No. 10-1340



In The

# Supreme Court of the United States

KFC CORPORATION, PETITIONER

*v.*

IOWA DEPARTMENT OF REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE IOWA SUPREME COURT*

## REPLY BRIEF

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JULY 12, 2011

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## REPLY BRIEF

Contrary to respondent's suggestion that there is no real conflict, a deep divide exists among the state courts that have addressed the question presented—a full third of the States. The issue is one faced only by state courts, and this Court: whether the Commerce Clause prohibits imposition of a state income tax on an out-of-state business that has no physical presence in the taxing State.[1] The ruling below is a near-repudiation of *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), tightly cabining this Court's decision to its specific facts. The Iowa Supreme Court expressly acknowledged that its ruling conflicts with the rulings of other state courts. Pet. App. 30a. Numerous other state courts also recognize the conflict that respondent attempts to deny. Pet. 13-15.

It cannot be doubted that this is an important issue. The Iowa Supreme Court recognized that this case presents an unanswered question of federal constitutional law. Pet. App. 33a. Indeed, before that court, respondent asserted that the state supreme court should decide the issue because it raises "substantial constitutional questions as to the validity of a statute and administrative rules, substantial issues of first impression, and fundamental and urgent issues of broad public importance." Iowa

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[1] Federal district courts and courts of appeals cannot exercise jurisdiction to address the question presented. 28 U.S.C. § 1341.

S.Ct. Appellee Br. 7. Respondent was correct. The question presented is important—as it affects billions of dollars annually—and it is unanswered. State courts have been left to "predict" how this Court might resolve it. Pet. App. 32a. That alone justifies this Court's review.

### A. Alternative Grounds That Respondent Could Have Raised, But Did Not, Are Not A Basis To Deny Review

1. Respondent's lead contention is that this Court's review is unnecessary because even if the Court grants and reverses, the State still might prevail on some other, as-yet-unpressed ground on remand. Opp. 4 (noting there are issues "not raised" in its motion for summary judgment which it might raise on any remand). But any such grounds are no impediment to review. To the contrary, those grounds are waived before this Court. *Glover v. United States*, 531 U.S. 198, 205 (2001) (refusing to consider alternative arguments for affirmance that were not raised in court of appeals); *McGoldrick v. Compagnie Generale Transatlantique*, 309 U.S. 430, 434 (1940) (same with respect to state courts). Nor is there any merit to respondent's suggestion that review is unwarranted when further proceedings might lead to the same judgment, on different grounds, following reversal. Under that theory, for example, a violation of the Fourth Amendment would almost never be reviewed, because even if this Court were to find a violation, a State might prevail on remand without the suppressed evidence.

2. Contrary to respondent's suggestion, this case is an ideal vehicle to resolve a pure question of law that has long divided state courts. The Iowa Supreme Court considered, and squarely decided, an important question of federal law left unresolved after *Quill*. The state court observed that this Court "ha[d] not considered this precise question post-*Quill*" (Pet. App. 33a), and thus explained that its "task" was to determine "how the United States Supreme Court would decide the issues presented in this case." Pet. App. 32a. The state court then upheld the tax assessment and corresponding penalties "in all respects" against petitioner based on its resolution of that very issue. Pet. App. 49a. A reversal by this Court thus would eviscerate the state court's justification for the tax.

Moreover, to the extent respondent appears to suggest otherwise (Opp. 5-6), this Court has jurisdiction under 28 U.S.C. § 1257(a). The state court judgment is final as to all issues. Absent review, nothing remains in this action for the state courts to resolve.

3. In any event, if this Court were to grant and reverse, that would affect the "ultimate outcome." Opp. 4. If physical presence is required, respondent's as-yet-unpressed arguments would provide no constitutional basis for taxing petitioner.

Even though petitioner has no employees, buildings, or real property within the State, respondent contends that there is a sufficient nexus because

some intangible intellectual property (trademarks) is used in the State by third parties and some "tangible six volume sets of operating manuals are located at Iowa franchisees' restaurants." Opp. 5-6. But that does not satisfy the physical presence requirement under *Quill*.

This Court in *Quill* explained that the in-state presence of a "few floppy diskettes"—containing proprietary software that is no different from the operating manuals in this case—is not enough for there to be physical presence. *Quill*, 504 U.S. at 302 n.1, 315 n.8. The *Quill* Court expressly rejected a "'slightest presence' standard of constitutional nexus" under *National Geographic Society v. California Board of Equalization*, 430 U.S. 551, 556 (1977). *Quill*, 504 U.S. at 315 n.8. As such, intellectual property (such as trademarks) used by third parties or even some tangible property (like manuals or diskettes) does not amount to the physical presence required by the Commerce Clause. *Ibid.* (concluding that the "licensing of software * * * does not meet the 'substantial nexus' requirement of the Commerce Clause.").[2] Accordingly, even if there was an evidentiary hearing

[2] Respondent suggests that in-state "others" helping petitioner might satisfy the physical presence requirement under *Tyler Pipe Industries, Inc. v. Washington Department of Revenue*, 483 U.S. 232 (1987), and *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960). But those decisions pertain to "sales representatives" of the out-of-state business. Nowhere does the record show that petitioner had any sales representatives, or even any non-employee agents, physically present in Iowa during the tax years at issue in this case.

(which respondent concedes would be required, Opp. 4), the facts respondent references would be insufficient as a matter of law to amount to a physical presence.

More importantly, as the case comes to this Court, the state tax has been upheld on the premise that petitioner has no physical presence in Iowa. The case thus squarely presents the question whether a State may tax the income of an out-of-state corporation that has no physical presence.[3]

### B. The State Court's Economic Nexus Decision Deepens A Concrete And Longstanding Conflict

Rather than directly confront the conflict in the state appellate courts, respondent denies its significance. First, respondent says that there is no real disagreement in the state courts because more recent decisions—in the past 10 years—all have been decided against the taxpayer. Opp. 14. Second,

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[3] For this reason, although *Lamtec Corp. v. Department of Rev.*, 246 P.3d 788 (Wash. 2011), petition for cert. filed, 79 U.S.L.W. 3629 (U.S. Apr. 19, 2011) (No. 10-1289), presents the same question and both petitions should be granted, this petition provides a better vehicle to resolve the issue should the Court review only one case. In *Lamtec*, the taxpayer had an actual physical presence in the taxing State. *Id.* at 790. As such, the question whether the Commerce Clause requires a physical presence is not as cleanly presented as it is here. Unlike in this case, the answer to the question could turn out to be academic in *Lamtec* or, at the very least, is tied up with the fact-bound question of what is a sufficient physical presence.

respondent claims that the Iowa Supreme Court upheld the state tax "without addressing the constitutionality of the 'economic presence' nexus standard." Opp. 3-4. But those arguments cannot be reconciled with the decision below. After acknowledging disagreement among state courts, Pet. App. 30a, the Iowa Supreme Court issued a broad constitutional ruling on the scope of a State's jurisdiction to tax, expressly holding that "a physical presence is not required under the dormant Commerce Clause" for "an income tax on revenue earned by an out-of-state corporation." Pet. App. 45a. Rather, the "presence of transactions within the state that give rise to * * * revenue provide sufficient nexus under established Supreme Court precedent." Pet. App. 35a.

### *1. The state supreme court acknowledged the longstanding conflict*

a. Respondent's claim of no "significant" conflict (Opp. 7-11) is undermined by decisions of numerous state courts reaching opposite conclusions. The Iowa Supreme Court itself recognized the existence of a conflict. Pet. App. 30a. Other state courts likewise have recognized that their rulings against the taxpayer have deepened "a split of authority [that] has developed regarding whether the Supreme Court's holding was limited to sales and use taxes." *Lanco, Inc. v. Director, Div. of Taxation*, 908 A.2d 176, 177 (N.J. 2006) (per curiam); *see also Tax Commissioner v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 231 (W. Va. 2006).

b. Equally unavailing are respondent's attempts to minimize the conflict between the ruling below and the decisions that have ruled for the taxpayer. Opp. 10.

Although respondent claims otherwise (Opp. 8-9), *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000) is in direct conflict with the decision below. In *Rylander*, the state court squarely addressed whether physical presence was required—i.e., what constitutes a "substantial nexus"—to impose the tax at issue. *Id.* at 299. The Texas court considered and rejected the taxing authority's argument that "*Quill Corp.* and [*National*] *Bellas Hess*[, *Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967)] should be limited to the context of sales and use taxes." *Ibid.* The court held that, "[w]hile the decisions in *Quill Corp.* and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause." *Id.* at 300. Thus, it is of no moment that *Rylander* arose in the context of a "certificate of authority" (Opp. 8), because the state court concluded that in the absence of any "physical presence in the state," there is no "sufficient nexus * * * to permit the state to assess tax." *Rylander*, 18 S.W.3d at 300.

Respondent makes no real effort to reconcile *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999) with the ruling below. Opp. 9-10. Instead, respondent primarily contends that the Tennessee Supreme Court might overrule *J.C. Penney*

and that an unpublished disposition reached a different conclusion. But, as the petition explained, the Tennessee Supreme Court's denial of review, unlike a denial of certiorari by this Court, gave the *J.C. Penney* court's decision binding statewide precedential effect. Pet. 18. Thus, the unpublished disposition that respondent cites has no bearing on whether *J.C. Penney* remains good law.

Finally, respondent asserts that *Guardian Industries Corp. v. Department of Treasury*, 499 N.W.2d 349 (Mich. Ct. App. 1993) is inapposite because the *taxpayer* in that case was the one advocating the position adopted by the Iowa Supreme Court here. In that case, the taxpayer asserted that another jurisdiction, rather than Michigan, could tax its transactions, even though it lacked any physical presence in that other jurisdiction. Opp. 10. But the important point is that the Michigan state court expressly held that "after *Quill*, it is abundantly clear that [a taxpayer] must show a physical presence in a target state to establish a substantial nexus to it." *Guardian Indus.*, 499 N.W.2d at 356. To the extent that, as respondent suggests, it matters *who* made the argument, the fact that the taxpayer did not prevail is simply evidence of the Iowa Supreme Court's observation that "it might be argued that state supreme courts are inherently more

sympathetic to robust taxing powers of states than is the United States Supreme Court." Pet. App. 32a.[4]

### *2. Review is warranted because States have expanded their repudiation of Quill to new transactions*

Respondent's observation (Opp. 7) that more courts in the conflict have ruled against taxpayers is not reason to deny review. Many of the rulings adverse to taxpayers involved transactions between in-state and out-of-state corporate affiliates—often where a holding company managed and licensed intellectual property rights to in-state corporate affiliates under common ownership. Some state courts have viewed these related-party arrangements with suspicion. *See, e.g.*, *Syms Corp. v. Commissioner of Revenue*, 765 N.E.2d 758 (Mass. 2002); Council on State Taxation Br. 6 (compiling cases). To some degree, those cases might be considered a distinct category by themselves.

The more recent trend in state courts, however, has been to expand the rationale of those rulings even further—to arms-length transactions that bear no resemblance to any of the related-party cases. There are far fewer cases that have adopted that approach,

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[4] Respondent contends that petitioner has "misrepresent[ed]" this statement. Opp. 18 n.4. That is not true. The court below expressly acknowledged this argument, and nowhere did the Iowa Supreme Court deny there was any merit to it.

and the ruling below is one of them. *See, e.g.*, *MBNA*, 640 S.E.2d at 226 (taxing out-of-state credit card company for in-state transactions); *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76 (Mass.), cert. denied, 129 S. Ct. 2827 (2009) (same). Considering only those rulings, the conflict in the state courts remains mature, but is less lopsided—three state courts (Michigan, Tennessee, and Texas) have required a physical presence and three state courts (Iowa, Massachusetts, and West Virginia) have held that economic nexus alone is enough.

As amici have explained, the franchisor-franchisee relationship is the quintessential arm's length transaction. International Franchise Association Br. 3. If the economic nexus test can justify a state tax against an out-of-state franchisor or an out-of-state bank (neither of which has any physical presence in the State), then a State can tax almost any economic relationship that has some connection to the State. Institute for Professionals in Taxation Br. 21.

Such an "economic nexus" justification leads to the absurd circumstance where a State cannot impose sales or use tax collection requirements on a transaction by an out-of-state seller (under *Quill*) but can impose an income tax on that seller for that same transaction. Pet. 26; Tax Executives Institute, Inc. Br. 11. As amici explain, that imposes a significant compliance burden on out-of-state businesses that are taxed merely because they engage in some transaction with an in-state customer. Council on State

Taxation Br. 5 (noting the ruling below creates a "nexus-by-customer" standard which will lead to significant costs due to unpredictability); Market America, Inc. Br. 9; Tax Executives Institute, Inc. Br. 13. Under the Iowa court's rationale, any out-of-state seller of goods—notwithstanding the absence of any in-state physical presence—could be subject to Iowa income tax as a result of sales made to Iowa businesses.

Absent this Court's review, the ruling below and others like it will redefine many of these arms-length transactions—particularly as more commerce is conducted over the Internet—and impose a significant burden on the national economy.

### C. The State's Merits-Based Arguments Demonstrate That Review Is Needed

Although the Iowa Supreme Court and other state courts have recognized that the question presented has not been answered by this Court and has divided state courts, respondent asserts that review should be denied because, in its view, the decision below is correct. Those merit-based arguments demonstrate the need for this Court's plenary review.

1. Respondent could not be more wrong that the ruling below is consistent with *Quill*. Respondent can point to no such physical presence in the State. Instead, respondent suggests (Opp. 11) that petitioner had the "functional equivalent" because its intellectual property was used by a third party in the State. But this Court in *Quill* already rejected the notion

that the licensing of intellectual property—software, in that case—satisfied the physical presence requirement. *Quill*, 504 U.S. at 315.

2. Respondent is incorrect in asserting that this Court has sustained state taxes in the absence of some physical presence in the taxing State. Opp. 14. In every case, the taxpayer owned some land or had some other tangible, physical connection to the taxing State, which is plainly lacking here.

Thus, in *Shaffer v. Carter*, 252 U.S. 37 (1920), the out-of-state taxpayer owned land and was exploiting land in the taxing State. Similarly, in *New York ex rel. Whitney v. Graves*, 299 U.S. 366 (1937), the out-of-state taxpayer sold a membership "seat" on the New York Stock Exchange and sought to avoid *New York* taxes on that transaction.

Nor do *Wisconsin v. J.C. Penney, Co.*, 311 U.S. 435 (1940), or *International Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435 (1944)—two Due Process rather than Commerce Clause cases—authorize a State to tax an out-of-state business with no physical presence within the taxing State. Rather, those cases stand for the unremarkable proposition that Wisconsin had the power to tax a business—that had an in-State physical presence—for its share of income that that business earned within its borders. *Int'l Harvester*, 322 U.S. at 438, 442; *J.C. Penney*, 311 U.S. at 440 n.1, 444-445. The Court sustained the tax because it was being imposed on the deferred income of those corporations rather

than on an out-of-state investor shareholder that received dividends. *Int'l Harvester*, 322 U.S. at 441 ("The power to tax the corporation's earnings includes the power to postpone the tax until distribution of those earnings * * * ."); *id.* at 447 (Jackson, J. dissenting) (explaining that the majority sustained the tax as "an income tax on the corporation, deferred until the income was distributed"); *J.C. Penney*, 311 U.S. at 442 ("The practical operation of this legislation is to impose an additional tax on corporate earning within Wisconsin but to postpone the liability for this tax until earnings are paid out in dividends.").

If anything, respondent's inability to find any case where physical presence was *not* required underscores the need for this Court's review. Any deviation from this longstanding and implicit requirement that is present in all of this Court's state tax decisions should come from this Court, not a patchwork of inconsistent state court decisions.

## CONCLUSION

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

Respectfully submitted,

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