IN THE WEST VIRGINIA SUPREME COURT OF APPEALS

MBNA America Bank, N.A.,
Petitioner,

v. No. 33049

West Virginia State Tax Commissioner,
Respondent.

BRIEF OF MBNA AMERICA BANK, N.A.

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PRELIMINARY STATEMENT

In reversing the thorough and well-reasoned decision of the Office of Tax Appeals, the Circuit Court below has issued against MBNA America Bank, N.A. ("MBNA") arguably the most radical and far-reaching decision issued by any state court on the issue of state tax jurisdiction. That decision condoned the action of the State in (1) casting its jurisdictional net far more widely than the Commerce Clause of the United States Constitution allows and (2) apportioning MBNA's income and capital to the State in a way that reaches profits that are not reasonably attributable to MBNA's in-state commercial activity. In so doing – and thereby sustaining the West Virginia State Tax Commissioner's denial of MBNA's claims for refund of West Virginia taxes – the Circuit Court decision flouts both the Constitution and sound tax policy.

The Circuit Court determined that an out-of-state corporation can be subject to West Virginia taxes on its income and capital simply because some of its customers – with whom it dealt from afar – were located in the state and because West Virginia educates its citizens and provides a court system that is potentially available to outsiders. There exists no U.S. Supreme Court precedent that supports such an audacious extension of a state's jurisdictional reach. The Circuit Court does not, nor could it, point to a specific substantial nexus between MBNA and West Virginia because none exists.

A finding of substantial nexus under the Commerce Clause must be based on the ***in-state activity and physical presence of the putative taxpayer***, not of its customers, whose activities are irrelevant to the inquiry. Furthermore, the mere availability of a state's court system and an educated populace are not sufficient to satisfy even the less exacting Due Process Clause "minimum connection" requirement for exercising judicial jurisdiction over a nonresident corporation, and these certainly are not sufficient to satisfy the much more demanding Commerce Clause "substantial nexus" requirement that is unequivocally required for tax jurisdiction.

In this case, MBNA had no substantial nexus with West Virginia. It had no physical presence in the state – no employees, no property and no assets. Instead, MBNA earned all of its income and capital in Delaware where it deployed all of its labor and capital; MBNA paid tax on 100% of its income and capital to Delaware.

Among the many flaws in the Circuit Court's opinion, the most glaring is that it incorrectly confuses two separate and independent Commerce Clause requirements for the exercise of state taxing jurisdiction, and in so doing, assumes them both away. Well before the U.S. Supreme Court distilled decades of constitutional jurisprudence into the oft-cited four-pronged test of its *Complete Auto Transit v. Brady* decision, it had been established law that the dormant Commerce Clause requires both a "substantial nexus" between the taxpayer and the State, and a "fair relationship" between the taxes imposed and the governmental services provided by the State to the taxpayer. In its decision below, the Circuit Court held that the substantial nexus requirement had been met because it found that the "fairly related" requirement had been satisfied through West Virginia's provision of the minimum benefits of a civilized society – educating potential customers and providing courts for potential business disputes. These two of *Complete Auto*'s four prongs are analytically separate and distinct. The "fairly related" requirement cannot be a proxy for the "substantial nexus" requirement; both are mandated under the U.S. Supreme Court's dormant Commerce Clause jurisprudence, and both must be specific to the corporation at issue. The facts here demonstrate that, whether or not the "fairly related" requirement may have been satisfied, the "substantial nexus" requirement was not.

The Circuit Court also incorrectly substitutes the "market exploitation" standard of the Due Process "minimum contacts" nexus requirement for the "physical presence" standard of the more exacting Commerce Clause "substantial nexus" requirement. While the U.S. Supreme Court has not had the opportunity to explicitly articulate an in-state physical presence requirement for satisfying the Commerce Clause substantial nexus requirement for corporate income and franchise tax jurisdiction, the Court has expressly held that substantial nexus is required before any type of tax may be imposed on an out-of-state corporation. Rather than rigorously analyzing the slim connections between MBNA and West Virginia and finding them inadequate to satisfy the Constitution's demanding "substantial nexus" requirement, the Circuit Court instead employs the less stringent Due Process "minimum contacts" requirement, summarily noting the existence of in-state customers and the benefits MBNA purportedly received or that are available from West Virginia. By employing the less stringent Due Process requirement, the Circuit Court simply – and unconstitutionally – exports the tax burden to nonresident businesses with the thinnest of justifications. That decision must be reversed.

Having erroneously determined that West Virginia possesses jurisdiction to tax MBNA, the Circuit Court proceeded erroneously to determine that West Virginia's formula for apportioning the bank's net income and capital to the State was valid, even though that formula improperly allows income and capital to be apportioned to a state where MBNA deployed none of its labor or capital.

The in-state activity of MBNA's customers – in contrast to MBNA's own (non-existent) in-state activity – is no more relevant to apportionment than it is to nexus; the inquiry must focus primarily (if not exclusively) on what MBNA itself does to earn its income and capital, and where it does it.

West Virginia had no jurisdiction to tax MBNA, which had no income or capital properly apportionable to the state in any event. The decision of the Circuit Court below must be reversed.

NATURE OF PROCEEDING AND RULINGS BELOW

This proceeding was brought by MBNA to recover a refund of the West Virginia Business Franchise Tax and Corporate Net Income Tax that it paid for tax years 1998 and 1999, on the grounds that the Commerce Clause of the United States Constitution and the statutes themselves bar their imposition. For each of these years, MBNA paid the tax required by the Commissioner and then filed a refund claim for each year and each tax. Following the Commissioner's denial of the refund claims, MBNA filed a protest with the Office of Tax Appeals raising two legal issues: (1) whether the Commissioner possesses the constitutional and statutory power to impose any amount of tax on MBNA and (2) if so, whether a single-factor receipts-based apportionment formula with "special" sourcing rules may be constitutionally applied to MBNA's West Virginia tax base.

Following a briefing and argument on stipulated facts, the Chief Administrative Law Judge of the Office of Tax Appeals determined that both the statutes at issue and the Commerce Clause prohibit the Commissioner's imposition of tax on MBNA, thus finding it unnecessary to rule on the second issue of proper apportionment.[1] The Commissioner appealed the former issue to the Circuit Court and MBNA appealed the latter.

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1 W.V. Admin. Dec. No. 03-185 RN (October 22, 2004) (the "OTA Decision").

The 13th Judicial Circuit Court reversed the decision of the Office of Tax Appeals, finding that both the statutes at issue and the Commerce Clause permitted the Commissioner's imposition of tax on MBNA, and that the apportionment formula applied to MBNA also did not violate the Commerce Clause.[2] On March 15, 2006, this Court granted MBNA's petition for leave to appeal. Both issues, taxability and apportionment, are now before this Court.

STATEMENT OF FACTS

The facts were stipulated by the parties in the proceeding before the Office of Tax Appeals, which also set forth the facts in its unpublished decision.[3]

MBNA's National Banking Business and Lack of West Virginia Contacts

MBNA was chartered as a national bank in 1991 in the State of Delaware.[4] During the years at issue (1998 and 1999), MBNA's principal place of business and commercial domicile was Wilmington, Delaware.[5] MBNA's principal business was issuing and servicing VISA and MasterCard credit cards for customers throughout the United States.[6] Many of those credit cards were specially designated for various associations located throughout the United States that had arranged for MBNA to provide credit cards for their members or affiliates. *Id.* MBNA did not engage in any secured corporate or property financing. *Id.*

MBNA had no office, place of business, real property, tangible property, other property, employees, or other representatives that were physically present in West Virginia during the two

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2 *Steager v. MBNA America Bank*, No. 04-AA-157 (W. Va. Cir. Ct., June 27, 2005) (unpublished opinion).

3 *See,* December 23, 2003 Stipulation of Facts and Exhibits ("Initial Stip."); January 12, 2004 Supplemental Stipulation of Facts ("Supp. Stip."); *see also,* OTA Decision.

4 OTA Dec., Findings of Fact ("FF") No. 1.

5 *Id.*, FF No. 2.

6 *Id.*, FF No. 3.

years at issue.[7] MBNA did not receive or process any accounts receivable in West Virginia.[8] In conducting its business operations, MBNA engaged in direct mail solicitation across the country, through the United States mail, including direct mail solicitation of West Virginia residents.[9] None of MBNA's mail solicitation activities were initiated in or from West Virginia. *Id.* In conducting its business operations, MBNA engaged in telephone solicitation across the country via long distance phone transmissions, including phone transmissions to residents of West Virginia.[10] None of MBNA's telephone solicitation activities were initiated in or from West Virginia. *Id.* MBNA has at various times out-sourced certain of its national marketing activities.[11] None of the businesses performing such services for MBNA was located in West Virginia. *Id.*

Even though it had no physical presence in West Virginia, MBNA did derive certain receipts from customers who provided West Virginia addresses. The percentage of MBNA's gross receipts attributable to customers with West Virginia addresses, out of the total of MBNA's gross receipts attributable to all sources, however, was only 0.192% in 1998 and within a similar range in 1999.[12]

<u>The Tax Matters At Issue</u>

The present dispute involves the West Virginia Business Franchise Tax ("BFT") and the West Virginia Corporate Net Income Tax ("CNT").

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7 *Id.*, FF No. 4.
8 *Id.*, FF No. 8.
9 OTA Dec., FF No. 5.
10 *Id.*, FF No. 6.
11 Initial Stip., ¶6.
12 Initial Stip., ¶19; OTA Dec., FF No. 15.

1. The Original BFT and CNT Returns

On or about September 9, 1999, MBNA filed (pursuant to a properly obtained extension) its original West Virginia Business Franchise Tax Return (Form WV/BFT-120) for the year ended December 31, 1998, showing tax in the amount of $32,010 (the "Original 1998 BFT Return"), which MBNA paid.[13] On or about September 9, 1999, MBNA filed (pursuant to a properly obtained extension) its original West Virginia Corporate Net Income Tax Return (Form WV/CNT-112) for the year ended December 31, 1998, showing tax in the amount of $168,034 (the "Original 1998 CNT Return"), which MBNA paid.[14] On the Original 1998 CNT Return for that year, MBNA reported $4,385,280,037 in gross receipts attributable to all sources (including West Virginia), including fees, service charges, interest income, other receipts from credit cards and travel and entertainment credit cards, and other sales.[15] On the Original 1998 Returns, MBNA reported $8,419,431 in gross receipts attributable to customers with West Virginia addresses, including fees, service charges, interest income, other receipts from credit cards and travel and entertainment credit cards, and other sales.[16]

2. The BFT and CNT Refund Claims

On or about September 13, 2002, MBNA timely filed refund claims seeking the return of the BFT and CNT it had previously paid for tax year 1998.[17] For its BFT refund claim, MBNA filed an amended West Virginia Business Franchise Tax Return (Form WV/BFT-120) for the year ended December 31, 1998, requesting a refund in the amount of $32,010 on the grounds of

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13 Initial Stip., ¶15, Ex. A.
14 Initial Stip., ¶16, Ex. B.
15 Initial Stip., ¶18.
16 Initial Stip., ¶17.
17 Initial Stip., ¶¶20-22.

"No Nexus" (the "BFT 1998 Refund Claim").[18] For its CNT refund claim, MBNA filed an amended West Virginia Corporate Net Income Tax Return (Form WV/CNT-112) for the year ended December 31, 1998, requesting a refund in the amount of $168,034 – also on the grounds of "No Nexus" (the "CNT 1998 Refund Claim").[19]

On or about December 16, 2002, the Commissioner's Corporate & Franchise Tax Unit issued a letter denying the BFT 1998 Refund Claim (the "BFT 1998 Denial Letter").[20] The BFT 1998 Denial Letter, referencing West Virginia Code § 11-23-5a(d) and noting MBNA's $8,419,431 in gross receipts for West Virginia, concluded "[t]herefore, you are regularly engaging in business in West Virginia." *Id.* On or about December 17, 2002, the Commissioner's Corporate & Franchise Tax Unit issued a letter denying the CNT 1998 Refund Claim (the "CNT 1998 Denial Letter"). Initial Stip., ¶24, Ex. F. The CNT 1998 Denial Letter, referencing West Virginia Code § 11-24-7b(d) and noting MBNA's $8,419,431 in gross receipts for West Virginia, concluded "[t]herefore, you are regularly engaging in business in West Virginia." *Id.*

Similarly, for the 1999 tax year, MBNA timely filed amended 1999 BFT tax returns claiming refunds of West Virginia BFT in the amount of $42,339.[21] MBNA also timely filed amended 1999 CNT tax returns claiming refunds of West Virginia CNT in the amount of $220,897.[22]

On or about December 22, 3003, MBNA received from the Commissioner's Corporate & Franchise Tax Unit a letter denying the BFT 1999 Refund Claim (the "BFT 1999 Denial

18 Initial Stip., ¶20, Ex. C.
19 Initial Stip., ¶21, Ex. D.
20 Initial Stip., ¶23, Ex. E.
21 OTA Dec., slip op., 6.
22 OTA Dec., slip op., 6.

Letter"). The BFT 1999 Denial Letter gave the same reason stated in denying the refund claims for 1998, by virtue of MBNA's West Virginia gross receipts for the year 1999 of $10,163,788, referencing the West Virginia Code.[23] On or about December 22, 3003, MBNA received from the Commissioner's Corporate & Franchise Tax Unit a letter denying the CNT 1999 Refund Claim (the "CNT 1999 Denial Letter"). The CNT 1999 Denial Letter gave the same reason stated in denying the refund claims for 1998, by virtue of MBNA's West Virginia gross receipts for the year 1999 of $10,163,788, referencing the West Virginia Code.[24]

3. **MBNA's Protest of the Refund Denials**

MBNA received the BFT 1998 Denial Letter and the CNT 1998 Denial Letter on December 23, 2002.[25] MBNA timely filed petitions to protest both of the denials.[26] On or about February 20, 2003, MBNA filed a Petition for Refund of Business Franchise Tax (Form WV/PET-REFUND) for the year ended December 31, 1998, requesting a refund in the amount of $32,010 (plus applicable interest), contending the Commissioner lacked jurisdiction over MBNA (the "BFT 1998 Refund Petition").[27] Also on or about February 20, 2003, MBNA filed a Petition for Refund of Corporate Net Income Tax (Form WV/PET-REFUND) for the year ended December 31, 1998, requesting a refund in the amount of $168,034 (plus applicable interest), again contending the Commissioner lacked nexus over MBNA (the "CNT 1998 Refund Petition").[28]

The Commissioner timely filed an Answer to each of the BFT 1998 Refund Petition and the CNT 1998 Refund Petition, denying all material allegations other than that MBNA is a

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23 OTA Dec., slip op., 6.
24 OTA Dec., slip op., 6.
25 Initial Stip., ¶ 25.
26 Initial Stip., ¶28.
27 Initial Stip., ¶26.
28 Initial Stip., ¶27.

National Bank and that the Commissioner had denied the BFT 1998 Refund Claim and the CNT 1998 Refund Claim by issuing the BFT 1998 Denial Letter and the CNT 1998 Denial Letter.[29] On or about June 23, 2003, MBNA was permitted to file an Amended BFT 1998 Refund Petition and an Amended CNT 1998 Refund Petition, with the Commissioner's consent.

MBNA received the BFT 1999 Denial Letter and the CNT 1999 Denial Letter on December 22, 2003. On or about February 6, 2004, MBNA riled a Petition for Refund of BFT and CNT with the Office of Tax Appeals.[30] This matter (including both tax years at issue) was fully and finally submitted on April 27, 2004, for decision by the Office of Tax Appeals.[31]

MBNA Lacks a Physical Presence in West Virginia

At the heart of MBNA's refund claims, and of its contention that the Circuit Court improperly allowed the Commissioner to impose BFT and CNT on MBNA, is MBNA's utter lack of any physical presence in West Virginia. Indeed, the Commissioner stipulated that MBNA had no physical presence in West Virginia,[32] and based its assertion of BFT and CNT taxability solely on MBNA's satisfaction of the presumption set forth in W. VA. CODE §§ 11-23-5a(d) and 11-24-7b(d), which prescribe purely economic factors instead of physical presence in the State. The Circuit Court erroneously held that these statutes, as applied to MBNA, passed constitutional muster.[33]

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29 Initial Stip., ¶29.
30 OTA Dec., slip op., 7.
31 OTA Dec., slip op., 7.
32 Initial Stip., ¶30.
33 The stipulated record also includes several exhibits relating to the Commissioner's own view of the application of the BFT and CNT to financial organizations, including memoranda from the Commissioner's counsel outlining constitutional and other concerns regarding the special financial organization nexus and apportionment rules at issue here (Initial Stip., Exhibits G and H), and several rulings and other guidance addressing the taxes as applied to financial organizations (Initial Stip., Exhibits I through K).

MBNA Would Have Apportionment Factors of Zero If MBNA Were <u>Any Other Type of Corporation</u>

If MBNA were any type of corporation other than a financial organization, the apportionment of its capital and income would have been accomplished using a three-factor formula, consisting of property, payroll, and sales factors, instead of a single gross-receipts (sales) factor formula. Additionally, as a general business, MBNA's receipts from intangible property would have been sourced to the state in which the greater proportion of income-producing activity had been performed (based on MBNA's costs of performance), rather than the state in which each customer lived.[34] If it were a general non-financial business, MBNA would have had a property factor of zero and a payroll factor of zero for purposes of the West Virginia BFT and CNT.[35] In addition, none of MBNA's receipts would have been sourced to West Virginia so MBNA would also have had a receipts factor of zero.[36]

ASSIGNMENTS OF ERROR

In this appeal, MBNA contends that the Circuit Court made two fundamental errors in its reversal of the Office of Tax Appeals decision. Each of these issues is addressed in detail below.

First, the Circuit Court fundamentally misunderstood the nature of the "substantial nexus" requirement of the Commerce Clause, initially replacing it with the Due Process "minimum contacts" requirement and then confusing it with the Commerce Clause's separate and distinct "fairly related to government services" requirement. This misunderstanding led the Circuit Court to conclude erroneously that West Virginia possessed jurisdiction to impose BFT and CNT on MBNA, when in fact the U.S. Constitution bars such taxation.

34 W. VA. CODE §§ 11-23-5(m) and 11-24-7(e)(12); *see* Initial Stip., ¶31.
35 OTA Dec., FF No. 16.
36 Initial Stip., ¶31.

Second, the Circuit Court failed to analyze West Virginia's special apportionment rules for financial organizations in light of the Commerce Clause's "fair apportionment" requirement that restricts a state tax imposition to only the portion of the profits or capital of a business that are reasonably attributable to its in-state commercial activity. This failure led the Circuit Court to conclude erroneously that a significant portion of MBNA's income and capital were taxable by West Virginia, when in fact the state (if it possessed jurisdiction to tax MBNA at all) was constitutionally barred from taxing any portion of the income or capital of MBNA.

POINTS AND AUTHORITIES

This case presents two questions, each of which warrants an affirmative response: First, does the Commerce Clause of the U.S. Constitution prevent West Virginia from taxing MBNA when MBNA has no physical presence in the state? Second, is the State's share of MBNA's income and capital zero in any event, because the State's special apportionment rules for financial organizations are invalid under the Commerce Clause? If this Court rules for MBNA on either of these issues, the other issue will be moot.

PART ONE: WEST VIRGINIA LACKS JURISDICTION TO TAX MBNA

I. MBNA LACKED THE IN-STATE PHYSICAL PRESENCE NECESSARY TO SATISFY THE COMMERCE CLAUSE'S SUBSTANTIAL NEXUS REQUIREMENT

In its decision below, the Circuit Court held that the State of West Virginia had jurisdiction to impose its Corporate Net Income Tax ("CNT") and Business Franchise Tax ("BFT") on MBNA "because its activities in the State generates [sic] income far in excess of what is required to establish nexus in the State which generation of income is supported by services provided by the State."[37] As explained below, the Circuit Court's erroneous holding must be reversed because its two rationales are founded on critical misconceptions of the fundamental constitutional principle that governs this question: a state may impose tax on an out-of-state corporation only when there is between them a substantial nexus, which can be established only when there is an in-state physical presence of the corporation. First, the substantial nexus requirement cannot be satisfied by a corporation's mere "generation of income" from in-state sources, notwithstanding a state statute that may attempt to do so.[38] Second, the substantial nexus requirement cannot be satisfied by a corporation's mere access to (or use of) "services provided by the State."[39]

The Due Process and Commerce Clauses of the United States Constitution[40] limit the jurisdictional power of West Virginia to impose tax on businesses that operate beyond its borders. The personal jurisdiction requirement of the Due Process Clause is merely "some minimum connection" between the corporation and the state.[41] In stark contrast, the authoritative Commerce Clause requirement for limiting the reach of a state's taxing power (regardless of tax type), enunciated decades ago by the U.S. Supreme Court, is "substantial nexus."[42] If the required substantial nexus is lacking, the state may not impose its tax.

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[37] *Steager v. MBNA America Bank,* No. 04-AA-157 (W. Va. Cir. Ct., June 27, 2005) (unpublished opinion), ¶ 23.

[38] W. VA. CODE §11-24-4(3).

[39] W. VA. CODE §11-24-4(3) and §11-24-3a(7) (for CNT); W. VA. CODE §11-23-6(a) and §11-23-3(b)(1).

[40] U.S. CONST., amend. XIV, § 1; art. I, § 8, cl. 3.

[41] *Miller Bros. Co. v. Maryland,* 347 U.S. 340, 345 (1954).

[42] *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977). The Commerce Clause "has long been understood, as well, to provide protection from state legislation inimical to the national commerce [even] where Congress has not acted." *Barclays Bank Plc v. Franchise Tax Board,* 512 U.S. 298, 310 (1994). This "self-executing" aspect of the Commerce Clause,

A. THE SUBSTANTIAL NEXUS REQUIREMENT CANNOT BE SATISFIED IN THE ABSENCE OF IN-STATE PHYSICAL PRESENCE

1. <u>The Commerce Clause Substantial Nexus Requirement Is More Exacting than the Due Process Minimum Contacts Nexus Requirement</u>

The U.S. Supreme Court has expressly held that, when determining whether a state may exercise its taxing jurisdiction over an out-of-state corporation, the Commerce Clause nexus requirement is a different – in fact, a higher – requirement than that mandated by the Due Process Clause. Indeed, in the watershed case of *Quill Corp. v. North Dakota*,[43] the U.S. Supreme Court held that "a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause."[44]

The U.S. Supreme Court's adoption of a "minimum contacts" jurisdictional requirement for Due Process but a "substantial nexus" requirement for the Commerce Clause reflects far more than a mere difference in terminology. The jurisdictional requirements read by the Court into these two clauses are radically different: The Due Process Clause minimum contacts

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commonly referred to as the dormant Commerce Clause, has its roots in our federal system of government. *Barclays*, 512 U.S. at 311, n. 9. The U.S. Supreme Court explained, in *Camps Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564, 571 (1997):

> During the first years of our history as an independent confederation, the National Government lacked the power to regulate commerce among the States. Because each State was free to adopt measures fostering its own local interests without regard to possible prejudice to nonresidents, ... a conflict of commercial regulations, destructive to the harmony of the States, ensued.

(internal quotations and citations omitted). "Under the Articles of Confederation, state taxes and duties hindered and suppressed interstate commerce; the Framers intended the Commerce Clause as a cure for those structural ills." *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992). As a direct consequence of the critical role played by the Commerce Clause in protecting our unity as a nation, the jurisdictional connection required by the Commerce Clause is much higher than the connection required by the Due Process Clause.

43 504 U.S. 298, 312 (1992).

44 *Quill*, 504 U.S. at 313.

requirement, with its less stringent standard of market exploitation, aims only at providing "fair notice" to persons. In dramatic contrast, the more exacting Commerce Clause substantial nexus requirement, with its inherent standard of physical presence,[45] aims to protect from undue burdens our national economy. The radical difference between these two standards is of critical importance to the resolution of this case. Whether or not the Due Process Clause allows West Virginia to tax MBNA, the Commerce Clause forbids it.

a. Due Process Requires Mere Market Exploitation

The U.S. Supreme Court has determined that, for state tax jurisdiction and other purposes, Due Process requires minimum contacts between a person and a state as a prerequisite for the state's assertion of jurisdiction over the person. This minimum contacts requirement is met through the mere exploitation of a state's marketplace, whenever a company "purposefully avails itself of the benefits of an economic market in the forum State."[46]

Persons are protected by Due Process. "The Due Process clause protects an individual's liberty interest ... [by] requiring that individuals have fair warning that a particular activity may subject [them] to the jurisdiction of the foreign sovereign."[47] The personal jurisdiction requirements of Due Process assure "fundamental fairness"[48] and "fair play"[49] to persons. If a person is found to be subject to personal jurisdiction under Due Process, the person may be haled into court in a lawsuit. The right to a limitation on this consequence is a personal right of

45 *Quill*, 504 U.S. at 314.
46 *Quill*, 504 U.S. at 307.
47 *Burger King Corp. v. Rudzewicz,* 471 U.S. 462, 472 (1985); citing *International Shoe v. Washington,* 326 U.S. 310, 319, n. 13 (1945) and *Shaffer v. Heitner,* 433 U.S. 186, 218 (1977).
48 *Quill*, 504 U.S. at 312.
49 *International Shoe*, 326 U.S. at 316.

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persons, who are free to waive it, and which may not be taken away by Congress.[50] No in-state physical presence of the person is required to satisfy this requirement.[51]

b. The Commerce Clause Requires a Materially Greater Connection with the State than Does Due Process

In contrast to the personal interests protected by Due Process, the dormant Commerce Clause protects federalism concerns of the nation and its national economy,[52] and a "unity of commercial ... interests."[53] A central purpose of the dormant Commerce Clause is to "limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce."[54] Among other requirements, the Commerce Clause requires that there exist a "substantial nexus" between the out-of-state business and the state before that state may impose tax on the business.[55] "[T]he 'substantial nexus' requirement is not, like Due Process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce."[56] This explains why a "corporation may have the 'minimum contacts' with a taxing State as required by the Due Process clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause."[57]

Recognizing that assertions of unbridled jurisdiction over any out-of-state company that merely has in-state customers "affirmatively places interstate commerce at a disadvantage,"[58] the U.S. Supreme Court has consistently followed the authoritative four-prong test it set forth in

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50 *Quill*, 504 U.S. at 305.
51 *Burger King*, 471 U.S. at 476; *Quill*, 504 U.S. at 308.
52 *Camps Newfound*, 520 U.S. at 571.
53 THE FEDERALIST No. 11 (Alexander Hamilton), *Concerning Commerce and a Navy*.
54 *Quill*, 504 U.S. at 313.
55 *Complete Auto*, 430 U.S. at 279, 288.
56 *Quill*, 504 U.S. at 313.
57 *Quill*, 504 U.S. at 313.
58 *Tyler Pipe Indus. v. Washington State Dep't of Revenue*, 483 U.S. 232, 243 (1987).

Complete Auto when scrutinizing the validity under the Commerce Clause of any type of tax.[59] A tax will be sustained "against Commerce Clause challenge when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[60] The first prong of the test, substantial nexus, is the proper focus for purposes of the jurisdictional question at issue in this matter.[61]

c. The Circuit Court Confused the Two Nexus Requirements

The Circuit Court's holding that jurisdiction can be presumed based merely "on the substantial revenue that MBNA generates from West Virginia citizens"[62] – that is, on MBNA's exploitation of the West Virginia market – amounts to a substitution of the less stringent Due Process minimum contacts requirement (market exploitation) for the more exacting Commerce Clause substantial nexus requirement (physical presence). This substitution is constitutionally impermissible, regardless of the type of tax involved. As the U.S. Supreme Court explained in *Quill*:

> The State contends that the nexus requirements imposed by the Due Process and Commerce Clauses are ***equivalent*** and that if, as we concluded above, a mail-order house that lacks a physical presence in the taxing State nonetheless satisfies the Due Process "minimum contacts" test, then that corporation also meets the Commerce Clause "substantial nexus" test. ***We disagree.***[63]

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59 *See, e.g., Barclays,* 512 U.S. at 310-311 (corporate income tax); *Commonwealth Edison v. Mont.*, 453 U.S. 609 (1981) (severance tax); *D. H. Holmes v. McNamara,* 486 U.S. 24 (1988) (use tax); *Japan Line Ltd v. County of Los Angeles*, 441 U.S. 434 (1979) (property tax).

60 *Complete Auto,* 430 U.S. at 279

61 For a discussion of the Circuit Court's confusion of the *Complete Auto* first prong "substantial nexus" requirement with its fourth prong "fairly related to the services" requirement, see Part One, section II of this brief, below.

62 *Steager v. MBNA,* at ¶8.

63 *Quill*, 504 U.S. at 312 (emphasis supplied).

The Supreme Court continued, unambiguously confirming a principle broadly applicable to all types of taxes: "Despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical. The two requirements are animated by different constitutional concerns and policies."[64]

As MBNA unquestionably solicited West Virginia customers (albeit from afar) and earned income from those West Virginia customers, it is likely that the Due Process Clause did not bar West Virginia from imposing BFT or CNT on MBNA. If it were not for the more exacting Commerce Clause requirement, MBNA would not have much to argue here.

2. <u>In-State Physical Presence Is Necessary to Meet the Substantial Nexus Requirement of the Commerce Clause</u>

a. Physical Presence is the U.S. Supreme Court's Chosen Test

The U.S. Supreme Court has noted that there is "little in the way of precise guides to the States in the exercise of their indispensable power of taxation."[65] A few "precise guides" do exist, however, and the Supreme Court's history of decision-making in Commerce Clause nexus cases reveals that the physical presence requirement is one of those guides. Physical presence, though not always explicitly articulated by the Court as such, nevertheless has been the inherent bright-line, base-line fact in every tax nexus case handed down by the U.S. Supreme Court since its watershed decision in *Complete Auto* – the hallmark of the Court's nexus jurisprudence across the decades.[66]

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[64] *Quill*, 504 U.S. at 312.

[65] *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457 (1959).

[66] The Supreme Court found Commerce Clause or Due Process nexus in the following cases, and in each case the taxpayer had a physical presence in the State: *Barclays Bank Plc v. Franchise Tax Bd.*, 512 U.S. 298, 311 (1994) (operations in state); *Amerada Hess Corp. v. Dir.*, 490 U.S. 66, 73 (1989) (operations in state); *D. H. Holmes Co. v. McNamara*, 486 U.S. 24, 32-34 (1988) (department stores in state); *Tyler Pipe Indus. v. Washington State Dep't of Revenue*, 483

With regard to the two U.S. Supreme Court cases cited by the Circuit Court,[67] they simply do not hold that direct taxes can be imposed on any actor regardless of a lack of physical presence in the taxing jurisdiction. *Whitney v. Graves* was a Due Process case[68] and so involved a nexus requirement that is far less exacting than the Commerce Clause substantial nexus requirement that governs the case at bar. There is absolutely nothing in that opinion that impacts whether income taxes may be imposed under the Commerce Clause despite a lack of physical presence in the state. Another Due Process case[69] applying a different constitutional requirement than that at issue here, *International Harvester* did not stand for the proposition that an out-of-state putative taxpayer can be subjected to tax in the absence of an in-state physical presence. Although the shareholder was out-of-state, the dividend-paying corporation had a large manufacturing presence in Wisconsin, and the Court effectively held that Wisconsin's tax on the shareholder's receipt of dividends was valid because it was nothing more than a delayed tax on the earnings of the in-state corporation itself, which had physical presence aplenty.

Even the Commissioner's own counsel acknowledged in 1990, when considering the nexus requirement applicable to the BFT and CNT specifically, that a higher level of real presence within the jurisdiction – the presence and activity of the putative taxpayer itself – is necessary, and that mere economic presence – the mere in-state presence and activity of the taxpayer's customer – is insufficient:

U.S. 232, 249-51 (1987) (independent contractor sales representatives in state); *Exxon Corp. v. Dep't of Revenue*, 447 U.S. 207, 226, 228 (1980) (mining operations in state); *Department of Revenue v. Association of Wash. Stevedoring Cos.*, 435 U.S. 734, 750 (1978) (entire operations in state); *National Geographic Soc. v. California Bd. of Equalization*, 430 U.S. 551, 556 (1977) (offices and employees in state).

67 *New York ex rel. Whitney v. Graves*, 299 U.S. 366 (1937); *International Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435 (1944).

68 *Whitney*, 299 U.S. at 370.

69 *International Harvester*, 322 U.S. at 439-440.

> [C]ustomers, receipts and loans are not bases of nexus. It is not the amount of customers, receipts or loans which determine nexus but rather the amount of ***business activity within the jurisdiction*** . It seems unlikely that the Courts would consider telephone calls and mail the kind of activity needed for substantial nexus.[70]

Just two years after the Commissioner's counsel warned of this result – shortly after the passage of West Virginia's special nexus rules for financial organizations – the U.S. Supreme Court confirmed those very concerns in *Quill*.

(i) ***<u>Quill Confirmed the Physical Presence Standard that Underpins All Commerce Clause Nexus Analysis</u>***

The U.S. Supreme Court in *Quill* illumined a central reality underlying all its Commerce Clause nexus cases: "***all of these cases*** [cited by the Court in its opinion] involved taxpayers who had a physical presence in the taxing state."[71] Physical presence is the common denominator; it is the common jurisdictional fact that underlies and binds together "all of these cases." The Court has never upheld a finding of nexus in any case regarding any type of tax where the putative taxpayer had no in-state physical presence.[72]

The physical presence standard is the natural result of the substantial nexus requirement because it flows directly from the structural considerations that ground the Commerce Clause. The simplicity of the physical presence standard serves as "a means for limiting state burdens on interstate commerce."[73] Without this standard, indiscriminate subjection of out-of-state corporations to state income and franchise tax jurisdiction would place heavy and complex

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[70] Initial Stip., Ex. G, at 6 (emphasis supplied). The Commissioner's counsel further acknowledged that "[d]eriving income within a state is not sufficient justification to permit taxation of that income. This is true regardless of the amount of income involved." *Id.*

[71] *Quill,* 504 U.S. at 314 (emphasis supplied).

[72] The Supreme Court found no physical presence and therefore barred the state from imposing tax in the following cases, in which the putative taxpayer had no physical presence in the state: *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967); and *Miller Bros. Co. v. Maryland*, 347 U.S. 340 (1954).

[73] *Quill*, 504 U.S. at 313.

burdens on companies that, when multiplied across industries and across the economy, would place a serious "drag" on interstate commerce. The physical presence standard permits the free flow of commerce throughout the nation. That is, the physical presence standard helps achieve the fundamental objective of the Commerce Clause: protection and enhancement of a single, integrated national economy.

(ii) <u>*Quill Governs This Case and Is Not Confined to its Facts*</u>

In an effort to minimize the impact of *Quill* – which barred state tax jurisdiction in the absence of the putative taxpayer's in-state physical presence – the Commissioner has argued below that the *Quill* Court reaffirmed the physical presence standard for tax jurisdiction only because the principle of *stare decisis* forced the Justices to continue to follow *National Bellas Hess*,[74] and, thus, that only sales and use taxes are subject to *Quill*'s physical presence standard for satisfaction of the substantial nexus requirement. Neither of these arguments can withstand careful scrutiny.

The *Quill* decision provided no indication that the physical presence requirement would have been abandoned but for *stare decisis*. Quite to the contrary, the Court stated categorically that "the bright-line rule of *Bellas Hess* furthers the ends of the dormant Commerce Clause."[74a] The Commissioner's inference that some of the Justices would have discarded the physical presence requirement in the absence of *stare decisis* is mere speculation and is utterly unsupportable.

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74 *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967).
74a *Quill*, 504 U.S. at 314.

Moreover, as other tribunals have concluded, there is no principled reason for applying a lower jurisdictional requirement for income tax than for sales and use tax. As physical presence is necessary for a finding of nexus that supports use tax jurisdiction over putative tax ***collectors***, it must also be necessary to support income tax jurisdiction over putative tax ***payers***. Several Justices of the U.S. Supreme Court have also recognized that there.is no justifying rationale for applying different nexus requirements for direct taxes and sales/use taxes. In his concurring opinion in *Quill* (joined by Justices Kennedy and Thomas), Justice Scalia noted that "it might have been possible to distinguish between jurisdiction to tax and jurisdiction to compel collection of taxes as agent for the State, but we have rejected that."[75]

The straightforward, practical economic effect of the BFT and CNT is that they are far more – and directly – burdensome than use tax collection responsibilities and, consequently, cannot logically be subject to a lower constitutional threshold. In comparison to imposing a mere duty to collect a tax from customers, Commerce Clause protections should be even greater for corporate income and franchise taxes because the direct imposition of a tax is obviously more burdensome.[76] Use tax collection duty merely requires the actor to collect the tax from its customers and then turn those same dollars over to the state – suffering the administrative complications and inconvenience, but not the cost, of the tax. In sharp contrast, direct taxes engender perfectly comparable administrative complications and burdens (due to the huge number of state and local jurisdictions that impose extremely non-uniform income, franchise and

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[75] *Quill*, 504 U.S. at 319 (Scalia, J., concurring). *See also Hartley Marine Corp. v. Mierke*, 196 W. Va. 669, 678 n.13 (1996) (citing *Western M. R.R. Co. v. Goodwin*, 167 W. Va. 804, 826 n.3 (1981) for the proposition that the "form of tax is irrelevant to the due process questions of nexus and state benefits") (citations omitted).

[76] *See National Geographic Soc. v. California Bd. of Equalization*, 430 U.S. 551 (1977); *Norton Co. v. Department of Revenue*, 340 U.S. 534, 537 (1951).

license taxes) but, more significantly, must be paid from the actor's own pocket, hitting the business' bottom line.

A careful reading of *Quill* reveals that the U.S. Supreme Court's *stare decisis*, reliance and administrative burdens analysis did not aim to determine whether physical presence ought to be the standard for use tax and not the standard for other taxes. On the contrary, the goal appears to have been to determine whether the case before the Court – use taxation of a mail order company – might present an appropriate case for the Court to *depart* from the generally applicable (and ubiquitous) physical presence standard. The Court concluded that no such exception was appropriate in the case before it. The physical presence standard, underlying all its nexus cases, applies to use taxation of mail order companies just as it does to all other types of taxes and industries. *Quill* is not limited to use taxes, but is an enunciation of a foundational principle of Commerce Clause jurisprudence. This "demarcation of a discrete realm of commercial activity that is free from interstate taxation,"[77] must transcend tax types, or else the bright-line physical presence standard will not achieve the object of the Commerce Clause nexus requirement – lessening burdens on interstate commerce.

b. State Case Law Is Consistent with These Conclusions

(i) West Virginia's Due Process Nexus Cases Do Not Apply

Previous Due Process nexus decisions of this Court employed a "purposive, revenue generating activities in the State"[78] requirement for tax nexus. This requirement is functionally identical to the modern (post-*Quill*) Due Process "minimal connection" / market-exploitation

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[77] *Quill*, 504 U.S. at 315.

[78] *Cincinnati Milacron Co. v. Hardesty*, 170 W. Va. 138, 140 (1982) (*but see* McHugh, J., dissenting: "I always thought that a sufficient nexus between the activities of the taxpayer and the State was required," *id.*, at 142); *Western M. R.R. Co. v. Goodwin*, 167 W. Va. 804, 826, n.3 (1981).

requirement and thus falls far short of the Commerce Clause "substantial nexus" requirement that governs the present case. Thus, these two West Virginia cases, because they address only the Due Process requirement and do not consider the significantly higher Commerce Clause requirement, provide the Commissioner with absolutely no support. As *Quill* made clear, even where a corporation does have Due Process nexus by virtue of purposefully availing itself of the taxing state's market, Commerce Clause nexus does not exist if the corporation does not have the additional substantial nexus with the state.

Furthermore, in each of these two pre-*Quill* decisions, the taxpayer was, in fact, physically present in West Virginia. The Commerce Clause requires something more than purposeful availment of a state's marketplace, and that something more is physical presence.

(ii) ***State Decisions Have Uniformly Demanded Physical Presence in Similar Contexts***

Other state judicial bodies have applied the *Quill* physical presence requirement in the contexts of taxes other than sales and use tax, rebuffing attempts by various state taxing authorities to tax businesses that had no physical presence in the state. In fact, there is not a single final state court decision – outside the unique context of "intangible holding companies" – that has permitted imposition of a direct tax on a business that had no physical presence in the state.

In a case strikingly similar to the case at bar, the Tennessee Court of Appeals rejected the state taxing authority's assertion of tax nexus over another credit card issuer, J.C. Penney National Bank, specifically because the bank had no physical presence in Tennessee other than the *de minimis* presence of its credit cards issued to Tennessee residents.[79] The Tennessee

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[79] *J. C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999).

Commissioner's assertion of asserted nexus was based, as in this case, on the bank's "regular solicitation" of business from customers located in Tennessee, its provision of credit and related credit card services to Tennessee customers, and its receipt of interest income and fee income from Tennessee customers. The Tennessee court, however, found the lack of physical presence determinative: "the Commissioner has pointed to no case in which the Supreme Court of the United States has upheld a state tax where the out-of-state taxpayer had absolutely no physical presence in the taxing state."[80] The U.S. Supreme Court denied certiorari in this case.[81]

Revenue departments in several states have attempted to assert tax jurisdiction over out-of-state companies that do little more than hold the intangible assets of their in-state affiliates, where the in-state affiliates reduce their income by paying royalties to the out-of-state holding companies. These situations often have been perceived by state revenue departments as examples of "tax shelters" and "abusive tax planning." In response, some state courts have been willing to depart from careful adherence to the physical presence standard that has been established by the U.S. Supreme Court for the substantial nexus requirement, but have done so only in the context of the holding company scenario. This Court need not determine whether those intangibles holding company cases were correctly or erroneously decided; they are completely inapposite to the case at bar because MBNA is a fully operational business that does nothing in the nature of an "abusive tax shelter" to reduce the income of an in-state affiliate. MBNA's facts, like those in the *J. C. Penney National Bank* case, have absolutely no relationship to that class of cases.[82]

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[80] *J. C. Penney Nat'l Bank*, 19 S.W.3d at 842.

[81] *Johnson v. J.C. Penney Nat'l Bank*, 531 U.S. 927 (2000).

[82] The first and most notorious case in which a state high court failed to follow decades of constitutional jurisprudence in order to shut down a perceived tax shelter was *Geoffrey, Inc. v.*

c. **Tax Policy Supports the Physical Presence Requirement**

In addition to U.S. Supreme Court authority and similar state court decisions, tax policy analysis also justifies the physical presence standard for satisfaction of the Commerce Clause substantial nexus requirement. Physical presence is superior to economic presence as a nexus requirement when measured against any of several tax policy criteria.

For example, a consistent nationwide standard, the need for which is especially acute where millions of dollars of income-based taxes can turn on whether nexus exists, can best be provided by the U.S. Supreme Court's test of physical presence (the situs of which is unambiguous), but cannot be reliably produced by a plethora of inconsistent state-specific statutory bright-line and economic presence tests, which would wreak havoc with the national economy. In addition, the settled expectations of credit card issuers, based upon the absence of any U.S. Supreme Court case holding that economic presence satisfies the Commerce Clause substantial nexus requirement, should be upset (if at all) only by Congress.

Additional tax policy criteria, all favoring the physical presence standard, include the reduction of litigation, avoidance of multiple taxation that would result from application of the economic presence standard, and avoidance of the formidable administrative problems and

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South Carolina Dep't of Revenue & Taxation, 437 S.E.2d 13 (S.C. 1993). Geoffrey, Inc., the intangibles holding company established by Toys R Us, had few employees and paid little tax anywhere.

In marked contrast, MBNA is one of the largest credit card issuers in the country, has thousands of employees and a large office complex in Delaware and paid tax on 100% of its income there. DEL. CODE ANN. 5 §1101(a). Press reports demonstrate that MBNA is no insubstantial tax planning vehicle: "Bank of America on Jan. 1 completed its $35 billion buyout of Wilmington-based MBNA, which had been the state's largest private employer with about 10,500 workers. Banks in Delaware pay about $150 million annually in state bank taxes, with MBNA's share accounting for about a third." Ted Griffith, *Bank of America Keeping MBNA's Charter in Delaware; State Preserves Millions in Tax Revenue, But Jobs Aren't Guaranteed,* The News Journal, Feb. 3, 2006, at 1A.

compliance burdens that would be the inevitable consequence of an economic presence standard.

B. THE CIRCUIT COURT ERRED WHEN IT FAILED TO FIND WEST VIRGINIA'S TAX JURISDICTION COULD NOT REACH MBNA

For the reasons set forth above, the Circuit Court was bound to apply the physical presence standard when determining whether West Virginia had jurisdiction to impose CNT or BFT on MBNA. It should not have applied the State's jurisdictional tax statutes but should have found them invalid as applied to MBNA because, setting forth as they do a jurisdictional threshold that – while arguably satisfying the Due Process minimum-contacts / market-exploitation nexus requirement – violates the Commerce Clause substantial nexus requirement with its physical presence standard.

It is a stipulated fact that MBNA was not physically present in the State of West Virginia because it had no office, place of business, real property, tangible property, other property, employees, or other representatives that were physically present in West Virginia.[83] As in the strikingly similar *J.C. Penney National Bank* case and the controlling *Quill* case (which the court in *J.C. Penney National Bank* called "almost identical" factually to its facts[84]), the only conceivable in-state physical presence of the putative taxpayer here is the *de minimis* in-state presence of the credit cards (comparable to the floppy diskettes in *Quill*) that provide customers with access to the company's products or services.[85] It is established law that a merely *de minimis* physical presence in the state does not satisfy the substantial nexus requirement, for

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[83] Initial Stip. ¶13.
[84] *J.C. Penney Nat'l Bank*, 19 S.W.3d at 839.
[85] There is nothing in the record here to suggest that MBNA owns its customers' credit cards, but ownership is irrelevant in any event because such ownership is "constitutionally insignificant." *J.C. Penney Nat'l Bank*, 19 S.W.3d at 840, n.18.

the U.S. Supreme Court has "expressly rejected a 'slightest presence' requirement of constitutional nexus."[86]

Consequently, for the Circuit Court to hold MBNA subject to West Virginia tax was reversible error.

II. THE "FAIRLY RELATED" REQUIREMENT IS NOT A VALID PROXY FOR THE SUBSTANTIAL NEXUS REQUIREMENT

The Circuit Court provided two rationales for holding that MBNA was subject to West Virginia tax jurisdiction. As discussed immediately above, its economic presence rationale (generation of income from in-state sources[87]), which correctly focuses on the first prong of the *Complete Auto* four-prong test, incorrectly replaces the exacting substantial nexus requirement of the Commerce Clause with the less stringent minimum contacts (market exploitation) requirement of Due Process.

The Circuit Court's second rationale represents a new and radical departure from reasoned constitutional nexus jurisprudence because it incorrectly confuses one prong of the *Complete Auto* test with another. In doing so, the Circuit Court pursues an approach taken by no other state appellate court in the country.

A. NO AUTHORITY SUPPORTS THE CIRCUIT COURT'S CONCLUSION THAT SUBSTANTIAL NEXUS CAN BE FOUND IN THE AVAILABILITY OF BASIC GOVERNMENTAL SERVICES

The Circuit Court's second rationale was that the State has jurisdiction to tax MBNA simply because "the State provides banking and consumer credit laws as well as access to its

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86 *Quill,* 504 U.S. at 315, n. 8 (quoting from *National Geographic Soc. v. California Bd. of Equalization*, 430 U.S. 551, 556 (1977). The Court in *Quill* agreed that "the existence in North Dakota of a few floppy diskettes [ordering software] to which Quill holds title seems a slender thread upon which to base nexus," and concluded that, while this "might constitute some minimal nexus," it did not satisfy the substantial nexus requirement. *Id.*

87 *Steager v. MBNA*, at ¶¶ 8, 23.

courts which support the generation of income by MBNA."[88] There is absolutely no authority to support this determination and, consequently, the Circuit Court cites none. In fact, if the Circuit Court's inventive availability-of-services requirement were the correct constitutional requirement or a valid proxy for the U.S. Supreme Court's substantial nexus requirement, then every state would automatically have a substantial nexus with every corporation that has in-state customers because every state in this nation has a judicial system and educates its citizens.

B. SATISFACTION OF THE "SUBSTANTIAL NEXUS" AND "FAIRLY RELATED" REQUIREMENTS MUST BE EVALUATED INDEPENDENTLY

The source of the Circuit Court's error appears to have been its fundamental confusion of two separate and distinct constitutional principles that bear on the validity of state tax imposition.

As explained above, the U.S. Supreme Court distilled decades of constitutional jurisprudence regarding state taxation into four requirements it set forth in *Complete Auto*: A state tax will withstand Commerce Clause challenge if it "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[89] This first question in the case at bar concerns the first of these requirements ("substantial nexus"), while the second question involves the second of these requirements ("fairly apportioned," discussed in Part Two of this brief below). Without any justification, the Circuit Court has mistakenly concluded that the substantial nexus requirement is automatically satisfied if the fourth requirement ("fairly related to the services provided by the State") is satisfied.

It may be an interesting academic exercise to ascertain whether the *Complete Auto* fourth-prong requirement is satisfied in this case. The Circuit Court concluded that it is, but the

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88 *Id.*
89 *Complete Auto*, 430 U.S. at 279.

validity of this conclusion is irrelevant to the resolution of this case. The question here is whether MBNA had a "substantial nexus" with West Virginia, not whether the CNT and BFT impositions are "fairly related" to the basic governmental services made available to MBNA by West Virginia ("banking and consumer credit laws as well as access to its courts.")[90] The thorough review of substantial nexus case law, presented above, contains not a whisper of a suggestion that the "fairly related" requirement can serve as a proxy for the separate and distinct "substantial nexus" requirement, because there is no such support.

Consequently, this fundamental rationale, on which the Circuit Court's holding is based, must be rejected, and the Circuit Court's decision reversed.

III. AS THERE IS INSUFFICIENT NEXUS BETWEEN MBNA AND WEST VIRGINIA, THE CIRCUIT COURT'S DECISION SUSTAINING THE COMMISSIONER'S DENIAL OF REFUNDS MUST BE REVERSED

The Circuit Court committed reversible error when it failed to follow the U.S. Supreme Court's substantial nexus requirement and its inherent physical presence standard. Neither of the rationales the Circuit Court provided for its holding – economic presence (generation of income) nor provision of governmental services – finds any support in the U.S. Supreme Court's nexus jurisprudence.[91] If the Circuit Court had properly applied U.S. Supreme Court

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90 *Steager v. MBNA*, at ¶¶ 8, 10.

91 Neither the Circuit Court nor the Commissioner have suggested that the activities of third parties (such as the law firms that assisted with a *de minimis* amount of collection activity in the state) could be attributed to MBNA for purposes of satisfying the substantial nexus requirement, nor could they. This reflects a correct understanding of the law because the U.S. Supreme Court has found the substantial nexus requirement satisfied by attribution of another's physical presence only in the narrow circumstance when the in-state party's activities are "significantly associated with the taxpayer's ability to establish and maintain a market in the state for the sales." *Tyler Pipe Indus. v. Washington State Dep't of Revenue*, 483 U.S. 232, 250 (1987); *see also, Scripto, Inc. v. Carson*, 362 U.S. 207 (1960). Specifically, the other party's in-state activities must involve "solicitation, which was the most important function in allowing [the

precedent, it would have found that the State had no jurisdiction to impose CNT or BFT on MBNA. If this Court finds no tax jurisdiction, it need not consider the second question, regarding the constitutionality of West Virginia's special apportionment rules for financial organizations.

PART TWO:
MBNA'S WEST VIRGINIA APPORTIONMENT IS ZERO

The Circuit Court gave short shrift to the second question in this case: Assuming, for sake of argument, that West Virginia is not barred from imposing tax on MBNA despite its lack of substantial nexus, is the State's share of MBNA's income and capital zero in any event because West Virginia's special apportionment rules, as applied to MBNA, are invalid under the Commerce Clause? The Circuit Court erroneously concluded, with little analysis, that these rules, as applied to MBNA, withstand constitutional challenge.

I. THE BFT AND CNT TAX BASES ARE NOT FAIRLY APPORTIONED FOR MBNA

As explained above, the second requirement by which the U.S. Supreme Court evaluates the constitutionality of state tax statutes under the Commerce Clause is that the tax must be

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out-of-state putative taxpayer] to maintain its business." *J.C. Penney Nat'l Bank v. Johnson,* 19 S.W.3d 831, 841 (Tenn. Ct. App. 1999); *see also, JS&A Group, Inc. v. SBE* (Cal. Ct. App. 1997) (unpublished opinion); *Baker & Taylor, Inc. v. Kawafuchi*, 82 P.3d 804, 813 (Haw. 2004); *House of Lloyd v. Commonwealth*, 694 A.2d 375, 377 (Pa. Commw. Ct. 1997); *In re Appeal of Family of Eagles, Ltd.*, 66 P.3d 858, 865 (Kan. 2003); *Department of Revenue v. Share Int'l*, 676 So.2d 1362 (Fla. 1996). The U.S. Supreme Court has emphatically recognized that in the two very specific fact-based cases where it condoned attribution (*Scripto* and *Tyler Pipe*), doing so was the "furthest extension" of state jurisdictional authority it had ever – and presumably, would ever – permit. *Quill*, 504 U.S. at 306. Collection activities do not satisfy this constitutional requirement.

"fairly apportioned."[92] If West Virginia's special apportionment rules for financial organizations are invalid as applied to MBNA because they do not satisfy this requirement, then the State's general apportionment rules apply by default. The Commissioner has stipulated that, in this event, none of MBNA's income or capital would be apportioned to West Virginia.[93] Therefore, if West Virginia's special apportionment rules for financial organizations are unconstitutional as applied to MBNA, then MBNA has no West Virginia income or capital, and is not liable for the CNT or BFT.

A. APPORTIONMENT MAY REACH ONLY THE INCOME AND CAPITAL OF A COMPANY THAT IS REASONABLY ATTRIBUTABLE TO THE COMPANY'S IN-STATE COMMERCIAL ACTIVITY

The Commerce Clause fair apportionment requirement mandates that, once a state has jurisdiction to impose tax upon a company, it may tax only that portion of the company's income and capital that is reasonably attributable to the commercial activities conducted by the company within the state. This requirement examines "the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to *activity* within the taxing State."[94] In an early application of this requirement, the U.S. Supreme Court found an apportionment method unconstitutional in a case where "the method adopted was not reasonably attributable to the processes conducted within the borders of that State."[95] Perhaps the clearest statement of the requirement is this:

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92 *Complete Auto*, 430 U.S. at 279.

93 Initial Stip., ¶ 31.

94 *Oklahoma Tax Comm'n v. Jefferson Lines*, 514 U.S. 175, 185 (1995) (emphasis supplied).

95 *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 133 (1931). In this case, the U.S. States Supreme Court struck down a North Carolina apportionment formula that did not adequately account for the out-of-state activities of the corporate taxpayer and their contribution to the taxpayer's income – taxing eighty percent of the taxpayer's income even though "the

[I]t is the *commercial activity* within the State, and not the sales volume . . . by which the tax must be apportioned.[96]

Under this requirement, an apportionment formula must be invalidated under *Complete Auto* if the formula, as applied to the taxpayer, is not at least a "rough approximation of a corporation's income that is reasonably related to the *activities conducted* within the taxing State."[97]

In all of these formulations of the fair apportionment requirement, the critical inquiry concerns the taxpayer's "commercial activities" within the state. In any judicial attempt to determine whether a state's apportionment formula, as applied to a particular taxpayer, properly includes the traditional three factors – property, payroll, and sales[98] – or only one or two of those factors, the question is whether those factors are "reasonably related to the activities [that the taxpayer] conducted within the taxing state."[99] That is, as the U.S. Supreme Court has explained, "the factor or factors used must actually reflect a reasonable sense of how income is generated" by the taxpayer.[100] Even though the Court has given state legislatures somewhat broad latitude in fashioning apportionment formulae, any formula that fails to satisfy the *Moorman* requirement that the factors be "reasonably related to the activities conducted within

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average income having its source in the manufacturing and tanning operations within the state of North Carolina was seventeen percent." *Hans Rees*, 283 U.S. at 134.

96 *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 281 (1978) (Brennan, J., dissenting) (emphasis supplied). Although this case is often mistakenly cited for the proposition that single-sales-factor apportionment formulae are inevitably constitutional, the majority opinion actually held only that the taxpayer had failed to prove that Iowa's formula produced arbitrary results for that taxpayer. Justice Brennan's dissent captured the essence of the Court's requirement.

97 *Moorman*, 437 U.S. at 273 (emphasis supplied).

98 For decades, the most common apportionment formula employed by states has been the three-factor formula set forth by the Multistate Tax Commission (MTC) in its model regulations. "The elements of the apportionment formula are the property factor, the payroll factor and the sales factor of the trade or business of the taxpayer." MTC Reg. §IV.9 (internal citations omitted).

99 *Moorman*, 437 U.S. at 273.

100 *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).

the taxing state" cannot be sustained because such a formula will not constitute "a realistic legislative solution" to the problem of apportioning income and capital.[101]

B. SALES-VOLUME APPORTIONMENT CAPTURES INCOME AND CAPITAL THAT IS NOT REASONABLY ATTRIBUTABLE TO MBNA'S IN-STATE COMMERCIAL ACTIVITY

For most corporations, their West Virginia apportionment is computed based on the traditional three-factor formula, composed of the average of three fractions, based on property, payroll and sales.[102] The denominator of each fraction is the dollar amount of that item everywhere, while the numerator is that portion of the item that is properly sourced to West Virginia. When determining the portion of a general corporation's sales receipts[103] that are sourced to West Virginia, the test turns on where the greater proportion of income producing activity was performed, based on the taxpayer's costs of performing the services.[104]

MBNA, however, has stipulated that it is a "financial organization" for purposes of the West Virginia BFT and CNT. In stark contrast to the apportionment formula and sourcing rule for general corporations, financial organizations are required by law to determine the portion of their tax base that is subject to BFT or CNT not according to the traditional three-factor formula, but instead with a special fraction that is based solely upon receipts.[105] For sourcing receipts, instead of applying a rule that would be consistent with the "cost of performance" sourcing rule for general corporations, a special market-state sourcing rule is provided for financial

101 *Goldberg v. Sweet*, 488 U.S. 252, 263-264 (1989).
102 W. VA. CODE §11-23-5 (BFT); W. VA. CODE §11-24-7 (CNT).
103 The referenced rule addresses sales of other than tangible personal property.
104 W. VA. CODE §11-23-5(m); W. VA. CODE §11-24-7(e)(12).
105 W. VA. CODE §11-23-5a(g) (BFT); W. VA. CODE §11-24-7b(g)(1)(D) (CNT).

organizations: interest and fee income from credit cards are sourced to West Virginia if the borrower is a state resident or the billings are sent to a West Virginia address. [106]

The U.S. Supreme Court's test of the constitutionality of an apportionment formula and its sourcing rules – are the rules "reasonably related to the activities conducted [by MBNA] within the taxing state"? – requires a functional analysis of the taxpayer's commercial activities.[107] ***Customer activity*** is irrelevant to functional analysis and to the Supreme Court's test; both functional analysis and the Supreme Court look to the ***commercial activity of the corporation*** itself. [108]

The logical consequence of the Court's requirement is this: While the traditional three-factor formula (property, payroll and sales) constitutes a reasonable proxy for the functions and assets that generate a company's (including a financial organization's) revenues and profits, the sales factor alone does not. Sales volume may give some indication of the magnitude of a company's business, but it is not and cannot be a reasonable proxy for functional analysis and the Supreme Court's test, both of which look to the commercial activities of the taxpayer –

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106 W. VA. CODE §11-23-5a(f)(1) (BFT); W. VA. CODE §11-24-7b(g)(1)(F) (CNT).

107 Although not described by the Court in so many words, the functional analysis approach in economics is the inquiry required by the U.S. Supreme Court when it requires that apportionment rules must reasonably reflect the taxpayer's in-state "commercial activity." Perhaps not coincidentally, functional analysis also underlies the federal tax transfer pricing regulations' approach to attributing global dealing activity: "The relative value of each participant's contribution to the global dealing activity must be determined in a manner that reflects the ***functions performed***, risks assumed, and ***resources employed*** by each participant in the activity ..." Treas. Reg. §482-8(e)(2) (emphasis supplied). Functional analysis similarly is the guiding principle behind international requirements for attribution of profits: "[T]he ***functional and factual analysis*** determines the attribution of profits to the [jurisdiction] in accordance with its functions performed, assets used and risks assumed, and informs also the attribution of free capital and interest bearing debt to the [jurisdiction]." Organization of Economic Cooperation and Development ("OECD"), *Discussion Draft on the Attribution of Profits to Permanent Establishment*, "Part 1 (General Considerations)," Aug. 2, 2004, ¶ 56 (emphasis supplied).

108 *Moorman*, 437 U.S. at 273.

which activities are conducted by the taxpayer's deployment of labor (quantified by the payroll factor) and assets (land and capital, quantified by the property factor)[109] – not to the activities of the taxpayer's customers (quantified by the sales factor.)

To determine whether this special apportionment formula and sourcing rule for financial organizations, as applied to MBNA, satisfies the test set forth above – are the rules "reasonably related to the activities conducted [by MBNA] within the taxing state"?[110] – a functional analysis of MBNA's activities must therefore be performed. A functional analysis of MBNA's commercial activity reveals that none of its economically significant functions are performed in West Virginia, nor are any of its assets developed, owned or maintained in West Virginia. It has been stipulated that none of the labor and none of the capital that MBNA uses to conduct its business enterprise is located in West Virginia.

Because it is stipulated that none of MBNA's "commercial activity" (its deployment of labor and capital) took place in West Virginia, there is no "economic justification for the State's claim upon the value taxed … [because the] State's tax reaches beyond that portion of value that is fairly attributable to [MBNA's] activity within the taxing State."[111] West Virginia's apportionment formula is computed with absolutely no regard for where MBNA's labor and capital are deployed – no regard for the location of MBNA's commercial activity – but instead

109 This hoary economic concept, that revenues and profits are derived from an organization's deployment of its labor and land/capital, has been a foundation of modern economic theory from the beginning. "In 1776, *The Wealth of Nations,* Adam Smith's monumental work, was published. Many economic historians credit Adam Smith with being the father of modern economics. … Smith's classical school identified three sources of wealth creation: land, labor and capital. These are the three factors of production that contribute to national wealth as well as to individual wealth." Reilly, Robt. F. and Schweihs, Robt. P., The Handbook of Business Valuation and Intellectual Property Analysis, New York, McGraw-Hill (2004), p. xxxix.

110 *Moorman*, 437 U.S. at 273.

111 *Jefferson Lines*, 514 U.S. at 185.

apportions income and capital based solely on the location of MBNA's customers (by dollar volume of receipts).

Application of West Virginia's special formula to MBNA is "out of all appropriate proportion"[112] to MBNA's commercial activity in West Virginia, because the sizable apportionment (and sizable tax) produced by the special formula must be contrasted to zero – which is both the apportionment and the tax that result for MBNA from application of the apportionment formula and sourcing rules for general corporations. In this important sense, the case at bar cries out for invalidation of the apportionment rules even more than did the case in *Hans Rees' Sons*, which involved merely the difference between eighty and seventeen percent apportionment, instead of the difference between sizable and zero apportionment.[113]

The Circuit Court's decision does not, because it could not, point to any activity of MBNA in West Virginia that would justify the Commissioner's attempt to impose tax on 100% of the income attributed to West Virginia customers.[114] By apportioning income and capital based solely on the location of MBNA's customers – and utterly ignoring the reality that all of the labor and capital that generated MBNA's receipts from West Virginia customers was "derived from the conduct of the enterprise in another State" – West Virginia's apportionment formula fails to satisfy the fair apportionment requirement as applied to MBNA.[115]

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[112] *Container*, 463 U.S. at 181.

[113] *Hans Rees' Sons*, 283 U.S. 123.

[114] The Circuit Court repeatedly pointed to the dollar volume of MBNA's receipts paid from West Virginia addresses, but provides no authority to even suggest that constitutional requirements may be ignored if the volume of customers located in a particular state exceeds a certain threshold.

[115] The Commissioner's own counsel has acknowledged that the enactment of the formula now being applied against MBNA would "specifically … skew more income to [the state] than would the requirement formula," with the result that "the external consistency test [another term for the

C. THE COMMERCE CLAUSE FORBIDS APPORTIONMENT THAT DISCRIMINATES AGAINST INTERSTATE COMMERCE

The Circuit Court also failed to address adequately the prohibition against discrimination against interstate commerce. The discrimination inherent in the formula in question was so evident that the Commissioner's counsel admitted at its enactment that "even if the Court finds the single factor formula to be fair under the fair apportionment prong, it might find that it violates the nondiscrimination prong, if it 'subjects an interstate taxpayer to more tax liability than a purely intrastate taxpayer conducting exactly the same activities within the State.'"[116]

The Circuit Court points out that West Virginia domiciled banks are taxed at the same rate as foreign banks such as MBNA. That is not the point. Discrimination can exist based on nothing more than an unfair apportionment formula, as the Supreme Court has noted: "[a] tax that unfairly apportions income from other States is a form of discrimination against interstate commerce."[117] Further, a tax will be found discriminatory if it negatively impacts the system of interstate commerce even if no in-state party is benefited over an out-of-state party.[118]

The issue here is that a single-factor sales apportionment formula (with special rules for sourcing income from intangibles more heavily to West Virginia) is specifically designed to increase the tax burden of non-domiciliary corporations that have customers inside West Virginia's borders. This discriminatory apportionment formula "produced results forbidden by the Commerce Clause,"[119] and so must be struck down.

Commerce Clause "fair apportionment" requirement discussed above] may be more difficult to pass….." Initial Stip., Ex. G, at 12.

116 Initial Stip., Ex. G, at 12 (quoting P. Tatarowicz, "An Analytical Approach to State Tax Discrimination Under the Commerce Clause," 39 Vand. L. Rev. 922 (1986)).

117 *Armco, Inc. v. Hardesty*, 467 U.S. 638, 644 (1984).

118 *See*, *General Motors Corp. v. Tracy*, 519 U.S. 278 (1997).

119 *Complete Auto*, 430 U.S. at 285.

D. THE CIRCUIT COURT ERRED WHEN IT FAILED TO INVALIDATE THE APPORTIONMENT SCHEME AS APPLIED TO MBNA

The Commerce Clause forbids apportionment that unfairly attributes income and capital in a manner that is not rationally related to the taxpayer's in-state commercial activity, but that is precisely what West Virginia's special apportionment rules do in MBNA's case. Consequently, the Circuit Court erred when it condoned the application of those rules to MBNA. It should have invalidated the application to MBNA of those special rules and concluded that MBNA had no income or capital properly apportioned to the State.

II. WEST VIRGINIA'S APPORTIONED SHARE OF MBNA'S INCOME AND CAPITAL IS ZERO

The conclusion flows naturally. West Virginia's special apportionment rules for financial organizations result in apportionment that is not rationally related to MBNA's in-state commercial activity. These rules therefore should have been invalidated by the Circuit Court, and the apportionment rules for general corporations applied instead. Under those rules, MBNA had no property in the state, no payroll in the state, and none of its receipts were properly sourced to the state. Consequently, MBNA's correct West Virginia apportionment was zero, and the Circuit Court's contrary holding must be reversed.

CONCLUSION

For the foregoing reasons, Petitioner MBNA America Bank, N.A. respectfully requests that the decision of the Circuit Court be reversed and that the decision of the Office of Tax Appeals be reinstated, awarding MBNA the full amount of its refund claims for Business Franchise Tax and Corporation Net Income Tax in 1998 and 1999, plus statutory interest and all other and further relief deemed appropriate.

Dated: April 26, 2006

Respectfully submitted,

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IN THE WEST VIRGINIA SUPREME COURT OF APPEALS

MBNA America Bank, N.A.,
Petitioner,
v.
West Virginia State Tax Commissioner,
Respondent.

No. 33049

CERTIFICATE OF SERVICE

I, Craig A. Griffith, hereby certify this 26th day of April, 2006, the foregoing ***"Brief of MBNA America Bank, N.A."*** of Petitioner, has been served upon the following parties, by placing exact and true copies thereof, in the United States mail, first class and postage pre-paid, in envelopes addressed as follows:

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