No. 19-119

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

REPLY BRIEF FOR PETITIONERS

CRAIG B. FIELDS
NICOLE L. JOHNSON
MORRISON & FOERSTER LLP
250 West 55th St.
New York, NY 10019

JAMES R. SIGEL
MORRISON & FOERSTER LLP
425 Market St.
San Francisco, CA 94105

JOSEPH R. PALMORE
Counsel of Record
MORRISON & FOERSTER LLP
2000 Pennsylvania Ave., N.W.
Washington, D.C. 20006
(202) 887-6940
JPalmore@mofo.com

Counsel for Petitioners

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COCKLE LEGAL BRIEFS (800) 225-6964
WWW.COCKLELEGALBRIEFS.COM

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REPLY BRIEF FOR PETITIONERS

Despite Maryland's attempts to complicate matters, this is a simple case. The Due Process and Commerce Clauses forbid States from taxing "value earned outside [their] borders." *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982). Yet Maryland applies an apportionment formula that attributes royalty and similar income received by an out-of-State franchisor (or similar entity) as earned entirely in the States (like Maryland) in which its *franchisee* operates. Pet. App. 88a-89a. Maryland does so by apportioning the franchisor's income based on the property, payroll, and sales of the franchisee—rather than the property, payroll, and sales of the taxpaying franchisor itself (as would the traditional apportionment formulas this Court has held fairly reflect the means "by which value is generated"). *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 381 (1991) (quotation marks and emphasis omitted). Maryland has applied this approach in "over a thousand" cases involving out-of-State enterprises. CSA Record E.213. The legal question is straightforward: does this formula reflect "a rational relationship between the income attributed to the State and the intrastate values of the enterprise," as the Constitution requires? *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 165-66 (1983).

Maryland's highest court has answered that question with a resounding yes. *Gore Enterprise Holdings, Inc. v. Comptroller of Treasury*, 87 A.3d 1263, 1286-87 (Md. 2014). Other State high courts, however, have held that a State cannot tax a franchisor based solely on a franchisee's in-State operations. *See Griffith v. ConAgra Brands, Inc.*, 728 S.E.2d 74, 81-82 (W.Va. 2012); *Scioto Ins. Co. v. Oklahoma Tax Comm'n*, 279 P.3d 782, 783 (Okla. 2012). Under the logic of these decisions, Maryland's apportionment formula must fall—its very premise is that a franchisor earns income, and is subject to tax, entirely in the State in which its franchisee operates. Only this Court can resolve that conflict.

In its opposition, Maryland denies little of this. After briefly (and unsuccessfully) attempting to reconcile the Maryland courts' decisions with those of the West Virginia and Oklahoma high courts, the State engages in a lengthy discussion of the merits. BIO 14-26. While it raises a host of factual and legal contentions, most are beside the point. Disputes about the taxes Staples paid before the years at issue here, for example, or assertions that Staples and its subsidiaries are a "unitary business enterprise," have nothing to do with the constitutionality of Maryland's apportionment formula. BIO 15-16, 19-20. And Maryland makes little effort to show that any of these supposed issues render this case an inadequate vehicle to address the legal question presented.

The critical facts are undisputed. Although the State is notably reluctant to discuss the non-statutory apportionment formula its taxing authorities have applied in hundreds of cases, it does not deny the formula's content or effect. As it eventually acknowledges, Maryland effectively treated the Maryland deductions East and C&C claimed for their royalty and similar payments to Staples and Superstore as Staples' and Superstore's in-State income—thus deeming that income earned in Maryland. BIO 17. And as Maryland cannot deny, the parties stipulated that both Staples and Superstore have substantial operations—all based *outside* Maryland. BIO App. 15a-16a, 21a-22a. Ultimately, Maryland's argument boils down to the contention that, notwithstanding the disconnect between the focus of its apportionment formula and taxpayers' actual economic activities, its approach "reflect[s] a reasonable sense of how petitioners' income is generated." BIO 17. Whether that assertion is correct is the question presented. Maryland's fervent belief that the Maryland courts are right is no reason for this Court to deny review of this important issue.

ARGUMENT

I. STATE COURTS ARE IN CONFLICT ON THE TREATMENT OF ROYALTY AND SIMILAR PAYMENTS

State courts are sharply divided over how to treat royalty and similar payments made by an entity in the taxing State to one outside it. As Staples and Superstore explained (Pet. 20-23), the Maryland Court of Appeals has joined courts in South Carolina, Iowa, Massachusetts, New Jersey, Louisiana, and North Carolina in holding that the receipt of such payments constitutes economic activity within the State that the State may constitutionally tax as income. The high courts of West Virginia and Oklahoma, by contrast, have correctly recognized that such payments reflect the value generated by the recipient outside the State, and thus cannot create the requisite nexus with the taxing State. *ConAgra*, 728 S.E.2d at 81-82; *Scioto*, 279 P.3d at 783; *see* Pet. 18-20.

Maryland's cursory effort to reconcile these decisions comes up short. Maryland devotes most of its discussion of *ConAgra* to explaining that the West Virginia Supreme Court of Appeals has held that taxpayers need not have a "physical presence" in the State, but only an "economic presence." BIO 11-12; *see* *ConAgra*, 728 S.E.2d at 81-82. That is both entirely true and entirely irrelevant: the conflict here concerns what sorts of activities will satisfy this "economic presence" requirement. On that question, Maryland asserts in conclusory fashion that, "based on the facts," the *ConAgra* court held that ConAgra Brands "did not purposefully direct its business or otherwise have a significant economic presence in West Virginia." BIO 12. Yet the "facts" in *ConAgra* provide Maryland no support (which is presumably why it does not actually discuss them). ConAgra Brands had licensed its trademarks for use in West Virginia, where a number of its affiliates made sales, and it received royalty payments in exchange. *ConAgra*, 728 S.E.2d at 80. While the Maryland Court of Appeals has held that such facts are alone sufficient to establish a taxpayer's economic presence (and that the royalty payments may be treated as in-State income), *Gore*, 87 A.3d at 1267, 1287, the West Virginia Supreme Court rejected the very same proposition, *ConAgra*, 728 S.E.2d at 84-85.

Any doubts on that score are resolved by *ConAgra Foods RDM, Inc. v. Comptroller of Treasury*, 211 A.3d 611 (Md. Ct. Spec. App. 2019). There, the Maryland court confronted the very same entity, ConAgra Brands, which had the same licensing agreements with affiliates in Maryland as it had in West Virginia. *Id.* at 617-18. Applying *Gore*, the Maryland court held that these relationships with in-State entities gave ConAgra Brands an economic presence that justified Maryland's taxation of its royalty income. *Id.* at 637. Here, the State insists that, unlike the West Virginia case, the Maryland case involved "substantial evidence of the company's economic presence in Maryland." BIO 12 n.5. That was indeed the Maryland court's conclusion. But what facts could distinguish the Maryland *ConAgra* decision from the West Virginia *ConAgra* decision? Maryland does not and cannot say.

Maryland's arguments on the Oklahoma Supreme Court's *Scioto* decision are equally unavailing. In *Scioto*, again, the out-of-State entity received royalty payments from entities operating within Oklahoma, and the Oklahoma Supreme Court held that this receipt did not constitute taxable in-State economic activity. 279 P.3d at 784.

Maryland's brief describes the facts of *Scioto* (BIO 12-14), but it identifies no legally relevant distinction. It is true, for instance, that Staples and Superstore have conceded they have a nexus with Maryland that would permit the State to impose *some* tax on them (BIO 12-13)—but that is because of their isolated employee visits in Maryland, not their receipt of royalty and similar payments from Maryland entities. CSA Record E.264. The relevant question here is whether the receipt of such payments can be treated as Maryland economic activity; *Scioto* holds it cannot. 279 P.3d at 784.

Similarly, Maryland argues that in *Scioto*, the taxpayer had "not been formed to avoid state income taxes" and had a legitimate purpose and assets outside the State. BIO 13. But Staples and Superstore are likewise not "shell entit[ies]," and their agreements with their affiliates are not "sham obligations[ ]"—as their substantial operations outside of Maryland demonstrate. *Scioto*, 279 P.3d at 783-84; *see* Pet. 7-8 (discussing revenue and employees of both entities). Perhaps the *Scioto* taxpayer "had no say on where a Wendy's restaurant business was located." BIO 13. But the *Scioto* court nowhere relied on this lack of restaurant-siting power. Instead, it held that the mere fact in-State affiliates could claim deductions for their royalty payments to out-of-State taxpayers was "no[ ] justification to chase such payments across state lines." *Scioto*, 279 P.3d at 784. Maryland cannot explain why this reasoning is not equally applicable here.

II. MARYLAND'S APPORTIONMENT FORMULA IS UNCONSTITUTIONAL

As Staples and Superstore have also shown, Maryland's non-statutory apportionment formula is plainly unconstitutional. Pet. 24-28. An apportionment formula must account for "the activities by which value is generated." *Container Corp.*, 463 U.S. at 183.

Yet Maryland's formula ignores these activities entirely. It treats as irrelevant the assets, personnel, and effort needed to *create* the value reflected in royalty and similar payments, and instead deems the only relevant economic activity to occur in the States in which the entities making those payments operate. Pet. App. 24a. Even though both Staples and Superstore had millions in assets and hundreds of employees outside Maryland devoted to creating the franchise and cash-management systems for which East and C&C compensated them (BIO App. 15a-16a, 21a-22a), the State simply treated as Maryland income *all* payments received from East and C&C in Maryland. BIO 17. The Constitution forbids a State from extending its taxing authority over out-of-State businesses in this fashion. *Container Corp.*, 463 U.S. at 170.

Maryland responds to this straightforward contention with a smattering of largely inapposite arguments. BIO 14-26. Because all go to the merits (to the extent they are relevant at all), extended discussion is unnecessary. But to eliminate any confusion Maryland's opposition may have created, each of these issues is addressed briefly below.

Unitary business. Maryland repeatedly asserts that Staples and its affiliates "were part of a unitary business." BIO 14. That does nothing to advance its case. Under the "unitary business" doctrine, a State may "tax an *apportioned* sum of [a] corporation's multistate business." *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dep't of Revenue*, 553 U.S. 16, 25 (2008) (emphasis added, quotation marks omitted). Generally, that is accomplished by calculating the taxpayer's federal taxable income and then apportioning it by some measure of the taxpayer's activity (*e.g.*, payroll, property, and sales) in each State. *Container Corp.*, 463 U.S. at 170; *see ConAgra Foods RDM*, 211 A.3d at 637. Maryland did not take that approach here. The question is whether its alternative formula "actually reflect[s] a reasonable sense of how income is generated." *Container Corp.*, 463 U.S. at 170. The relevant test is exactly the same for unitary and non-unitary businesses. *Ibid.*

Evidence of costs. Maryland insists Staples and Superstore were required to produce evidence of their specific costs corresponding to their receipt of Maryland-based payments from East and C&C. BIO 8 n.4, 17-18. In fact, Staples and Superstore did produce evidence of such costs, showing that any actual *income* was far less than the total revenue they received from these two entities. *See* Pet. 12 n.1. But regardless, Maryland's refusal to consider that evidence is an issue entirely separate from the constitutionality of the State's apportionment formula. Even assuming Maryland was correct to treat this revenue as taxable income, that does not mean it could then treat the *entirety* of that income as taxable where East and C&C operate. To the extent Petitioners bore any burden, it was not to demonstrate exactly what their tax liability should have been given the State's (erroneous) assumptions, but instead simply to show that " 'there is no rational relationship between the income attributed to the State and the intrastate value of the enterprise.'" *Container Corp.*, 463 U.S. at 180 (quoting *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 220 (1980)).

Alternative benchmarks. Maryland claims Petitioners' economic benchmarks were not "evidence" that Maryland's formula produced disproportionate results, just "alternative apportionment formulas." BIO 21. Even ignoring these benchmarks, the stipulated facts (including evidence of Staples' and Superstore's operations outside Maryland) were more than sufficient to demonstrate that Maryland's formula did not fairly measure Staples' and Superstore's in-State economic activity. BIO App. 15a-16a, 21a-22a. Regardless, these sorts of benchmarks are precisely the sort of evidence on which this Court has long relied in evaluating the constitutionality of State assessments. *See Hans Rees' Sons v. State of North Carolina ex rel. Maxwell*, 283 U.S. 123, 134-36 (1931). If (as here), disregarding the corporate structure of the entities involved and simply apportioning their total taxable income by their combined activities would result in total tax liability 20 times lower than that generated by the State's apportionment formula, something is presumably wrong with that formula. CSA Record E.157; *contra* BIO 21-22.

Dr. Cody. Maryland attacks Dr. Cody, the expert who explained these benchmarks, for purportedly misunderstanding how Staples operated before 1998. BIO 23-24. Yet nothing Dr. Cody said turned on Staples' pre-1998 taxes or structure. Maryland seizes on a stray comment Dr. Cody made during his live testimony, in which he explained it was relevant to consider "[i]f there had been no restructuring at all." CSA Record E.152. As Dr. Cody's discussion of this benchmark clarified, he simply meant that it was instructive to compare the liability Maryland imposed on the recently-restructured Staples entities with what the total liability would have been if their corporate structures were disregarded. CSA Record E.157. And even if Dr. Cody's testimony were disregarded, Staples and Superstore outlined these benchmark calculations in their brief. Pet.'s Tax Court Br. 33-34. This was not an issue on which expert testimony was necessary. The record contained all of the Staples entities' federal and Maryland tax returns. *E.g.*, CSA Record E.643. Calculating their total tax liability under Maryland's statutory apportionment formula is a matter of simple arithmetic.

Pre-1998 taxes. Maryland claims that a Staples affiliate's pre-1998 Maryland taxes were a "credible benchmark" and that Petitioners' taxes during the years at issue here were not significantly higher. BIO 19-20. But as Maryland admits, "[d]uring that [pre-1998] period, the Comptroller made assessments using the same apportionment formula as employed in this case." BIO 19. Any similarity is thus unsurprising. Comparisons of tax liability from various years in which the State used the same formula do nothing to demonstrate the formula is constitutionally sound.

Forfeiture of internal inconsistency. Maryland claims Petitioners forfeited the contention that

Maryland's apportionment formula fails the internal-consistency test. BIO 25. But the need for "internal consistency" is simply a subsidiary aspect of the requirement that "an apportionment formula must, under both the Due Process and Commerce Clauses, be fair." *Container Corp.*, 463 U.S. at 169. At every stage of this litigation, Staples and Superstore have argued that Maryland's formula is unfair and violates the Due Process and Commerce Clauses, thus preserving the issue. Pet.'s Tax Court Br. 35-36; Pet.'s Circuit Court Br. 32-33; Pet.'s CSA Br. 32-33; Pet.'s CA Cert. Pet. 13; *see Yee v. Escondido*, 503 U.S. 519, 534 (1992) ("Once a federal claim is properly presented, a party can make any argument in support of that claim; parties are not limited to the precise arguments they made below."). Petitioners had little need or ability to further elaborate on this contention once the Maryland Court of Appeals expressly held that the challenged formula is internally consistent. *Gore*, 87 A.3d at 1286.

Merits of internal inconsistency. Maryland contends there is no "evidence in the record" that its formula violates the internal-consistency test, again because Staples and Superstore purportedly failed to produce certain specific information about their costs. BIO 25-26. Maryland appears to misunderstand the test—even though it has recent first-hand experience with it. *Comptroller of the Treasury v. Wynne*, 135 S. Ct. 1787 (2015) (holding Maryland's personal income tax flunked internal-consistency test). The internal-consistency test "looks to the structure of the tax at issue to see whether its identical application by every

State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate." *Id.* at 1802 (quotation marks omitted). The only "evidence" needed is of the State's tax structure. That evidence is present here: Maryland applied its non-statutory formula to Staples and Superstore (and over a thousand similarly situated businesses) and a more traditional three-factor formula to businesses based in-State. Pet. App. 24a-25a, 88a-89a; CSA Record E.213. The effect of this two-tiered approach is to discriminate against interstate commerce. If every State taxed in-State businesses based on *their* activities, but out-of-State businesses based on their *franchisees'* activities, then every business based in one State with franchisees in another would have some portion of its income taxed twice. *See Wynne*, 135 S. Ct. at 1803. Maryland's apportionment formula is thus unconstitutional.

III. THE QUESTION PRESENTED IS IMPORTANT AND MERITS THIS COURT'S REVIEW

Maryland makes no effort to deny the importance of the question presented.[1] Pet. 30-33. It could not: whether States may stretch their taxing authority beyond their borders in this fashion is a question of critical importance to businesses nationwide, one implicating fundamental principles of our federal system. Absent this Court's intervention, States will

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[1] Nor does it dispute that this petition is related to *Arizona v. California*, No. 22O150, and at the very least should be held pending disposition of that case. *See* Pet. 32-33.

push even further past the constitutional limits on their powers, and taxpayers will suffer the uncertainty and duplicative taxation that results. Certiorari should be granted.

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,

JOSEPH R. PALMORE
Counsel of Record
MORRISON & FOERSTER LLP
2000 Pennsylvania Ave., N.W.
Washington, D.C. 20006
(202) 887-6940
JPalmore@mofo.com

CRAIG B. FIELDS
NICOLE L. JOHNSON
MORRISON & FOERSTER LLP
250 West 55th St.
New York, NY 10019

JAMES R. SIGEL
MORRISON & FOERSTER LLP
425 Market St.
San Francisco, CA 94105

Counsel for Petitioners

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