No. 10-1340

IN THE

Supreme Court of the United States

KFC CORPORATION,
Petitioner,

v.

IOWA DEPARTMENT OF REVENUE,
Respondent.

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

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF THE PETITIONER

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June 1, 2011

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

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INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of the petition for a writ of certiorari.[1] Tax Executives Institute

[1] Pursuant to Rule 37.6, *amicus* Tax Executives Institute, Inc. states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Pursuant to Rule 37.2(a), counsel of record for both parties received timely notice of the intent to file an *amicus* brief under this rule and both parties have consented to its submission in letters filed with the Clerk.

(hereinafter "TEI" or "the Institute") is a voluntary, nonprofit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. TEI was organized in 1944 under the laws of the State of New York and is exempt from taxation under section 501(c)(6) of the Internal Revenue Code (26 U.S.C.). The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws, reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and vindicating the Commerce Clause and other constitutional rights of all business taxpayers.

TEI has approximately 7,000 members who represent more than 3,000 of the leading corporations in the United States, Canada, Europe, and Asia, including many domiciled or doing business in the State of Iowa. Because TEI members and the companies by whom they are employed will be materially affected by the Court's disposition of the constitutional issues raised by this case, the Institute has a special interest in this matter.

The core issue in this case is whether the Commerce Clause of the United States Constitution prohibits a State from imposing its corporate income tax on businesses with no connection to the State other than having customers located there. The Iowa Supreme Court says yes, contending that taxpayers cross the Commerce Clause's jurisdictional threshold merely by licensing intangible property to unrelated persons in the State — by its so-called economic presence in the State. *Amicus* Tax Executives Institute disagrees, believing the decision below is flawed and casts an ominous shadow over the protections

accorded interstate businesses by the Commerce Clause.

This difference of view, while undesirable, is not surprising because the contours of the Commerce Clause have grown increasingly unsettled as state tax authorities and state courts have distended controlling precedent in the absence of dispositive guidance from this Court. Nearly two decades have passed since the Court last addressed the limits the Constitution imposes on the States' authority to impose tax on out-of-state businesses. Since the Court's 1992 decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), which sustained a taxpayer challenge under the Commerce Clause, States and taxpayers have been left unassisted in their efforts to interpret and apply these limits. The resulting clutter of vague and inconsistent standards has undermined the protections of the Commerce Clause.

Varying state definitions of what constitutes a taxable presence, and palpable uncertainty over their constitutional validity, are at odds with "the national interest in keeping interstate commerce free from interferences which seriously impede it." *Southern Pacific Co. v. Arizona*, 325 U.S. 761, 776 (1945). Businesses having no presence in a State other than customers now have the unenviable choice of engaging in expensive legal battles to vindicate their Commerce Clause rights or expending significant resources to comply with complex, burdensome tax systems that vary widely from State to State.

More than six decades ago, the Court recognized that, from time to time, "[t]here is a 'need for clearing up the tangled underbrush of past cases' with reference to the taxing power of the States." *North-western States Portland Cement Co. v. State of*

Minnesota, 358 U.S. 450, 457 (1959). The need for periodic judicial intervention springs from the dramatic evolution of interstate commerce, the aggressive actions of the States, and the lack of action by Congress to regulate taxation by the States. *Amicus* TEI respectfully submits that the time has come for the Court to intervene to resolve this issue of transcendent importance.

ARGUMENT

I. THE EVOLVING ECONOMY REQUIRES A CLEAR RULE IDENTIFYING THE LIMITS OF STATES' TAXING POWERS

The Court's intercession in this case is required because the U.S. economy has evolved considerably since the founding of the Republic and, indeed, since the Court's seminal decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). The Nation has moved from an agricultural and manufacturing base to one that depends increasingly on the value added by services and intangible property. What's more, advances in technology permit ever-greater amounts of services and intangibles to be delivered remotely (and electronically) through private networks or over the Internet. This trend shows no sign of abating as consumers across the country make purchases or otherwise participate in the economy through personal computers and portable devices such as smartphones, iPads, and other tablet computers.

The emergence and growth of electronic commerce is not the only area in which the economic marketplace has changed. The franchise industry, in which petitioner KFC conducts business, provides another example. Across the United States, business owners have sought to capitalize on established trademarks

and processes of nationally recognized brands to generate local business through franchise agreements. Generally, these agreements feature the licensing of trademarks, know-how, and business processes (collectively "intangible property") by the owners of that intangible property to independent business owners in exchange for a royalty. At bottom, the franchisor/franchisee relationship at issue in this case reflects arrangements common throughout the modern economy: the use by customers of intangible property for a fee.

How the Commerce Clause affects the States' ability to tax remote commerce, intangible property, and services is not a matter of idle concern. It is of transcendent importance for businesses and the States, especially given their burgeoning proportion of the overall economy. Every day, businesses across the country engage in millions of routine transactions with their customers that transcend state borders without delivery of a physical product. This involves businesses both large and small and is the inevitable consequence of the reshaping of our national and global economy — not a base effort by multistate corporate behemoths to improperly reduce their state income tax burdens.

In *Quill*, the Court confirmed that the Commerce Clause requires a taxpayer's physical presence in a State before it can impose an obligation to collect sales and use taxes. Regrettably, the States have vitiated that holding — essentially on the grounds that such a bright-line standard is irrelevant in today's world — and have instead asserted taxing authority on the basis of a taxpayer's ephemeral "economic" presence with the State. This so-called standard, however, is in reality no standard at all: It

authorizes taxation on the basis of the thinnest of reeds. It thus threatens to upend both taxpayers' reasonable expectations and the mobility of commerce that the Commerce Clause was intended to guarantee.

II. ESSENTIAL FACTS OF THE CASE: KFC'S ECONOMIC "PRESENCE" IN IOWA REFLECTS UBIQUITOUS BUSINESS ARRANGEMENTS

The taxpayer in this case, KFC Corporation (KFC), licenses its Kentucky Fried Chicken trademarks and related know-how and systems to independent franchisees operating approximately 3,400 restaurants throughout the United States, including Iowa. These independent restaurant owners enter into arm's-length agreements with KFC for the use of KFC trademarks, know-how, and business processes in exchange for a royalty payable to KFC. Under these arrangements, KFC retains the right to control the use of its trademarks and the nature and quality of the goods sold bearing those trademarks. That control is maintained by contractual provisions requiring restaurant owners to adhere to prescribed menu items; standards for advertising, marketing, and physical facilities; and to purchase equipment and supplies from approved vendors. Beyond these quality-assurance and brand protection arrangements, KFC exercises no control over the decisions or operations of the independent businesses run by local franchisees who, among other things, are responsible for complying with the applicable tax rules relating to income earned by their restaurants.

KFC maintains its headquarters in Kentucky and does not own or operate any restaurants in Iowa. It

has no employees in the State. It has no connection to the State other than the presence of its independent franchisees (*i.e.*, its customers) operating restaurants in the State utilizing KFC-owned and licensed intangible property.

The Iowa Department of Revenue assessed KFC in 2001 arguing that the use of KFC's intangible property in Iowa brought KFC within the State's taxing jurisdiction. KFC protested the assessment, but the Iowa Department of Inspections and Appeals found in favor of the Department of Revenue. KFC appealed to the circuit court and ultimately to the Iowa Supreme Court, both of which upheld the assessment on the grounds that KFC had substantial nexus in Iowa as a result of its agreements with in-state franchisees.

III. THE DANGER OF AN OPEN-ENDED NEXUS STANDARD

The Commerce Clause prohibits States from subjecting out-of-state businesses to tax absent a "substantial nexus" with the State. U.S. Const. art. I, § 8, Cl. 3; *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). "The crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for sales." *Tyler Pipe Industries, Inc. v. Washington Department of Revenue*, 483 U.S. 232, 250 (1987) (quoting the Washington Supreme Court's opinion in the same case, 715 P.2d 123, 126 (Wash. 1986)). From the 1950s through the 1980s, the Court applied this benchmark in numerous cases, regularly providing guidance to taxpayers and States on the contours of the nexus standard. *See, e.g., Northwestern States*

Portland Cement Co. v. State of Minnesota, 358 U.S. 450 (1959) (maintaining a sales force in the State created nexus); *General Motors Corp. v. Washington Department of Revenue*, 377 U.S. 436 (1964) (employee living and supervising automobile dealers in State created nexus); *Standard Pressed Steel Co. v. Washington Department of Revenue*, 419 U.S. 560 (1975) (single employee living in State and consulting with in-state customer regarding anticipated needs and requirements caused nexus); *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977) (two sales offices in State created nexus).

Although "[t]he resulting judicial application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides," *Northwestern States Portland Cement Co.*, 358 U.S. at 457, "[f]rom the quagmire there emerge . . . some firm peaks of decision which remain unquestioned." *Id.* at 458. Most notably, this Court's decisions interpreting the substantial nexus standard have without exception required *physical presence by the taxpayer in the State*. And, importantly, the Court has held that a taxpayer's physical presence must be substantial; a minimal presence simply does not meet that standard. *National Geographic Society*, 430 U.S. at 556 (rejecting the California Supreme Court's assertion that the "slightest presence" in the State created nexus).[2]

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[2] The Court reaffirmed this conclusion in *Quill*:

> Although title to "a few floppy diskettes" present in a State might constitute some minimal nexus, in *National Geographic Society* v. *California Bd. of Equalization*, 430 U.S. 551, 556 (1977), we expressly rejected a "'slightest presence'

The physical presence touchstone for States to exert their taxing authority dates to at least 1967. In that year, the Court held in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), that a sales and use tax could not constitutionally be imposed on a vendor whose only contacts with the taxing State were through the mail and by common courier. In its most recent decision addressing substantial nexus, the Court in *Quill* upheld that bright-line, physical-presence test of Commerce Clause nexus not only because such a test "furthers the ends of the dormant Commerce Clause" by "demarcati[ng] . . . a discrete realm of commercial activity that is free from interstate taxation," *id*. at 315, but because it fosters the "interest in stability and orderly development of the law" that undergirds the doctrine of *stare decisis*. *Runyon v. McCrary*, 427 U.S. 160, 190-91 (1976) (Stevens, J., concurring) (quoted in *Quill Corp.*, 504 U.S. at 315).[3] 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. *Id*. at 314.

It has been nearly two decades since the Court last considered the Commerce Clause's jurisdictional limits on state taxation of out-of-state businesses,

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> standard of constitutional nexus." We therefore conclude that Quill's licensing of software in this case does not meet the "substantial nexus" requirement of the Commerce Clause.

504 U.S. at 315 n.8.

[3] "[T]he continuing value of a bright-line rule in this area and the doctrine and principles of *stare decisis* indicate the *Bellas Hess* rule remains good law." *Quill Corp.*, 504 U.S. at 317.

despite numerous opportunities to do so.[4] In the interim, several States have either judicially, legislatively, or administratively narrowed or rejected outright *Quill*'s restriction on state power and sought to tax businesses even though they had no physical presence within the State.

In this case, the Iowa Department of Revenue asserted that the use of KFC's intangible property in Iowa — its "economic presence" in the State — imbued Iowa with authority to tax the company. *See* App. 87a.[5] The Iowa Supreme Court sustained that finding, holding that "a physical presence is not required under the dormant Commerce Clause of the United States Constitution in order for the Iowa legislature to impose an income tax on revenue earned by an out-of-state corporation arising from the use of its intangibles located within the State of Iowa." *KFC Corporation v. Iowa Department of Revenue*, 792 N.W.2d 308, 328 (Iowa 2010). While the court acknowledged the existence of a *de minimis* threshold, it left taxpayers with no real sense of the point at which a slight presence matures into

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[4] *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C.), *cert. denied*, 510 U.S. 992 (1993); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 546 U.S. 821 (2005); *Lanco, Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007); *Tax Commissioner v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006), *cert. denied*, 551 U.S. 1141 (2007); *Geoffrey, Inc. v. Commissioner of Revenue*, 899 N.E.2d 87 (Mass.), *cert. denied*, __ U.S. __, 129 S. Ct. 2853 (2009); *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76 (Mass.), *cert. denied*, __ U.S. __, 129 S. Ct. 2827 (2009).

[5] References to "App." are to the appendix filed with KFC Corporation's Petition for a Writ of Certiorari to the Supreme Court of the State of Iowa.

substantial nexus. It did note that it "would be absurd" to impose an income tax on an author who has no connection with the State other than customers who purchase the author's books, *id.* at 325, but beyond that, the guidance provided by the court was evanescent. Thus, authors may sleep a little easier as a result of that statement, but other businesses selling services or intangibles to Iowa customers wholly from locations outside the State cannot be so sanguine: They now face the prospect of either paying Iowa income tax or fighting the issue of slightest "presence" in Iowa courts.

Iowa's "economic nexus" rule effectively nullifies the Commerce Clause's limitations on state taxing power. Instead of the bright line of *Quill*, there is virtually no line at all, as the concept of "economic nexus" is invoked as a shibboleth to sidestep the restrictions of the Commerce Clause. And, regrettably, Iowa is not alone. For example, California law defines nexus as existing when a taxpayer "actively engages in any transaction for the purpose of financial or pecuniary gain or profit in California." Cal. Rev. & Tax Code § 23101(a). Other States have similarly vague (and, therefore, broad) statutory definitions of nexus. *See e.g.*, Ga. Code Ann. § 48-7-31(a) (nexus exists when a corporation "engages within this state in any activities or transactions for the purpose of financial profit or gain"); 35 Ill. Comp Stat. § 5/201(a) ("a tax measured by income on . . . [every] corporation for the privilege of earning or receiving income in . . . [the] state"); and N.H. Rev. Stat. Ann. § 77-A:1(XII) (nexus results from the "purposeful direction of business toward the state").

State departments of revenue have interpreted these amorphous legislative standards expansively,

concluding that only the most inconsequential presence is required to create nexus. Thus, the Oregon Department of Revenue promulgated a regulation in May 2008 stating that "[s]ubstantial nexus exists where a taxpayer regularly takes advantage of Oregon's economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in the state." Oregon Administrative Code § 150-317.010(2). *See also, e.g.*, Florida Department of Revenue, Technical Assistance Advisement 07C1-007 (October 17, 2008) ("physical presence . . . [is] not required to impose Florida's corporate income tax"); Maine Revenue Services, Tax Alert, Vol. 18, Issue 2 (February 2008) ("[t]he State Tax Assessor construes Maine law to assert the tax jurisdiction of Maine to the full extent permitted by the Constitution and laws of the United States"); and Michigan Revenue Administration Bulletin 2008-4 (October 21, 2008) (substantial nexus includes economic nexus). The Iowa Department of Revenue itself issued a ruling in 2008 that strains even the broadest reading of this Court's guidance when it ruled that an out-of-state corporation had nexus with the State solely as a result of licensing software to customers in Iowa. *See* Iowa Department of Revenue, Policy Letter 08240032 (May 14, 2008).

In the absence of guidance from the Court, "there is little wonder that there has been no end of cases testing out state tax levies." *Northwestern States Portland Cement Co.*, 358 U.S. at 457. Indeed, the resulting void has emboldened States to distend this Court's holdings and, in effect, abrogate taxpayers' Commerce Clause rights. As a result, multistate taxpayers must weigh the costs of acceding to unreasonable assertions of taxing authority against

the costs and uncertainty of challenging overzealous States in prolonged legal battles.[6]

IV. THE COMPLIANCE BURDENS SPAWNED BY AN EXPANSIVE ECONOMIC NEXUS RULE WOULD CREATE AN "UNREASONABLE CLOG UPON THE MOBILITY OF COMMERCE"

Iowa's broad economic nexus standard prefigures a massive expansion of taxpayers' obligations to comply with burdensome state tax filing obligations. Businesses that receive income from others' use of their intangible property (such as trademarks) would have to monitor where that property was used, determine what part of the income derived from each use was attributable to which jurisdiction, research the tax consequences of such use in each jurisdiction, and then undertake to comply with applicable filing and payment requirements. They would likely have to revise their licensing agreements, change their accounting systems to capture much more information, and set in place procedures to ensure compliance with myriad filing and reporting requirements. Thus, the burdens spawned by the broad standard are not imaginary or remote; they are real and profuse. None of these tasks would be easy, and none would be inexpensive.[7] The burden of

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[6] "In a Union of 50 States, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation." *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 777-78 (1992).

[7] Additionally, publicly traded corporations must record a liability on their financial statements for income tax positions that are not supported by authority rising to a "more likely than not" level of assurance. Financial Accounting Standards Board,

uncertainty, compounded by the cost of compliance efforts, could not help but act as an "unreasonable clog upon the mobility of commerce." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935).

These very concerns with administrative costs and burdens informed the Court's decision in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967). There the Court explained that permitting the imposition of a use tax collection duty on a business that maintained no physical presence in the State would give rise to "unjustifiable local entanglements" of interstate commerce. *Id*. at 760. The Court reasoned that the administrative and recordkeeping requirements that would arise in the absence of a physical presence test "could entangle National [Bellas Hess's] interstate business in a virtual welter of complicated obligations to local jurisdictions . . . ." *Id.* at 759-60.

While the Iowa Supreme Court acknowledged that the Commerce Clause prevents states from overburdening the conduct of interstate business, it asserted that the burdens of complying with sales and use taxes far exceed those associated with the state corporate income tax. 792 N.W.2d at 325. To be sure, the burden of complying with sales and use tax rules in "the Nation's 6,000-plus taxing jurisdictions," *Quill Corp.*, 504 U.S. at 313 n.6, is

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Financial Accounting Series, No. 281-B, *FASB Interpretation No. 48–Accounting for Uncertainty in Income Taxes* (2006) (codified at ASC 740-10). FIN 48 was issued by the Financial Accounting Standards Board in July 2006 and is generally effective for fiscal years beginning after December 15, 2006. These requirements force publicly traded companies to address directly the consequences of this uncertainty in the preparation of their financial statements.

significant. Multistate taxpayers, however, also labor under weighty corporate income and franchise tax compliance burdens. Indeed, a 2002 study concluded that State income tax compliance costs are approximately double the costs of the federal burden,[8] in large measure because of differences among the States. "[S]tates differ in their reporting and filing procedures that determine which corporations must file a return, which related entities file together or separately, due dates for filing and paying taxes, and acceptance of federal extensions."[9]

More recently, States have pushed corporate taxpayers to file detailed forms with their returns adding to the compliance burden on multistate businesses. For example, since January 1, 2004, Tennessee has required taxpayers to separately disclose all amounts paid to affiliated companies for the use of intangible property in their corporate income tax returns. Failure to comply with this requirement results in a penalty of 50 percent of any related understatement. Tenn. Code Ann. § 67-1-804(b)(2). Taxpayers filing corporate income tax returns in California must file state-specific schedules disclosing the calculation of capital gains, differences between book income and taxable income, depreciation, and deductions for dividends. California Form 100 (Corporation Franchise or Income Tax Return) (2010). In addition, States have moved toward compelling taxpayers to disclose tax positions deemed to be "uncertain" with their corporate income

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[8] Sanjay Gupta & Lillian Mills, *How Do Differences in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, 56 National Tax Journal 355-71 (June 2003).

[9] *Id* at 358.

tax returns.[10] This growing wave of reporting requirements, which shows no signs of abating, significantly burdens businesses across the country.

Moreover, the burdens on interstate commerce spawned by an excessively loose nexus standard extend beyond state-level income taxes. Many States have empowered cities and other localities to impose income and gross receipts taxes on business, greatly expanding the jurisdictions where a nexus determination is relevant. For years, municipalities in Michigan and Ohio have administered income taxes separate from the state-level business taxes, as has New York City. *See, e.g.*, City of Lansing, Michigan, Municipal Ordinances, pt. 8, title 4, § 882.01; Columbus, Ohio, City Codes ch. 361; NYC Admin. Code § 11-601. Also, businesses with a taxable presence in certain counties and cities must pay a gross receipts tax based on revenue with a situs in that locality. *See e.g.*, Fairfax, Virginia, County Ordinances § 4-7.2;[11] Los Angeles, California, Municipal Code ch. II, art. 1; Philadelphia, Pennsylvania,

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[10] Effective for tax years beginning January 1, 2010, large corporate taxpayers must report all uncertain tax positions to the Internal Revenue Service on Schedule UTP (Uncertain Tax Position Statement). California's Franchise Tax Board requires a copy of the federal Schedule UTP to be included with taxpayers' California corporate income tax filings. *See* Instructions, California Form 100 (California Franchise or Income Tax Return Booklet) (2010), at 3. The Multistate Tax Commission, a compact of numerous States, held a meeting on March 3, 2011, for personnel from state departments of revenue around the country that included an information session summarizing experience at the federal level with establishing Schedule UTP.

[11] Localities in Virginia may impose a tax on a business' gross receipts or taxable income. Va. Code Ann. § 58.1-3702.

Code title 19, § 2600; and Seattle, Washington, Municipal Code title 5, ch. 5.45.

The decisions of state courts blithely assume that compliance with these complicated and varying laws can be effected by the flip of a computer switch. Although modern technology can facilitate compliance, it does not make it free, easy, or automatic. Businesses must purchase computer software, hire personnel to ensure its maintenance, and establish procedures for capturing data that may not even exist in the ordinary course of conducting business. Even then, compliance with many state — or local — income tax rules cannot be reduced to the level of automated computerized processing. Certainly, these burdens could be tempered if States and local jurisdictions could agree on a single set of definitions, exemptions, and rates, but there is absolutely nothing to suggest any agreement will be soon forthcoming. The "virtual welter of complicated obligations to local jurisdictions," *National Bellas Hess*, 386 U.S. at 760, has not abated but, rather, has intensified. It remains a matter of constitutional significance and cannot be ignored.

CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of certiorari and reverse the decision below.

Respectfully submitted,

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June 1, 2011