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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.

BRIEF OF APPELLANT

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

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The Corporate Executive Board Company ("CEB") respectfully submits its Opening Brief of Appellant from a final judgment in favor of Appellee/Defendant Virginia Department of Taxation (the "Department").

I. STATEMENT OF THE CASE

A. Nature Of The Case

This is a Corporation Income Tax case in which CEB is challenging the apportionment of its income by the Department during the three tax years at issue, 2011 through 2013. Specifically, the apportionment method used by the Department, the Statutory Method, produced substantial double taxation of CEB's income in each of those years. Because the Statutory Method, as applied to CEB's business, resulted in an unconstitutional and inequitable apportionment, the Department was required by law, upon CEB's request, to adopt an alternative apportionment method. Despite this statutory mandate, the Department refused to adopt the alternative apportionment method proposed by CEB that would have eliminated the double taxation of CEB's income.

The central issue in this case is whether the Department can use an apportionment method that effectively disregards the existence of interstate commerce by treating CEB's out-of-state sales of intangible goods as if they were in-state sales, and subjects CEB to substantial double taxation as well as doubling the apportioned income on which CEB was required to pay Virginia Corporation

Income Tax. This unfair consequence is the result of the cost of performance sourcing provision in the Virginia apportionment statute (Code § 58.1-416), which provides that revenues from the sales of intangible goods will be deemed to be Virginia sales for apportionment purposes if the plurality of the work that created the intangible goods was performed in Virginia. Whatever the merits of this sourcing rule in the past, in today's world of electronically delivered digital products, this rule resulted in a grossly distorted apportionment for CEB, whose products are almost entirely digital and delivered electronically.

This case also raises important issues about the Department's obligation to allow a taxpayer to use an alternative apportionment method that eliminates the substantial double taxation of its income. Because it is widely recognized that apportionment methods can sometimes result in unconstitutional or inequitable apportionments, Virginia's apportionment statute includes a relief provision (Code § 58.1-421) that *requires* the Department to adopt, upon the taxpayer's request, an alternative apportionment method if the taxpayer's apportionment is unconstitutional or inequitable. By regulation, an apportionment is considered inequitable if it results in double taxation that is attributable to Virginia's apportionment method and not to some other state's unique apportionment method.

There is no dispute that double taxation of CEB's income occurred during the three tax years in question; indeed, it is a stipulated fact that roughly one-third

of CEB's sales revenues were used both by Virginia and another state to apportion CEB's income for taxation. Nor is there a serious issue that the alternative method CEB has proposed—the use of destination-based sourcing for the sales of its products—is a commonly used sourcing method, both in Virginia (for tangible goods) and in many other states (for both tangible and intangible goods). Nevertheless, the Department has refused to apply an alternative apportionment method to CEB's income, even though the statute requires it to do so where an apportionment is unconstitutional or inequitable. This case thus provides an opportunity for this Court to address the proper application of Code § 58.1-421 where a taxpayer has demonstrated undeniable double taxation and proposed an alternative apportionment method that is well within the mainstream of state apportionment practices.

B. Material Proceedings Below

In November of 2014, CEB filed a refund claim pursuant to Code § 58.1-421 and 23 VAC 10-120-280 for its 2011, 2012 and 2013 taxable years (the "Tax Years"), in which it asked the Department to apply an alternative apportionment method to its income in those years for purposes of the Virginia Corporation Income Tax. Joint Appendix ("JA") 42-JA43 ¶¶ 20-21. The Department failed to act on CEB's refund claim within three months, resulting in a deemed denial of the claim pursuant to Code § 58.1-1823. JA43 ¶ 22. On June 20, 2016, CEB filed suit

in the Circuit Court of Arlington County in which it requested that the Circuit Court find that CEB's apportionment was inapplicable (unconstitutional) and inequitable, that its tax liabilities be redetermined based on its proposed alternative method of apportionment, and that the court order a corresponding refund of taxes to CEB for the Tax Years. JA16-JA17. In August of 2016, the parties filed joint stipulations of fact and cross motions for summary judgment, and the case was submitted to the Circuit Court on fully stipulated facts. JA39-JA160. Following a hearing on February 9, 2017, the Circuit Court issued its Memorandum Opinion on September 1, 2017 ("Mem. Op."), JA745-JA763, and subsequently entered its Final Order granting the Department's motion and denying CEB's motion on September 12, 2017. JA764-JA766. On October 10, 2017, CEB timely filed its notice of appeal. JA767-JA769. CEB filed its Petition for Appeal on December 8, 2017, which this Court granted on May 9, 2018.

II. ASSIGNMENTS OF ERROR

1. The trial court erred in granting the Tax Department's motion for summary judgment, and in denying CEB's motion for summary judgment, in ruling that the general apportionment method as applied to CEB for the Tax Years did not violate the Commerce Clause or the Due Process Clause of the U.S. Constitution, and was not "inapplicable" within the meaning of Code § 58.1-421 and 23 VAC 10-120-280.[1]

2. The trial court erred in granting the Tax Department's motion for summary judgment, and in denying CEB's motion for summary judgment, in ruling that the general apportionment method as applied to CEB for the Tax Years was not "inequitable" under Code § 58.1-421 and 23 VAC 10-120-280.[2]

3. The trial court erred in granting the Tax Department's motion for summary judgment, and in denying CEB's motion for summary judgment, in ruling that the Department was not required, under Code § 58.1-421 and 23 VAC 10-120-280, to allow CEB to use the alternative method of apportionment proposed by CEB.[3]

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[1] Assignment of Error 1 was preserved at JA766, JA651-JA652 (19:20–20:12), JA653 (21:2-5), JA653-JA654 (21:14–22:3), JA655 (23:3-15), JA658-JA660 (26:5–28:15), JA661-JA662 (29:14–30:9), JA665 (33:4-21), JA688 (56:6-21), JA691-JA692 (59:13–60:3), JA242-JA245, JA313-JA314, JA476-480.

[2] Assignment of Error 2 was preserved at JA766, JA650 (18:12-22), JA663-JA664 (31:11–32:20), JA665-JA666 (33:22–34:10), JA688 (56:6-21), JA245-JA249, JA314-JA315, JA480-JA482.

[3] Assignment of Error 3 was preserved at JA766, JA666-JA667 (34:16–35:15), JA673-JA674 (41:13–42:7), JA678-JA679 (46:18–47:1), JA681-JA682 (49:17–50:9), JA695-JA696 (63:17–64:17), JA701 (69:2-9), JA733 (101:10-19), JA249, JA315-JA317, JA482.

III. STATEMENT OF FACTS

A. The Corporate Executive Board Company.

CEB is a multinational corporation headquartered in Arlington, Virginia. JA39 ¶ 2, JA40 ¶ 7.[4] CEB's customers include executives from 97 of the Fortune 100 companies and more than 10,000 organizations around the world. JA39 ¶ 1, JA40 ¶¶ 8-9, JA48 ¶ 47. CEB has two revenue streams relevant here: "Core Product" sales, from which CEB generates over 90 percent of its revenue, and "Solutions" sales (collectively "CEB's products"). JA40 ¶¶ 9-10, JA48 ¶ 47.

CEB's Core Product is an annual fixed-fee subscription service that includes online access to best practices research, executive education and networking events, tools used for analyzing business functions and processes, and customized advisory support. JA40 ¶ 9, JA48 ¶ 48. CEB offers different types of subscriptions for executives in different areas such as Human Resources, Finance and Strategy, and Information Technology. JA40-JA41 ¶ 11, JA50 ¶ 59. For each subscription, the customer is the individual corporate executive who uses the product; for example, the customer of a Tax Director Roundtable subscription is the tax director of a particular organization. JA50 ¶ 59. CEB's Solutions are

[4] The facts are drawn from the Joint Stipulations of Fact and Designation of Issues for Determination, filed August 12, 2016. In addition to the Joint Appendix cites, the pertinent paragraphs of the Joint Stipulations also are cited.

professional services, including employee education and performance analytics and executive education seminars. JA40 ¶ 10.

The Commonwealth provides a relatively tiny market for CEB's products, accounting for less than five percent of CEB's gross revenue; only about $66 million of CEB's $1.76 billion in total sales during the Tax Years were attributable to customers located in Virginia. JA41 ¶ 12, JA42 ¶¶ 17-19, JA50 ¶ 59. In contrast, more than 95 percent of CEB's revenue was derived from out-of-state sources during the Tax Years. JA42 ¶¶ 17-19. In other words, CEB generates almost all of its revenue from sales to customers located outside of Virginia.

B. CEB's Apportionment Under The Statutory Method.

For Corporation Income Tax purposes, under the general apportionment method, Code §§ 58.1-406–58.1-421, CEB apportioned its nationwide income based on the average of four factors: a property factor, a payroll factor, and a double-weighted sales factor.[5] JA41 ¶ 13.

The property factor was computed as a ratio of CEB's property located in Virginia to all of its property nationwide. Code § 58.1-409. CEB reported a property factor of 88 percent in 2011; 81 percent in 2012; and 82 percent in 2013. JA41-JA42 ¶¶ 13-19.

[5] While only three factors are computed (*i.e.*, property, payroll and sales), this formula is called the four-factor method to reflect that the sales factor is counted twice.

CEB's payroll factor was computed as a ratio of compensation paid to CEB's employees working in Virginia to compensation paid to all of its employees nationwide. Code § 58.1-412. CEB reported a payroll factor of 65 percent in 2011, 61 percent in 2012, and 63 percent in 2013. JA41-JA42 ¶¶ 13-19.

The sales factor was computed as a ratio of CEB's sales "deemed" to be in Virginia to all of its sales nationwide. Code §§ 58.1-414, 416. Because CEB's products are intangible goods, the apportionment methodology applied to CEB's income under the Virginia statute deemed almost all of CEB's sales to have been made in Virginia because the plurality of CEB's income-producing activity, *based on cost of performance*, was performed in Virginia. Code § 58.1-416 ("When certain other sales deemed in the Commonwealth").[6] Applying Virginia's general apportionment method (including treating nearly all of its sales as having occurred in Virginia), CEB reported a sales factor of 97 percent in 2011, 91 percent in 2012, and 88 percent in 2013. JA41-JA42 ¶¶ 13-19. In fact, CEB's actual sales from Virginia sources—that is, from customers located in Virginia—never exceeded 5.2 percent of CEB's total sales in any Tax Year. JA42 ¶¶ 17-19. Stated somewhat

[6] The section provides as follows: "Sales, other than sales of tangible personal property, are in the Commonwealth if: 1. The income-producing activity is performed in the Commonwealth; or 2. The income-producing activity is performed both in and outside the Commonwealth and a greater proportion of the income-producing activity is performed in the Commonwealth than in any other state, based on costs of performance."

differently, while the statute deemed between 88 and 97 percent of CEB's sales during the Tax Years at issue to have been made in Virginia, in fact approximately 95 percent of CEB's sales were made to customers located outside of Virginia. JA44 ¶¶ 32-33. Had CEB's products been sold in tangible form (*i.e.*, as books and other printed materials, as they once were), the revenue from CEB's sales would have been sourced to the location of its customers and CEB's sales factor would have reflected only the revenues from its sales to customers located in Virginia.

This four-factor formula (property, payroll, and double-weighted sales), together with the above-described sales factor "deeming" provision (Code § 58.1-416), is the "Statutory Method." JA41-JA42 ¶¶ 13-19. Pursuant to the Statutory Method, CEB's overall Virginia apportionment percentage during the Tax Years was 87 percent in 2011, 81 percent in 2012, and 80 percent in 2013. JA41-JA42 ¶¶ 14-16, JA44-JA45 ¶ 35. CEB paid millions of dollars in Virginia Corporation Income Tax in each of the Tax Years based on these apportionment percentages. JA41-JA42 ¶¶ 14-16.

CEB also paid income tax in many other states. JA45 ¶ 36. For sales factor apportionment purposes, CEB assigned millions of dollars in sales to other states based on the actual location of its customers (*i.e.*, the source of the revenue). JA45-JA47 ¶¶ 37-38, JA47 ¶¶ 40-41. The sales made in these other states that were used to apportion CEB's income in those states were the same sales that were

deemed to have been made in Virginia under the Statutory Method. JA45-JA47 ¶¶ 36-38.

For example, in 2013 CEB received $65 million from sales made to customers located in California. JA46 ¶ 38, JA47 ¶ 41. These California sales accounted for nearly 10 percent of the market for CEB's products nationwide. *Id*. In paying its corporation income tax in California, CEB included this $65 million of sales revenue in the numerator of its California sales factor to compute the percentage of CEB's income taxable in California. JA47 ¶ 41. However, for Virginia apportionment purposes, the Statutory Method "deemed" the same $65 million in sales to have been made in Virginia, meaning that the same $65 million also was included in the numerator of CEB's Virginia sales factor to compute the percentage of CEB's income taxable in Virginia. *Id*. This double inclusion in both California's and Virginia's sales factors resulted in the double taxation of the same $65 million in sales revenue received by CEB from its sales to California customers. *Id*.

Twenty-three states other than Virginia laid claim to CEB's sales for apportionment purposes based on sales made to customers in those states during the Tax Years. JA46-JA47 ¶ 38. Specifically, the table below (JA46-JA47 ¶ 38) shows CEB's sales revenues that, in addition to being included in Virginia's sales

factor under the Statutory Method, were also included in the sales factor in another state in which CEB paid tax:

State	2011	2012	2013
AL	$649,116 (0.13 %)	$1,186,924 (0.22 %)	$1,622,208 (0.26 %)
AZ	$9,766,716 (1.94 %)	-	-
CA	-	-	$65,056,631 (9.6 %)
CO	$1,585,504 (0.32 %)	$2,055,078 (0.37 %)	$1,443,415 (0.24 %)
CT	$1,244,048 (0.25 %)	$1,661,187 (0.30 %)	$2,086,079 (0.34 %)
DE	$1,146,171 (0.26 %)	$520,927 (0.09 %)	$722,592 (0.12 %)
GA	$11,529,049 (2.36 %)	$11,485,861 (2.09 %)	$14,554,716 (2.38 %)
IA	$2,245,332 (0.46 %)	$2,900,368 (0.53 %)	$3,069,071 (0.50 %)
IL	$22,936,917 (4.55 %)	$31,676,818 (5.42 %)	$35,328,671 (5.09 %)
MA	-	$9,179,508 (1.61 %)	$9,738,063 (1.40 %)
MD	$6,693,640 (1.49 %)	$7,143,443 (1.30 %)	$8,567,418 (1.40 %)
ME	$700,502 (0.14 %)	$382,588 (0.07 %)	$551,122 (0.08 %)
MI	$9,316,214 (2.01 %)	$10,853,315 (1.89 %)	$13,351,724 (1.92 %)
MN	$12,703,677 (2.53 %)	$16,150,864 (2.77%)	$16,113,955 (2.32 %)
NC	$7,474,053 (1.67 %)	$8,065,095 (1.46 %)	$9,766,889 (1.60 %)
NJ	$2,876,965 (0.64 %)	$3,453,212 (0.63 %)	$3,110,837 (0.51 %)
NY	$14,288,645 (2.92 %)	$15,607,376 (2.83 %)	$15,907,792 (2.61 %)
OK	$2,950,845 (.61 %)	$3,026,882 (0.55 %)	$2,565,187 (0.42 %)
RI	$238,412 (0.05 %)	$231,726 (0.04 %)	$0 (0 %)

State	2011	2012	2013
SC	-	$771,765 (0.14 %)	$595,759 (0.10 %)
TX	$5,621,258 (1.22 %)	$8,929,219 (1.57 %)	$9,334,660 (1.36 %)
UT	$1,376,971 (0.30 %)	$1,585,375 (0.28 %)	$2,176,399 (0.31 %)
WI	$8,126,540 (1.67 %)	$7,724,931 (1.32 %)	$9,665,843 (1.58 %)

As the above table reflects, the total dollar amount of sales assigned to other states for apportionment purposes, and also deemed to have been made in Virginia under the Statutory Method, was $123,470,575 in 2011, $144,592,462 in 2012, and $225,329,031 in 2013. These sales were included in the apportionment numerators in Virginia *and* in each of the 23 states in which the sales occurred for purposes of determining CEB's taxable income in each state, resulting in substantial double taxation. JA46-JA47 ¶ 38. Overall, when all the double taxation of CEB's sales across the United States is taken into account, *CEB paid state income tax on over 120 percent of its nationwide income*. JA47 ¶ 40.

C. <u>CEB's Request To Use An Alternative Apportionment Method.</u>

In that the Statutory Method subjected CEB to taxation on a greater portion of its income than is reasonably attributable to business or sources within Virginia, CEB filed an administrative claim for refund pursuant to Code § 58.1-421 ("the Relief Statute") with regard to the Tax Years, objecting to the application of the Statutory Method to its facts and circumstances, and proposing to use an

alternative apportionment method that sources sales based on customer location. JA42-JA43 ¶¶ 20-21. The Department refused to apply the Relief Statute, and denied CEB's refund claims. JA43 ¶ 22.

D. CEB's Apportionment Under Its Proposed Method.

In this case, CEB proposes to apportion its income using the same four-factor formula as the Statutory Method (*i.e.*, property, payroll, and double-weighted sales), but with one significant change: sales would be assigned to the source of the revenue (*i.e.*, the location of the customer) to reflect the actual market for CEB's products (*i.e.*, destination-based sourcing, also called market-based sourcing). JA43 ¶ 29, JA44 ¶ 32. This four-factor formula, together with the destination-based sourcing rule, is the "Proposed Method." JA43 ¶ 29. It should be noted that the Proposed Method is the same method that Virginia uses to apportion sales of tangible personal property. Code § 58.1-415.[7] Accordingly, if CEB had sold and delivered its products as books or as other tangible personal property (as it once did), the Proposed Method is the exact method Virginia would have used to apportion CEB's income from those sales.

[7] Some Virginia manufacturers are given the option under certain circumstances to choose the single-factor sales apportionment method. Code § 58.1-422. Under either apportionment method Code § 58.1-415 governs the sourcing of the product sales.

As noted, 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. JA44 ¶ 31. For example, because CEB received $12 million from sales to its Virginia customers in 2011 (representing 2.4 percent of its total sales nationwide), CEB would assign to the Virginia apportionment numerator only those $12 million of sales from Virginia sources. JA44 ¶ 32, JA50 ¶ 59. Under the Proposed Method, sales revenue received from customers in other states would no longer be "deemed" to constitute sales made in Virginia. JA44 ¶ 33. And, of course, under the Proposed Method, CEB would continue to report the same high Virginia property and payroll factors in that those factors would remain unchanged. JA44-JA45 ¶ 35.

E. The Gross Disparity Between CEB's Apportionment Under The Statutory Method And Its Proposed Method.

CEB's overall apportionment percentage under the Statutory Method was more than double what it would be under the Proposed Method. JA44-JA45 ¶ 35. The following table (taken from JA44-JA45 ¶ 35) compares the calculation of CEB's apportionment percentages (in round numbers) under the Statutory Method (SM) and the Proposed Method (PM) in each of the Tax Years:

	2011			2012			2013	
	SM	PM		SM	PM		SM	PM
Property Factor	88%	88%		81%	81%		82%	82%
Payroll Factor	65%	65%		61%	61%		63%	63%
Sales Factor	97%	2%		91%	3%		88%	5%
Sales Factor	97%	2%		91%	3%		88%	5%
Apportionment Percentage	**87%**	**40%**		**81%**	**37%**		**80%**	**39%**

In sum, by using the Statutory Method rather than the Proposed Method requested by CEB, the Department *more than doubled* the amount of income on which CEB was required to pay Virginia Corporation Income Tax in each of the Tax Years.

IV. AUTHORITIES AND ARGUMENT

A. Summary of Argument.

Virginia's Statutory Method, as applied to CEB's business, produced an unconstitutional apportionment and substantial double taxation of CEB's income. This occurred because of Virginia's cost of performance sourcing provision applicable to the sale of intangible goods, Code § 58.1-416, which sources the revenues from such sales entirely to Virginia for apportionment purposes if the plurality of the work that created the intangible good was performed in Virginia. As a result, although 95% of the revenues CEB obtained from its sales of products were from customers located outside of the Commonwealth, virtually all of those revenues were sourced to Virginia and thereby included in the apportionment of CEB's income for determining its Corporation Income Tax. Consequently, during the Tax Years, approximately one-third of CEB's sales revenues were used by both Virginia *and* by another state for purposes of apportioning CEB's income for taxation. This necessarily led to substantial double taxation of CEB's income.

Under the decisions of the U.S. Supreme Court and this Court applying the Commerce and Due Process Clauses to apportionment challenges, a state is not permitted to reach beyond its borders and tax more than its fair share of interstate income. As this Court recently reaffirmed in *Kohl's Dep't Stores, Inc. v. Virginia Dep't of Taxation*, 295 Va. 177, 186 (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."

This constitutionally mandated fair apportionment requirement requires an apportionment to be both internally and externally consistent. Internal consistency is not at issue in this case. But the apportionment here fails the external consistency test. For an apportionment to meet the external consistency test it must actually reflect a reasonable sense of how the income is generated. That is, a state may only tax "its fair share of an interstate transaction." *See Goldberg v. Sweet*, 488 U.S. 252, 260-61 (1989).

In this case, Virginia taxed more than its "fair share" of CEB's income through the application of a provision that—contrary to economic reality—"deemed" virtually of all of CEB's sales to have been made in Virginia. As a result, the existence of interstate commerce was wholly disregarded in Virginia's apportionment of CEB's income, in that CEB's *interstate* sales to its customers located outside of Virginia were treated as if they instead were *intrastate* sales to customers located inside of Virginia. Because 95 percent of CEB's sales were to its *interstate* customers, this "deeming" of CEB's sales had the effect of allowing Virginia to tax more than 80 percent of CEB's overall income. Had the Commonwealth applied an apportionment method to CEB's income that accurately

reflects both intrastate and interstate commerce, as it uses for the sales of tangible goods, Virginia would have taxed CEB on only approximately 40 percent of its overall income during the Tax Years. This unfair result plainly constitutes the type of "gross disparity" that entitles a taxpayer to relief. *See Dep't of Taxation v. Lucky Stores, Inc.*, 217 Va. 121, 129-30 (1976).

In additional to being unconstitutional, the Statutory Method resulted in an inequitable apportionment of CEB's income. The Statutory Method, as applied to CEB, resulted in an inequitable apportionment within the meaning of the apportionment statute and its implementing regulations because the Statutory Method caused double taxation attributable to Virginia rather than to another state's unique method of apportionment. Because of Virginia's "deeming" provision (Code § 58.1-416), millions of dollars of CEB's out-of-state sales were used by both Virginia and the state where the sale occurred for purposes of apportioning CEB's income for taxation in both states. The 23 other states that included these sales as part of their apportionment of CEB's income were not employing a unique method of apportionment in that destination-based sourcing is now used in almost all states (including Virginia)[8] for the apportionment of

[8] Hellerstein, *State Taxation* ¶ 8.06[3][a] (3d ed. 2001 & Supp. 2018-1) ("[T]he states almost always employ the destination test to assign sales of tangible personal property in their income apportionment formulas."); Expert Report of (continued...)

revenues from the sales of tangible goods and by many states for the apportionment of revenues from the sales of intangible goods. Accordingly, because Virginia unfairly included virtually of all of the revenues from CEB's sales to out-of-state customers in it apportionment of CEB's income, the resulting substantial double taxation of CEB's income was caused by Virginia's method of apportionment and not by another state's unique method of apportionment.

The "gross disparity" or inequity of the Department's apportionment of CEB's income has been greatly exacerbated over the years by two significant developments. First, as already noted, because of changing technology—that is, the widespread movement toward digital products that are distributed electronically—CEB's products are now intangible in nature (*i.e.*, PDFs and other digital files), whereas in the past its products were largely tangible goods (*i.e.*, books and other printed materials) subject to a destination-based sourcing rule.

The second significant development is the increasing adoption by other states of destination-based sourcing of sales, which has long been used for sourcing the sales of tangible goods, but which now increasingly is being used by other states for sourcing the sales of intangible goods. *See generally* Hellerstein ¶ 9.18[3][a] & [c]. Because of the nature of CEB's business, which involves the

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Professor Richard D. Pomp ("In the case of tangible personal property, all states assign the sales using the so-called destination principle."). JA258.

sale of intangible goods to customers located almost entirely outside of Virginia, these two developments had a particularly distortive effect on its Virginia income apportionment, which the Department could and should have addressed under the apportionment statute.

In adopting the Statutory Method, the General Assembly recognized the possibility of unconstitutional and inequitable apportionments, and, accordingly, included a "safety valve" in the form of Code § 58.1-421, known as the Relief Statute. This safety valve mandates the use of an alternative apportionment method, upon the request of the taxpayer, if the Statutory Method produces an inapplicable (*i.e.*, unconstitutional) or inequitable apportionment of that taxpayer's income. In this case, the Statutory Method has produced both. Yet, despite the undeniable double taxation CEB demonstrated to the Department, and the fact that the this double taxation was not caused by another state's unique method of apportionment, the Department refused to apply Code § 58.1-421 and denied CEB the mandated apportionment relief.

The Circuit Court incorrectly framed CEB's request as a request for a change in Virginia's general apportionment policy. But CEB did not seek below, and does not seek here, a change in Virginia's income apportionment policy. Rather, CEB *only* requested that Virginia's apportionment statute be implemented in the way in which it was meant to be implemented; that is, that an alternative

apportionment method be used by the Department that cures the unconstitutional and inequitable apportionment of its income. The alternative apportionment method that CEB requested did both by "actually reflect[ing] a reasonable sense of how income is generated" by CEB in Virginia and elsewhere. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983). As such, granting CEB's request for the application of its Proposed Method is entirely consistent with the policy underlying Virginia's apportionment statute.

The alternative method CEB proposed for the apportionment of its income is workable and sensible, and would not lead to an arbitrary result. This fact is self-evident, in that the destination-based sourcing CEB proposed is the very same method Virginia uses to source income from billions of dollars in sales of tangible goods by Virginia businesses to their out-of-state customers. In addition, many states today use destination-based sourcing for revenue from the sales of *intangible goods*, which is why roughly one-third of the revenue CEB obtains from the sales of its products is used to source its income for apportionment purposes in both Virginia and in another state. Simply put, destination-based sourcing—which has been used in Virginia for many decades for sourcing revenues from the sales of tangible goods—is neither unique nor arbitrary. To the contrary, it is a sensible and workable apportionment method that the Department should have allowed

CEB to use when confronted with the fact that the application of the Statutory Method resulted in substantial double taxation of CEB's income.

B. CEB Is Entitled To Relief Because The Statutory Method Resulted In An Unconstitutional Apportionment Of Its Income During The Tax Years. (Assignments of Error 1, 2 & 3).

1. The Standard of Review.

The parties submitted their cross motions for summary judgment to the Circuit Court on fully stipulated facts. Each assignment of error raises a question of law that is reviewed *de novo* by this Court, *Ford Motor Credit* Co. *v. Chesterfield County*, 281 Va. 321, 334 (2011), and each concerns the application of law to stipulated facts, which also is reviewed *de novo*, *Dykes v. Friends of the C.C.C. Road*, 283 Va. 306, 308 (2012).

2. A state tax must be fairly apportioned.

The United States Constitution prohibits the Commonwealth, when imposing an income-based tax, from "tax[ing] value earned outside [of] its borders." *Container Corp.*, 463 U.S. at 164 (*quoting ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982)). Under the Commerce Clause, a tax must (1) be applied to an activity with a substantial nexus with the taxing State; (2) be fairly apportioned; (3) not discriminate against interstate commerce; and (4) be fairly related to the services provided by the State. *See Complete Auto Transit, Inc., v. Brady*, 430 U.S. 274, 278 (1977); *City of Winchester v. American Woodmark Corp.*, 252 Va. 98, 101 (1996). And, under the Due Process Clause of

the Fourteenth Amendment, there must be a "minimal connection" between the interstate activities and the taxing State (*i.e.*, a nexus), as well as a "rational relationship between the income attributed to the State and the intrastate values of the enterprise" (*i.e.*, a fair apportionment). *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 437 (1980) (citations omitted).[9]

The central purpose behind the fair apportionment requirement is to ensure that each State taxes only its fair share of an interstate transaction or its fair share of income derived from interstate commerce.[10] *Goldberg v. Sweet*, 488 U.S. at 260-61; *see also General Motors v. Tracy*, 519 U.S. 278, 298 n. 12 (1997) ("the requirement of apportionment . . . assur[es] that interstate activities are not unjustly burdened by multistate taxation"); *Kohl's Dep't Stores,* 295 Va. at 186 ("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

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[9] The Circuit Court erroneously focused on the nexus requirement of the Commerce and Due Process Clauses. JA754-JA757 (Mem. Op. 10-13). Nexus is not at issue in this case. CEB does not dispute the Commonwealth's ability to impose a tax on CEB's income, so long as the tax is fairly apportioned and does not result in double taxation.

[10] Both the Commerce and Due Process Clauses require a state income tax to be fairly apportioned. *See Container Corp.*, 463 U.S. at 169. The U.S. Supreme Court's fair apportionment analysis is substantially the same under the Commerce and Due Process Clauses.

can be fairly apportioned to the state.").[11] The fair apportionment requirement stems from the prohibition against multiple or double 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." *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 184-185 (1995).

Fair apportionment requires a tax to be both internally and externally consistent. *Goldberg*, 488 U.S. at 261-62. The parties agree that the Statutory Method is internally consistent.[12] But the Statutory Method is not externally consistent.

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[11] The Circuit Court devoted much of its analysis to describing and defining CEB's activities in Virginia, which it cited as support for its ruling. JA756-JA758 (Mem. Op. 12-14). But, from the standpoint of the fair apportionment requirement, the fact that CEB performed income producing activities in Virginia is not the issue. Rather, the issue is whether the application of the cost of performance sourcing provision to CEB's sales, by ignoring the overwhelmingly interstate nature of those sales, produced an unfair apportionment of CEB's income.

[12] *See Winchester*, 252 Va. at 102 ("An assessment is internally consistent if applying the text of the taxing statute, and assuming that every other jurisdiction applied the same statute, the taxpayer would not be subjected to a risk of double taxation.") (citing *Goldberg*, 488 U.S. at 261).

3. Under the external consistency test, the apportionment must actually reflect how income is generated.

External consistency requires that the factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated. *See Container Corp.*, 463 U.S. at 169; *Goldberg*, 488 U.S. at 262. As observed by the Supreme Court in *Jefferson Lines*: "External consistency . . . looks . . . to 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 economic activity within the taxing State." 514 U.S. at 185 (citing *Goldberg* and *Container Corp.*); *see also Winchester*, 252 Va. at 102. A court must strike down an apportionment formula as externally inconsistent if the taxpayer proves by clear and cogent evidence that the income attributed to the taxing state is in fact out of all appropriate proportions to the business transacted in that state, *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 135 (1931), or has led to a grossly distorted result, *Norfolk & Western Ry. Co. v. Mo. State Tax Comm'n*, 390 U.S. 317, 326 (1968). *See also Container Corp.*, 463 U.S. at 170; *Lucky Stores*, 217 Va. at 129.

In *Lucky Stores* this Court distilled the constitutional principles discussed above into a "gross disparity" test for evaluating the constitutionality of an apportionment formula as applied to a particular taxpayer in the context of a request for alternative apportionment under the Relief Statute. As held by this

Court there, in order to determine whether extraterritorial values are being taxed, the court "*must* compare the percentage of total taxable income produced by the formula in question [here, the Statutory Method] with the percentage of total taxable income produced by the taxpayer's proposed method [here, the Proposed Method]." 217 Va. at 129 (emphasis added). If there is a gross disparity in these percentages, the taxpayer is entitled to relief. *Id*.

4. The General Assembly chose to apportion based on property, payroll, and sales factors in order to reflect both the supply side and the demand side of business.

There is an overarching logic underlying the apportionment formulation. The property and payroll factors are intended to collectively reflect the supply side of a corporation's business activity, while the sales factor is intended to reflect the demand side of that activity. As noted by the Joint Legislative Audit and Review Commission ("JLARC") in its 2010 Report to the Governor and General Assembly: "[T]he sales factor was originally intended to attribute income to the state where consumption occurs or where the benefit of the product is received." JA507-JA508. The sales factor is double weighted to equalize the supply and demand sides of a corporation's business because both contribute to its profits. *See* Expert Report of Professor Richard D. Pomp ("The payroll and property factors double-weight the origin states and these are balanced by double-weighting the customer-based sales factor.") JA260.

The sales factor should reflect the value of the market for a taxpayer's products because the purpose of the sales factor is to balance the property and payroll factors by giving weight to elements of the business not reflected in the property and payroll factors. *See* George T. Altman and Frank M. Keesling, *Allocation of Income in State Income* (2d ed. 1950). Accordingly, the sales factor answers the question of where the market is for the taxpayer's goods and services. *See, e.g.*, *Microsoft Corp. v. Franchise Tax Bd.*, 150 Cal. Rptr. 3d 770, 775 (Cal. Ct. App. 2012) ("The inclusion of the sales factor in the . . . apportionment formula is based on the idea that a state which provides a market for a product is entitled to some tax returns on the income which it has helped to produce.") (internal quotation marks omitted); *Vodafone Americas Holdings, Inc. v. Roberts*, 486 S.W.3d 496, 526 (Tenn. 2016) ("[T]he contribution of the consumer states toward the production of the income should be recognized by attributing sales to those states.")[13] (quoting William J. Pierce, *The Uniform Division of Income for State Tax Purposes,* 35 Taxes 747, 780 (1957)); Hellerstein ¶ 8.06[3] ("The sales factor, by contrast [to the property and payroll factors], attributes income to states in which goods are consumed and serves as a counterbalance to the property and

[13] In *Vodafone*, the Tennessee Supreme Court upheld the determination of the Tennessee Commissioner of Revenue to require Vodafone to use destination-based sourcing for the revenues from its sales of cellphone service in Tennessee even though Tennessee's standard apportionment formula permitted Vodafone to use cost of performance sourcing.

payroll factors that tend to attribute income to states in which goods are produced.”).

As noted by the U.S. Supreme Court, courts have approved apportionment formulas that use property, payroll, and sales factors because those factors in combination reflect a very large share of the activities by which value is generated, thus enabling those formulas to avoid the type of distortion that was present in *Hans Rees*.[14] *Container Corp.*, 463 U.S. at 183; *see also* Hellerstein ¶ 8.06[1]. However, the formulas in those cases were approved in the context of destination-based sourcing for sales of personal property. Even in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978), in which the Supreme Court approved a single-factor apportionment method, that method was based on a single sales factor with destination-based sourcing.

5. As a result of Virginia’s “deeming” provision, the Statutory Method failed to reflect a reasonable sense of how CEB generates its income through interstate commerce.

A grossly distortive result occurs when the apportionment formula fails to reflect the full spectrum of activities by which value is generated. *See Container Corp.*, 463 U.S. at 182. In CEB’s case, those activities include both production

[14] In *Hans Rees*, the Supreme Court struck the application to a particular taxpayer of a formula that, “albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction.” *See Container Corp.*, 463 U.S. at 183.

(*i.e.*, supply side) activities and sales (*i.e.*, demand side) activities. But the Statutory Method, as applied to CEB for the Tax Years, only reflects the production side of CEB's business. *See* Hellerstein ¶ 8.06[3][b] ("Finally, and most importantly, the [cost of performance sourcing rule] often fails to reflect the 'market' for the taxpayer's services or other income-producing activities, which was the underlying purpose of the sales factor as originally conceived.").

The Statutory Method ignored the fact that 95 percent of CEB's products, by revenue, were sold to customers located outside of the Commonwealth. Because the Statutory Method simply "deems" those sales to have occurred in Virginia for apportionment purposes (per Code § 58.1-416), the Statutory Method reads out of the income apportionment scheme all interstate commerce related to those sales. Such an apportionment formulation which ignores the existence of interstate commerce by treating out-of-state sales as if they were in-state sales cannot survive constitutional scrutiny.

Because the sales factor that CEB was required to use under the Statutory Method did not reflect the fact that 95 percent of CEB's sales were made to customers located in states other than Virginia, the property and payroll factors—which reflect the production side of economic activity—were not balanced by the sales factor. Instead, the way in which the Statutory Method applied the sales factor to CEB's circumstances simply amplified the taxation effect of the property

and payroll factors, resulting in an overall apportionment that was egregiously unbalanced, with over 80 percent of CEB's income treated as taxable by Virginia. *See* Hellerstein ¶ 8.06[3][b] (noting that the cost of performance sourcing rule for intangibles "tends to replicate the property and payroll factors").

As the Supreme Court acknowledged in *Goldberg*, the focus of the external consistency test is not on the tax statute's formal language, but rather on its practical effect. 488 U.S. at 264 ("It should not be overlooked, moreover, that the external consistency test is essentially a practical inquiry."); *see also Winchester*, 252 Va. at 101-02 ("The [U.S. Supreme] Court also restated the realist approach, noting that the focus is not on the tax statute's formal language, but rather on its practical effect.") (citing *Complete Auto Transit* and *Jefferson*). For the reasons discussed above, the practical effect of the Statutory Method for CEB is that Virginia is disregarding the existence of interstate commerce in the apportionment process and unduly burdening CEB with substantial double taxation.

As previously noted, for the Tax Years, 23 other states laid claim to a portion of CEB's income because of CEB's sales activities in those states. That is, those 23 states claimed to be entitled to something based on CEB's sales in each state. Virginia, however, claimed to be entitled to nearly everything from CEB's sales in Virginia as well as from CEB's sales in every one of those 23 states (as well as every other state in which CEB's customers reside), even though only 5

percent of CEB's sales were actually in Virginia. Thus, in CEB's circumstances, the Statutory Method's overreaching resulted in precisely the type of double taxation the fair apportionment requirement is intended to preclude.

6. The Statutory Method, as a result of the provision "deeming" nearly all of CEB's sales to be Virginia sales, resulted in an unconstitutional gross disparity

As a result of the "deeming" provision, which treats nearly all of CEB's sales as having occurred in Virginia, the Statutory Method was grossly distortive. Applying the comparative analysis set forth in *Lucky Stores*, the difference in each year between the percentage of CEB's total income attributed to Virginia under the Statutory Method (over 80%) and the Proposed Method (less than 40%) indisputably constitutes a "gross disparity."[15] As noted earlier, CEB's Virginia apportionment (and thus its Virginia tax) is more than *twice* as high under the Statutory Method as under the Proposed Method. Indeed, it is a stipulated fact that the Statutory Method caused CEB to attribute to Virginia more than twice the amount of income that would be attributed under the Proposed Method. *See* section III.E., *supra*. These dramatically higher percentages are "out of all appropriate proportion" to CEB's business and sources in the Commonwealth.

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[15] The Circuit Court failed to apply the comparative analysis required by this Court in *Lucky Stores*, and, therefore, erroneously disregarded the stipulated evidence of gross disparity. Furthermore, the Circuit Court based its conclusions on gross receipts tax cases which are inapposite because they focus on transactions rather than total income. JA754-JA757 (Mem. Op. 10-13).

Accordingly, the Statutory Method, as applied to CEB during the Tax Years, was unconstitutional and CEB is entitled to relief as a matter of law.

The Proposed Method—the same method that Virginia uses for tangible personal property—is both constitutional and reasonable because it acknowledges and reflects the existence of interstate commerce in the sales of CEB's products. The Proposed Method thus achieves the legislative purpose of balancing the supply side of CEB's business, as reflected in the property and payroll factors, with the demand side of CEB's business, as reflected in the sales factor proposed by CEB.

C. CEB Is Entitled To Relief Because The Statutory Method Resulted In An Inequitable Apportionment of CEB's Income. (Assignments of Error 1, 2 & 3)

1. The Standard of Review.

This Court's review of the Circuit Court's decision below is pursuant to a *de novo* standard of review. *See* section IV.B.1, *supra*. With respect to the Department's determination that CEB's apportionment was not inequitable, the taxpayer has the burden of proving that the Department's assessment is contrary to law. *Lucky Stores*, 217 Va. at 127. Alternatively, the taxpayer may prove that the Department abused its discretion and acted in an arbitrary, capricious, or unreasonable manner. *Id*.

2. The stipulated evidence establishes that the Statutory Method resulted in the substantial double taxation of CEB's income.

Even if this Court were to determine that the Statutory Method did not produce an unconstitutional result in CEB's case, the Relief Statute provides an alternative basis for relief in cases where the Statutory Method results in an inequitable apportionment.

Although the Relief Statute does not specify when the Statutory Method "is in fact . . . inequitable," the Department's regulations do so. Under 23 VAC 10-120-280(B)(4)(b), the Statutory Method is inequitable if "(1) It results in double taxation of the income, or a class of income, of the taxpayer; and (2) The inequity is attributable to Virginia, rather than to the fact that some other state has a unique method of allocation and apportionment." In *Lucky Stores*, this Court upheld the Department's interpretation of "inequitable," as that term now appears in the regulation. *Lucky Stores*, 217 Va. at 132. This case provides this Court (possibly for the first time) with the opportunity to apply that standard to a particular taxpayer's facts and circumstances.

The Circuit Court failed to apply the legal standard set forth in the Department's own regulation for evaluating whether the Statutory Method was inequitable. It incorrectly concluded that "Virginia's method does not double tax CEB." JA758 (Mem. Op. at 14). However, the record contains ample and

indisputable evidence of double taxation—that is, taxation of the same income by more than one state. JA45-JA47 ¶¶ 37-41. Although CEB obtained almost all of its revenue from customers located in other states, the Statutory Method deemed almost all of CEB's sales to have occurred in Virginia. As a result, millions of dollars of CEB's sales were assigned for apportionment purposes to and were made subject to tax in both Virginia and the state where the actual sale occurred. As a consequence, CEB paid tax on a multistate basis on over 120 percent of its nationwide income during the Tax Years. JA47 ¶ 40.

3. The double taxation of CEB's income was attributable to Virginia's apportionment method, and not to some other state's unique apportionment method.

In order for a taxpayer to obtain relief under the Relief Statute (Code § 58.1-421), the taxpayer must demonstrate that the Statutory Method, as applied to the taxpayer, results in double taxation and that the inequity is attributable to Virginia's apportionment method 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).

As discussed above, the double taxation in this case was caused by the Statutory Method's "deeming" provision, Code § 58.1-416, which treats CEB's interstate business as essentially intrastate in nature. But, in fact, CEB does business all over the country. As noted, during the Tax Years, 23 other states taxed CEB based on the sales that occurred in those states because one of their

corporate citizens purchased, used and paid for CEB's products. Each of those states is entitled under its apportionment law to include some portion of CEB's sales in apportioning CEB's income for taxation. But Virginia's position, based on the "deeming" provision, is that it is entitled to include nearly all of CEB's sales in making its apportionment determination. Accordingly, it is Virginia's Statutory Method—and not some other state's unique apportionment method—that is the source of the double taxation here and the resulting substantial inequity.

The destination-based sourcing method used by these 23 other states—and used by Virginia for the sale of tangible personal property—can in no sense be considered unique. Furthermore, it is the same apportionment method that has been approved repeatedly by the U.S. Supreme Court and by innumerable state courts, and it represents the current trend in sales factor sourcing across the United States. *See* section IV.D.2, *infra*; JA260.[16] Accordingly, the double taxation of CEB's income is not due to another state's unique allocation or apportionment method, but is due to the application of the Statutory Method—specifically, by Code § 58.1-416.

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[16] *See* Expert Report of Professor Richard D. Pomp ("[T]he robust trend today is for state legislatures and tax departments to replace their costs of performance approach used for services and intangibles with customer-based sourcing.") JA260.

In that CEB demonstrated that (1) its income was subject to double taxation, and (2) the inequity was attributable to Virginia's apportionment method and not some other state's unique apportionment method, CEB was entitled to relief under Code § 58.1-421 and 23 VAC 10-120-280(B)(4)(b). The Department's refusal to provide such relief, and allow CEB to apply an alternative apportionment method, was in violation of both the statute and the regulation. The Circuit Court's ruling to the contrary was erroneous as a matter of law.

D. Given That The Statutory Method Resulted In An Inapplicable And Inequitable Apportionment Of CEB's Income, The Department Was Required To Allow CEB To Use The Alternative Apportionment Method CEB Proposed Under Code § 58.1-421. (Assignments of Error 1, 2 & 3)

1. The Standard of Review.

This Court's review of the Circuit Court's decision below is pursuant to a *de novo* standard of review. *See* section IV.B.1, *supra*. With respect to the Department's determination that it would not allow CEB to use its proposed alternative method of apportionment, the taxpayer has the burden of proving that the Department's assessment is contrary to law or that the Department abused its discretion and acted in an arbitrary, capricious, or unreasonable manner. *See* section IV.C.1., *supra*.

2. The cost of performance sourcing rule has become increasingly unfair to CEB over the years as other states have adopted destination-based sourcing for revenues from the sales of intangible goods.

As noted above, if CEB were still providing its products to its customers as books and other printed materials, it would be subject to the destination-based sourcing rule applicable to tangible personal property (Code § 58.1-415). The cost of performance sourcing rule to which it is instead subject has become increasingly distortive, and the resulting double taxation increasingly substantial, because the trend in the states has to been to move to sales factor and destination-based sourcing with respect to sales of intangible goods. *See* Hellerstein ¶ 9.18 ("In recent years, . . . the relative importance of the sales factor has increased as a growing number of states have relied more heavily (if not exclusively) on sales in their apportionment formulas."); *id*. ¶ 9.18 [3][a] ("a growing number of states have abandoned the traditional UDITPA rule for the more defensible 'market state' approach") & *id*. ¶ 9.18 [3][c] (providing state-by-state summaries of the changes in the sourcing rules applicable to sales other than sales of tangible personal property).

This trend also was noted by the JLARC in its 2010 Report to the Governor and General Assembly:

> Eight states have recently adopted market-based sourcing to attribute sales of intangible goods and services to their state. . . . A primary reason why states are switching to market-based sourcing is to more

> appropriately source income to both production and consumption states, rather than source only to the production state.

JA505-JA506.

Accordingly, the substantial double taxation to which CEB is now subject as a result of the application of the Statutory Method to its business has become increasingly unfair to CEB both because of the advance of new technology, under which its products have become digitized and delivered electronically, but also due to the fact that other states are moving to a greater use of the sales factor combined with destination-based sourcing in their sourcing of revenues from the sales of intangible goods.

3. The Department's refusal to allow CEB to use an alternative apportionment method is contrary to Code § 58.1-421, which requires such relief where the taxpayer demonstrates the Statutory Method to be inapplicable or inequitable in its circumstances.

Code § 58.1-421 provides that, where the Statutory Method results in an inapplicable (that is, unconstitutional) or inequitable apportionment, the taxpayer may seek an "alternative method of allocation or apportionment as it believes to be proper under the circumstances . . . ." If the Department concludes that the method of allocation or apportionment "is in fact inapplicable or inequitable, it *shall* redetermine the taxable income by such other method of allocation or apportionment as seems best calculated to assign to the Commonwealth for taxation the portion of the income reasonably attributable to business and sources

within the Commonwealth . . . ." *Id*. (emphasis added) The Department contends that, although this provision speaks in plainly mandatory terms ("it *shall* redetermine"), its obligation to redetermine is not mandatory because it did not conclude that CEB's apportionment was inapplicable or inequitable. *See* Opposition to Petition for Appeal, at 4-5 ("Whether to grant such an exception is within the Department's discretion."). However, if—as demonstrated above—CEB's apportionment is inapplicable or inequitable, the Department cannot relieve itself of its mandatory obligation by taking the position that it never determined the apportionment to be inapplicable or inequitable. In other words, the Department does *not* have the discretion to refuse to correct an inapplicable or inequitable apportionment simply by declining to acknowledge the unconstitutionality or inequity of the apportionment at issue.

The Department's refusal to provide CEB with relief under Code § 58.1-421 was contrary to the statute and an abuse of its discretion. Although Code § 58.1-421 and the analogous "equitable apportionment" provision of Uniform Division for Income Tax Purposes Act (UDITPA) are not identical, both require the use of an alternative apportionment of the taxpayer's income if the statutory apportionment method results in an unconstitutional or unfair result. As noted in Hellerstein:

> As Professor William Pierce, UDITPA's principal draftsman, observed, UDITPA's equitable apportionment provision "necessarily must be used where the statute reaches arbitrary or unreasonable results so that its application could be attacked on constitutional

> grounds. . . . [D]epartures from the basic formula should be avoided except where reasonableness requires. Nevertheless, some alternative must be available to handle the constitutional problem *as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics*."

Hellerstein ¶ 9.20[3][a] (emphasis in original).[17] *See also Vodafone*, 486 S.W.3d at 521-22 ("The language of the variance statute presupposes that, in some instances, an arithmetically correct tax computation utilizing the statutory apportionment formula will not fairly represent the extent of the taxpayer's business activity in Tennessee.").

Accordingly, in refusing to allow CEB to use an alternative method of apportionment the Department violated the Relief Statute and abused its discretion.

4. CEB's Proposed Method is a workable and sensible method of apportionment that is based on an apportionment method Virginia already uses and that cures the deficiencies in the Statutory Method that result in an unconstitutional and inequitable apportionment of CEB's income.

The alternative apportionment method CEB has proposed in this case is both sensible and workable. In fact, as previously discussed, it is the same apportionment method that Virginia uses for sourcing income from the sale of tangible personal property. Under that method, a sale of a tangible product is

[17] Nor is it necessary for the apportionment to be unconstitutional for the taxpayer to be entitled to relief under Code § 58.1-421. *See* Hellerstein ¶ 9.20[3][a] ("[T]he construction that most tribunals have given to the equitable relief provision, allowing it to operate even in the absence of a showing that the standard formula results in unconstitutional distortion, provides a salutary 'safety valve' to avoid unfair results that may not rise to the level of unconstitutional distortion.")

sourced to the state where the tangible product is "ultimately received after all transportation has been completed . . . regardless of where title passes, or other conditions of sale." Code § 58.1-415.

While the Department argued below that CEB's Proposed Method is unworkable and would be susceptible to manipulation (JA721-JA722), these concerns are not credible given that the Proposed Method is the very method Virginia has used for decades for the sourcing of sales of tangible goods. Billions of dollars of income generated by Virginia companies every year shipping products out-of-state are apportioned under the exact same apportionment method that CEB has proposed here. Moreover, the fact that many states source income from the sales of *intangible goods* (as well as tangible goods) to the destination of the good—and that this is the clear trend among the states—further demonstrates that CEB's Proposed Method is neither unworkable nor an invitation to manipulation.

The Circuit Court also was mistaken in its conclusion that CEB's Proposed Method would lead to an arbitrary result because the sales to its customers under the Proposed Method are sourced to the state of the customer's billing address, which the Court called the "zip code factor method." JA752-JA753, JA757-JA758 (Mem. Op. at 8-9, 13-14). In fact, as the Joint Stipulations demonstrate, the use of CEB's customers' billing address to source the sales of its products is entirely appropriate. Specifically, the Joint Stipulations provide:

> 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.* For example, the contact person for a Member that purchased Tax Director Roundtable would be the Member's tax director. More than 94% of these individual users were physically located outside of Virginia during the Tax Years. Because CEB offers different versions of the Core Product to different markets (*e.g.*, Human Resources, Finance and Strategy, Information Technology, etc.), it was common for CEB to have several Members from the same company but in different locations, *in which case multiple invoices were sent to various locations based on the addresses for the contact people.*

JA50 ¶ 59 (emphasis added). Accordingly, as the parties also stipulated: "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* . . . ." JA44 ¶ 32 (emphasis added).[18] Moreover, the use of billing addresses for sourcing sales for apportionment purposes is a commonly used method and in no sense arbitrary. *See Vodafone*, 486 S.W.3d at 526 ("While no method is perfect, sourcing Vodafone's cellphone service receipts according to the billing address of the customer appears reasonably suited to producing a rough approximation of the corporate income that

[18] The Circuit Court also was simply incorrect in finding that there was "no direct evidence or reasonable inference show[ing] the extent to which any CEB customer actually operates or uses the data or information within its billing address, or the extent, if any, to which the data and information are accessed . . . ." JA762 (Mem. Op. at 18). To the contrary, the Joint Stipulations specifically states that "[t]he contact person is the individual that uses the product," and that "the default billing address was the contact person's address for most Members." JA50 ¶ 59. *See also* JA51 ¶ 60 ("Billing addresses did not change during the Tax Years unless the Member notified CEB of a change in operations or location. This happened very infrequently if at all.").

is reasonably related to the activities conducted within the taxing State.") (citations and internal quotation marks omitted).[19]

As discussed above, the Proposed Method also has the important advantage of including in CEB's apportionment the value of the economic activity associated with the demand side of its products. Contrary to the Circuit Court's apparent belief, CEB did not propose its alternative apportionment method in order to "negate[] the type or extent of business CEB conducted within Virginia in relation to its income, or to generate its income." JA757-JA758 (Mem. Op. at 13-14). The Proposed Method does *not* eliminate from the apportionment calculation the very substantial production activities of CEB in Virginia, which are accounted for by the property and payroll factors, and which remain entirely unchanged under the Proposed Method.[20]

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[19] Under the Proposed Method, it does not actually matter in which state the non-Virginia customer is physically located for purposes of computing CEB's Virginia apportionment. In computing the sales factor, the only location-based consideration that affects the sales factor is whether the customer is located inside or outside of Virginia. In other words, under the Proposed Method, it does not matter whether the customer is physically located in California or Illinois—the sales factor computed for determining Virginia's apportionment will be the same.

[20] In that CEB's property and payroll factors (which reflect its significant production activities in Virginia) remain unchanged under the Proposed Method (JA44-JA45 ¶¶ 30, 35), its Virginia apportionment percentage would still be very substantial. CEB's total Virginia apportionment under the Proposed Method would average approximately 37 percent (JA44 ¶ 34), and its Virginia tax liability would average roughly $1.9 million for each of the three Tax Years—still by far the highest tax liability of any state in which CEB does business (JA50 ¶ 57).

In sum, the Proposed Method is a reasonable and sensible apportionment method—grounded in a destination-based sourcing rule that is already used in Virginia for sales of tangible goods—that cures the deficiencies of the Statutory Method as applied to CEB's business by eliminating the unfairness and double taxation to which CEB is subjected under the Statutory Method.

V. CONCLUSION

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

Dated: June 18, 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 18th day of June, 2018.

/s Robert W. Loftin

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Robert W. Loftin