No. ________

In The
Supreme Court of the United States

STAPLES, INC., AND STAPLES THE OFFICE SUPERSTORE, INC., PETITIONERS

v.

MARYLAND COMPTROLLER OF THE TREASURY

ON PETITION FOR A WRIT OF CERTIORARI TO THE MARYLAND COURT OF SPECIAL APPEALS

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

When an out-of-State business receives royalty fees, franchise fees, or similar payments from in-State businesses, may a State imposing income taxes constitutionally apportion such income to itself based on the activities of only the in-State businesses?

PARTIES TO THE PROCEEDINGS

Pursuant to Rules 14.1 and 29.6, petitioners state the following:

The parties to the proceeding are listed in the caption.

Staples, Inc. is a wholly owned subsidiary of Arch Parent, Inc., which is a wholly owned subsidiary of Arch Parent Holdings, Inc. Arch Parent Holdings, Inc. is majority owned by Arch Superco, Inc. No publicly traded corporation owns 10% or more of Arch Parent Holdings, Inc. Arch Superco, Inc. is not a publicly traded company. It has no parent corporation and no publicly held corporation owns 10% or more of its stock.

Staples the Office Superstore, Inc. is now known as Staples the Office Superstore LLC. Staples the Office Superstore LLC is a wholly owned subsidiary of Office Superstore West LLC. Office Superstore West LLC is a wholly owned subsidiary of Office Superstore East LLC. Office Superstore East LLC is a wholly owned subsidiary of USR Parent, Inc. USR Parent, Inc. is a wholly owned subsidiary of USR Intermediary, Inc. USR Intermediary, Inc. is a wholly owned subsidiary of USR Topco Holdings, Inc. USR Topco Holdings, Inc. is a wholly owned subsidiary of USR Superco, Inc. USR Superco, Inc. is not a publicly traded company. It has no parent corporation and no publicly held corporation owns 10% or more of its stock.

STATEMENT OF RELATED PROCEEDINGS

Staples, Inc. and Staples the Office Superstore, Inc. v. Comptroller of the Treasury, Nos. 09-IN-OO-0148, 09-IN-OO-0149, Maryland Tax Court. Judgment entered May 28, 2015.

In the Matter of Staples, Inc. et al., No. C-02-CV-15-002009, Anne Arundel County Circuit Court. Judgment entered January 10, 2017.

Staples, Inc. et al. v. Comptroller of the Treasury, No. 2597, Maryland Court of Special Appeals. Judgment entered August 9, 2018. Amended judgment entered November 16, 2018.

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PETITION FOR A WRIT OF CERTIORARI

Staples, Inc. ("Staples") and Staples the Office Superstore, Inc. ("Superstore") respectfully petition for a writ of certiorari to review the judgment of the Maryland Court of Special Appeals.

OPINIONS BELOW

The opinion of the Maryland Court of Special Appeals (App., *infra*, 1a-38a) is unreported but available at 2018 Md. App. LEXIS 785. The opinion of the Circuit Court for Anne Arundel County (App., *infra*, 39a-54a) is unreported. The opinion of the Maryland Tax Court (App., *infra*, 55a-63a) is unreported but available at 2015 Md. Tax LEXIS 6.

JURISDICTION

The Court of Special Appeals entered judgment on August 9, 2018. Staples and Superstore timely filed a motion for reconsideration and the Court of Special Appeals issued a revised opinion on November 16, 2018. Staples' and Superstore's timely petition for a writ of certiorari to the Maryland Court of Appeals was denied on February 22, 2019. App., *infra*, 93a. On May 13, 2019, Chief Justice Roberts extended the time to file a petition for a writ of certiorari until June 21, 2019. On June 7, 2019, Chief Justice Roberts granted a second extension until July 22, 2019. This Court has jurisdiction under 28 U.S.C. § 1257(a).

CONSTITUTIONAL PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const., art. I, § 8, cl. 3, provides: "[T]he Congress shall have Power * * * [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

The Fourteenth Amendment's Due Process Clause, U.S. Const., amend. XIV, § 1, provides: "No State shall * * * deprive any person of life, liberty, or property, without due process of law * * * ."

INTRODUCTION

This case concerns the scope of a State's power to impose taxes on the income of an interstate business that has no meaningful operations in the State. Specifically, if an out-of-State business receives franchise-fee, royalty, or similar payments from an in-State entity, may the State constitutionally treat these payments as income earned by the out-of-State business within the State? The States' highest courts are sharply divided on the issue, which implicates hundreds of millions of dollars in tax revenues and creates uncertainty for thousands of businesses nationwide.

Some courts have held that States cannot impose income taxes on business that simply receive royalty or similar income related to another entity's business in the State. These courts have recognized that the Due Process and Commerce Clauses prohibit States from attempting to tax the value a business has created outside the State's jurisdiction.

Other courts, however, have adopted an erroneously permissive view of the States' authority over interstate commerce. These courts have held that out-of-State entities' mere receipt of royalties from businesses within the State is in-State activity that the State may constitutionally tax.

Maryland—the State that imposed the particular taxes at issue here—has adopted an especially aggressive version of the latter view. With the approval of the Maryland Court of Appeals, Maryland taxing authorities have applied a non-statutory apportionment formula that treats *all* royalty and similar payments as earned in the States in which the entities making those payments operate. The State has imposed this novel formula on over a thousand out-of-State businesses that would not otherwise be subject to Maryland's corporate income tax.

The present case illustrates the distortions that this sort of overreach produces. Petitioners Staples and Superstore conduct no meaningful business within Maryland. But based entirely on the operations of their affiliates—separate corporate entities that had already fully paid any income taxes to the State—Maryland imposed millions of dollars of tax liability upon Staples and Superstore. Even accepting the premise that Staples and Superstore could be subject to some Maryland income tax, Maryland's non-statutory formula overstates their taxable income by a factor of 20.

This Court's review is needed to resolve this split of authority and ensure that States do not continue to expand their revenue bases beyond constitutional limits. Without this Court's guidance, businesses will continue to confront a tangle of conflicting State laws—an intolerable situation given the paramount need for certainty in this area. And if left to stand, decisions like the one below will encourage States to seek innovative new ways to tax out-of-State businesses—which generally lack the same political power as in-State businesses to resist such increased obligations. This Court should grant the petition to clarify that State taxing authorities cannot venture beyond State boundaries in the way Maryland has here.

STATEMENT

A. Constitutional Framework

The Due Process Clause and the Commerce Clause impose "distinct but parallel limitations on a State's power to tax out-of-state activities." *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Department of Revenue*, 553 U.S. 16, 24 (2008). These limitations reflect the essential requirement of both Clauses that there be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2093 (2018) (quotation marks omitted); *see Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777 (1992). Accordingly, a State may not "tax income arising out of interstate activities * * * unless there is a minimal connection or nexus between the interstate activities and the taxing States, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 165-66 (1983) (internal quotation marks omitted); *see Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). In other words, "a State may not tax value earned outside its borders." *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982).

When a business enterprise transcends state lines, issues arise concerning the fair apportionment of its income. Consistent with the Uniform Division of Income for Tax Purposes Act, many States have adopted a three-factor formula that equally weighs the proportion of the interstate business's property, payroll, and sales that is within the taxing State. *See Container Corp.*, 463 U.S. at 170. If, for example, a business has 20 percent of its property in a given State, 30 percent of its payroll in that State, and 40 percent of its sales there, the three-factor formula would permit the State to tax 30 percent of the business's total income (the sum of these three proportions divided by three). *See* Uniform Act §§ 9, 10, 13, 15. This three-factor formula rests on the understanding that "payroll, property, and sales appear in combination to reflect a very large share of the activities *by which value is generated*" and thus indicate where a business's income may be fairly considered to have been earned. *Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358, 381 (1991) (quotation marks omitted).

Because this formula generally accounts for the sources of income, it has become "something of a benchmark against which other apportionment formulas are judged." *Container Corp.*, 463 U.S. at 170. This Court has occasionally approved States' deviations from the three-factor formula. *E.g.*, *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978). But it has cautioned that "[s]ome methods of formula apportionment are particularly problematic because they focus on only a small part of the spectrum of activities by which value is generated." *Container Corp.*, 463 U.S. at 182. And it has emphasized that where a taxpayer can show "by clear and cogent evidence that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted in that State,' or has 'led to a grossly distorted result,'" the apportionment formula is unconstitutional. *Moorman Mfg. Co.*, 437 U.S. at 274 (quoting *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931), and *Norfolk & Western R. Co. v. Missouri State Tax Comm'n*, 390 U.S. 317, 326 (1968), internal citations and alterations omitted).

B. Factual Background

1. The Staples entities

Staples was founded in 1985, and it opened its first office superstore in Brighton, Massachusetts in 1986. CSA Record E.266. Its corporate headquarters and much of its operations were (and remain) in Massachusetts. CSA Record E.266.

In 1996, Staples announced a merger with Office Depot. CSA Record E.267. As part of the anticipated merger, Staples developed a plan to reorganize its corporate structure. CSA Record E.268. Although the merger ultimately fell through, Staples still decided to proceed with the planned reorganization, which it implemented in 1998. CSA Record E.268.

The reorganization led to four separate corporate entities: Staples, Superstore, Staples the Office Superstore East, Inc. ("East"), and Staples Contract & Commercial, Inc. ("C&C"). CSA Record E.269. Staples was the parent company; Superstore and C&C were its wholly owned subsidiaries; and East was a wholly owned subsidiary of Superstore. CSA Record E.269. Each of these four operating companies had a distinct role.

Staples provided a variety of managerial and administrative services to its subsidiaries, including marketing support, strategic planning, and legal, financial, and accounting services. CSA Record E.270. Superstore, East, and C&C paid Staples fees for its provision of these services. CSA Record E.278. Staples also coordinated a cash management system, allowing its subsidiaries to borrow funds (with interest) when they had negative account balances. CSA Record E.279-80. To support these operations, Staples owned more than $100 million in real property, and it paid employee compensation ranging between $55 million and $105 million annually during the years in question. CSA Record E.277-78.

Superstore operated the Staples franchise system. It owned and managed Staples' trademarks and other intellectual property. CSA Record E.273. It also developed the marketing schemes for the Staples-brand retail stores, conducted the advertising campaigns, negotiated merchandizing agreements with various vendors, and oversaw the construction and remodeling of retail stores. CSA Record E.273-75. Superstore operated its own retail stores (none of which was in Maryland). CSA Record E.275-76. It also provided its franchise system to East and C&C, which paid it royalties in return (a franchise fee of 4.5 percent of net monthly income for East, and 3.5 percent for C&C). CSA Record E.275-76. Like Staples, Superstore was based in Massachusetts. CSA Record E.271. During the years in question, it owned more than $150 million in real property and paid between $100 and $225 million in employee compensation annually. CSA Record E.272-73.

East operated distribution centers and retail stores selling office supplies and equipment. CSA Record E.271. It conducted this business in a number of States, including Maryland. CSA Record E.271.

C&C operated a catalog business selling office supplies and equipment, as well as a contract stationer business and a large-customer sales business. CSA Record E.272. Like East, it conducted this business in Maryland, among other States. CSA Record E.272.

2. The Staples entities' Maryland tax returns

Because of their operations in Maryland, both East and C&C filed Maryland corporate income tax returns for the years 1998 through 2003. CSA Record E.264. At that time, Maryland used a three-factor apportionment formula similar to that set forth in the Uniform Act (though the State did not weigh the factors equally, providing twice the weight to the sales factor). App., *infra*, 88a-89a; *see* Md. Tax-General Code § 10-402(c)(1) (2005). When this formula was applied to their property, payroll, and sales, between 6.5 and 9 percent of East's income was apportioned to Maryland, while slightly under 2 percent of C&C's income was apportioned to Maryland. CSA Record E.425, E.434, E.444, E.458, E.478, E.484, E.486, E.488, E.490, E.498, E.515. East and C&C paid any Maryland income taxes due on their apportioned incomes. *E.g.*, CSA Record E.426, E.435.

Because neither Staples nor Superstore generally conducted any business in Maryland, neither initially filed tax returns in Maryland. CSA Record E.264. Indeed, because neither Staples nor Superstore had any property, product sales, or personnel based in Maryland, none of their income would be attributed to the State under Maryland's standard three-factor apportionment formula. App., *infra*, 84a; 70a.

3. The Comptroller's determination

During an audit of East and C&C, Maryland officials took note of the interest and franchise-fee payments these entities had made to Staples and

Superstore. App., *infra*, 66a. Because these payments were legitimate costs of business, both East and C&C had deducted them when calculating their total taxable incomes. App., *infra*, 66a-67a.

The Maryland Comptroller, however, decided that it would treat these interest and franchise-fee payments as income earned by Staples and Superstore in Maryland. In doing so, it relied on *Comptroller of the Treasury v. SYL, Inc.*, 825 A.2d 399 (Md. 2003). App., *infra*, 70a-72a. There, the Maryland Court of Appeals held that simply by licensing intellectual property for use in the State, out-of-State corporations establish a sufficient nexus with Maryland that the State can constitutionally tax their royalty income. *SYL*, 825 A.2d at 416-17 (citing *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13, 16 (S.C. 1993)).

Under Maryland's three-factor formula, however, *none* of Staples' or Superstore's income could be attributed to the State because Staples and Superstore had no meaningful operations there. The Comptroller was thus forced to adopt an alternative formula to impose any tax liability. App., *infra*, 91a; CSA Record E.299.

The Comptroller's formula focused entirely on *East and C&C's* activities—not those of Staples or Superstore, the entities actually being taxed. App., *infra*, 67a; CSA Record E.264-65. Specifically, the Comptroller first took the total amount of interest and franchise fees Staples and Superstore received from East and C&C. It then multiplied that sum by a "blended apportionment factor" calculated by combining East and C&C's individual apportionment factors (that is, the proportions derived by applying the three-factor formula to East and C&C's property, payroll, and sales) in proportion to the total amount of interest and franchise fees each of these two entities had paid to Staples and Superstore. App., *infra*, 24a. So if, for example, 9 percent of East's income was apportioned to Maryland in 1998, the Comptroller treated 9 percent of the franchise fees that East paid to Superstore in that year as Superstore's taxable Maryland income. As a State auditor later testified, the Comptroller had applied this non-statutory apportionment formula in "over a thousand" other cases in which out-of-State corporations would not otherwise be subject to Maryland tax. CSA Record E.213.

This methodology reflected two critical underlying assumptions. *First*, Maryland's formula deemed all income Staples and Superstore received related to East and C&C as earned in those States in which East and C&C operated—not in those States where Staples and Superstore actually operated. To take a simple example: if East had operated exclusively in Maryland and made all its retail sales there, the Comptroller would attribute to Maryland *all* of Superstore's franchise-fee income from East even if Superstore had performed all the work related to the franchise system that generated this income in Massachusetts. *Second* and relatedly, by treating all franchise-fee and interest payments as *income* and not just revenue, the Comptroller effectively deemed everything Staples and

Superstore had done to earn these payments as entirely costless.[1]

All told, the Comptroller ordered Superstore to pay the State more than $12 million in taxes and interest. App., *infra*, 66a. It assessed Staples' liability at nearly $450,000. App., *infra*, 80a. It also imposed penalties of more than $1.6 million combined. App., *infra*, 66a; App., *infra*, 80a.

C. Procedural History

1. Tax court proceedings

a. Both Staples and Superstore filed petitions of appeal in the Maryland Tax Court. During discovery, Staples and Superstore determined that certain of their employees had visited Maryland during the years at issue. CSA Record E.264; E.274. For that reason, both entities acknowledged they had a sufficient nexus with Maryland such that they could constitutionally be subject to *some* State income tax (*e.g.*, corresponding to income related to these visits), and they accordingly filed Maryland corporate tax returns. CSA Record E.264. Both companies maintained, however, that the franchise fees and interest they received from East and C&C could not be treated as Maryland income, and they asserted that the Comptroller's apportionment

[1] Although the Maryland Court of Special Appeals later claimed that Staples and Superstore had not provided any evidence of expenses (App. *infra*, 33a), both Superstore and Staples had proffered their federal income tax returns—which delineated all of the expenses these entities incurred—as well as specific information related to their operating costs. *E.g.*, CSA Record E.643; E.781-942.

formula bore no relation to their business in the State and was therefore unconstitutional.

Staples and Superstore supported these contentions with the report and testimony of Dr. Brian Cody. The parties stipulated that Dr. Cody was qualified to testify as an expert in economics. CSA Record E.281. As he explained, "income for tax purposes" is generally "attributed to the locations of the firm's economically substantive functions and assets"—which here would all be outside of Maryland. CSA Record E.1734-37.

Dr. Cody used a comparison to two alternative benchmarks to illustrate the degree to which the Comptroller's apportionment formula distorted Staples' and Superstore's Maryland income. *First*, he addressed what the tax liability of all four of the Staples entities would have been had they simply been treated as one corporate entity rather than four separate entities—a calculation performed by combining the income of all four entities, multiplying it by the three-factor apportionment figure derived from these entities' total sales, payroll, and property, and then applying the Maryland tax rate. CSA Record E.157; Pet's Tax Court Br. 33. This analysis revealed that for the tax year ending in 2003, for example, the consolidated entities would have been entitled to a *refund* of slightly more than $8,000, rather than the additional $1.05 million in liability the Comptroller had imposed. Pet's Tax Court Br. 34. All told, the Comptroller's formula transformed what would have been approximately $310,000 in total tax liability into $6.5

million—a distortion of over 2,000 percent. CSA Record E.157.

Second, Dr. Cody reached a similar result with a "market sourcing" benchmark. To perform this calculation, Dr. Cody accepted the Comptroller's assignment to Maryland of the interest and franchise fees that East and C&C paid to Staples and Superstore. Pet's Tax Court Br. 31-32. He then calculated a sales-based apportionment factor by comparing this supposed Maryland revenue to Staples' and Superstore's total receipts nationwide.[2] Pet's Tax Court Br. 31-32; CSA Record E.155. Under this methodology, Staples' and Superstore's total tax liability would have been only around $750,000—meaning the Comptroller's method had produced an increase in liability of over 850 percent. CSA Record E.157.

b. The tax court rejected Staples' and Superstore's constitutional objections. It explained that in *Gore Enterprise Holdings, Inc. v. Comptroller of the Treasury*, 87 A.3d 1263 (Md. 2014), the Maryland Court of Appeals had since "sanctioned the constitutionality, propriety, and fairness" of applying this very apportionment formula to royalty and similar payments. App., *infra*, 60a. It dismissed Dr. Cody's use of the "consolidated entity" benchmark, apparently (and erroneously) believing that it somehow turned on a comparison to Staples' tax liability before 1998. App.,

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[2] Because this approach disregarded Staples' and Superstore's substantial payroll and property outside the State, it actually tended to overstate any Maryland income. CSA Record E.155.

infra, 62a. The court did not address Dr. Cody's "market sourcing" benchmark at all. Recognizing, however, that Staples and Superstore "had a reasonable basis for challenging the law and acted in good faith," the court abated all penalties the Comptroller had imposed. App., *infra*, 63a.

2. Appellate proceedings

a. The Maryland Circuit Court affirmed the tax court's conclusion that the Comptroller's assessment did not contravene the federal Constitution. It reasoned that a "Maryland retailer's use of its out-of-state affiliate's intangible assets generally produces income for the out-of-state affiliate, which income is taxable in Maryland." App., *infra*, 44a (citing *SYL*, 825 A.2d 399). And it agreed with the tax court's conclusion that, consistent with *Gore Enterprise Holdings*, the Comptroller's apportionment formula had not "produced a disproportionate, distorted, arbitrary, or unreasonable tax liability." App., *infra*, 49a.

b. The Maryland Court of Special Appeals affirmed. Relying on *Gore Enterprise Holdings*, the court concluded that " 'the Comptroller's apportionment formula captured Staples East's and Staples C&C's expenses in Maryland—expenses that simultaneously constituted income' for Staples, Inc. and Superstore." App., *infra*, 29a-30a (quoting *Gore Enterprise Holdings*, 87 A.3d at 1287, alterations omitted). It thus held that " 'the formula reflects a reasonable sense of how Staples, Inc.'s and Superstore's income is generated,' and 'passes constitutional muster.' " App., *infra*, 30a (quoting *Gore Enterprise Holdings*, 87 A.3d at 1287, alterations and some quotation marks omitted).

Like the tax court, the Court of Special Appeals addressed Dr. Cody's testimony in only cursory fashion. It erroneously characterized his "consolidated entity" benchmark as being premised on some sort of temporal comparison, and it ignored the "market sourcing" benchmark entirely. App., *infra*, 33a-34a. Instead, the Court of Special Appeals concluded C&C's and East's allocation of "their activities among the states [in which] they conducted business" was sufficient to "ma[k]e clear to the Comptroller" how much of Staples' and Superstore's supposed income could be "properly attributed to the State." App., *infra*, 34a. In other words, *all* of Staples' and Superstore's interest and franchise-fee income could be attributed to States, like Maryland, in which their affiliates made sales.

c. The Maryland Court of Appeals denied Staples' and Superstore's petition for a writ of certiorari. App., *infra*, 93a.

REASONS FOR GRANTING THE PETITION

I. STATE COURTS ARE IN CONFLICT ON WHETHER STATES CAN CONSTITUTIONALLY TAX OUT-OF-STATE ENTITIES' INCOME

Maryland's highest court has firmly established the critical premise on which the decision below rests: royalty or similar payments made to an out-of-State entity establish a nexus between that entity and the

State and can be treated as income earned in-State. *SYL*, 825 A.2d at 416-17; *Gore*, 87 A.3d at 1287.[3] In reaching this conclusion, the Maryland Court of Appeals has followed a line of State-court authority that started with the South Carolina Supreme Court's decision in *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (1993). These courts have all adopted an expansive view of States' power to tax out-of-State entities.

By contrast, other States' highest courts have rejected the premise that the mere receipt of royalty or similar payments establishes the requisite nexus with the State from which those payments originate. Under the reasoning of this line of authority, the payments that Staples and Superstore received from East and C&C would only have been taxable in Maryland to the extent of Staples' and Superstore's minimal in-State operations. These payments certainly would not be treated as earned *entirely* where East and C&C operated. The Court should take this opportunity to resolve this entrenched conflict.

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[3] Although the decision below is unpublished, this Court has regularly granted certiorari to review unpublished decisions that, as here, rely upon and apply binding authority setting forth the relevant legal principle. *E.g.*, *Nieves v. Bartlett*, 139 S. Ct. 1715, 1721-22 (2019); *Mont v. United States*, 139 S. Ct. 1826, 1831-32 (2019); *Byrd v. United States*, 138 S. Ct. 1518, 1525 (2018); *Oil States Energy Servs., LLC v. Greene's Energy Grp., LLC*, 138 S. Ct. 1365, 1372 (2018); *Manuel v. City of Joliet*, 137 S. Ct. 911, 916-17 (2017); *Beckles v. United States*, 137 S. Ct. 886, 891-92 (2017); *Riley v. California*, 573 U.S. 373, 378 (2014).

A. Multiple State Courts Have Held That States Cannot Tax Out-Of-State Entities' Royalty Income

1. The decisions of the Maryland courts cannot be reconciled with that of the West Virginia Supreme Court of Appeals in *Griffith v. ConAgra Brands, Inc.*, 728 S.E.2d 74 (W.Va. 2012). There, the court held that both the Due Process and Commerce Clauses prohibit States from taxing out-of-State entities solely on the basis that they receive licensing and royalty fees from in-State entities. *Id.* at 84.

In *ConAgra*, a national food-products company that held the rights to brand names such as Butterball and Healthy Choice had created a wholly owned subsidiary—ConAgra Brands—to manage, oversee, and protect its intellectual property. *Id.* at 76. ConAgra Brands then executed licensing agreements with a variety of third-party and affiliated companies, including a number of licensees that made millions of dollars of sales in West Virginia. *Id.* at 76-77. Much like Maryland here, the West Virginia tax authorities sought to impose the State's corporate income and business franchise taxes on the royalty payments ConAgra Brands had received from its West Virginia licensees. *Id.* at 77.

The West Virginia Supreme Court of Appeals held that the Constitution precludes such overreach. The court emphasized that ConAgra Brands' operations—that is, where it had "paid all expenses in defending its trademarks and trade names against infringement and in overseeing national marketing by developing marketing strategies and purchasing advertisements with national media outlets"—were located entirely outside the State. *Id.* at 81-82. The court thus held that the corporation lacked a "significant economic presence" in West Virginia. *Id.* The court acknowledged that there were "many" decisions from other state courts that "suggest that the assessments in the matter now to be determined would be upheld." *Id.* at 83-84 (discussing *Geoffrey*, 437 S.E.2d 13, and *KFC Corp. v. Iowa Dep't of Revenue*, 792 N.W.2d 308 (Iowa 2010)). But the court nevertheless held that an out-of-State licensor could not be subject to tax on the basis of its licensees' activities in the State. *Id.* at 84.

2. The Oklahoma Supreme Court reached the same conclusion in *Scioto Ins. Co. v. Oklahoma Tax Comm'n*, 279 P.3d 782 (Okla. 2012). There, Oklahoma sought to tax the royalty payments a Vermont corporation received from licensing the rights and operating practices to Wendy's restaurants through its affiliate Wendy's International, which then contracted with franchisees in Oklahoma. *Id.* at 783. The Oklahoma Supreme Court recognized that the "use of the intellectual property by individual Wendy's restaurants in Oklahoma has several taxable consequences"—including, for example, the generation of taxable sales made by those franchisees in the State and the payment of employment-based taxes related to Oklahoma workers. *Id.* But the court held the State could not tax royalty payments made to an entity that did not engage in any of its own operations in Oklahoma. *Id.* at 784.

Instead, the court held, "due process is offended by Oklahoma's attempt to tax an out of state corporation that has no contact with Oklahoma other than receiving payments from an Oklahoma taxpayer (Wendy's International) who has a bona fide obligation to do so under a contract not made in Oklahoma." *Id.* In language directly applicable to the facts of this case, the court continued: "The fact that the Oklahoma taxpayer can deduct such payments in determining the Oklahoma taxpayer's income tax liability is not justification to chase such payments across state lines and tax them in the hands of a party who has no connection to the State of Oklahoma." *Id.*[4]

B. Other State Courts Have Held That Royalty Payments May Be Deemed Earned Where Ultimate Sales Are Completed

1. As the present case demonstrates, Maryland courts reject this limited understanding of States' taxing authority. The Maryland Court of Appeals first

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[4] Other state courts have reached the same constitutional holding in similar factual circumstances. *See Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. Ct. App. 2000); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999). Unlike the high courts of West Virginia and Oklahoma, these courts grounded their decisions in the "physical presence" requirement then set forth in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). *See Rylander*, 18 S.W.3d at 299-300; *J.C. Penney Nat'l Bank*, 19 S.W.3d at 839-42. These courts have not revisited the issue since this Court overruled this aspect of *Quill*. *See Wayfair*, 138 S. Ct. at 2099. The Missouri Supreme Court has also reached the same result as the West Virginia and Oklahoma high courts as a matter of state law. *See Acme Royalty Co. v. Dir. of Revenue*, 96 S.W.3d 72, 75 (Mo. 2002) (en banc) ("[I]n order for the Appellants to be liable for taxes in Missouri, *they* must have had some activity: property, payroll, or sales, in the State of Missouri.").

charted that course in *SYL*, which involved the State's effort to tax two separate out-of-State corporations that, in exchange for royalty payments, had licensed their intellectual property to retailers in States including Maryland. 825 A.2d at 401, 408. Both corporations "did not own or lease tangible property in Maryland, had no employees in Maryland, and maintained no bank accounts in Maryland." *Id.* Nevertheless, the court held that "a portion" of these out-of-State corporations' incomes attributed to the retailers' "Maryland business[ ]" could be "subject to Maryland income tax." *Id.* at 417.

The Maryland Court of Appeals expanded on this reasoning in *Gore Enterprise Holdings*, approving the same apportionment formula that the Comptroller applied to Staples and Superstore here. 87 A.3d at 1284-89; *see* App., *infra*, 29a-30a. The *Gore* court again confronted the circumstance in which an out-of-State corporation had licensed its intellectual property to an entity operating within Maryland. 87 A.3d at 1267. The court reiterated that Maryland could constitutionally impose its income tax on such out-of-State corporations, and it went on to conclude that *all* of the royalty payments corresponding to Maryland could be treated as "income" in Maryland. *Id.* at 1287; *accord* App., *infra*, 30a (applying *Gore*).

The Maryland Court of Special Appeals further entrenched this position in *ConAgra Foods RDM, Inc. v. Comptroller of the Treasury*, ___ A. 3d ___, 2019 WL 2703119 (Md. Ct. Spec. App., June 27, 2019). There, the Court of Special Appeals confronted Maryland's attempt to impose its income tax on ConAgra Brands—the very same corporation that prevailed in the West Virginia *ConAgra Brands* decision. 728 S.E.2d 74. As was true in West Virginia, ConAgra Brands has no operations of its own in Maryland. *ConAgra Foods*, 2019 WL 2703119 at *10-11, 17. Nevertheless, the Maryland court applied *SYL* and *Gore* to reject the very same constitutional arguments accepted by the West Virginia Supreme Court, holding that ConAgra Brands could be subject to tax simply because its affiliates operated in Maryland and it received royalty and other income from those entities. *Id.* at *17.

2. In adopting this permissive reading of the Due Process and Commerce Clauses, the Maryland Court of Appeals has relied in large part on the South Carolina Supreme Court's decision in *Geoffrey, Inc. v. South Carolina Tax Commission*. *See SYL*, 825 A.2d at 401. The taxpayer in *Geoffrey* was the owner of a number of trademarks and brand names, including "Toys R Us." 437 S.E.2d at 15. Toys R Us, the taxpayer's parent company, operated retail stores throughout the county, paying a royalty of one percent of net sales for the uses of these trademarks. *Id.*

The South Carolina Supreme Court rejected both Due Process and Commerce Clause challenges to the State's effort to tax the receipt of these royalty payments. On the Due Process Clause, the Court reasoned that the out-of-State corporation had, through its licensing, "directed its activity" at South Carolina, and that the "real source" of its income was "South Carolina's Toys R Us customers." *Id.* at 16, 18. As for the Commerce Clause, the court declared that the supposed "presence" of the corporation's intellectual property in South Carolina was enough to create a "substantial nexus" with the State. *Id.* at 18.

3. Like the Maryland Court of Appeals, a number of other States' high courts have accepted *Geoffrey*'s reasoning—and in doing so reached results directly contrary to those reached by the West Virginia and Oklahoma high courts. Thus, in *KFC Corp. v. Iowa Dep't of Revenue*, the Iowa Supreme Court (while recognizing that *Geoffrey* had been "criticized as cursory and conclusory") held that the State could impose its corporate income tax on KFC Corporation based on KFC's licensing its franchise system to independent franchisees in Iowa. 792 N.W.2d at 310, 321, 328. The court reached that conclusion even though KFC itself had no property or employees in the State. *Id.* In *Geoffrey, Inc. v. Comm'r of Revenue*, the Massachusetts Supreme Court reached the same conclusion, again with respect to the owner of the Toys R Us trademark. 899 N.E.2d 87, 95 (Mass. 2009). And in *Lanco, Inc. v. Director, Div. of Taxation*, the New Jersey Supreme Court agreed that New Jersey could impose its corporate income tax even where "the corporation lacks physical presence in New Jersey but derives income through a licensing agreement with a company conducting retail operations in New Jersey." 908 A.2d 176, 176-77 (N.J. 2006); *see also*, *e.g.*, *Bridges v. Geoffrey, Inc.*, 984 So.2d 115, 128 (La. Ct. App. 2008) (upholding tax on royalty income earned by out-of-State entity); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004) (same).

*   *   *

The split now involves a large number of state appellate courts and shows no signs of abating. This Court should grant review here to resolve it.

II. THIS CASE IS A GOOD VEHICLE TO ADDRESS THE QUESTION PRESENTED

This case presents an ideal vehicle for this Court to resolve this division of authority. Indeed, even if the decision below did not implicate any split, review would still be warranted given how far beyond constitutional limits Maryland—with the approval of its highest court—has extended its taxing authority. Not only has Maryland declared that it may tax out-of-State entities based on their licensing and similar income related to entities that operate in-State, but it has adopted an apportionment formula that effectively declares that *all* such income should be taxed by the State where those separate entities operate. And it has sought to apply this revenue-enhancing formula to "over a *thousand*" out-of-State businesses. CSA Record E.213 (emphasis added); *see also*, *e.g.*, *ConAgra Foods*, 2019 WL 2703119 at *18-22 (affirming application of this same formula). Here, as elsewhere, application of that formula has produced distortions that plainly exceed constitutional bounds. This Court should use this opportunity to make clear that such efforts by State taxing authorities to arrogate to themselves the proceeds of interstate commerce are unconstitutional.

A. Maryland's Apportionment Formula Is Necessarily Unconstitutional

Maryland's apportionment formula cannot withstand constitutional scrutiny. As recounted above (*supra* pp. 4-6), States' power to tax interstate income is limited by the requirement that there be "a rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Container Corp.*, 463 U.S. at 165-66 (quotation marks omitted). Thus, an apportionment formula must account for the "activities by which value is generated," assigning to a given State only the income that could reasonably be said to arise from the productive activities within that State. *Id.* at 182.

Yet the formula the Maryland Comptroller has applied in this (and many other) cases—which treats all royalty and similar income as earned in the State in which ultimate sales are made—produces results that have little or no correlation with the actual business activities that Maryland might reasonably seek to tax. That is because the formula does not even account for the operations of the corporations on which the tax is actually imposed (here, Staples and Superstore). Instead, Maryland double-counts the in-State operations of *other* corporations (here, East and C&C) that have already paid their income-tax liability to the State.

The distortive effect of Maryland's taxing scheme can be illustrated by considering the typical franchise relationship. Franchisees (like East) generate value by operating retail stores and making sales to consumers. That value may be taxed in the States in which the franchisees operate. Franchisors (like Superstore) generate value by creating the franchise system that franchisees implement and maintaining intellectual property rights. The price at which the franchisor sells those rights to franchisees (*i.e.*, the franchise fee) reflects the value of the franchisor's efforts. If all of the franchisor's efforts are concentrated in a given State, its income should be apportioned to that State: that is where it has actually created the value for which it is being compensated. *See* CSA Record E.1733-34. The decisions in *ConAgra* and *Scioto* (*supra* pp. 18-20) reflect this straightforward economic reasoning.

Under Maryland's alternative formula, however, *none* of the franchisor's income will be apportioned in this manner; rather, its income will be attributed entirely to the State or States in which the *franchisees* operate. Indeed, unless the franchisor also happens to have franchisees in the State in which it is headquartered, Maryland would not attribute *any* of the franchisor's income to the State in which it actually created and maintained the rights that generate that income. Effectively, Maryland treats the franchisees' operations as creating *both* the value associated with making retail sales *and* the value of the franchise system actually created elsewhere by the franchisor. It has empowered itself to tax both.

Such a duplicative formula cannot possibly approximate a fair assessment of "the activities by which value is generated" by each taxpayer. *Trinova*, 498 U.S.

at 381 (emphasis omitted); *see Target Brands v. Dep't of Revenue of Colo.*, 2017 Colo. Dist. LEXIS 1305, at *113 (D. Colo., Dnvr. County, Jan. 30, 2017) (recognizing, under state law, that a formula focused entirely on the operations of a taxpayer's affiliate cannot produce "an equitable allocation and apportionment" of the taxpayer's income). Rather, Maryland's apportionment "constitutes impermissible taxation of income outside its jurisdictional reach." *Hunt-Wesson, Inc. v. Franchise Tax Bd. of Cal.*, 528 U.S. 458, 468 (2000).

Maryland's taxation scheme also discriminates against interstate commerce. That is because it fails what this Court has called the "internal consistency" test, which asks whether interstate commerce would be subject to duplicative taxation if every State applied the challenged tax structure. *Comptroller of the Treasury v. Wynne*, 135 S. Ct. 1787, 1802 (2015) (holding that Maryland's scheme for taxing the incomes of both residents and non-residents was impermissibly discriminatory). Maryland's approach would have that prohibited effect. In contrast to its treatment of out-of-State businesses, Maryland apportioned the total income of businesses based in-State (income which would include the receipt of franchise fees and royalties) by a three-factor apportionment formula that included property and payroll (*i.e.*, the inputs used to create the franchise system). *See* App., *infra*, 20a-21a. Thus, for in-State entities, Maryland deemed the *creation* of the franchise system, and not just the ultimate sales by franchisees, to have generated taxable income. If every State took Maryland's approach—taxing the creation of a franchise system if it took place in Maryland, but taxing the ultimate sales associated with that system if created out-of-State—interstate businesses would be taxed twice on the same income and thus put at a constitutionally impermissible "disadvantage." *Wynne*, 135 S. Ct. at 1803.

The State should not be permitted to continue to employ such a facially unconstitutional tax scheme.

B. Application Of Maryland's Formula Has Had An Unconstitutional Impact Here

Maryland's apportionment formula has created such constitutionally prohibited distortions here. There is no question that neither Superstore nor Staples had any meaningful operations within Maryland. As the parties have stipulated, neither entity owned any property in Maryland, sold any products there, nor—aside from a few occasional visits—employed anyone in the State. CSA Record E.272; E.277. There is likewise no question that Superstore and Staples *did* have substantial operations outside of Maryland. Again, as the parties have stipulated, both entities owned a great deal of property and employed a substantial number of people—all outside of Maryland. CSA Record E.277-78; E.272-73.

Even just these stipulated facts suffice to demonstrate that the income Maryland has attributed to itself is necessarily "out of all appropriate proportions to the business transacted in that State." *Container Corp.*, 463 U.S. at 170 (quotation marks omitted). Staples and Superstore are not shell companies, but entities that perform significant, productive work. That work generates the value reflected in the interest and franchise-fee payments they have received. Because these productive activities are performed *outside* Maryland (where the personnel and property required to perform such work are located), the value they generate cannot be apportioned to Maryland.[5] In nevertheless seeking to tax this income, the State has transgressed constitutional limits. *Id.*

That conclusion becomes inescapable when Dr. Cody's alternative benchmarks are considered. Dr. Cody's analysis demonstrates that, even accepting the State's premise that Staples and Superstore earned some revenue attributable to Maryland, a full accounting of their operations (as opposed to the State's myopic focus on the operations of East and C&C alone) would produce an exponentially lower tax bill. Indeed, the State's formula resulted in a 2,000 percent increase compared to what Staples' and Superstore's liability would have been had they simply been treated as a single combined entity with East and C&C, and more than an 850 percent increase compared to what their liability would have been had these franchise-fee and interest payments been treated as sales attributable to Maryland consumers. CSA Record E.157. This Court has held that an apportionment method that overstated a taxpayer's in-State income

[5] The formula at issue bears no relation to the Maryland visits by Staples and Superstore employees—visits that provided the only nexus that could conceivably permit the State to impose *some* tax on those entities.

by over 250 percent was "beyond the state's authority." *Hans Rees' Sons*, 283 U.S. at 128, 134, 136. The distortion here far exceeds any constitutional threshold.

Tellingly, none of the courts below was able to muster any meaningful response to any of this evidence. Although the Court of Special Appeals emphasized the interdependence of Staples, Superstore, C&C, and East, it did not and could not deny that Superstore and Staples engaged in real, income-producing activities outside the State. App., *infra*, 14a-15a. With respect to Dr. Cody's alternative benchmarks, the courts were able to offer up only the peculiar assertion that his consolidated-entity "opinion was premised on the assumption that Staples operated as a single entity prior to 1998"—something that was manifestly not true, and in any event not at all responsive to Dr. Cody's separate market-sourcing benchmark. App., *infra*, 33a (quotation marks omitted). This case thus presents a clean factual record on which this Court can address the constitutionality of such a method of apportionment.

III. THE ISSUE IS IMPORTANT AND WARRANTS THIS COURT'S REVIEW

This important constitutional question merits this Court's attention. As the Court has recognized, "[i]n 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*, 504 U.S. at 777-78. The Maryland apportionment formula applied in this case is a particularly egregious example of a State's stretching its taxing power beyond its own boundaries. But the line of state-court authority on which the Maryland Court of Appeals has relied in affirming Maryland's exercise of that power evinces the same expansive view. In this respect, Maryland's approach may be different in degree, but it is not different in kind from that used in other States. This Court's intervention is needed to ensure that States do not transgress this basic premise of our constitutional system.

Without this Court's guidance, State taxing authorities can be expected to push further and further beyond constitutional and territorial bounds. Indeed, States have every incentive to increase the scope of their taxing authority, lest they lose out in revenue to other States more willing to test constitutional limits. And State taxing authorities are particularly prone to direct their attention at out-of-State businesses, which are far less likely to have any political voice in the taxing State. Such efforts to target foreign businesses may only be further encouraged by this Court's removal of the artificial—but nevertheless restraining—"physical presence" requirement, which until recently might have tempered some States' more adventuresome exercises of taxing power. *See Wayfair*, 138 S. Ct. 2080; *supra*, p. 20, n. 4.

The problems created by States' reaching beyond their own borders are only further compounded by businesses' inability to predict how States might attempt to exercise such authority. States are often reluctant to divulge the precise details of whether and how they will tax out-of-State businesses. *See* Joseph Bishop-Henchman, *The History of Internet Sales Taxes from 1789 to the Present Day:* South Dakota v. Wayfair, 2018 CATO SUP. CT. REV. 269, 290-91 (2008) (noting that in Bloomberg Tax's recent survey of state tax departments, four declined to say what would constitute a tax nexus with the State, seven "said their answers cannot be relied upon as guidance by taxpayers," and "[t]he remaining states provide a variety of bewildering and mostly inconsistent rules"). Here, of course, Maryland's chosen apportionment formula has been applied to more than a thousand taxpayers, but it is not embodied in any statute or regulation—rather, it is something the Comptroller has devised and applied on a case-by-case basis. It is no wonder that the relative costs of complying with state income taxes are already double those of complying with the federal income-tax regime. *See* Sanjay Gupta & Lillian Mills, *Does Disconformity in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, 56 NAT'L TAX J. 355, 357 (2003). These costs will only increase if States continue to seek innovative new ways to tax out-of-State businesses.

The importance of this issue—and the degree to which States' attempts to expand their tax bases may threaten the orderly relations among the States—is illustrated by a recent action Arizona filed against California. *See Arizona v. California*, No. 22O150. Invoking this Court's original jurisdiction and pressing constitutional claims paralleling those advanced by Staples and Superstore here, Arizona challenges

California's imposition of its "doing business" tax on entities that do not themselves have any operations in California, but have invested in LLCs that conduct business there. *See* Arizona Bill of Complaint 2, *Arizona v. California*, No. 22O150 (Feb. 28, 2019) (citing *Wayfair*, 138 S. Ct. 2080, and *Complete Auto Transit*, 430 U.S. 274). This Court recently called for the views of the Solicitor General in that case. *See Arizona v. California*, __ S. Ct. __, 2019 WL 2570637, *1 (June 24, 2019). Although the Court should grant the petition for certiorari here regardless of what happens in the *Arizona v. California* proceedings, it should at the very least hold this petition pending resolution of that parallel case.

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Tax laws "can give no quarter to uncertainty." *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 543 (1979). This Court should grant this petition to make clear that States cannot reach beyond their boundaries to tax the value created in other States.

CONCLUSION

The petition for a writ of certiorari should be granted or, in the alternative, should be held for *Arizona v. California*, No. 22O150.

Respectfully submitted,

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