IN THE SUPERIOR COURT OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

LEHMAN BROTHERS BANK, FSB,	)	
	)	
Appellee,	)	
	)	
v.	)	C.A. No. 05A-06-004-FSS
	)	
STATE BANK COMMISSIONER,	)	
	)	
Appellant,	)	

Submitted: August 28, 2006
Decided: November 30, 2006

OPINION and ORDER

Upon Appeal From the State Bank Commissioner's Decision – *AFFIRMED*

Stanford L. Stevenson, III, Esquire, Morris Nichols Arsht & Tunnell, 1201 N. Market Street, 18th Floor, P.O. Box 1347, Wilmington, Delaware, 19899. Attorney for Plaintiff.

Thomas P. McGonigle, Esquire, Wolf Block Schorr and Solis-Cohen, LLP, Wilmington Trust Center, Suite 1001, 1100 North Market Street, Wilmington, Delaware, 19801. Attorney for Defendant.

SILVERMAN, J.

This is an appeal from a decision by the State Bank Commissioner upholding a tax assessment and penalties imposed under the bank franchise tax. The appellant, a federal bank chartered in Delaware, challenges the tax's applicability, as most of the Bank's employees, especially its senior management, work in New York. Alternatively, the Bank contends that the tax violates federal Commerce and Due Process Clauses.

A common thread running through the Bank's argument is its insistence that it is a multi-state operation and Delaware taxed all of its operations, regardless of where they happened. Thus, the Bank repeatedly accuses Delaware of overreaching. That argument exaggerates what Delaware taxed. The bank franchise tax covers all the Bank's business activities relating to the mortgages, but only while the mortgages were on the Bank's books here. Delaware, for example, did not tax the Bank's activities through Aurora in Colorado, the decision-making in New York or the interest earned while the mortgages were in New York.

I.

Although the parties disagree about their legal significance, they basically agree about the facts. As discussed in the Commissioner's decision and presented below, Lehman Brothers Holdings, Inc., has operated a mortgage business since the 1980s. LBH's executive office and senior management were in New York. LBH bought or acquired mortgages issued by independent mortgage lenders and brokers, or by its subsidiary mortgage company, Aurora Loan Services, Inc. LBH did not deal directly with the borrowers. Before 1999, LBH's mortgage business was funded by unsecured bank loans, commercial paper, or short and long-term repurchase agreements. This funding was unstable since the markets could collapse, causing a financial crisis for LBH. Due to this instability, for several years LBH actively sought a federal savings bank. Through a federal savings bank, LBH would gain access to Federal Home Loan Bank funds. FHLB funding is more stable and efficient than market funding. Also, a FHLB would lend more money on the dollar, up to 70%.

Around July 1, 1999, LBH acquired Delaware Savings Bank, FSB, changing the Bank's name to Lehman Brothers Bank, FSB. The Bank's Federal Stock Charter became effective on June 30, 1999, making the Bank a federally chartered savings bank, organized under the Federal Home Owner's Loan Act, Section 5. Being organized under HOLA, the Bank was subject to regulation and supervision by the United States Office of Thrift Supervision. Also, a federal charter gave the Bank access to the FHLB, which gave the Bank the ready source of funds LBH wanted. For the tax years in question, 2000-2003, the Bank's home office, designated in its federal charter, was Wilmington, Delaware, and the Bank's sole retail banking office was in Wilmington. Delaware's home office designation meant that the Bank could access funds through the FHLB in Pittsburgh.

As stated in the record, the Bank's income came primarily from the mortgage banking business, but the Bank did have an unprofitable retail banking office for personal banking, including savings and checking accounts. As provided above, LBH primarily used the Bank to obtain federal funds and buy mortgages.

To fund mortgages, the Bank had two primary sources: money generated by CD sales and loans made by the FHLB in Pittsburgh. Since only a bank can accept deposits and issue CDs, the CDs were issued in the Bank's name and deposited at the Bank. Also, the Bank, not LBH, could receive loans from the FHLB. Therefore without the Bank, LBH would not have had access to FHLB loans nor be could it issue CDs. After LBH acquired the Bank, up to 90% of the funds for its mortgage business came from the Bank. Of this 90%, 25-30% came from the CDs, and 50-60% from the FHLB loans.

Using the FHLB loans and proceeds from CD sales, the Bank obtained mortgages from three sources. The Bank obtained some mortgages by buying residential mortgage pools. The Bank would buy a group of these mortgages that were already issued and funded.

Alternatively, the Bank originated mortgage loans directly, either through a broker or correspondent channel. With a broker, a borrower who wanted a mortgage would go to LBH's subsidiary, Aurora. Aurora, under the Bank's guidelines, would review the loan and approve the borrower's credit and the mortgage. Aurora's services usually took place in Colorado. For an Aurora mortgage settlement, the Bank, through its funding desk in New York, would wire the funds to Aurora. The funds came to the funding desk from the Bank in Delaware through CDs and FHLB funds, as explained above. These mortgages were funded by the Delaware Bank and in the Bank's name. Therefore, the Bank held these mortgages.

Otherwise, when the Bank bought a mortgage through a correspondent channel, another lender would underwrite and fund the loan. The lender held that mortgage. Then, the lender would sell the mortgage to the Bank, through Aurora. Again, the Bank would then hold the mortgage.

In all three situations, the Bank held the mortgages in Delaware. Normally, the Bank would keep the mortgages for 45-60 days, with the mortgages staying on the books in Delaware, generating interest income for the Bank. As the Bank's representative testified:

> [W]e sent the money to Delaware because that's where our main operating – that's where our operating account was….[I]t has to hit the books and records somewhere. It can't really hit your books and records in New York. It has to hit your books and records in the bank.

During these 45-60 days, the Bank received about 4% in interest income, amounting to millions of dollars. According to the Bank, this interest income comprised 97-98% of the Bank's total income. The Bank then "sold" the mortgages to LBH, realizing no profit on the transfer. As discussed below, LBH is challenging the tax Delaware indirectly imposed on the income earned by the Bank while the mortgages were held in Delaware.

As mentioned, however, most of the Bank's management was located in New York. To conduct the mortgage banking business, 20-25 full-time employees and 66 "dual employees" were in New York. These "dual employees" held positions with the Bank, and the Bank reimbursed LBH for their services. Also, the Bank had 24 "dual employees" in Colorado who were on Aurora's payroll. These Colorado employees followed the Bank's guidelines when approving mortgages, and the Bank reimbursed Aurora for these employees' services.

II.

For each year at issue, the Bank filed a franchise tax report. For the years 2000-2002, the Bank filed under 5 *Del. C.* § 1101(a),[1] as a banking organization with its principal place of business in Delaware. The Bank claimed a 50% income deduction on its franchise tax report, using a line 4(b) deduction. Line 4(b) allows a banking organization to deduct "[n]et operating income before taxes verifiable by documentary evidence from any...branch within the United States pursuant to § 771 of Title 5..., which is derived from business activities carried on outside the State and subject to income taxation under the laws of another state...." The Bank, however,

---

[1] "A franchise tax is hereby imposed on the "taxable income" of banking organizations and trust companies...."

failed to provide the "documentary evidence" specified in 5 *Del. C.* § 1101(a)(1).

In 2002, the Commissioner requested the required documentation. After repeated requests with no response, the Commissioner finally notified the Bank that its 2000-2002 tax returns were deficient and recalculated the Bank's tax liability, without the line 4(b) deduction. The Commissioner computed the Bank's franchise tax assessments, not including penalties as:

- $3,209,996 for 2000;
- $4,936,270 for 2001;
- $7,715,354 for 2002; and
- $11,577,586 for 2003.

The Commissioner also assessed late payment penalties amounting to $14,515,474 for 2000-2003, and also another penalty of $5,251.74 for each day after May 20, 2005 that the assessments remain unpaid.

The Bank disputed the assessment, and the Commissioner sent a notice initiating a proceeding to determine the Bank's franchise tax for 2000-2002.[2] Meanwhile, the Bank filed its 2003 tax return without claiming a 4(b) deduction. Instead, the Bank reported dramatically less income than the previous years, relying

[2] 29 *Del.C.* § 10122 ("Whenever an agency proposes to proceed for a case decision, it shall give 20 days' prior notice to all parties....").

on 5 *Del. C.* § 1101(b).[3] The Commissioner then sent the Bank another notice initiating proceedings, this time to determine tax liability for the 2003 tax year.

In September 2004, the Bank recomputed the franchise tax owed for the years at issue, based on amended reports prepared by its accountants, Ernst & Young, LLP. And, the Bank asked for refunds. These amended returns were prepared on the premise that the Bank was not headquartered in Delaware but instead should be treated as a branch. The Commissioner initially rejected the recalculations and denied refunds. At the Bank's request, an evidentiary hearing on all the assessments was held on September 30, 2004, before the Commissioner.

In his decision, dated May 20, 2005, the Commissioner upheld the deficiencies and penalties, and he further found that the franchise tax did not violate Delaware law, and the federal Commerce or Due Process Clauses. On June 10, 2005, the Bank filed a timely Notice of Appeal with this court. The Bank does not challenge the administrative proceedings' procedural correctness.

III. Standard of Review

This is on appeal from the State Bank Commissioner's Decision. The Commissioner's factual findings will be upheld if they are supported by substantial

---

3 "A franchise tax is hereby imposed on the 'taxable income' of federal savings banks not headquartered in this State but maintaining branches in this State, verifiable by documentary evidence."

evidence.[4] Questions of law are reviewed *de novo*.[5] In other words, the court will apply the facts as the Commissioner found them to be, to the law as the court finds it to be, and in that way decide the appeal.

IV. Delaware's Franchise Tax

The Bank vehemently argues that it is not a Delaware domiciliary, as it is federally chartered, and therefore, neither legally nor commercially domiciled in the state. Instead, the Bank contends that it is headquartered, and also commercially domiciled, in New York, meaning that the Bank would pay less franchise taxes. Alternatively, the Bank contends its mortgage activity was conducted outside Delaware, and therefore, Delaware cannot include this out-of-state activity when computing the bank franchise tax.

A franchise tax generally is a tax on an entity for the right or privilege of doing business or exercising its franchise in a state.[6] While it is a tax on doing business, the tax is based on the "taxable income" of corporations or banking

---

4 29 *Del. C*. 10142(d). *See also Public Water Supply Co. v. DiPasquale*, 735 A.2d 378, 380-81 (Del. 1999).

5 *Bd. of Educ. of Smyrna School Dist. v. DiNunzio,* 602 A.2d 85, 93 (Del. 1990). *See also State Dept. of Correction v. Worsham*, 683 A.2d 1104, 1106 (Del. 1994); *Public Water*, 735 A.2d at 380-81.

6 *Pacific Co. v. Johnson*, 285 U.S. 480, 501 (1932). *See also Martin v. Producers Pipe Line Co.*, 113 F.2d 817, 818 (6th Cir. 1940).

organizations doing business in the state.[7] Franchise taxes "are not placed upon a particular corporate business or transaction, but upon the privilege of doing business as a corporation and exercising corporate powers for the purpose of producing a profit."[8] "The term 'doing business' is not uniformly defined in the cases, and its meaning will vary dependent on the situation."[9]

A franchise tax is different from other taxes, including income taxes, as it is imposed for different purposes. "The [franchise] tax is not laid on property or on income, though both are regarded in measuring it."[10] A state can tax the entity's income and also impose a franchise tax since "income taxes are based on taxing individuals and entities on monies made whereas franchise taxes stem from the notion that a company should pay for the privilege of operating its business in this state."[11]

---

[7] 5 *Del. C.* § 1101.

[8] *Broadmoor-Kingsport Apartments, Inc. v. State*, 686 S.W.2d 70, 72 (Tenn. 1985). Although this case deals with a corporate franchise tax, the statute included banks and was also for the privilege of doing business in the state, as is the case here. T.C.A. § 67-4-903 (1985) states, "All corporations...doing business in Tennessee, including state chartered banks and national banks doing business in Tennessee shall, without exception other than as provided herein, pay to the commissioner of revenue, annually a privilege tax."

[9] *Id.*

[10] *Southern Realty Corp. v. McCallum*, 65 F.2d 934, 935 (5th Cir. 1933).

[11] *Miss. State Tax Com'n v. Chevron U.S.A., Inc.*, 650 So. 2d 1353, 1355-56 (Miss. 1995). *See also Bass*, 266 U.S. at 280.

Therefore, a franchise tax is still constitutional even if it taxes property that was already subjected to taxation.[12]

In Delaware, a bank franchise tax is "imposed on the 'taxable income' of a banking organization."[13] In its Post-Hearing Reply Brief, the Bank argues that it was not a banking organization.[14] On appeal, however, the Bank no longer disputes that it is a banking organization for franchise tax purposes, and therefore, it must pay the franchise tax.[15] Under Delaware's bank franchise tax, the taxation method depends on whether the banking organization is headquartered in Delaware.[16] Under §§ 101(4)(b) and 1101(a), a bank whose "principal office" is based in Delaware is taxed on all taxable income, except the bank may exclude income earned from activities conducted outside Delaware by branches or subsidiaries subject to tax outside Delaware.[17] If the bank is not "headquartered" in Delaware, if it is an out-of-state bank with a branch in Delaware, it is still subject to a franchise tax, but to a

---

[12] *Bass, Ratcliff & Gretton v. State Tax Comm'n*, 266 U.S. 271, 280 (1924).

[13] 5 *Del. C.* § 1101(a).

[14] Appellant's Post-Hearing Reply Brief at 13.

[15] *See* 5 *Del. C.* § 101 (17) and 7 *Del. C.* § 101.

[16] 5 *Del. C.* § 1101(a)-(b).

[17] 5 *Del. C.* §§ 101(4)(b), 1101(a).

limited extent.[18] For an out-of-state bank, the franchise tax is only imposed on the income from that branch in Delaware.[19] The code, though, does not define "headquartered" or "principal office."

A. Headquarters

Relying on the fact that the Bank is chartered in Delaware and its home office is here, the Commissioner found that the Bank is headquartered in Delaware for franchise tax purposes. The Bank, however, draws a distinction between its home office and headquarters. Because the Bank's senior management is New York-based and some mortgage decisions come from there, the Bank concludes that the Commissioner was legally bound to hold that the Bank was headquartered in New York for franchise tax purposes.

Also, the Bank urges the court to look to the Uniform Division of Income for Tax Purposes, a model law, which defines commercial domicile as the "principal place from which the trade or business of the taxpayer is directed or managed," and the Multistate Tax Commission Regulation, another model law, which defines commercial domicile as "the place from which the trade or business is

---

[18] 5 *Del. C.* § 1101(a)-(b).

[19] *Id.*

principally managed or directed."[20] As the Commissioner found, both arguments are flawed. First, Delaware has never adopted UDITPA, although it has been around for years. Second, Delaware is not a MTC member. Therefore, neither UDITPA nor MTC is controlling.

The Bank further argues that the Commissioner should look to the definition of commercial domicile provided in 30 *Del. C.* § 1901(2), which is identical to the UDITPA's definition. This also is unpersuasive. Thirty *Del. C.* § 1901(2) deals with corporate income tax, not a bank franchise tax. Also, commercial domicile is never mentioned in 5 *Del. C.* § 1101.

Meanwhile, four reasons support the Commissioner's finding that the Bank is headquartered in Delaware for franchise tax purposes. First, as a general matter, there may be several ways to characterize the Bank as an entity. Under the statute, however, there are only two possibilities: the bank is either headquartered in Delaware or the bank is located out-of-state with a branch in Delaware. For franchise tax purposes, the Bank simply cannot be a branch. At times the Bank calls itself a branch, yet it fails to show, with supporting documents, that it is a branch as defined in 5 *Del. C.* § 1101.

The Commissioner correctly held that to be a branch, a bank must apply

---

[20] UDITPA § 1(b) and MTC Regulation §2(c)(1)

and be approved by authority of the State Bank Commissioner.[21] As noted in the record, the Bank has not received such authority.[22] Therefore, by negative inference, the Bank must have been headquartered in Delaware as it clearly was not a branch. That conclusion is also consistent with how the Bank operated. No banking took place in New York. It cannot be that the Delaware entity was a branch bank.

Second, under 12 C.F.R. § 545.91(a), which governs the Bank, "[a]ll operations of a Federal savings association are subject to direction from the home office." If there is a change in the home office's address, the Federal savings association must apply to the OTS Regional Office.[23] Furthermore, "the principal place of business of an institution is the state in which the institution maintains its home office."[24] Although these federal definitions are not dispositive, Delaware's Supreme Court has used federal definitions when a Delaware statute did not clearly define a term.[25] The record shows that the Bank's federal stock charter designates Wilmington, Delaware as the home office, and the Bank has never applied to change

---

[21] 5 *Del. C.* § § 770(a)(1), 771(a).

[22] The Bank once had a Delaware branch, which closed in 2000. Also, in 2003, the Bank received authority to open a branch in Jersey City, New Jersey.

[23] 12 C.F.R. § 545.91(b).

[24] 12 C.F.R. § 925.18(b).

[25] *Dir. of Revenue v. CNA Holdings, Inc.*, 818 A.2d 953, 957-59 (Del. 2003).

this status.

Third, a federal savings bank "may become a member only of, or secure advances from, the Federal Home Loan Bank of the district in which is located the institution's principal place of business…."[26] Here, the Bank's principal place of business in Delaware allowed LBH access to the FHLB in Pittsburgh. The FHLB in Pittsburgh does not serve New York. Therefore, it is understood that the FHLB in Pittsburgh could only serve the Bank if the Bank's place of business was in Delaware, not New York.

Fourth, as the Commissioner held, he has traditionally "deferred to the bank's federal chartering authority to determine the location of the bank's principal office for franchise tax purposes." This is based on 5 *Del. C.* § 801(5), which states that a bank is located in the State if the "organization certificate identifies an address in this State as the place at which its discount and deposit operations are to be carried out." This definition is cross-referenced in the franchise tax provisions.[27] The Bank's charter designates Wilmington as its home office. Therefore, the Commissioner correctly concluded that the Bank is headquartered in Delaware for franchise tax purposes.

---

[26] 12 U.S.C. § 1424(b).

[27] 5 *Del. C.* § 1101(a)(1)(b.2).

B. Taxable Income

Although the Bank dwells on "domicile," "headquarters" and "principal place of business," it ignores the fact that all its income was actually earned in and derived from sources in Delaware. Even if the Bank were not headquartered in Delaware for franchise tax purposes, which it is, the Bank actually earned the money in Delaware. That means the income is still included in the Bank's "taxable income." For income tax purposes, there are two basic ways a state can tax: a state can tax a person or entity domiciled in the state, even on income earned outside the jurisdiction, or the state may tax nonresidents on their income derived from sources within the state.[28] Although a franchise tax is different from an income tax, the franchise tax in Delaware is calculated based on a bank's "taxable income." If Delaware could tax the income, then that income can be included in calculating the franchise tax. So, "taxable income" includes all income derived from sources in the state.

The Commissioner relied on two important facts when deciding that the income was earned in Delaware. First, the Bank actually received the interest income in Delaware, as that is where the income "hit the books." Second, the Bank obtained the funds used to generate the income through Delaware. Those funds included the money from CD sales and the FHLB loans. Without the funds from Delaware, the

[28] *Shaffer v. Carter*, 252 U.S. 37, 57 (1920).

Bank and LBH could not have produced the income. Further, the Commissioner made it clear that after the Bank "sold" the mortgages to New York, he did not include any of the New York interest income in the franchise tax assessment. Thus, Delaware only taxed income the Bank earned in Delaware.

The Bank continually focuses on where the decisions were made and where the employees were located to reach the conclusion that none of its activities took place in Delaware. The Bank, though, tries to minimize Delaware's involvement. While the Bank emphasizes the employee's location and payroll, these employees were on the Bank's books and funded through Delaware. Ultimately, they were paid by the Bank in Delaware. The Bank also de-emphasizes the fact that the interest income was earned at the Bank in Delaware.

The lynchpin of the Commissioner's decision is the fact that the Delaware tax is only imposed on interest income earned in Delaware. In computing the franchise tax, Delaware did not include other transactions, e.g. when the mortgages were purchased outside Delaware or any interest earned after their transfer to LBH in New York.[29] As described above, what is done within the state's own

---

[29] Transcript of hearing pgs. 40-41. Answers by Mr. Slomka, the Bank's CEO : "And so as I said, it's about 45 to 60 days on average of the loans we have sitting in our portfolio…We earn our approximate 4 percent net interest margin on them during that time and then sell them over to the holding company.

(continued...)

borders can be taxed.[30] Here, Delaware only taxed what happened within the state. Delaware taxed the mortgage interest, for franchise tax purposes, only when the mortgages were held by and on the books at the Delaware Bank. Also, the funds used to purchase the mortgages came from the Bank. The Bank marshaled the FHLB funding received in Delaware with money earned from the CD sales in Delaware and channeled it to the borrowers. Therefore, the taxed income was earned in Delaware.

As the Commissioner determined the tax was only on activities that occurred in Delaware, it was unnecessary to determine where the Bank is domiciled. But if the case turned on the Bank's domicile, there is much to commend Delaware as the Bank's domicile. The Bank kept its home and its most valuable properly in Delaware, as discussed above.

V. Constitutional Arguments

The Bank also argues that Delaware cannot tax all the Bank's interest income, as doing so violates the Commerce and Due Process Clauses. Under the former, the Bank's only takes issue with one prong of the analysis, described below.

---

[29](...continued)

Q: Is it the interest on the mortgages held for that 45-day period that comprises the bulk of the income of the bank?

A: That's correct."

30 *Stephan v. State Tax* Comm'r, 245 A.2d 552, 554 (Del. 1968); Guaranty *Trust Co. of N.Y. v. Com. of Virginia*, 305 U.S. 19, 23 (1938).

The Bank contends that the tax is not fairly apportioned. Under the Due Process Clause, the Bank argues no rational relationship exists between the tax and the income. Under both clauses, the argument is that the Bank "earned nearly all of its income from activities conducted entirely outside of Delaware, principally from its mortgage banking activities conducted in New York," and therefore, Delaware cannot tax the interest income.

When reviewing a statute, the court presumes the statute is valid unless it clearly contravenes a constitutional provision.[31] A strong presumption for validity exists for state taxing statutes.[32] Additionally, tax assessments by the proper taxing authority are considered presumptively valid.[33] "[I]t is to be presumed that governmental authority has been exercised correctly and in accordance with the law."[34]

The challenger then has the heavy burden to overcome these

---

[31] *McClelland v. Mayor and Council of Wilmington,* 159 A.2d 596, 601 (Del.Ch. 1960). *See also State v. Wickenhoefer,* 64 A. 273, 276-77 (Del. 1906); *Davies Warehouse Co. v. Bowles*, 321 U.S. 144, 153 (1944); *Pacific States Box & Basket Co. v. White*, 296 U.S. 176, 185 (1935).

[32] *Kunkel's Estate v. U. S.*, 689 F.2d 408, 424 (3rd Cir. 1982). *See also Estate of Kunze v. C.I.R.*, 233 F.3d 948, (7th Cir. 2000).

[33] *Delaware Racing Ass'n v. McMahon,* 340 A.2d 837, 840 (Del. 1975). *See also In re AWB Associates, G.P.*, 144 B.R. 270 (E.D.Pa.1992).

[34] *Id.*

presumptions.[35] Under both the Commerce and Due Process Clauses, when a state has chosen an apportionment method, an objecting taxpayer has the burden to demonstrate by "'clear and cogent evidence,' that 'the income attributed to the State is in fact out of all appropriate proportions to the business transacted…in that State, or has led to a grossly distorted result.'"[36] Also, if two states are taxing the income, a taxpayer has to show that this state is the one that was at fault in the constitutional sense.[37]

The Commissioner found, after looking at each argument, that the Bank did not meet its burden of proof. First, the Bank failed to prepare a separate Delaware balance sheet accounting for the money earned in Delaware. For example, the Commissioner found that the Bank "did not consider the interest that the home office should charge to the mortgage operation because the home office was the source of deposit funds . . . and FHLB borrowings."

Second, the Bank failed to demonstrate exactly what was allegedly being taxed in other states. The Bank argues that the franchise tax subjects the Bank to multiple taxation, but fails to show how. The Bank, through

---

[35] *CNA Holdings*, 818 A.2d at 959.

[36] *Oklahoma Tax*, 514 U.S. at 195 (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274 (1978)).

[37] *Moorman*, 437 U.S. at 267-68.

PricewaterhouseCooper's Separate Accounting Review, establishes that it is paying taxes in other jurisdictions, but does not lay out the kind of tax is being imposed. For example, the Bank does not say whether the other states taxed the same mortgage interest income or if they taxed other transactions, such as an origination fee or transfer fee.

Different states taxing different transactions is constitutional.[38] For example, a property tax and income tax on the same corporate property is not double taxation.[39] Similarly, a franchise tax and income tax on the same property is also not double taxation.[40] Therefore, if the other states imposed an income tax, as opposed to a franchise tax, the franchise tax is valid. Nothing in the record reveals that Delaware is taxing the same thing that another state is taxing. The Bank also failed to prove that Delaware was at fault for any duplicative tax.[41] Thus, the Bank has not met its burden to show that the tax is constitutional.

A. Commerce Clause

The Commerce Clause, Article I, § 8, clause 3, expressly authorizes

---

[38] *Indian Motorcycle Co. v. U.S.*, 283 U.S. 570, 574 (1931).

[39] *State of Tennessee v. Whitworth*, 117 U.S. 129, 135-37 (1886).

[40] *Mississippi State Tax Com'n v. Chevron U.S.A., Inc.,* 650 So.2d 1353, 1355 (Miss. 1995).

[41] *See, e.g., Oklahoma Tax*, 514 U.S. at 195-96 and *Moorman*, 437 U.S. at 277.

Congress to "regulate Commerce…among the several States." Although this is an "affirmative grant of power," the Supreme Court has consistently held that the Commerce Clause contains a negative implication, known as the dormant Commerce Clause.[42] Concerned with the national economy, the dormant Commerce Clause prohibits certain state actions that interfere with interstate commerce.[43]

Some state taxes impermissibly interfere with interstate commerce, and therefore encroach on the regulatory authority granted by Congress.[44] The Supreme Court, however, has repeatedly held that the Commerce Clause's purpose is not to "relieve those engaged in interstate commerce from their just share of state tax burden…."[45] Therefore, state taxation is only prohibited when it imposes a burden on interstate commerce.[46] A burden exists if the tax subjects interstate commerce to an unreasonable risk of multiple taxation.[47] Even so, some duplicative taxes are

---

42 *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 179-180 (1995).

43 *South Carolina State Highway Dept. v. Barnwell Brothers, Inc.*, 303 U.S. 177, 185 (1938).

44 *Oklahoma Tax*, 514 U.S. at 179-80.

45 *Id.* at 182 (quoting *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254 (1938)).

46 *Quill*, 504 U.S. at 309-10.

47 *Moorman*, 437 U.S. at 288.

tolerable because all states do not follow identical taxation methods.[48] Simply because some duplicative taxes exist does not, by itself, render a state's tax unconstitutional.[49]

Again, when challenging a statute, the taxpayer carries the burden. Not only must the taxpayer prove that the tax is unconstitutional, but also must show that this state is the one at fault. To determine a statute's constitutionality under the dormant Commerce Clause, the Supreme Court has consistently applied the *Complete Auto,* four-part test.[50] This test upholds a tax as long as it is "[1] applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State."[51] The parties agree that *Complete Auto* controls here.

As mentioned above, the Bank contends that the bank franchise tax violates the Commerce Clause because the tax is not fairly apportioned. The Bank insists that Delaware cannot tax 100% of the Bank's income, since none of its income generating activities occurred in Delaware. Also, by taxing all the Bank's income, the Bank contends that Delaware is subjecting the Bank to multiple taxation.

---

48 *Id*. at 278.

49 *Id.*

50 *Oklahoma Tax*, 514 U.S. at 182.

51 *Quill*, 504 U.S. at 311 (citing *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)).

1. Substantial Nexus

Under the *Complete Auto* test's first prong, a substantial nexus must exist with the taxing state.[52] The Commerce Clause's nexus requirement can be met if the taxpayer has physical presence in the state.[53] This prong is also satisfied if the taxpayer conducts activities in the taxing state that "substantially contributed to the taxpayer's ability to maintain operations in the taxing state."[54]

The Bank does not deny its nexus to Delaware, even for Commerce Clause purposes, since the Bank is physically present here. Also, the Bank's Delaware activities, such as accepting CD deposits and accessing FHLB loans, substantially furthered the Bank's mortgage business, contributing over 90% of the funds for it.

2. Fair Apportionment

In analyzing *Complete Auto's* second prong, the court determines "whether a tax is fairly apportioned by examining whether it is internally and

---

[52] *Id.*

[53] *Id.* at 312.

[54] *J.C. Penney Nat. Bank v. Johnson*, 19 S.W.3d 831, (Tenn. Ct. App. 1999) (citing *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232, 250-51 (1987) and *Scripto, Inc. v. Carson*, 362 U.S. 207, 210-12 (1960)).

externally consistent."[55] As mentioned, this is the one prong challenged by the Bank. For internal consistency, the tax must be such that if applied by every jurisdiction, there would not be multiple taxation.[56] "Thus, the internal consistency test focuses on the text of the challenged statute and hypothesizes a situation where other States have passed an identical statute."[57] If every state's franchise tax included mortgage interest only when its banks held the mortgages, there would not be multiple taxation. Therefore, the internal consistency test is met.

"The second and more difficult requirement is what might be called external consistency-the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."[58] "The external consistency test asks whether the State has taxed only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed."[59] External consistency looks at the economic justification for the state's claim upon the value taxed.[60]

---

[55] *Goldberg v. Sweet*, 488 U.S. 252, 261 (1989).

[56] *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).

[57] *Goldberg,* 488 U.S. at 261.

[58] *Container Corp.*, 463 U.S. at 169.

[59] *Goldberg,* 488 U.S. at 262 (citing *Container Corp.*, 463 U.S. at 169-70).

[60] *Oklahoma Tax*, 514 U.S. at 185.

Again, a state is allowed to impose a tax on what happens within its borders.[61] And as mentioned above, Delaware only imposed its franchise tax on the income received in Delaware, when the interest income is on the books here. This income is attributable to Delaware since the funds from the Bank "fueled the entire mortgage banking business." Without these funds, the Bank could not buy the mortgages. And, it was the Bank that bought the mortgages. (It does not matter that someone else, LBH, told the Bank which mortgages to buy.) Then, the Bank earned money from them while they were here. Delaware did not tax any other transactions. It did not tax the Bank's activities outside Delaware, such as Aurora's lending in Colorado. Nor did it tax the loans and the interest income after they were moved from Delaware to New York.

Also, the Commissioner's bank franchise tax assessment is fairly apportioned because, as mentioned, an in-state bank can deduct business done outside the state,[62] and an out-of-state bank can deduct income from out-of-state branches, as long as it submits documentation to support that deduction.[63] Thus, to the extent that income is earned in a branch outside of Delaware and subject to tax in another state,

---

[61] *Guaranty Trust*, 305 U.S. at 23.

[62] 5 *Del. C.* 1101(a).

[63] 5 *Del. C.* 1101(b).

it is not included in calculating Delaware's franchise tax.[64] This is a separate accounting method that taxes only what happens within the state. In other words, this method "taxes corporations that operate within its borders only on the income those corporations recognize on their own books."[65] This separate accounting method has been upheld as constitutional.[66] That is exactly what is happening here. Delaware only taxed income that the Bank recognized on its books.

Additionally, as mentioned above, the Bank did not meet its burden to show that the tax is unfairly apportioned. Although the Bank did show the Commissioner that it was paying taxes in other jurisdictions, the Bank failed to show exactly what was being taxed elsewhere. This is not enough to overcome the tax statutes's strong presumption of validity.

3. Non-Discriminatory

Under *Complete Auto's* third prong, the state cannot discriminate against interstate commerce by providing a direct commercial advantage to local business.[67] Unconstitutional discrimination typically occurs when a state taxes in-state

---

[64] *Id.*

[65] *Id.*

[66] *Barclays Bank PLC v. Franchise Tax Bd. of California*, 512 U.S. 298, 305 (1994).

[67] *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 329 (1977).

transactions differently than out-of-state transactions.[68] The Bank does not claim the statute is discriminatory, as the tax treats the Bank like a local business. Moreover, federal law permits a state to tax a federal savings bank or national bank the same as in-state banks.[69] The Bank admittedly is taxed exactly the same as a state chartered bank.

4. Fair Relationship

The *Complete Auto* test's fourth prong requires a fair relation between a tax and benefits, which means that the taxpayer has to "contribute to the cost of providing *all* governmental services, including those services from which it arguably receives no direct 'benefit.'"[70] This means "that the measure of the tax be reasonably related to the taxpayer's presence or activities in the State."[71] "The purpose of this test is to ensure that a State's tax burden is not placed upon persons who do not benefit from services provided by the State."[72]

"The fourth prong of the *Complete Auto* test thus focuses on the wide

---

[68] *Id.*

[69] 12 U.S.C. § 548 and §1464(h).

[70] *Oklahoma Tax*, 514 U.S. at 199-200 (quoting *Goldberg*, 488 U.S. at 267) (emphasis in original).

[71] *Id.*

[72] *Goldberg,* 488 U.S. at 266-67 (citing *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 627 (1981)).

range of benefits provided to the taxpayer, not just the precise activity connected to the interstate activity at issue."[73] The Supreme Court noted that "a taxpayer's receipt of police and fire protection, the use of public roads and mass transit, and the other advantages of civilized society satisfied the requirement that the tax be fairly related to benefits provided by the State to the taxpayer."[74] These benefits though do not have to be limited to the exact services provided by the entity being taxed.[75]

The Bank does not contest the fair relationship test because the Bank received the normal protection that a state offers, including access to courts, fire and police protection, a safe place to conduct business, as well as services furnished to the Bank's employees, such as schools, health care, and welfare benefits. Also, the Bank is authorized to lend money in accordance with Delaware laws, especially when it extends credit to others outside the state.[76] Therefore, the Bank uses Delaware law to lend money in other states, without regard to the other state's lending restrictions or usury laws. As the *Complete Auto* four-part test is met and the Bank has not met its burden to prove otherwise, Delaware's tax does not violate the Commerce Clause.

---

[73] *Id*. at 267.

[74] *Id*.

[75] *Id*.

[76] 12 C.F.R. § 560.110.

B. Due Process Clause

"The Due Process Clause 'requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.'"[77]

> For a State to tax income generated in interstate commerce, the Due Process Clause of the Fourteenth Amendment imposes two requirements: a 'minimal connection' between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise.[78]

Under this analysis, the courts look at "the fundamental fairness of governmental activity."[79] Therefore, Due Process focuses on the "notice" or "fair warning" to the taxpayer.[80]

As previously mentioned, the Bank also argues that taxing all the Bank's income violates the Due Process Clause because no rational relationship exists between the tax and the income, as the income was earned from activities conducted outside of Delaware.

1. Minimal Connection

To satisfy the first requirement, only a "minimal connection" is

---

[77] *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992) (quoting *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-345 (1954)).

[78] *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 436 (1980) (citing *Moorman*, 437 U.S. at 272-73.

[79] *Quill*, 504 U.S. at 299.

[80] *Id*.

necessary.[81] "The requisite 'nexus' is supplied if the corporation avails itself of the 'substantial privilege of carrying on business' within the State…."[82] The court must decide whether the "connections with a State are substantial enough to legitimate the State's exercise of power over him."[83] The touchstone for the Due Process analysis is established in *International Shoe*, which requires minimum contacts.[84] Physical presence in the taxing state satisfies the minimum connection.[85] Nexus has also been found where the taxpayer merely maintains an office in the taxing state.[86]

Despite their similar language, the nexus requirements of the Due Process and Commerce Clauses are not identical.[87] The Commerce Clause is more stringent than the Due Process Clause on the state's taxation power.[88] Here, the Bank does not dispute that it has minimum contacts with Delaware, as the Bank has

---

[81] *Quill*, 504 U.S. at 303.

[82] *Mobil,* 445 U.S. 425, 436 (quoting *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444-445, (1940)).

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

[84] *International Shoe Co. v. State of Washington*, 326 U.S. 310, 316 (1945).

[85] *Id*. at 307-308.

[86] *D.H. Holmes, Ltd. v. McNamara*, 486 U.S. 24, 32 (1988); *National Geographic v. Cal. Equalization Bd.*, 430 U.S. 551, 556 (1977).

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

[88] *Id*. at 313. *See also J.C. Penney Nat. Bank v. John*son, 19 S.W.3d 831 (1999).

physical presence here, a banking office in Wilmington, and that is where its income "hits the books." As these facts satisfy the Commerce Clause's substantial nexus requirement, that is enough to satisfy the Due Process minimal connection.

2. Rational Relationship

For the second requirement, a rational relationship must exist between the taxed income and the "values connected with the taxing State."[89] Here, the court must consider "whether the taxing power exerted by the State bears fiscal relation to protection, opportunities and benefits given by the state."[90] The tax will be upheld "if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society."[91] "The simple but controlling question is whether the state has given anything for which it can ask return."[92] Usually, the privilege of carrying on a business in the state supports a tax.[93] Police and fire protection, emergency health services, public utilities, and "a safe climate to conduct business" have also been deemed enough to

---

89 *Moorman*, 437 U.S. at 267 (citing *Norfolk & Western R. Co. v. MO. State Tax Comm'n*, 390 U.S. 317, 325 (1968)).

90 *J.C. Penney*, 311 U.S. at 444.

91 *Id.*

92 *Id.*

93 *Id.*

support the tax.[94] As analyzed above, the Bank receives many of Delaware's benefits and protection, thus satisfying this requirement.

The fact that the tax is "contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction."[95] In other words, it does not matter that the mortgages were originated or approved somewhere else nor that the funds for the mortgages came through Pittsburgh. That does not affect Delaware's ability to impose a tax.

The Supreme Court has noted that to guarantee that the rational relationship test is further satisfied, a state should use some apportionment formula, so that the risk of multiple taxation is not unreasonable.[96] As to that, Delaware's bank franchise tax allows for extraterritorial income to be apportioned through a separate accounting method, so long as the taxpayer prepares sufficient records.[97] As previously noted, an in-state bank can exclude income earned from activities

---

[94] *Bridges v. Autozone Properties, Inc.*, 900 So.2d 784, 809 (La. 2005). *See also Appeal of R.J. Reynolds Tobacco Co.*, 326 S.E.2d 911, 919 (N.C. Ct. App. 1985); *Zelinsky v. Tax Appeals Tribunal of State*, 801 N.E.2d 840, 848 (N.Y. 2003).

[95] *J.C. Penney*, 311 U.S. at 444.

[96] *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 437-40 (1980).

[97] 5 *Del. C.* § 1101(a)-(b).

conducted outside Delaware by branches or subsidiaries.[98] Also, an out-of-state bank would only include income from the in-state branch when computing its taxes.[99] Thus, a bank is able to apportion, and exclude, out-of-state income when determining its tax liability. Thereby, the Commissioner correctly held that the bank franchise tax does not violate the Due Process Clause.

VI. Other Arguments

A. Professor Pomp's Testimony

The Bank argues that Professor Richard D. Pomp should have been allowed to testify and offer his opinion letter into evidence. During the hearing, Pomp was allowed to testify, but not about (1) the meaning of "commercial domicile" according to common usage and (2) whether the Bank's franchise tax assessment is consistent with the normative principles of state taxation. Pomp's opinion letter, which discussed these two issues, was not admitted into evidence. The Bank claims that disallowing his testimony was an abuse of discretion since Pomp was highly qualified. The Bank relies on Delaware Rules of Evidence, 702, which states that an expert witness may testify if his "specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue…."

The Commissioner ruled that this evidence was irrelevant under D.R.E.

---

[98] 5 *Del. C.* §§ 101(4)(b), 1101(a).

[99] 5 *Del. C.* § 1101(b).

401.[100] The Commissioner found that "commercial domicile" is a legal concept, as opposed to a fact, and testimony about normative principles of taxation did "not belong on the witness stand" because these principles do not speak directly to Delaware's laws. In the alternative, the Commissioner excluded the evidence as cumulative, since "[a]mple factual testimony existed in the record prior to Professor Pomp's proffered testimony…."

The Commissioner has discretion to exclude evidence at a hearing if it is "irrelevant, immaterial, insubstantial, cumulative and privileged evidence…."[101] Also as the Commissioner properly noted, expert testimony expressing an opinion concerning applicable domestic law is inadmissible.[102] Therefore, the Commissioner's discretionary decision to exclude some of Professor Pomp's testimony and opinion letter was proper.

B. Ernst & Young Analysis

The Bank also argues that if the tax is constitutional, it should be entitled to use the separate accounting methodology presented by its accounting experts, Ernst

---

[100] "'Relevant evidence' means evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence."

[101] 29 *Del. C.* § 10125(b).

[102] *Itek Corp. v. Chicago Aerial Industries, Inc.*, 274 A.2d 141, 143 (Del. 1971).

& Young, LLP. This assessment relied on 5 *Del. C.* § 1101(b), which imposes a franchise tax on banks not headquartered in the state. As discussed above, the Commissioner correctly found that the Bank was not headquartered in Delaware, and therefore not entitled to use separate accounting under 5 *Del. C.* § 1101(b). The Commissioner also concluded that the Bank did not provide enough information to support the Ernst & Young analysis, and therefore, the analysis should not be considered.

C. Commissioner's Abatement Authority

Finally, the Bank argues that the Commissioner erred in refusing to abate the Bank's tax assessment or penalties, as both the taxes and penalties were excessive, leading to an inequitable result. The Commissioner is authorized to abate both tax assessments and penalties under 5 *Del. C.* § 1114(a).[103] The Code, however, authorizes the Commissioner to abate, but does not demand that he do so.[104] Therefore, the matter is discretionary. Furthermore, as both the Commissioner and the Bank noted, the Delaware statute is almost identical to the Internal Revenue Code's abatement provision, which has been construed as a discretionary power as

[103] "The Commissioner is authorized to abate the unpaid portion of the assessment of any tax, interest, penalty, additional amount or addition to the tax, or any liability in respect thereof, which is: (1) Excessive in amount…."

[104] 5 *Del. C.* § 1114(a).

opposed to a duty.[105] If the Bank is correct that under the Internal Revenue Code abatement is a form of "equitable clemency,"[106] the Commissioner is still free to abate, but is not required to do so.

"In order to prevail on a claim that the IRS abused its discretion in failing to abate interest, a taxpayer must prove that the IRS exercised its discretion arbitrarily, capriciously, or without sound basis in fact or law."[107] The Commissioner did not abate here because "the proposed assessment in this case was not 'excessive' in that the Bank has been assessed for the proper amount of tax and penalty due based on the correct application of the statute." Since the Commissioner has discretion on abatement and the Bank did not prove that the Commissioner exercised this authority arbitrarily, the Commissioner did not err in refusing to abate the Bank's taxes or penalties.[108]

---

[105] I.R.C. § 6404(a)(1). *Matter of Bugge*, 99 F.3d 740, 744 (5th Cir. 1996). *Wright v. C.I.R.*, T.C.M. 2004,-69 (2004).

[106] *Edelson v. C.I.R.*, 829 F.2d 828, 832 n.4 (9th Cir. 1987).

[107] *McElroy v. C.I.R.*, T.C.M. 2004-254 (2004). *Dormer v. C.I.R.*, T.C.M.. 2004-167 (2004).

[108] The court, however, is not adopting all the Commissioner's reasoning: that judicial notice should be taken for LBH's filings and websites touting Delaware as its principal office and headquarters; that the only requirement under HOLA is that a state tax statute treat state and nationally chartered banks alike; and that the Bank could have avoided the tax by structuring its organization differently.

VII.

For the foregoing reasons, the Commissioner's May 20, 2005 decision is based on substantial evidence, and it is legally sound. Therefore, it is ***AFFIRMED***.

IT IS SO ORDERED.

/s/ Fred S. Silverman
Judge

FSS/lah
oc: Prothonotary (Civil Appeal's Division)