No. 00-205

IN THE

SUPREME COURT OF THE UNITED STATES

RUTH E. JOHNSON, COMMISSIONER OF REVENUE,
STATE OF TENNESSEE,
Petitioner,

v.

J.C. PENNEY NATIONAL BANK,
Respondent.

On Petition for Writ of Certiorari to the Court of Appeals of the State of Tennessee

Brief *Amicus Curiae* of Multistate Tax Commission In Support of Petitioner

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Brief *Amicus Curiae* of Multistate Tax Commission In Support of Petitioner

The Multistate Tax Commission ("MTC") submits this brief as *Amicus Curiae* in support of granting the Petition for Writ of Certiorari under Rule 37.2 of the Court's Rules.[1]

INTEREST OF *AMICUS CURIAE*

The MTC is the administrative agency created by the Multistate Tax Compact ("COMPACT"). *See* RIA ALL STATES TAX GUIDE ¶ 701 *et seq.*, p. 751 (1995). Twenty-one States have legislatively established full membership in the COMPACT. In addition, two States

[1]No counsel for any party authored this brief in whole or in part. Only *Amicus* MTC and its full member States made any monetary contribution to the preparation or submission of this brief. Consent of all parties to the filing of this brief is filed concurrently with this brief.

are sovereignty members and nineteen States are associate members.[2] The Court upheld the validity of the COMPACT in *United States Steel Corp.* v. *Multistate Tax Comm'n*, 434 U.S. 452 (1978).

The COMPACT evolved out of concern of the States and multistate taxpayers about proposed federal legislation to regulate state tax systems following the findings and recommendations of the Willis Committee.[3] *See* D. Brunori, *Interview: Gene Corrigan, a 'Proud Parent' of the MTC*, 17 STATE TAX NOTES 1295 (November 15, 1999). The States' primary interest in forming the COMPACT was to preserve the States' taxing power in the context of multijurisdictional commerce, an essential governmental power if the States were to preserve their constitutional role.

The specific purposes of the COMPACT that fulfill its overall aim of preserving state tax sovereignty are

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[2] Compact Members: Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Maine, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. Sovereignty Members: Florida and Wyoming. Associate Members: Arizona, Connecticut, Georgia, Illinois, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, New Hampshire, New Jersey, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Wisconsin, and West Virginia.

[3] The Willis Committee, a congressional study of state taxation mandated by TITLE II, PUB. L. NO. 86-272, 73 STAT. 555, 556 (1959), made extensive recommendations as to how Congress could regulate state taxation of interstate and foreign commerce. See generally INTERSTATE TAXATION ACT: HEARINGS ON H.R. 11798 AND COMPANION BILLS BEFORE SPECIAL SUBCOMM. ON STATE TAXATION OF INTERSTATE COMMERCE OF THE HOUSE COMM. ON THE JUDICIARY, 89th Cong., 2d Sess. (1966).

(1) facilitation of proper determination of state and local tax liability of multistate taxpayers; (2) promotion of uniformity or compatibility in significant components of tax systems; (3) facilitation of taxpayer convenience and compliance; and (4) avoidance of duplicative taxation.

In furtherance of the purposes of the COMPACT, the MTC seeks a clarified understanding of the constitutional nexus standard for the imposition of income and net worth taxes. A clear nexus standard will advise those engaged in interstate commerce of the extent of their obligation to pay their fair share of state taxes. See *Oklahoma Tax Comm'n* v. *Jefferson Lines*, 514 U.S. 175, 184 (1995); *Barclay's Bank PLC* v. *Franchise Tax Bd.*, 512 U.S. 298, 310 (1994). An authoritative statement from this Court on the nexus standards for income and net worth taxes will also facilitate taxpayer convenience and compliance, because taxpayers will more readily understand the constitutional limits of the Commerce Clause with respect to these taxes. As detailed in the first part of the following argument, there is a compelling need for the Court to speak in the area at issue in this matter. Granting review will bring some order to an otherwise raucous free-for-all that presently exists in the face of the Court's silence.

REASONS FOR ALLOWING WRIT

I. THIS MATTER IS IMPORTANT TO OUR FEDERAL SYSTEM, BECAUSE

A. THERE IS A COMPELLING NEED FOR MEANINGFUL DIRECTION ON THE IMPORTANT ISSUE OF THE NEXUS STANDARD FOR INCOME AND NET WORTH TAXES;

The MTC urges the Court to review this case because it represents a pivotal opportunity for the Court to provide meaningful direction to the business community and the States.[4] The ever-simmering and important issue of constitutional nexus pertaining to taxes other than the imposition of a use tax collection obligation upon a remote business has become increasingly contentious. The issue stated here is most fundamental, going far beyond the constitutionality of some limited element of an operating income tax. See *Hunt-Wesson, Inc.* v. *Franchise Tax Bd.*, 528 U.S. ____, 120 S. Ct. 1022 (2000) (operation of interest offset provision within state income tax ruled unconstitutional). The very core of state taxing power is at issue—what connection must a remotely operated business have with a taxing State in order to support jurisdiction to im-

[4] Your *Amicus* is not enchanted with describing one of the parties for whom meaningful direction from the Court would be beneficial as "the States." The term does not readily admit that "the States" is an abstraction representing the people collectively within the body politic. The true beneficiaries of clear understanding of nexus principles are not the state legislatures, state executives, or state tax administrators, but the citizens of the several States themselves.

pose an income tax and a net worth tax as distinguished from the imposition of a use tax collection obligation.

The specific issue can properly be stated as, "Is some sort of 'physical presence' required before a State, consistent with the dormant Commerce Clause, may impose an income tax and/or a net worth tax with respect to a financial institution that maintains established, ongoing, contractual relationships with its customers in the taxing State."

The ongoing and contractual nature of the contact that is at issue in this case is, of course, far different from the intermittent catalog purchases presented in *National Bellas Hess, Inc.* v. *Dept. of Revenue*, 386 U.S. 753 (1967), and *Quill Corp.* v. *North Dakota*, 504 U.S. 298 (1992)). But this observation does not mean this matter with this unique factual aspect is of interest only to States that have asserted taxing jurisdiction over newly emerging, centrally organized, and remotely operated financial institutions. (This issue nonetheless is important to the States that have recognized the changing reality that banking and related financial services are increasingly provided by remotely organized and operated institutions. See Randall J. Pielsnik, *State Taxation of Multistate Banking Operations—A State by State Analysis, Parts 1 and 2*, 18 J. STATE TAX. 40 (SUMMER 1999), and 60 (FALL 1999), republished in 17 STATE TAX NOTES 383 (AUGUST 9, 1999) and DOC. 1999-34495 (SEPTEMBER 15, 1999) (electronic).)[5]

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[5] In assessing the degree to which remotely operated financial institutions are currently subject to state tax, one must recall that "[b]ecause of a long history of Federal restrictions, . . . state taxation of banks was essentially a residence-based system." STATE AND LOCAL TAXATION OF BANKS AND OTHER FINANCIAL INSTITUTIONS at v

As has been noted by others, state taxation of other operations not involving the financial institution industry is also at risk. See esp., *e.g.*, *In Matter of KMart Properties, Inc.*, N.M. Dept. of Taxation & Rev. Admin. Hearing No. 00-04 (Feb. 1, 2000), on appeal, *sub. nom.*, *Kmart Properties, Inc.* v. *Taxation & Revenue Dept.*, N.M. Court App. No. 211440 (expansive discussion of widely used tax planning technique (the "passive income company" or "PIC" plan) to divert revenue to separately incorporated entity holding trademarks and other intangibles).

The passive income company plan shows how far awry the application of the *Bellas Hess* and *Quill* "physical presence" test to income taxes has gone.

(AM. BAR ASS'N, SECTION OF TAXATION, 1995-96 ED.). Following revolutionary changes in the statutory governance of the banking system, including passage of the Riegel-Neal Interstate Banking and Branching Efficiency Act of 1994, PUB. L. 103-328, 108 STAT. 2338, financial institutions have pursued a more centralized, remotely directed business plan. In light of these changes, States have begun to modernize their state taxing systems to reflect more market-state orientation, including jurisdiction. TAXATION OF BANKS, above, at v. Also, in evolutionary terms of impacting *all* state tax systems, it has not been that long since Congress adopted a statutory declaration that States could impose an income tax on national banks. Secs. 1 and 2, PUB.L 91-156 (1969).

Nevertheless, several of the States as noted in the article cited in the text and the ABA book cited in this note have affirmatively extended their bank taxes to remotely operated banks. Several other States have statutory standards of nexus that offer the potential to support the same result. These standards include "doing business," "deriving income," receiving interest on loans secured by property in the State, concepts of business situs, obtaining or soliciting business, and constitutionally permitted jurisdiction.

The PIC plan essentially assumes that a single enterprise can self-deal among its own affiliates and thereby achieve non-taxation of income, because the affiliate (the PIC) holding the intangibles that are licensed under a royalty agreement for use in the taxing State is allegedly not "physically present" in that State. Your *Amicus* is unable to identify how preservation of a tax-exemption of an affiliated PIC through application of a "physical presence" rule upholds the constitutional value of unburdened interstate commerce. What application of the physical presence rule to PIC plans shows is that *Bellas Hess* and *Quill* have become planning tools justifying extensive (and presumably expensive) planning of corporate organizational and operational structure in order to defeat a legitimate tax. This result cannot be justified under the dormant Commerce Clause. As the Court has observed, "[t]he importance of the commerce clause to the Union is very great. But it is also important to prevent that clause being used to deprive the States of their lifeblood by a strained interpretation of facts." *Superior Oil Co.* v. *Mississippi*, 280 U.S. 390, 395 (1930) (Holmes, J.). We would also add given the planning technique rejected in *Superior Oil* that the Court also intended that strained tax planning under the Commerce Clause not be used to deprive the States of critical tax revenues.

If the PIC plan were not enough, the emerging deregulation of utility services is another area where long-established state taxation is potentially at risk. The increasingly deregulated electricity industry is one case in point. Commentators indicate nexus is at issue in the remote sale of electricity. See Deloitte & Touche LLP, FEDERAL, STATE AND LOCAL TAX IMPLICATIONS OF ELECTRIC UTILITY INDUSTRY RESTRUCTURING,

AN ANALYSIS FOR THE NATIONAL COUNCIL ON COMPETITION AND THE ELECTRIC INDUSTRY at 20-21 (October 1996).

Besides impacting the power of the States to impose income and net worth taxes on remote operations, other than the imposition of a use tax collection obligation, there are other considerations that make this case an ideal candidate for the Court's attention. The crisp and clear statement of the issue presented buttresses our enthusiasm for this case. The MTC welcomes Commissioner Johnson's active pursuit of the precise issue here presented in fully and properly developed proceedings in the court system of Tennessee. This case affords a proper platform for this Court to evaluate the merits of the positions taken.

B. WITHOUT AN AUTHORITATIVE STATEMENT OF THE COURT ON THE IMPORTANT NEXUS ISSUE PERTAINING TO INCOME AND NET WORTH TAXES, THE INTEGRITY OF STATE TAX SYSTEMS IS AT RISK.

The integrity of the state tax system is also implicated by the assertion that the "physical presence" test is broadly applicable to all forms of state taxation. This assertion is one that has been left unanswered far too long. The negative aspects of letting this issue continue to fester are clear. Taxpayers in the face of the cacophony of claims of tax immunity are puzzled by what they should do. Should they be governed by the likelihood of a challenge to their reporting position and the likely outcome of that challenge or by competitive pressures whose close ally, the political process, will ensure that the sting of losing on compliance is not too severe?

Disrespect for state tax systems has increased because the States lack an authoritative statement of this Court. In many respects following *Quill*, state tax systems have lost credibility with taxpayers in general. Some background on this observation in order.

The Court and Congress have let the nexus stand-off simmer unchanged, since this Court rendered its decision in *Quill*. With the Court on the sidelines, the States' only recourse has been pursuit of litigation to provide evidence that what they preach is sound. But litigation is piecemeal at best. The other option of providing a reasoned assessment of reporting obligations outside of litigation are shouted down in the absence of an authoritative statement of the Court. See Richard D. Pomp and Michael J. McIntyre, *State Taxation Of Mail-Order Sales Of Computers After* Quill*: An Evaluation Of MTC Bulletin 95-1*, 11 STATE TAX NOTES 177 (JULY 15, 1996), that analyzes the soundness of *Multistate Tax Comm'n Nat'l Nexus Prog. Bull. 95-1*, republished at 10 STATE TAX NOTES 62 (JANUARY 1, 1996), that met stiff, if not hostile, opposition.

The absence of any authoritative statement of the Court has emboldened respected representatives of taxpayers to make what your *Amicus* views as questionable statements of the governing principles of nexus as to income taxes. These statements include assertions that pre-*Quill* due process nexus cases are not binding precedent for understanding the requirements of the Commerce Clause, Kendall L. Houghton & Douglas L. Lindholm, *COST Opposes MTC Nexus Bulletin 95-1*, 10 STATE TAX NOTES 973, 974 (MARCH 25, 1996); neither the MTC nor the States may interpret existing Supreme Court precedent to support nexus positions in the absence "irrefutable" precedent, *Id.* at 977; by use of the

descriptive phrase, "furthest extension," similar to "furthest constitutional reach" used in *Bellas Hess*, 386 U.S. at 757, *Quill* intimated in 1992 that there has been movement away from *Scripto, Inc.* v. *Carson*, 362 U.S. 207 (1960), *Id.* at 975; and there is no substantive constitutional difference between nexus to support a use tax collection obligation and a net income tax obligation. Fred O. Marcus, *Limitations on States' Jurisdiction to Impose Net Income Based Taxes* 1410:0007, TAX MANGMT. MULTISTATE TAX PORTFOLIO (BNA 2000).

The nexus stand-off largely continues today unabated. Causes for not making much progress include (i) a generally hostile tax environment; (ii) the States' apparent failure in the hostile environment to convince taxpayers of the soundness of their position in circumstances not yet fully developed by the nexus precedent of the Court; (iii) a lack of appropriated funds to support wide-spread litigation that is required to cut the "Gordian knot" of nexus; (iv) the emergence of the electronic commerce industry that for now appears largely opposed to most government regulation, including taxation; and (v) the reluctance of some state courts in the face of *Quill* to analyze nexus issues afresh for fear of overstepping bounds perceived to have been established by this Court. As to item (v), see Argument II, below.

That a stand-off continues following *Quill* is not totally unexpected, since both tax administrators and taxpayers had placed so much anticipation on the outcome of *Quill*. As has been observed elsewhere, what was really needed following *Quill* was less *legal* counsel and more *psychological* counsel. "Tax administrators required counseling to overcome negative thinking attributable to the understandable depression caused by the loss in *Quill*; practitioners, on the other hand, needed counseling

to ground themselves in reality following their manic high that came from the *Quill* victory." Paull Mines, *Conversing with Professor Hellerstein: Electronic Commerce and Nexus Propel Sales and Use Tax Reform*, 52 TAX L. REV. 581, 604 n.124 (1997).

But even though the continuing stand-off is understandable, the overreaction to *Quill* is curious. The holding of *Quill*, a reaffirmation of *Bellas Hess,* is quite limited. A simple, but accurate, statement of the holding of *Bellas Hess* which *Quill* reaffirmed is that a State may not impose a *use tax collection obligation* on a remote seller whose contact is limited to common carrier and the U.S. mail. 386 U.S. at 758. *Quill* repeated this holding at least five times. 504 U.S. at 301 (first paragraph of opinion), 307, 311 (two occurrences), and 315. The Court describes this principle as the physical presence requirement. 504 U.S. at 311 ("*Bellas Hess*' 'sharp distinction'"), 314 (*Bellas Hess* established physical presence requirement), and 317 (*Bellas Hess* physical presence requirement) The Court also expressly limited the application of *Quill* by noting that it had not applied the same "physical presence" requirement to other taxes. 504 U.S. at 314 and 317.

We believe, therefore, the Court should use this case for its potential to provide an authoritative and balanced assessment of the applicability of *Bellas Hess* and *Quill* in areas outside of the use tax collection obligation. In seeking intervention of the Court, the MTC is not so bold as to believe that the Court will necessarily agree with the emerging understanding of the States as to appropriate nexus requirements for income and net worth taxes. But the Court remains the final arbiter of the content of the dormant Commerce Clause and the MTC views the opportunity to have amplification of nexus rules in the context of the taxes at issue here better than to

allow state tax systems to atrophy through the continued stand-off that currently exists.

II. THE COURT SHOULD INSTRUCT STATE COURTS THAT THEY MAY NOT ABDICATE THEIR RESPONSIBILITY TO GIVE FULL AND FAIR CONSIDERATION OF FEDERAL CONSTITUTIONAL ISSUES PROPERLY RAISED IN STATE TAX MATTERS.

The MTC is disturbed by the refusal of the Tennessee Court of Appeals to address whether the "physical presence" standard of nexus applicable to the imposition of a use tax obligation on a remote seller applies to the taxes here at issue. The Court dismissed the tax administrator's argument that *Bellas Hess* and *Quill* were inapplicable with the observation,

> However, we are not in a position to speculate as to how the Supreme Court might decide future cases. We are only able to rely on past decisions. Any constitutional distinctions between the franchise and excise taxes presented here and the use taxes contemplated in *Bellas Hess* and *Quill* are not within the purview of this court to discern. As such, we feel that the outcome of this case is governed by *Bellas Hess* and *Quill*, as those decisions interpret the first prong of the *Complete Auto* test.

The MTC sees taxpayers themselves now urging this approach to constitutional adjudication in state court systems. App. Furnitureland Reply Br. 20 in *Furnitureland South, Inv.* v. *Comptroller of Treasury*, now pending, Md. Ct. App. No. 6 (September Term 2000) (province of U.S. Supreme Court and Congress to determine meaning of "common carrier" in

Bellas Hess and *Quill* safe harbor). The Court should take this case to remind the state courts of their constitutional responsibility within our federal system to address properly raised constitutional issues.

Refusal of a state court to address properly raised constitutional issues fully and fairly is unacceptable in our federal system where the first instance of constitutional understanding pertaining to state taxes is largely reached in the state court system. 28 U.S.C. § 1341 (1994) (Tax Injunction Act). The approach of the Court of Appeals also unjustifiably results in holding the indispensable state taxing power hostage to a presumption against the state taxing power, when, if anything, the presumption should operate in the opposite direction.

No one can seriously question the competence and duty of the state courts to decide constitutional issues. *Arkansas* v. *Kansas & T. Coal Co.*, 183 U.S. 185, 190-91 (1901); *cf. Alden* v. *Maine*, 527 U.S. 706, 755 (1999) (good faith state application of Constitution implements supremacy clause). Of course in applying the Constitution, a state court must adhere to the precedent of the Supreme Court to the extent they exist. *Chesapeak & O. Ry. Co.* v. *Martin*, 283 U.S. 209, 221 (1931).

The problem with a state court abdicating the responsibility to resolve constitutional issues properly raised is that it leaves the litigants at the mercy of a default rule the court would adopt to avoid deciding the constitutional issue. In this case, abdication meant a ruling in favor of a remote bank in the absence of a precise precedent of the Court. This kind of decision-making ensures that the state tax administrators will never succeed in state courts with respect to reasonable interpretations of constitutional limitations on state taxing power in the ab-

sence of a precise and controlling precedent. But application of this kind of default rule is unwarranted and unsupportable by the jurisprudence of the Court.

In the first place, the Court long ago recognized the importance of state taxation as an element of state sovereignty in our federal system. *McCulloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316, 428-29 (1819) ("All subjects over which the sovereign power of a state extends are objects of taxation."); *Travis* v. *Yale & Towne Mfg. Cos.*, 252 U.S. 60, 75 (1920) (state may impose tax upon the incomes of nonresidents arising from any business, trade, profession, or occupation carried on within its borders).

Further, the Court has clearly established that interstate commerce is not immune from state tax and interstate commerce must pay its fair share of taxes. E.g., *Oklahoma Tax Comm'n* v. *Jefferson Lines, Inc.*, 514 U.S. 175, 184 (1995); *D.H. Holmes Co.* v. *McNamara*, 486 U.S. 24, 31 (1988). "[I]t was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of [the] state tax burden even though it increases the cost of doing business." *Commonwealth Edison Co.* v. *Montana*, 453 U.S. 609, 623 - 624 (1981); *Western Live Stock* v. *Bureau of Revenue*, 303 U.S. 250, 254 (1938).

Additionally, the Court clearly operates from the premise that the burden to establish any exemption, including exemptions based upon constitutional principles, rests on the taxpayer. *Norton Co.* v. *Dept. of Revenue*, 340 U.S. 534, 537 (1951) (limited as to other matters in *National Geographic Soc'ty* v. *California Bd. of Equalization*, 430 U.S. 551, 560 (1977)); see also, *General Motors Corp.* v. *Washington*, 377 U.S. 436, 441-42 (1964); *Container Corp. of*

America v. *Franchise Tax Bd.*, 463 U.S. 159, 175-76 (1983).

The bias that might be described as favoring state taxing power even in the face of a constitutional challenge is closely allied with the important recognition of the Supreme Court that state taxing power is an essential element of state sovereignty. *Wisconsin* v. *J.C. Penney Co.*, 311 U.S. 435, 444 (1940); *National Private Truck Council, Inc.* v. *Oklahoma Tax Comm'n*, 515 U.S. 582, 587 (1995), *quoting Dows* v. *City of Chicago*, 11 Wall. 108, 110 (1871) ("It is upon taxation that the several States chiefly rely to obtain the means to carry on their respective governments, and it is of the utmost importance to all of them that the modes adopted to enforce the taxes levied should be interfered with as little as possible.") Without the power to tax, States are left with no resources to discharge their governmental responsibility in our federal union. See *Department of Revenue* v. *ACF Industries, Inc.*, 510 U.S. 322, 345 (1994) (considerations of federalism support view that tax system not proscribed). As the *ACF Industries* further illustrates, considerations of federalism are so strong that they influence interpretation of a possible restriction based upon a congressional statute validly enacted under the Commerce Clause whose express intent is to regulate state taxing power. See also *Gregory* v. *Ashcroft*, 501 U.S. 452 (1991) (clear or plain statement rule applied).

In the face of this fundamental understanding, the MTC does not believe a state court facing a properly raised constitutional issue can avoid its responsibility to do the best it can by ruling against the state taxing power. In sum, we submit the Tennessee Court of Appeals should have been guided by the strong presumption that the Court does not

lightly undermine state taxing authority. See *Superior Oil Co.* v. *Mississippi*, 280 U.S. 390, 395 (1930).

CONCLUSION

Upon the foregoing and other arguments that have been presented to the Court, *Amicus Curiae* Multistate Tax Commission respectfully urges the Court to grant the Petition and issue a writ of certiorari to the Court of Appeals of the State of Tennessee.

Respectfully submitted,

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September 5, 2000