvester* and *Whitney* was today's due process standard 'plus something' as well." *Id.* at 362 (footnote omitted).

As in *International Harvester,* the tax in dispute did "not discriminate against nonresidents or foreign corporations, or place an undue burden on them without a corresponding burden on residents or domestic corporations" making it "not a case where 'legislative action is not likely to be subjected to those political restraints which are normally exerted on legislation where it affects adversely some interests within the state'." *Id.* at 443 n.2 (citation omitted). Furthermore, out-of-state corporations are not as powerless regarding state legislation as in the past "in light of the growth of national advocacy groups [such as those filing *amici curiae* briefs in this case] that protect the local interests of their members and the involvement of national political parties in state political affairs." *KFC*, 792 N.W.2d at 327 (Pet. App. 44a). Also, "the mechanism to control any improper shifting of tax burdens onto out-of-state taxpayers is enforcement of the discrimination and apportionment prongs of *Complete Auto*, not the nexus requirement." *KFC, id.*[4]

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[4] KFC misrepresents the decision below when it states, "As the Iowa Supreme Court acknowledged, state appellate courts have been 'inherently more sympathetic to robust taxing powers of states than is the United States Supreme Court.'" (Pet. 18) The Iowa court's actual statement was that *"it might be argued*

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The four-prong Commerce Clause test set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), requires a "substantial nexus" with the taxing state but does not require a physical presence. *Complete Auto* does confirm that in evaluating the validity of a state tax under the Commerce Clause the tax's practical effect, not formalism, must be considered. 430 U.S. at 279. The KFC franchisees' licensed physical manifestations of KFC's intangible Marks are little different from a lease by KFC of physical assets containing its marks to local businesses in Iowa. To distinguish between income from the use of marks in Iowa and income from the lease of tangible property bearing the marks in Iowa, both of which have the same purpose of market creation, would elevate form over substance. In both instances, protection and opportunities are bestowed by government services for which taxes can be exacted.

There is no support for the claim (COST 14-16) that physical presence "is the cornerstone" for the prongs of the *Complete Auto* test that are not at issue in this case. In fact, when apportioning royalties and license fees from intangibles:

> the locus of the intangible's use . . . offers as sound a basis as one is likely to find for determining the source of intangible income. In any event, attributing the source of royalty

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that state supreme courts are inherently more sympathetic" to states' taxing powers, not that they actually have been. *KFC*, 792 N.W.2d at 322 (emphasis added; Pet. App. 32a).

> income to states in which the royalty producing intangible actually is used is more defensible than a rule attributing the source of royalty income on the basis of the taxpayer's operating factors. Furthermore, assigning the royalty income on the basis of the use of the intangible fulfills the purpose of the sales factor in recognizing the contribution that the market state makes to the production of the taxpayer's income.

Walter Hellerstein, *State Taxation of Corporate Income from Intangibles: Allied-Signal and Beyond*, 48 Tax L. Rev. 739, 867 (Fall 1993) (footnotes omitted). "There is an established tradition of attributing the income from patents, copyrights, and similar intangibles to the states in which they are exploited." *Id.* at 868-69 (footnote omitted).

IV. ALLEGED BURDENS ON INTERSTATE COMMERCE DO NOT JUSTIFY REVIEW.

"It was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing the business." *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938). Many types of taxes, including those imposed on income, "in one way or another add to the expense of carrying on interstate commerce, and in that sense burden it; but they are not for that reason prohibited." *Id.* at 255.

The various administrative and financial burdens alleged in the petition and by the *amici curiae* for "multistate taxpayers" or "out-of-state corporations" or "multi-state franchisors" do not differ in type or degree from those existing for taxpayers who have the type of "physical presence" that KFC and the *amici curiae* claim is constitutionally required. Having employees or tangible property in a state does not lessen the "questions and judgments that must be made in calculating a corporate income tax liability" (COST 9). The "issues a taxpayer faces when filing a return" are the same for "any taxpayer seeking to comply." *See* COST brief p. 10. Also, contrary to KFC's implication (Pet. 22), the Iowa Supreme Court did *not* adopt a different nexus standard for different types of industries.

In determining its taxable net income for Iowa income tax purposes, a corporation makes certain adjustments (mostly reducing its taxable income) to its "taxable income before the net operating loss deduction, as properly computed for federal income tax purposes under the Internal Revenue Code." Iowa Code § 422.35. As is true for the Iowa franchise tax addressed in *First National Bank of Ottumwa v. Bair*, 252 N.W.2d 723 (Iowa 1977), this results in a "quick and efficient system" that is "practical" for both the taxpayer and the Iowa Department of Revenue. *Id.* at 726. "The taxpayer is permitted to merely lift the figures off the federal return and transfer them to the Iowa tax return. The Department of Revenue receives the benefit of the regulations and interpretations of

the federal agency." *Id.* The taxpayer also receives that benefit, especially because any adjustments required also involve figures already calculated for federal income tax purposes. *See* Iowa Code § 422.35. "The returns required are not onerous and have been used by other corporations for years." Dir. Order p. 13 (Pet. App. 84a).

For an income tax "there is no vicarious liability for taxes that should have been imposed on third parties," "far fewer jurisdictions are involved" than for use taxes,[5] the "taxpayer does not become a virtual agent of the state in collecting taxes from thousands of individual customers," and "tax assessments are only made periodically." *KFC*, 792 N.W.2d at 325 (Pet. App. 37a-39a). The Iowa income tax is not a financial burden, because it "is only imposed on enterprises showing a profit and the tax obligation is not heavy

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[5] There is no support for the claim (COST 9) that the number of state and local jurisdictions "that can impose a business activity tax is dramatically higher than the number of jurisdictions imposing a sales and use tax." That is certainly not true in Iowa, where local sales and services taxes may be imposed but not local income taxes. *See* Iowa Code chapter 423B ("Local Option Taxes"). Further, regardless of how many jurisdictions *can* impose an income tax, 45 states impose a general corporate income tax, and the District of Columbia and New York City are the only localities that actually *do* impose a tax on corporate net income derived from sources within the locality. *See* Sheldon H. Laskin, *Only a Name? Trademark Royalties, Nexus, and Taxing That Which Enriches*, 22 Akron Tax J. 1, 13 & nn.53, 54 (2007).

unless the profits are high." *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 281 (1978).

An *amicus curiae* claims that sales and use tax compliance is "more straightforward" and less complex than is corporate income tax compliance, because "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?" (COST 8-9) However, determining whether a transaction is subject to Iowa's sales or use tax can require consideration of five pages of statutory provisions in the 2011 Iowa Code describing what tangible personal property and services are generally taxable (sections 423.2 and 423.5) and 20 pages of exemptions from Iowa sales and/or use tax (sections 423.3 and 423.6). The entire sales and use tax chapter of the Iowa Code fills more than 62 pages. In contrast, the statutes in the 2011 Iowa Code for corporation income tax fill 16 pages, and the sections imposing the tax and setting forth how to calculate the Iowa taxable income and the tax due (sections 422.33 and 422.35) are on 11 pages. Whether an income tax imposes a lesser burden than does collection of a use tax is no greater "sheer speculation" (IPT 14) than is the opposite conclusion.

There is no precedent giving rise to reliance on a "physical presence" standard for an income tax. *KFC*,

792 N.W.2d at 325 (Pet. App. 38a).[6] In *Quill* the Court twice noted that it had never adopted the *Bellas Hess* physical-presence requirement for "other types of taxes." *See Quill*, 504 U.S. at 314, 317. This Court's other decisions discussed above also negate the claim of "settled interests" or "settled economic expectations" (IFA 2, 6). Using a business situs theory, states have long asserted nexus for income from intangibles. *See* Michael T. Fatale, *Geoffrey Sidesteps Quill: Constitutional Nexus, Intangible Property and the State Taxation of Income*, 23 Hofstra L. Rev. 407, 444-47 (1994) (discussing state cases and regulations). "[T]he states have generally relied upon the business situs doctrine and, under *Quill*, their reliance interest should be respected." *Id.* at 450-51 (footnote omitted).

KFC and the *amici curiae* allege various burdens that are irrelevant, because they apply to businesses that are not subject to Iowa's income tax under the standard upheld by the Iowa Supreme Court. Iowa is not taxing a portion of KFC's income merely because some KFC trade name appeared in Iowa, KFC had

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[6] IFA cites certain "facts" in connection with its discussion about "retroactive unanticipated" liabilities for tax, penalties, and interest (IFA 12) that have no basis or support. There was no evidence in this case that the assessment at issue was the first one received by KFC or that it could not have been anticipated by KFC. IFA does not know when the Iowa Department of Revenue first issued an income tax assessment to KFC or whether an assessment for earlier years may have been issued prior to the due dates for returns for the years litigated in this case.

Iowa customers, or there was some contractual or other economic relationship with an in-state party. There is no reason to assume that without review and guidance by this Court multiple states will assert that a "substantial nexus" exists for a company "that advertises and sells products across state lines by telephone, internet, radio, TV or catalog" (MA 3). Such facts are extremely different from ones considered or relied upon in *KFC*.

Contrary to a claim made (TEI 12), the Iowa Department of Revenue has not "issued a ruling" that nexus results "solely as a result of licensing software to customers in Iowa." First, rather than being a Department "ruling," the document cited is merely an intra-Department memorandum from one employee to another (neither being the director) years prior to the *KFC* decision. Second, the memorandum does not rely "solely" on the licensing of software. It addresses a situation where software is licensed by a company to professionals in Iowa who use it to generate governmental reports for their Iowa customers. The company received "electronic filing fees/royalty payments" when the reports were filed. Those fees were earned by the company from intangible property with a business situs in Iowa.

Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511 (1935), cited by an *amicus curiae* for its claim of an "unreasonable clog upon the mobility of commerce" (TEI 13-14), does not address a nexus issue or the situs of intangibles. *Seelig* addresses a statute that restricted the in-state sale of certain milk produced

outside the state, "establishing an economic barrier against competition with the products of another state or the labor of its residents." *Id.* at 527. That type of "unreasonable clog" is irrelevant to this case.

Claims made in the petition and by *amici curiae* about burdens on commerce due to a state "over-reaching" to "export its tax burdens to nonresidents" and "to tax activities outside its borders" with "extra-territorial taxes" leading to "severe multiple taxation" relate to prongs of the *Complete Auto* Commerce Clause test other than the one at issue in this case. Issues regarding discrimination and multiple taxation were not raised in the parties' motions for summary judgment. These separate speculative claims do not support review of the substantial nexus question presented in this case.

A physical-presence requirement for income taxes would not eliminate uncertainty or litigation as to constitutional nexus. The physical-presence rule has not been such a "bright-line" test as to eliminate uncertainty for sales and use taxes. Whether there is a sufficient physical presence has been the issue in many sales and use tax cases decided after *Quill*.[7]

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[7] *See, e.g., Pledger v. Troll Book Clubs, Inc.*, 871 S.W.2d 389 (Ark. 1994); *Borders Online, LLC v. State Bd. of Equalization*, 29 Cal. Rptr. 3d 176 (Cal. Ct. App. 2005); *Current, Inc. v. State Bd. of Equalization*, 29 Cal. Rptr. 2d 407 (Cal. Ct. App. 1994); *Dell Catalog Sales, L.P. v. Comm'r of Revenue Servs.*, 834 A.2d 812 (Conn. Super. Ct. 2003); *Fla. Dep't of Revenue v. Share Int'l Inc.*, 667 So. 2d 226 (Fla. Dist. Ct. App. 1995), *aff'd*, 676 So. 2d 1362 (Fla. 1996); *Brown's Furniture, Inc. v. Wagner*, 665 N.E.2d 795

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Indeed, there have been different conclusions reached by courts applying the *Quill* test to the same corporation with the same types of contacts in each state. *Compare In re Scholastic Book Clubs, Inc.*, 920 P.2d 947, 958 (Kan. 1996) (finding substantial nexus with state sufficient to impose use tax), with *Scholastic Book Clubs, Inc. v. Mich. Dep't of Treasury*, 567 N.W.2d 692, 695-96 (Mich. Ct. App. 1997) (no substantial nexus or physical presence was found).

KFC claims that the ruling below has "international implications" because a foreign business could find itself subject to state taxes even though an international tax treaty immunizes it from federal income tax. (Pet. 26-27) First, because Iowa Code section 422.35 uses the federal "taxable income before the net operating loss deduction" as the starting point for computing the taxable Iowa net income, the position of the Iowa Department of Revenue has been that in the absence of federal taxable income there is no Iowa taxable income. Second, no issue was raised below regarding the Foreign Commerce Clause; nor have arguments related to federal international tax policy been examined or a relevant evidentiary record

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(Ill. 1996); *In re Family of Eagles, Ltd.*, 66 P.3d 858 (Kan. 2003); *In re Intercard, Inc.*, 14 P.3d 1111 (Kan. 2000); *Dell Catalog Sales L.P. v. Taxation & Revenue Dep't of N.M.*, 199 P.3d 863 (N.M. Ct. App. 2008); *Orvis Co. v. Tax Appeals Tribunal*, 654 N.E.2d 954 (N.Y. 1995); *SFA Folio Collections, Inc. v. Tracy*, 652 N.E.2d 693 (Ohio 1995); *House of Lloyd v. Commonwealth*, 684 A.2d 213 (Pa. Commw. 1996), *aff'd*, 694 A.2d 375 (Pa. Commw. 1997); *Koch Fuels, Inc. v. Clark*, 676 A.2d 330 (R.I. 1996).

made in the proceedings below. If a foreign corporation challenges a state tax on such grounds in the future, it may create a complete record and seek review by this Court at that time. Meanwhile, as explained below, the policy arguments made by KFC and the *amici curiae* should be presented to Congress.

V. THE COURT SHOULD DENY THE PETITION IN DEFERENCE TO THE CONSTITUTIONAL ROLE OF CONGRESS IN WEIGHING BURDENS ON INTERSTATE COMMERCE.

The question presented by KFC is better decided by Congress, which can evaluate burdens imposed on interstate commerce and "has the ultimate power to resolve" it, being "free to disagree" with any ruling this Court makes on the question presented. *See Quill*, 504 U.S. at 318. Congress has enacted or considered several limitations on state taxation.[8] In recent years it has considered bills regarding a nexus

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[8] *See, e.g.*, 15 U.S.C. § 381 (corporation net income tax); 15 U.S.C. § 391 (generation or transmission of electricity); 49 U.S.C. §11501 (rail transportation property); 47 U.S.C. § 151 (Internet Tax Freedom Act); 4 U.S.C. § 114 (retirement income); 46 U.S.C. § 11108(b)(2)(B) (individuals who work on navigable waters of more than one State); 49 U.S.C. § 14503(a) (interstate bus employees); 49 U.S.C. § 11502(a) (interstate railroad employees); Mobile Workforce State Income Tax Fairness and Simplification Act of 2007, H.R. 3359, 110th Cong. (2007); Telecommuter Tax Fairness Act of 2007, S. 785, 110th Cong. (2007).

standard for a state's business activity tax.[9] The fact that Congress has not yet given multistate corporations the nexus standard they seek does not mean that Congress has not been investigating and considering the issue.

Multistate corporations want to have their burdens lessened by having uniformity among states and local jurisdictions for "definitions, exemptions, and rates" (TEI 17) and for "tax bases" and apportionment "formulas," including the calculation of the "factors used to apportion" income (IPT 16). When discussing the need for national uniform rules for the division of income if duplicative taxation were to be prevented, this Court recognized that the content of any such uniform rules "would require a policy decision based on political and economic considerations that vary from State to State" and "should be determined only after due consideration is given to the interests of all affected States" by Congress, as "[i]t is to that body, and not this Court, that the Constitution has committed such policy decisions." *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 280 (1978). Similarly, the impact of various nexus standards on economic activity, job growth, the national economy, and compliance issues raised by KFC and the *amici curiae* are ones involving legislative facts better investigated and weighed by Congress in hearings, reports, and

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[9] *See, e.g.,* Business Activity Tax Simplification Act of 2003, H.R. 3220, 108th Cong. (2003); Business Activity Tax Simplification Act of 2011, H.R. 1439, 112th Cong. (2011).

debates. Congress can consider the burdens for taxpayers having a physical presence in several states, for taxpayers whose intangibles have a business situs in several states, and for states' residents contemplating or operating small businesses that must compete with franchised businesses that benefit from the use of franchisors' goodwill to attract customers and the operating assistance received from franchisors. (It may be that franchising has actually had a negative impact on job growth and the United States economy, rather than the positive one alleged by IFA.) The potential loss of states' revenue under various standards could also be considered. Judicial review, in contrast, is limited by the evidentiary record and the particular issue raised and decided below. For these reasons, the Court should defer to the legislative role of Congress.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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