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IN THE

SUPREME COURT OF VIRGINIA

RECORD NO. 171627

THE CORPORATE EXECUTIVE BOARD COMPANY,

Appellant/Plaintiff,

v.

VIRGINIA DEPARTMENT OF TAXATION,

Appellee/Defendant.

REPLY BRIEF OF APPELLANT

From the Circuit Court of Arlington County
Case No. CL16-1525

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I. The Relief Statute, Code § 58.1-421, Requires The Department As A Matter Of Law To Permit CEB To Use An Alternative Method Of Apportionment If CEB's Apportionment Under the Statutory Method Is Inapplicable Or Inequitable.

The Department of Taxation ("Department") repeatedly asserts in its brief that it is left to its "sound discretion" whether to allow The Corporate Executive Board Company ("CEB") to use an alternative method of apportionment, and that its determination in that regard is subject to an abuse of discretion standard.[1] Dep't Br. at 17, 18, 31-32, 36, 38, 41. That is not the correct standard.

Under Code § 58.1-421, CEB *by law* is entitled to use an alternative method of apportionment if it demonstrates that its apportionment under the Statutory Method is either inapplicable (that is, produces an unconstitutional result) or inequitable. If CEB demonstrates that its apportionment is inapplicable, the Department *must* allow CEB to use an alternative method of apportionment that produces a constitutional result. Contrary to its argument, the Department has *no discretion* to subject a taxpayer to an apportionment that produces an

[1] Citing *LZM, Inc. v. Va. Dep't of Taxation*, 269 Va. 105, 109 (2005), the Department further asserts that its "interpretation of a tax statute is entitled to great weight." Dep't Br. at 16, 31-32. However, Code § 58.1-205(4) provides that, in any proceeding commenced under Code § 58.1-1825, rulings and administrative interpretations, except regulations or specified types of rulings, "shall be accorded no weight." *See Kohl's Dep't Stores*, 295 Va. at 180 n.1 (granting petition for rehearing). The Department does not explain how, in light of Code § 58.1-205(4), its determination to refuse to allow CEB to use an alternative method of apportionment should be given "great weight."

unconstitutional result, and the Department cites no contrary case law.

Similarly, if an apportionment is inequitable, the Department *must* allow the taxpayer to use an alternative method of apportionment that is not inequitable. Pursuant to 23 VAC 10-120-280(B)(4)(b), an apportionment is "inequitable" if the apportionment (1) results in double taxation of the taxpayer's income *and* (2) "[t]he inequity is attributable to Virginia, rather than to the fact that some other state has a unique method of allocation and apportionment." As interpreted in *Dep't of Taxation v. Lucky Stores, Inc.*, 217 Va. 121 (1976), the assessment must be set aside if it "is contrary to law or [ ] the administrator has abused his discretion and acted in an arbitrary, capricious or unreasonable manner." *Id*. at 127. An inequitable apportionment is contrary to law, and the Department does not have the "discretion" to require a taxpayer to use an apportionment the taxpayer has shown to be inequitable. The Department cites no contrary case law.

There is no dispute regarding the double taxation of CEB's income. The only issue is whether the double taxation is attributable to Virginia or to some other state's unique method of apportionment. Given that CEB has shown that the double taxation of its income is not the result of some other state's unique method of apportionment, the Department's refusal to allow CEB to use an alternative method of apportionment is both contrary to law *and* an abuse of discretion.

While the Department has a certain amount of discretion regarding what

alternative method of apportionment it will allow the taxpayer to use pursuant to Code § 58.1-421, that alternative method of apportionment *must* provide a constitutional *and* equitable result to the taxpayer. It bears emphasis in that regard that the Department has not proposed to this Court (or to the Circuit Court below) a different method of apportionment other than the Statutory Method. Rather, the Department simply opposes *any* deviation from the Statutory Method. Consequently, the only apportionment method before the Court that meets that statutory standard of constitutionality and equity is CEB's Proposed Method.

II. The Department Is Incorrect That The Apportionment Of CEB's Income Does Not Present Any Constitutional Concerns.

The Department argues that the apportionment of CEB's income does not present any constitutional concerns, relying primarily on passages regarding double taxation in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978). The Department's argument is contrary to Code § 58.1-421, which requires the use of an alternative apportionment methodology if the Statutory Method yields an unconstitutional result. The Department also largely ignores more recent opinions of the U.S. Supreme Court, including *Comptroller of Treasury of Md. v. Wynne*, 135 S. Ct. 1787 (2014), that hold that the existence of double taxation can present serious constitutional issues.

It is important to note that the Department does *not* dispute in its brief that, under the apportionment applied to CEB here, the existence of interstate commerce

has been disregarded. That is, the Department does not dispute—for it cannot dispute—that, although 95 percent of CEB's sales were made to customers outside of Virginia, CEB's apportionment "deemed" all those interstate sales to have been made in Virginia. Nor does the Department dispute that, by ignoring the existence of interstate commerce, CEB's apportionment more than doubled the amount of CEB's income taxable under the Virginia Corporation Income Tax *and* subjected a substantial portion of CEB's income to double taxation.

To be sure, it is *not* CEB's contention that the existence of double taxation, of itself, necessarily renders an unconstitutional result. Rather, CEB's argument is that an apportionment, as here, that wholly disregards the existence of interstate commerce, and that thereby produces a *much* higher apportionment of taxable income *and* substantial double taxation, produces an unconstitutional result.

The Department's argument that the existence of double taxation is of no constitutional importance cannot be reconciled with *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995), where the Court explained the relationship of the fair apportionment requirement to the risk of multiple taxation:

> The difficult question in this case is whether the tax is properly apportioned within the meaning of the second prong of *Complete Auto's* test, "the central purpose [of which] is to ensure that each State taxes only its fair share of an interstate transaction." *Goldberg* [*v. Sweet*, 488 U.S. 252, 260-261 (1989)]. This principle of fair share is the lineal descendant of *Western Live Stock's* prohibition of multiple taxation, which is threatened whenever one State's act of overreaching combines with the possibility that another State will claim its fair share

> of the value taxed: the portion of value by which one State exceeded its fair share would be taxed again by a State properly laying claim to it. . . . Here, the threat of real multiple taxation (though not by literally identical statutes) may indicate a State's impermissible overreaching.

514 U.S. at 184-85. *See also General Motors Corp. v. Tracy*, 519 U.S. 278, 298 n.12 (1997) ("[T]he requirement of apportionment . . . assur[es] that interstate activities *are not unjustly burdened by multistate taxation.*") (emphasis added) (citing *Jefferson Lines*).

Indeed, only three years ago, the U.S. Supreme Court spoke extensively in *Wynne* on the constitutional issues raised by double taxation.[2] In its discussion of three early decisions involving double taxation,[3] the Court observed: "In all three of these cases, the Court struck down a state tax scheme that might have resulted in the double taxation of income earned out of the State and that discriminated in favor of intrastate over interstate economic activity." *Wynne*, 135 S. Ct. at 1795. Here, CEB not only has been subjected to substantial double taxation (it is not merely a risk), but CEB's interstate sales resulted in a higher overall tax of CEB's income because they were used for two states' apportionments, whereas CEB's

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[2] In *Wynne*, the Supreme Court held that the Maryland tax at issue violated the internal consistency test. The Maryland Court of Appeals in its opinion in *Wynne* held that the tax also failed the external consistency test because it created a risk of multiple taxation. *Wynne*, 135 S. Ct. at 1795; *Comptroller of Treasury of Md. v. Wynne*, 64 A.3d 453, 467-68 (Md. 2013) (citing and quoting *Jefferson Lines*).

[3] *J.D. Adams Mfg. Co. v. Storen*, 304 U.S. 307 (1938); *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434 (1939); *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948).

intrastate sales were only used for Virginia's apportionment. Consequently, CEB paid state income tax on over 120 percent of its nationwide income. JA47 ¶ 40.[4]

The Department's reliance on *Moorman* is misplaced. While the Court discussed double taxation in *Moorman*, it did so in the context of that being the sole possible basis for the taxpayer's constitutional challenge. *Moorman*, 437 U.S. at 278 ("The only conceivable constitutional basis for invalidating the Iowa statute would be that the Commerce Clause prohibits any overlap in the computation of taxable income by the States."). That is, *Moorman* held that the existence of some double taxation will not, of itself, render an apportionment unconstitutional; it did *not* hold that the existence of double taxation is unimportant when assessing whether an apportionment methodology produces an unconstitutional result, as applied to a specific taxpayer and its specific facts and circumstances.

In light of the Department's repeated statements (Dep't Br. at 3, 27-28) that CEB is challenging the constitutionality of the cost of performance sourcing provision (Code § 58.1-416), it must be reiterated that CEB has never taken that position. The Statutory Method's cost of performance sourcing provision may not

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[4] The discussion in *Wynne* of *J.D. Adams* is highly instructive: "Holding that this scheme violated the dormant Commerce Clause, we explained that the 'vice of the statute' was that it taxed, 'without apportionment, receipts derived from activities in interstate commerce.' . . . If these receipts were also taxed by the States in which the sales occurred, we warned, interstate commerce would be subjected 'to the risk of a double tax burden to which intrastate commerce is not exposed, and which the commerce clause forbids.'" 135 S. Ct. at 1795 (citations omitted).

produce an unconstitutional result for other Virginia taxpayers based on their particular facts and circumstances. But, for the reasons already fully briefed, with respect to the particular facts and circumstances of CEB's situation, the cost of performance sourcing provision has resulted in an unconstitutional result as contemplated by Code § 58.1-421 (i.e., doubling of CEB's Virginia apportionment and substantial double taxation of CEB's income). *See* 23 VAC 10-120-280(B)(4)(a) (providing that the unconstitutionality of a challenged apportionment is determined "under the particular facts and circumstances of the taxpayer's situation").[5]

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[5] The Department contends that, under the Proposed Method, CEB would have "nowhere income," which it describes as a "phenomenon where income is taxed in no State." Dep't Br. at 28 n.11 (citation omitted). The Department appears to be confusing taxable income with sales revenues. During the years at issue, CEB's income was taxed in Virginia and 35 other states. JA45 ¶ 36. Under the Proposed Method, because of CEB's very high property and payroll factors, Virginia would still apportion approximately 40 percent of CEB's total income for taxation. CEB Br. at 14-15. It is true that, under the Proposed Method, there might be some CEB sales revenues that would not be included in any states' apportionment given that, during those years, roughly one-third of the states where CEB was taxed used cost of performance sourcing for intangible goods. JA49 ¶ 53. But, because Virginia would still tax CEB on 40 percent its income, and CEB would continue to pay tax in the other 35 states under their apportionments, CEB would continue to pay substantial taxes on its total income. In contrast, the substantial double taxation of CEB's income under the Statutory Method is indisputable. *See* JA47 ¶ 40 (CEB taxed on over 120 percent of its nationwide income). Moreover, in light of the clear trend toward destination-based sourcing for sales of intangible goods (CEB Br. at 35, 37-38), as additional states adopt such destination-based sourcing, the amount of CEB's sales revenues that would not be used in any states' apportionment under the Proposed Method would decrease correspondingly.

The Department's argument that CEB has substantial connections to Virginia, which largely replicates the Circuit Court's discussion regarding those connections, is irrelevant. It is not, and has never been, CEB's contention that it does not have significant contacts with Virginia or that substantial work on its products was not performed in Virginia. The "substantial nexus" requirement is a separate requirement under the Commerce Clause analysis from the fair apportionment requirement. *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 278 (1977). As discussed in CEB's Opening Brief (CEB Br. at 22-24), the fair apportionment requirement does not look to a taxpayer's nexus to the state but to whether the state is taxing only its fair share of an interstate transaction or its fair share of income derived from interstate commerce. *See Kohl's Dep't Stores, Inc. v. Virginia Dep't of Taxation*, 295 Va. 177, 186 n.5 (2018) ("A state's jurisdiction to tax a corporation does not include the authority to tax all of that corporation's income, which is inherently divisible and only taxable to the extent it can be fairly apportioned to the state."). The Department's argument regarding CEB's extensive contacts with Virginia thus improperly confuses the "substantial nexus" requirement with the "fair apportionment" requirement.[6]

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[6] In support of its argument, the Department relies on case law relating to the constitutionality of sales taxes rather than the constitutionality of income apportionments. For example, the Department cites passages from *Jefferson Lines*, *supra*, and *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938), at Dep't (continued...)

Both the U.S. Supreme Court and this Court have emphasized that the constitutional fair apportionment analysis "is essentially a practical inquiry." *Goldberg*, 488 U.S. at 264; *City of Winchester v. American Woodmark Corp.*, 252 Va. 98, 101-02 (1996) ("the focus is not on the tax statute's formal language, but rather on its practical effect"). Here, 35 states take the position that they are entitled to tax a portion of CEB's income because of CEB sales in their states. Virginia, on the other hand, takes the position that it is entitled to use all of CEB's interstate sales to achieve an apportionment that taxes over 80 percent of CEB's income.[7] From a practical standpoint, it is Virginia, and not the 35 other states, that is taxing more than its "fair share" of CEB's income derived from interstate commerce.

Br. at 22, without explaining that the passages relate to whether advertising in publications distributed out-of-state had a sufficient nexus to the state to be subject to that state's *sales tax*. Importantly, after the discussion in *Jefferson Lines* on this point, the Court went on to distinguish *Central Greyhound, supra,* because that case involved a tax more akin to an income tax than a sales tax. *Jefferson Lines*, 514 U.S. at 190 ("The Court thus understood the gross receipts tax to be simply a variety of tax on income, which was required to be apportioned to reflect the location of the various interstate activities by which it was earned.")

[7] The Department does not appear to dispute that there is a "gross disparity" between CEB's apportionment percentages under the Statutory Method from the apportionment percentages under the Proposed Method, as that term was used in *Lucky Stores*, 217 Va. at 129. Rather, the Department argues that such a "gross disparity" is a necessary but not sufficient condition for finding an apportionment unconstitutional. Dep't Br. at 29-30. But the Department's argument does not respond to CEB's central point that the Statutory Method's treatment of all of CEB's *interstate* sales as *intrastate* sales led directly to a "gross disparity" in CEB's apportionment percentage for each year.

III. The Department Cites No Evidence That The Substantial Double Taxation Of CEB's Income Is The Result Of Some Other State's Unique Method Of Allocation And Apportionment.

As discussed above, pursuant to Code § 58.1-421, the Department *must* also permit CEB to use an alternative method of apportionment if CEB can show that its apportionment results in double taxation of its income *and* "[t]he inequity is attributable to Virginia, rather than to the fact that some other state has a unique method of allocation and apportionment." 23 VAC 10-120-280(B)(4)(b). There is no issue regarding the double taxation of CEB's income. The only possible issue is whether the double taxation is attributable to Virginia or to some other state's unique method of apportionment.

While the Department defends the cost of performance sourcing method in its brief, it cites absolutely no evidence that destination-based sourcing is a unique method of apportionment. To the contrary, as discussed in CEB's Opening Brief (CEB Br. at 35, 37-38), destination-based sourcing is used by virtually every state (including Virginia) for sales of tangible goods, and has been adopted by many states for sales of intangible goods and services. As set forth in the Joint Stipulations, during the three tax years at issue, only approximately one-third of the 36 states in which CEB paid taxes used a cost of performance sourcing method similar to that of Virginia. JA45 ¶ 36; JA49 ¶ 53. In no sense can the 23 other states that used destination-based sourcing to source CEB's sales as part of their

apportionments of CEB's income be considered to have used a unique method of apportionment. JA46-JA47 ¶ 38. Thus, under the applicable standard set forth in Code § 58.1-421 and 23 VAC 10-120-280(B)(4)(b), the Department was *required by law* to permit CEB to use an alternative method of apportionment.

The Department argues that, nevertheless, its refusal to allow CEB to use an alternative method of apportionment is justified by the fact that the cost of performance sourcing provision for intangible goods and services has been in place in Virginia for nearly 60 years, and that most states had a similar rule for many years. Dep't Br. at 33-35. It contends that the decision to allow CEB to use destination-based sourcing method in lieu of cost of performance sourcing is ultimately a policy decision that must be made by the General Assembly. *Id.* at 36. But that plainly is not the standard set forth in Code § 58.1-421.

The Relief Statute does not speak in terms of what may have been constitutional or equitable in the past. Rather, it speaks in terms of whether a *particular* taxpayer's apportionment for a *particular* tax year is constitutional and equitable with respect to the *particular* circumstances of *that* taxpayer. The Department's position that it will not deviate from the cost of performance sourcing provision because that provision has been in existence for nearly 60 years is inconsistent with the very purpose of the Relief Statute, which is to provide a mechanism for relief to taxpayers that can show that the application of the

Statutory Method to *their* facts and circumstances has resulted in an unconstitutional or inequitable apportionment of *their* income.[8]

Accordingly, the Department's argument that the General Assembly's decision not to modify the cost of performance sourcing provision supports its determination to deny CEB's request to use destination-based sourcing for the sales of its products is wrong, in that the Relief Statute is specifically intended to deal with situations, such as the one here, where the Statutory Method produces an unconstitutional result or inequitable apportionment. *See* CEB Br. at 38-40. It is ironic that the Department argues that any decision to modify the cost of performance sourcing provision in a particular taxpayer's circumstances is a policy decision it cannot assume unto itself, while at the same time it simply disregards the policy embodied in the Relief Statute that taxpayers should be allowed to use an alternative method of apportionment where the Statutory Method produces an unconstitutional result or inequitable apportionment of their income.[9]

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[8] The Department suggests that, if this Court were to rule in CEB's favor, a variety of other taxpayers would attempt to take advantage of that ruling. Dep't Br. at 37-38. Whatever other taxpayers might do in such a circumstance, Code § 58.1-421 requires that the Department must consider each taxpayer's specific facts and circumstances individually in making its determination whether to permit the taxpayer to use an alternative method of apportionment.

[9] The Department argues that CEB's position is undermined by its election to use cost of performance sourcing in California when given that choice. Dep't Br. at 35. But, had CEB made the choice to use destination-based sourcing in California in those years, it would have elected to have its income double taxed in its single

(continued...)

The Department's argument begs the question if there is any alternative method of apportionment that a taxpayer could propose under the Relief Statute which deviates from the Statutory Method that the Department would approve. The Department's argument that the provisions of the Statutory Method reflect the General Assembly's intention, and therefore cannot be altered for any taxpayer's situation, presumably applies to all taxpayers and all of the statute's provisions. If that logic justifies denying a taxpayer's proposed alternative apportionment, then Code § 58.1-421 would not appear to have any real purpose.

IV. The Alternative Apportionment Method CEB Has Proposed Is Reasonable And Workable, And Cures The Deficiencies In The Apportionment Of CEB's Income Under The Statutory Method.

The Department argues that if CEB is entitled to administrative relief pursuant to Code § 58.1-421, the destination-based sourcing that CEB proposed in its alternative apportionment method, and used by 23 other states, is problematic and does not "realistically reflect how or where CEB earns its income." Dep't Br. at 44. Specifically, even if CEB were permitted to use destination-based sourcing of its sales, the Department challenges CEB's proposal to use its customers' billing addresses as the "destination" for purposes of sourcing its sales revenues.

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largest market. Of course, beginning in 2013, CEB no longer had that choice, and consequently all of CEB's sales revenues from its California customers (representing almost 10 percent of all its overall sales) are used by both California and Virginia in their apportionments of CEB's income. JA47 ¶ 41.

While the Department proffers various hypotheticals to suggest that customer billing addresses are problematic to use, it does not address the stipulated facts, which speak directly to this issue and contradict the Department's claim that the use of customer's billing addresses is inappropriate. It is difficult to understand the Department's disregard of these stipulations given that the relevant stipulations were quoted in CEB's Opening Brief on this very point. CEB Br. at 41-42.

Specifically, Joint Stipulation 59 (JA50) states in pertinent part: "During the Tax Years, the default billing address was the contact person's address for most Members. The contact person is the individual that uses the product." And Joint Stipulation 32 (JA44) states: "Under the Proposed Method, CEB's sales are assigned to the source of the revenue to reflect CEB's customer base in a particular state . . . ." *See also* CEB Br. at 42 n.18. The Department simply ignores these stipulations—which directly contradict its argument that customer billing addresses do not accurately reflect the destination of CEB's products.

As the Tennessee Supreme Court recently stated in another apportionment case where customer billing addresses were used to source the taxpayer's income: "While no method is perfect, sourcing . . . service receipts according to the billing address of the customer appears reasonably suited to producing a rough approximation of the corporate income that is reasonably related to the activities conducted within the taxing State." *Vodafone Americas Holdings, Inc. v. Roberts*,

486 S.W.3d 496, 526 (Tenn. 2016) (citation omitted). While CEB's destination sourcing method may not be perfect, it is a reasonable and workable approach to identifying the destination of CEB's sales for sourcing its income.

Conclusion

For the reasons stated in its Opening Brief and this Reply Brief, CEB respectfully requests that this Court reverse the judgment in favor of the Department and enter judgment in favor of CEB.

Dated: July 27, 2018

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that Rule 5:26 of the Supreme Court of Virginia has been complied with and pursuant to the Rule, a PDF version of this brief has been filed through VACES and three paper copies delivered to the Clerk's Office. An electronic version has also been delivered to opposing counsel via email to Toby J. Heytens, Solicitor General, and Stephanie Anne Lipinski Galland, Counsel for Appellee, on this 27th day of July, 2018.

s/ Robert W. Loftin
Robert W. Loftin