A-89 SEP 2005

C-548 SEP 2005

LANCO, INC.,	SUPREME COURT OF NEW JERSEY DOCKET NO. 58,542
Plaintiff-Petitioner,	App. Div. Docket No. A-3285-03T1
vs.	
DIRECTOR, DIVISION OF TAXATION,	CIVIL ACTION
Defendant-Respondent.	ON APPEAL AS OF RIGHT AND PETITION FOR CERTIFICATION FROM A FINAL JUDGMENT OF THE SUPERIOR COURT OF NEW JERSEY, APPELLATE DIVISION
	Sat Below: Honorable Edwin H. Stern Honorable Barbara B. Wecker Honorable Ronald B. Graves

BRIEF OF *AMICUS CURIAE*
THE INVESTMENT COMPANY INSTITUTE

FILED
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CLERK

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I. STATEMENT OF THE MATTER INVOLVED

The Investment Company Institute (the "Institute") respectfully submits its brief *amicus curiae* to assist the Court in its consideration of the issue presented on certification and on appeal in this matter.[1] Founded in 1940, the Institute is the national association of the American investment company industry. Its membership includes open-end investment companies (commonly known as "mutual funds"), closed-end investment companies, investment advisers, and principal underwriters and sponsors of unit investment trusts.

The Institute is concerned about efforts by the New Jersey Division of Taxation (the "Division") to impose an income tax on nonresident entities that do not have a "physical presence" in New Jersey. Specifically, application of New Jersey's corporation business tax (the "CBT") to entities that provide management and other services to Institute members from a location outside of New Jersey would disrupt longstanding expectations and, contrary to the Appellate Division's opinion, exceed the State's authority to tax under the Commerce Clause of the United States Constitution. For the reasons set forth herein, the Institute urges that the Court reverse the judgment

[1] By Order dated April 30, 2004, the Appellate Division granted the Institute's motion to appear as *amicus curiae*. Accordingly, the Institute may participate in this appeal without seeking leave. R.1:13-9.

of the Appellate Division and acknowledge and confirm that the "physical presence" requirement under the Commerce Clause is applicable also to the CBT.

II. QUESTION PRESENTED

Whether the Appellate Division committed reversible error by refusing to require that a taxpayer have a physical presence in New Jersey in order to be subjected to the CBT.

III. FACTUAL BACKGROUND

The Institute's membership is comprised largely of regulated investment companies ("RICs") and the organizations that provide services to RICs. The RIC is an entity that gathers assets from investors (who own the RIC's shares) and collectively invests these assets in stocks, bonds, or money market instruments. Through the collective investments of the RIC, each investor shares in the returns from the RIC's portfolio while receiving professional investment management and other benefits and services. RICs are among the most common investment vehicles, particularly for small investors, and frequently are the investment vehicles for retirement and 401(k) plans (including state retirement plans) and for Section 529 education plans.

RICs typically do not have employees of their own, though they do have officers and a board of directors or trustees. One responsibility of the board of directors or trustees is to enter into contractual arrangements with third parties for management and related services. Among these contractual services are investment advisory/asset management services relating to the RIC's portfolio securities. RICs, however, also typically have contractual arrangements with one or more service providers to provide for the sale and distribution of RIC shares to investors and accounting and shareholder services.

The RIC's assets typically are limited to its portfolio securities. These assets are usually maintained at a custodial institution with which the RIC has a contractual relationship. RICs are registered under the Securities Act of 1933 and the Investment Company Act of 1940 and are classified as corporations for both federal income tax purposes and New Jersey CBT purposes. The Investment Company Act of 1940 and related rules adopted by the Securities and Exchange Commission ("SEC") require most RICs to have a majority of directors on their board who are independent of the RIC's investment adviser and other affiliates. The RIC board is required to annually review and approve the RIC's contract with its investment adviser.

The Court should reverse the judgment of the Appellate Division. The taxation of nonresident taxpayers with no physical presence in New Jersey violates the Commerce Clause of the United States Constitution and New Jersey law. The decision of the Appellate Division, if sustained, would mean that virtually any taxpayer who enters into a contract or other arrangement with a New Jersey customer or consumer could be liable for the CBT - - even absent any other contacts with New Jersey. The California investment adviser that invests money for New Jersey clients and others across the country would have to be concerned with liability for the CBT even though all of its operations take place in California. In essence, extension of the CBT to taxpayers with no physical presence in New Jersey would have a chilling effect on the willingness of businesses to offer their goods and services in New Jersey.

IV. ARGUMENT/ERRORS COMPLAINED OF

A. The Appellate Division Committed Reversible Error Because Its Decision Violates the Commerce Clause.

The New Jersey Tax Court correctly concluded that the Division's attempt to tax the income of nonresident entities such as Lanco, Inc. ("Lanco") under the CBT exceeds the State's taxing authority under the Commerce Clause. Lanco, Inc. v. Director, Div. Of Taxation, 21 N.J. Tax 200, 214 (Tax 2003), rev'd, 379 N.J. Super. 562 (App. Div. 2005). In reversing the Tax Court, the Appellate Division performed little independent assessment, relying instead on decisions from other states to reject established precedent of the United States Supreme Court.

Because these state court decisions are flawed, so too is the Appellate Division's opinion, and this Court should reverse its judgment.

1. The Commerce Clause and State Taxing Authority.

The Commerce Clause of the United States Constitution authorizes Congress to regulate commerce with foreign nations and among the several states. Article 1, Section 8, cl.3. The Commerce Clause concerns the effects of state regulation on the national economy and prohibits discrimination against interstate commerce. See Quill Corp. v. North Dakota, 504 U.S. 298, 309, 112 S.Ct. 1904, 1911, 119 L.Ed.2d 91 (1992). Even in the absence of Congressional action, the Supreme Court has noted that "[t]he . . . clause by its own force, prohibits discrimination against interstate commerce, whatever its form or method . . . ." Id. (citations omitted). This is sometimes referred to as the "dormant" or "negative" commerce clause.

The Appellate Division incorrectly concluded that taxing the income of nonresident entities whose activities are wholly outside the State of New Jersey comports with the State's taxing authority under the Commerce Clause. The elimination of the "physical presence" requirement with regard to certain (but not all) kinds of taxes would introduce uncertainty into an area of the law that the Supreme Court has long criticized as a "quagmire" and unduly confusing. Quill, 504 U.S. at 315, 112 S.Ct. at 1915, 119 L.Ed.2d 91; Northwestern States Portland Cement Co. v. State of Minnesota, 358 U.S. 450, 458, 79 S.Ct. 357, 362, 3 L.Ed.2d 421 (1959).

The analysis of when a state can impose a tax on a foreign taxpayer has focused on whether the subject tax is apportioned to the taxpayer's "local activities within the taxing State forming sufficient nexus to support the same." Northwestern States, supra., 358 U.S. at 452, 79 S.Ct. at 359, 3 L.Ed.2d 421. In Complete Auto Transit, Inc. v. Bradley, 430 U.S. 274, 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977), the Supreme Court enunciated the four essential criteria in determining whether a state tax that affects interstate commerce passes Constitutional muster:

1. There must be a sufficient connection (i.e., substantial nexus) between the activity to be taxed and the state seeking to impose the tax;

2. The tax must be fairly apportioned to the activities conducted by the taxpayer within the taxing state;

3. The tax must not discriminate against interstate commence; and

4. The tax must fairly relate to the services provided by the state.

430 U.S. at 279, 97 S.Ct. at 1079, 51 L.Ed.2d 326.

In Quill, the Supreme Court held that while the Due Process Clause did not bar a use tax collection duty for a mail-order vendor engaged in continuous and widespread solicitation of business within North Dakota, there was insufficient nexus under the Commerce Clause to impose such an obligation. 504 U.S. at 317, 112 S.Ct. at 1916, 119 L.Ed.2d 91. In discussing the Complete Auto Transit factors, the Quill Court noted that the second and third prongs of the analysis, which require fair apportionment and nondiscrimination, prohibit taxes that pass an unfair share of the tax burden onto interstate commerce. Id. at 313, 112 S.Ct. at 1913, 119 L.Ed.2d 91. The first and fourth prongs, which require a substantial nexus and a relationship between the tax and state-provided services, limit the reach of the state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce. Id.

2. "Physical Presence" Is A Prerequisite To Taxation.

Much of the controversy regarding the application of the Commerce Clause in the area of state taxation has revolved around whether a taxpayer must have a physical presence with the taxing state. Prior to Quill, the Supreme Court had held in National Bellas Hess, Inc. v. Department of Revenue of Ill. that an Illinois statute requiring an out-of-state mail order seller to collect use tax under facts similar to Quill violated both the Due Process and Commerce Clauses. 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d. 505 (1967). Recognizing that due process jurisprudence had evolved substantially in the 25 years since Bellas Hess, particularly in the area of judicial jurisdiction, the Quill Court concluded that physical presence was no longer a requirement for state tax jurisdiction under the Due Process Clause. 504 U.S. at 308, 112 S.Ct. at 1911, 119 L.Ed.2d. 91. For purposes of the Commerce Clause, however, the Quill Court held that the physical presence requirement enunciated in Bellas Hess still applies.

By adopting the distinction between sales and use taxes and income taxes (like the CBT) espoused by the courts in Geoffrey, Inc. v. South Carolina Tax Comm'n, 437 S.E.2d 13 (S.C.), cert. denied, 510 U.S. 992, 114 S.Ct. 550, 126 L.Ed.2d 451 (1993), and A&F Trademark, Inc., v. Tolson, 605 S.E. 2d 187 (N.C. Ct. App. 2004), cert. denied , __ U.S. ___, __ S.Ct.__, 73 USLW 3719 (2005), the Appellate Division in Lanco sidestepped the Quill Court's teaching. Avoiding constitutional precedent, however, is not so simple.

Both Bellas Hess and Quill involved issues of state tax nexus for sales and use tax purposes. With respect to other taxes, such as business activity taxes, the Court stated that "although we have not, in our review of other types of taxes, articulated the same physical presence requirement that Bellas Hess established for sales and use taxes, that silence does not imply repudiation of the Bellas Hess rule." 504 U.S. at 314, 112 S.Ct. at 1914, 119 L.Ed.2d. 91. In other words, the Court stated that it may apply a physical presence standard like that of Bellas Hess to other taxes. The Court noted that a "bright line" physical presence requirement "furthers the ends of the dormant Commerce Clause." Id.

The Quill Court flatly rejected North Dakota's contention that if an entity's contacts with the state satisfied the minimum contacts test for the Due Process Clause, it also satisfied the nexus test for the Commerce Clause:

> The two standards are animated by different constitutional concerns and policies. . . . [T]he Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy.

504 U.S. at 312, 112 S.Ct. at 1913, 119 L.Ed.2d. 91.

Thus, the Quill Court noted that a tax may be consistent with due process and yet unduly burden interstate commerce. 504 U.S. at 313 n.7, 112 S.Ct. at 1914 n.7, 119 L.Ed.2d. 91. The Appellate Division's distinction between types of tax fails to account for or apply these clear constitutional principles.

The 'tax type' distinction is also flawed because, as Lanco explains in its Brief on Appeal to this Court, the cases on which the Geoffrey and A&F Trademark courts relied for it are suspect. They either pre-date Quill, were overruled by Quill, or did not involve the Commerce Clause. (Pb8-10).

Notably, the Division's own words contradict the conclusion reached by the Appellate Division. Each year, the Division submits its Annual Report to the Governor and the Legislature of New Jersey. Part of that report includes a description of each tax administered by the Division. In each of the past seven years, the Division has stated that the corporation income tax (repealed in 2002) "has become practically obsolete due to Corporation Business Tax regulations as well as New Jersey's adoption of the Multistate Tax Commission's guidelines and the U.S. Supreme Court decision, *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992) . . . ." See, e.g., 1996 Annual Report of the Division of Taxation, at 28 (January 1997)(emphasis added);[2] see also, Annual Division Reports for 1997 through 2003.[3] This statement reflects the Director's unequivocal acknowledgement that the principles set

[2] 1996 Annual Report at p. 28, http://www.state.nj.us/treasury/taxation/pubs.htm.

[3] 2003 Annual Report at p. 25; 2002 Annual Report at p. 25; 2001 Annual Report at p. 24; 2000 Annual Report at p. 30; 1999 Annual Report at p. 28; 1998 Annual Report at p. 28; 1997 Annual Report, at p. 32. All of the Division's Annual Reports from 1996 to 2003 can be accessed at http://www.state.nj.us/treasury/taxation/pubs.htm.

forth in Quill apply to business activity (i.e., income) taxes as well as sales and use taxes.

The Tax Court was correct when it observed, "the question of the necessity of physical presence for Commerce Clause nexus has been addressed in other state court decisions after Quill and Geoffrey. None of them find nexus absent physical presence." 21 N.J. Tax at 212. Thus, for instance, the State of Tennessee did not have jurisdiction to impose its franchise and excise taxes on an out-of-state taxpayer with no presence in the state notwithstanding that the taxpayer derived revenue from Tennessee customers from its credit card operations in that state, including through the solicitations for credit cards that were sent on its behalf. J.C. Penney Nat'l Bank v. Johnson, 19 S.W.3d 831 (Tenn. Ct. App. 1999), cert. denied, 531 U.S. 927, 121 S.Ct. 305, 148 L.Ed.2d 245 (2000). The court in that case concluded that the taxpayer's relationship with the State of Tennessee was insufficient to satisfy the "'substantial nexus' requirement found in the first prong of the Complete Auto Transit test." Id. at 838. The court in J.C. Penney also noted that "the Commissioner [of Revenue for the state of Tennessee could] point[] to no case in which the Supreme Court of the United States has upheld a state tax where the out-of-state taxpayer had absolutely no physical presence in the taxing state." Id. at 842. See also Rylander v. Bandag Licensing

Corp., 18 S.W.3d 296, 300 (Tex. App. 2000)("when the corporation conducts its activities solely through interstate commerce and lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax); Acme Royalty Co. v. Director of Revenue, 96 S.W.3d 72 (Mo. 2002)(interpreting state law, corporate income tax statute did not apply to income earned by foreign corporations from licenses of marks used by related operating corporations in Missouri).

3. New Jersey Case Law Supports A "Physical Presence" Element.

This Court's jurisprudence is consistent with Quill and its progeny. The Tax Court determined that New Jersey has consistently held that physical presence is necessary for a finding of "substantial nexus" under Commerce Clause analysis. 21 N.J. Tax at 218. For example, in Avco Financial Services Consumer Discount Co. One, Inc. v. Director, Div. of Taxation, 100 N.J. 27 (1985), this Court examined the imposition of New Jersey's corporation income tax on a Pennsylvania corporation that conducted business activities in the State of New Jersey.[4] Citing the decision in Bellas Hess, the Court held that the "question turns on how the taxpayer has come into the state to work the market." Id. at 38. The Court found that the taxpayer

[4] The corporation income tax, which was repealed in 2002, was a direct tax on income that foreign corporations derive from New Jersey sources that otherwise would escape taxation under the CBT because of the interstate nature of the entity's business.

in that case engaged in a "vigorous, systematic and persistent effort, aided by a substantial physical presence to collect overdue accounts, occupied the New Jersey offices of its affiliate to conduct business, and regularly used the New Jersey courts to pursue its rights." Id. at 40 (emphasis added). Based upon the record in that case, this Court concluded that the taxpayer was subject to taxation on that portion of its income that could be allocated to its activities in the State of New Jersey. Id. at 41. The linchpin of taxability was the taxpayer's physical presence, and the result would likely have been different in the absence thereof.

The Appellate Division did not address at all the Avco decision. It also failed to address in detail any contrary authority. Moreover, the Supreme Court in Quill criticized the "formal distinction between taxes on the 'privilege of doing business' and all taxes [as] serv[ing] no purpose within our Commerce Clause jurisprudence, but . . . 'only as a trap for the unwary draftsman.'" 504 U.S. at 314, 112 S.Ct. at 1914, 119 L.Ed.2d 91 (citation omitted).

4. The Decision In Quill Should Apply Here.

The record suggests that Lanco's activities in New Jersey are even more attenuated than those of the vendor in the Quill case; therefore, the teaching of Quill should apply without question.

In Quill, the non-resident vendor regularly solicited North Dakota residents through mailings and telephone calls directed into that State. 504 U.S. at 302, 112 S.Ct. at 1907, 119 L.Ed.2d 91. The vendor in Quill, although located in other states, was the sixth largest shipper of office supplies into the State of North Dakota. Id. at 302, 112 S.Ct. at 1907-1908, 119 L.Ed.2d 91. Despite those contacts, the Supreme Court concluded that Quill was not subject to taxation by the State of North Dakota. It specifically rejected the contention that Quill's licensing of intangibles used within North Dakota could satisfy the substantial nexus requirement of the Commerce Clause. Id. at 315 n.8, 112 S.Ct. at 1914 n.8, 119 L.Ed.2d 91.

Lanco's contacts are far less significant. Based upon a fair reading of the record, Lanco's only contact with New Jersey is its contract - executed in Delaware - with a separate corporation (Lane Bryant, Inc.) that conducts retail operations in, among other states, New Jersey. (Da98-108).[5] That agreement permits Lane Bryant, Inc. to use Lanco's marks in, *inter alia*, the State of New Jersey. (Da98). Although Lanco requires that Lane Bryant observe certain standards of quality in connection with Lane Bryant's use of the marks, it is Lane Bryant, not Lanco, that uses the marks in New Jersey. Indeed, the agreement

[5]The citation is to the Director's appendix filed in the Appellate Division.

requires Lane Bryant to pay Lanco in Delaware, (Da101, 106), and requires that any dispute between them be resolved in a Delaware forum using Delaware law. (Da107). If Quill's ongoing business dealings with North Dakota residents, including long term software license agreements with North Dakota residents, were insufficient to pass Constitutional muster, Lanco's agreement with Lane Bryant also fails the test.

The Appellate Division noted the Division's assertion "that the agreement between Lanco and Lane Bryant 'promotes increased retail purchases of merchandise' at stores in New Jersey, and that 'growth in retail sales burdens [New Jersey] by increasing traffic, requiring police and fire protection, and imposing demands on the labor pool.'" 379 N.J. Super. at 566-67. This disregards the fact, however, that any demands on the state are addressed via the taxation of Lane Bryant, Inc. Any further taxation of Lanco effectively compensates the state twice for the same services.

5. The Court Should Reject the Attempt to Impose a Tax Burden on Nonresidents.

The Appellate Division embraced the notion that a mere economic nexus for income taxes, predicated upon the mere derivation of income from in-state sources, satisfies Commerce Clause concerns. The deleterious effect that this view will have on the Institute and its members highlights how wrong it is.

In a typical situation, services are provided to a RIC that is not located in New Jersey (regardless of whether the RIC has New Jersey shareholders) by a separate service provider that has no physical presence in New Jersey. The majority of the Institute's RIC members are not in New Jersey. In such situations, the nonresident service provider is neither deriving receipts from sources within New Jersey nor engaging in contacts within the state.[6] This is true even if the RIC has New Jersey shareholders.[7]

The Appellate Division's judgment, if not reversed, presumably would permit the Division to tax any nonresident corporation (including those with no contacts to New Jersey) that provides services to another corporation (also possibly including those with no contacts to New Jersey) based solely on the fact that the corporation purchasing the services has New Jersey shareholders (or possibly as long as some amount of the corporation's receipts can find their origin in New Jersey). Were shareholder presence sufficient to establish jurisdiction,

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[6] N.J.A.C. §§18:7-1.6(a)vii and viii.

[7] The typical RIC, regardless of whether it has a New Jersey presence or purchases service from a New Jersey vendor, will have shareholders who are residents of New Jersey, since RIC shares are widely held.

virtually every public corporation would be subjected to the CBT.

Further, under the Appellate Division's view, any investment adviser hired by a New Jersey resident potentially would be subject to the CBT, no matter his location. Not only would such an imposition be unconstitutional, it would present immeasurable compliance problems since the service provider may not know the location of its customer (such as where an investment adviser manages the assets of a pool of portfolio securities, possibly held by an independent entity in "street" name).

Extension of the CBT to taxpayers with no physical presence in New Jersey has broad policy implications that could have a negative effect on virtually every industry. The Court should reject the economic nexus approach taken by the Appellate Division and refuse to allow the Director to shift tax burdens from residents to nonresidents.

B. The Decisions Relied on by the Appellate Division are Flawed.

As noted in section IV.A.2 above, the cases on which the Appellate Division relied are of questionable value.

The premise of Geoffrey, that the burdens associated with collecting a sales and use tax are materially different from those from those involved with collecting an income tax, is suspect, particularly in this age of computerized data processing capabilities. The New Jersey Tax Court properly reasoned that this distinction was incorrect:

> . . . it does not appear that the differences between the use tax collection obligation, on the one hand, and liability for income taxation, on the other, are so significant as to justify a different rule for each concerning physical presence as an element of Commerce Clause nexus. . . . The Supreme Court cases decided before Quill strongly suggest that physical presence is a necessary element of nexus for income taxation. Finally, other state court cases decided since Quill do not follow the Geoffrey rule.

21 N.J. Tax at 208. The Tax Court rightly concluded that "[t]he use tax collection obligation does not, to put it plainly, seem significantly more burdensome than the liability to pay an income tax. If physical presence is not a constitutional necessity for one, it is illogical that it should not be for both." Id. at 209.

Reliance on the decision in A&F Trademark also undermines the Appellate Division's judgment. The North Carolina intermediate appellate court focused on the "tone" of Quill and not its holding and upon "privileges and benefits" of North Carolina's "marketplace," which Quill had rejected as an adequate basis for nexus assertions. The North Carolina court was also swayed by the Supreme Court's *stare decisis* concerns, but it failed to abide by the Supreme Court's holding and failed to credit those same *stare decisis* concerns for income-based taxes.

The Appellate Division's reliance on Secretary v. Gap (Apparel), Inc., 886 So. 2d 459 (La. Ct. App. 2004) is also misplaced. The Louisiana court did not perform any analysis of the Commerce Clause issue. Rather, it merely concluded that the respondents' intangible property had acquired a "business situs" in Louisiana and thus satisfied the concerns of the Due Process Clause.

V. **REASONS FOR CERTIFICATION**

Because the Appellate Division has abandoned the physical presence requirement for income tax purposes, its decision will affect all taxpayers, and thus this case presents a question of significant public importance and is ripe for certification. R. 2:12-4. The Director has shown, through the CBT and the New Jersey Business Tax Reform Act, N.J.S.A. 54:10A-2, a clear intent to tax the income of even the most remote taxpayer. The adoption by the Appellate Division of the economic nexus test will further such unconstitutional overreaching and have broad policy implications that could have a negative effect on virtually every industry. The Commerce Clause of the United States Constitution, as interpreted, requires that a taxpayer have a physical presence to be subject to taxation. This Court should grant certification and reverse the judgment of the Appellate Division to reaffirm this basic principle and to avoid harsh and unfair tax treatment.

Respectfully submitted,

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B-548 SEP 2005

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Re: Lanco, Inc. v. Director, Division of Taxation
Docket No. 58,542

Dear Mr. Townsend,

Pursuant to a telephone conversation today with your office, this is to inform you that *amicus curiae* Multistate Tax Commission, hereby withdraws its brief on the merits previously filed with your office.

In lieu thereof, the Multistate Tax Commission will rely on the brief *amicus curiae* filed by the Multistate Tax Commission in the Superior Court, Appellate Division, in response to the petition currently pending in this Court.

Thank you very much for your attention to this matter

Very truly yours,

Sheldon H. Laskin
Director, National Nexus Program

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