IN THE SUPERIOR COURT OF THE STATE OF DELAWARE

VERISIGN, INC.,	)	
	)	
Plaintiff,	)	
	)	
v.	)	C.A. No. N19C-08-093 JRJ
	)	
DIRECTOR OF REVENUE,	)	
	)	
Defendant.	)	

OPINION

Date Submitted: December 7, 2020
Date Decided: December 17, 2020

Upon Plaintiff's Motion for Summary Judgment: **GRANTED**.
Upon Defendant's Motion for Summary Judgment: **DENIED**.

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Jurden, P.J.

I. INTRODUCTION

Corporations can join with groups of affiliated corporations to file consolidated income tax returns with the Internal Revenue Service. On these consolidated returns, groups can claim consolidated net operating loss ("NOL") deductions. In Delaware, group members must file separate-company income tax returns with the Delaware Division of Revenue (the "Division"). If a member claims a separate-company NOL deduction, the Division limits it to the amount of the consolidated NOL deduction that the member's group claimed on its consolidated income tax return.

Applying that policy, the Division limited the amount of the NOL deduction that Verisign, Inc. could claim in two tax years. The limitation exposed positive taxable income for those years, and the Division taxed it. The Division assessed almost $1.67 million in income tax (plus interest and penalties) against Verisign. Verisign has challenged the validity of the Division's limitation policy and seeks to have its tax assessment stricken. Verisign and the Director of Revenue have now filed cross-Motions for Summary Judgment. The parties have stipulated that no material facts are in dispute.[1] For the reasons explained below, Verisign's Motion is **GRANTED**, and the Director's Motion is **DENIED**.

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[1] Pre-Trial Stipulation and [Proposed] Order ("Pre-Trial Stipulation), at 16 (Trans. ID. 66105127).

II. BACKGROUND

A. Statutory and Regulatory Framework

Each non-exempt corporation must pay Delaware an income tax on the "taxable income" that it earns by conducting business in Delaware.[2] For the purpose of Delaware income tax, "taxable income" is the portion of a corporation's "entire net income" that is apportioned to Delaware.[3] A corporation's "entire net income" is the corporation's "federal taxable income . . . as computed for purposes of the federal income tax."[4] The "federal income tax" is "the tax imposed on corporations by the federal Internal Revenue Code [("IRC")]."[5] Accordingly, the parties agree that the starting point for calculating Delaware corporate income tax is a corporation's federal taxable income.[6]

Pursuant to the IRC, a corporation's federal "taxable income" is calculated by taking the corporation's gross income and subtracting all applicable deductions that the IRC allows.[7] One of these deductions lies at the core of this case: the NOL deduction.[8] An NOL is the "flip side" of taxable income; if a corporation's allowable

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[2] 30 *Del. C.* § 1902(a).
[3] 30 *Del. C.* § 1903(b) (listing the provisions governing this apportionment).
[4] 30 *Del. C.* § 1903(a).
[5] 30 *Del. C.* § 1901(10).
[6] Pre-Trial Stipulation, at 6 ¶ 4 (citing 30 *Del. C.* §§ 1901(10), 1902(a), 1903(a)–(b)) (Trans. ID. 66105127).
[7] 26 U.S.C. § 63(a). "Gross income" is defined in 26 U.S.C. § 61.
[8] 26 U.S.C. § 172.

deductions exceed the corporation's gross income, an NOL results.[9] Suppose that in Year 1, Corporation X were to receive $1 million in gross income and could claim deductions of $5 million. In that case, Corporation X would have produced an NOL of $4 million in Year 1.

The IRC allows a corporation to "carry over" an NOL into each of the next 20 tax years to reduce its federal taxable income.[10] Corporation X could take its $4 million NOL from Year 1 and reduce its federal taxable income in any tax year until Year 21.[11] If Corporation X were to use its Year 1 NOL to reduce its Year 2 federal taxable income to zero, it could carry over the remainder into Year 3. And if Corporation X were to produce another NOL in Year 3, it could carry over both NOLs into Year 4.

A corporation that produces an NOL can claim an NOL deduction on its own federal income tax return. But corporations need not file their federal income tax returns on a separate-company basis. In fact, the IRC allows a group of affiliated corporations "to file a single *consolidated* return, . . . [leaving] it to the Secretary of

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[9] 26 U.S.C. § 172(c); *United Dominion Indus. v. United States*, 532 U.S. 822, 825 (2001) (citing 26 U.S.C. § 172(c)).

[10] 26 U.S.C. § 172(b)(1)(A)(ii); *Metro One Telcoms., Inc. v. Comm'r*, 704 F.3d 1057, 1060 (9th Cir. 2012).

[11] When Corporation X uses its NOL to reduce its taxable income in a particular year, its NOL diminishes by the amount of the reduction. So Corporation X would enter Year 21 with whatever amount remained from its Year 1 NOL.

the Treasury to work out the details by promulgating regulations governing such returns."[12]

Pursuant to these U.S. Treasury regulations, groups can elect to report their "consolidated taxable income" on consolidated federal income tax returns.[13] Consolidated taxable income is calculated by "combining the separate taxable income . . . of each member of the group and then incorporating certain adjustments calculated on a consolidated basis."[14] Of course, this calculation may result in an NOL rather than positive taxable income. In that case, the regulations allow the group to claim a "consolidated NOL" deduction.[15] Naturally, a group's consolidated NOL deduction could be better or worse for a particular group member than if the member had never joined the group and simply claimed its own NOL deduction.

Although the federal government allows groups to file consolidated returns based on their consolidated taxable income, Delaware does not.[16] Delaware expresses this prohibition in its statutes[17] and corporate income tax return

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[12] *United Dominion Indus.*, 532 U.S. at 826 (emphasis added) (citing 26 U.S.C. §§ 1501–1502).
[13] 26 C.F.R. § 1.1502-11.
[14] *Duquesne Light Holdings, Inc. v. Comm'r*, 861 F.3d 396, 412–13 (3d Cir. 2017) (citing *United Dominion Industries, Inc. v. United States*, 532 U.S. 822, 826 (2001)).
[15] 26 C.F.R. § 1.1502-21.
[16] 19 *Del. C.* § 1903(a); 19 *Del. C.* § 1902(a); Del. Form 1100i (2016) Corporate Income Tax Return Instructions, at 3; Del. Form 1100i (2015), Corporate Income Tax Return Instructions, at 3 (Ex. 1 to Verisign's Supporting Brief) (Trans. ID. 66012510); *see also* Pre-Trial Stipulation, at 7 ¶ 6 (citations omitted) (Trans. ID. 66105127).
[17] 19 *Del. C.* § 1903(a) (emphasis added) ("The 'entire net income' of *a* corporation for any income year means the amount of *its* federal taxable income . . . ."); 19 *Del. C.* § 1902(a) (emphasis added) ("*Every* . . . corporation . . . shall annually pay a tax . . . .").

instructions.[18] So when a member of a consolidated group files a Delaware income tax return, it must "calculate its stand-alone federal taxable income, including all deductions, in accordance with the IRC *as if* that corporation filed a separate-company (non-consolidated) federal income tax return."[19] In this way, the corporation must disaggregate its own federal taxable income and deductions from its group's consolidated amounts and present them to the Division. The corporation does this on a pro forma federal income tax return, which it files with its Delaware income tax return for the same year.[20]

If a Delaware corporation claims a consolidated NOL deduction on its federal consolidated return, it can claim an NOL deduction on its Delaware return by taking the following two steps. First, as noted above, it must "compute its NOL on a separate-company basis under the IRC."[21] Second, it must "*limit* that separate-company NOL to the consolidated NOL deduction of the federal consolidated group

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[18] The tax instructions for calendar years 2015 and 2016 (the years at issue in the instant Motions) provide, in relevant part:

> Enter on Line 1 the amount of your Federal taxable income. The State of Delaware does not recognize an affiliated group of corporations as a taxable entity. Consolidated and combined returns are not permitted. The starting point for Delaware corporate income taxes is Federal taxable income of the separate corporation, as if each corporation had filed a separate Federal corporate income tax return.

Del. Form 1100i (2016) Corporate Income Tax Return Instructions, at 3; Del. Form 1100i (2015), Corporate Income Tax Return Instructions, at 3 (Ex. 1 to Verisign's Supporting Brief) (Trans. ID. 66012510); *see also* Pre-Trial Stipulation, at 6 ¶ 5 (Trans. ID. 66105127).

[19] Pre-Trial Stipulation, at 7 ¶ 7 (emphasis added) (citation omitted) (Trans. ID. 66105127).

[20] *See* Delaware Division of Revenue, Corporate Income Tax FAQs (Ex. 3 to Verisign's Supporting Brief), at 2 (Trans. ID. 66012510).

[21] Pre-Trial Stipulation, at 7 ¶ 8 (Trans. ID. 66105127).

of which the [corporation] is a member."[22] The validity of the limitation in step two is the central issue in this case.[23]

B. Stipulated Facts and Procedural History

Verisign, Inc. was incorporated in Delaware in 1995.[24] From 1995 to 2016, Verisign filed corporate income tax returns with the Division.[25] At the federal level, Verisign filed consolidated income tax returns with an affiliated group of corporations (the "Verisign Group").[26] Hence, Verisign accompanied each of its Delaware income tax returns with a pro forma federal Form 1120 calculating its separate-company federal taxable income and deductions pursuant to the IRC.[27]

From tax years 2005 to 2013, Verisign generated about $2.89 billion in NOLs on a separate-company basis.[28] Verisign carried over those NOLs into the 2014 tax year and reduced its federal taxable income to zero.[29] Verisign carried over the remainder of its NOLs (about $2.76 billion) into the 2015 tax year and reduced its

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[22] *Id.* (emphasis added). Pursuant to its audit manual, the Division does not apply the limitation in step two if every member of the consolidated group files a Delaware income tax return. *Id.* at 8 ¶¶ 9–11 (quoting BMF Audit & Reconciliation System, CIT Exception Processing – All Exceptions, Detailed Instructions ("Audit Manual") (Ex. 5 to Verisign's Answering Brief), at 327) (Trans. ID. 66054682).
[23] *See id.* at 7 ¶ 8.
[24] *Id.* at 6 ¶ 1.
[25] *Id.* at 6 ¶ 2.
[26] *Id.* at 6 ¶ 3.
[27] Verisign's Pro Forma Federal Form 1120s (Ex. 8 to Verisign's Supporting Brief) (Trans. ID. 66012510).
[28] *Id.*; *accord* Pre-Trial Stipulation, at 8–9 ¶¶ 13–14 (containing a table showing the calculation of Verisign's NOL for each tax year from 2005 to 2013) (Trans. ID. 66105127).
[28] Pre-Trial Stipulation, at 9 ¶ 14 (Trans. ID. 66105127).
[29] *Id.*

federal taxable income of about $115 million to zero.[30] Verisign again carried over the remainder of its NOLs (about $2.65 billion) into the 2016 tax year and reduced its federal taxable income of about $157 million to zero.[31]

The Division limited the amount of Verisign's NOL deductions in tax years 2015 and 2016 to the amount of the Verisign Group's consolidated NOL deductions for those years.[32] The Verisign Group's consolidated NOL deductions amounted to about $39 million and $2 million in tax years 2015 and 2016, respectively.[33] So the Division's limitation meant that Verisign could not reduce its federal taxable income to zero in either year. That meant that Verisign had positive federal taxable income, which, in turn, meant that Verisign owed income tax to Delaware.[34]

The Division assessed almost $1.67 million (plus interest and penalties) against Verisign; that amount represented the difference between Verisign's federal taxable income and the Verisign Group's consolidated NOLs for the two tax years.[35] Verisign protested the assessment, but the Division denied the protest.[36] After filing

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[30] *Id.* at 9 ¶ 15.
[31] *Id.* at 10 ¶ 16
[32] *See id.* at 12 ¶ 21.
[33] *Id.* at 13 ¶ 25. Part of the reason for the Verisign Group's comparatively low consolidated NOL deductions was the dividend income that members of the Verisign Group received, including over $850 million in dividend income from foreign subsidiaries in 2014. *Id.* at 12–13 ¶ 24. Indeed, the amount of Verisign Group's consolidated NOL deductions would have exceeded the amount of Verisign's own NOL deductions in tax years 2015 and 2016 if the Verisign Group were allowed to deduct dividends from foreign subsidiaries in the same manner as dividends from domestic subsidiaries. *Id.* at 14 ¶ 29.
[34] *Id.* at 13 ¶¶ 25–26.
[35] *Id.*
[36] *Id.* at 13 ¶ 27.

a petition with the Tax Appeal Board, Verisign removed the matter to this Court.[37] Verisign and the Director of Revenue, standing in for the Division, have each moved for summary judgment.[38]

III. STANDARD OF REVIEW

In general, summary judgment is appropriate when "there is no genuine issue as to any material fact and . . . the moving party is entitled to a judgment as a matter of law."[39] When, as here, the parties file cross-motions for summary judgment and agree that there no genuine issues of material fact,[40] "the Court shall deem the motions to be the equivalent of a stipulation for decision on the merits based on the record submitted with the motions."[41]

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[37] *Id.* at 14 ¶ 28.
[38] Motion for Summary Judgment of Defendant Director of Revenue (Trans. ID. 66012318); Plaintiff's Motion for Summary Judgment (Trans. ID. 66012510). On October 12, 2020, the Director filed her Supporting Brief. Memorandum in Support of Defendant Director of Revenue's Motion for Summary Judgment ("Director's Supporting Brief") (Trans. ID. 66012318), and Verisign filed its Supporting Brief. Plaintiff's Opening Brief in Support of Its Motion for Summary Judgment ("Verisign's Supporting Brief") (Trans. ID. 66012510). On October 26, 2020, the Director filed her Answering Brief. Answering Brief in Opposition to Plaintiff Verisign, Inc.'s Motion for Summary Judgment ("Director's Answering Brief") (Trans. ID. 66054582), and Verisign filed its Answering Brief. Plaintiff's Answering Brief to Defendant Director of Revenue's Motion for Summary Judgment ("Verisign's Answering Brief") (Trans. ID. 66054682). On November 6, 2020, the Director filed her Reply Brief. Reply Brief in Support of Defendant Director of Revenue's Motion for Summary Judgment ("Director's Reply Brief") (Trans. ID. 66089738), and Verisign filed its Reply Brief. Plaintiff's Reply Brief in Further Support of Plaintiff's Motion for Summary Judgment ("Verisign's Reply Brief") (Trans. ID. 66089875). Finally, on November 12, 2020, the Director filed her Corrected Reply Brief. Reply Brief in Support of Defendant Director of Revenue's Motion For Summary Judgment ("Director's Corrected Reply Brief") (Trans. ID. 66104712).
[39] Super. Ct. Civ. R. 56(c).
[40] Pre-Trial Stipulation, at 16–17 (Trans. ID. 66105127).
[41] Super. Ct. Civ. R. 56(h).

IV. DISCUSSION

The Division's limitation policy has been explained in two ways throughout this litigation.[42] For the purpose of resolving the instant Motions, however, the Court will use the parties' stipulated explanation: "First, consistent with Delaware statute, a taxpayer must compute its NOL on a separate-company basis under the IRC. *Second, the taxpayer must limit that separate-company NOL to the consolidated NOL deduction of the federal consolidated group of which the taxpayer is a member*."[43]

A. Whether the Division's Policy Is Consistent with Delaware Statute

1. Parties' Contentions

Verisign argues that the Division's policy is "contrary to Delaware statute."[44] In Verisign's view, the policy poses a statutory issue because Delaware's corporate income tax statutes do not reference the U.S. Treasury regulations, so "Delaware statute does not incorporate the consolidated NOL."[45] According to Verisign,

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[42] First, the Director testified during her deposition that the policy operates as follows: a Delaware corporate taxpayer calculates its "NOL on a separate company basis, and then you would compare it to *the consolidated NOL* to see if it was less than that amount." Deposition of Director of Revenue (Ex. 4 to Verisign's Answering Brief) at 70:22–71:1 (emphasis added) (Trans. ID. 66054682). Second, the Director explains in her briefing that the "policy limits corporate taxpayers to the [NOL] recognized at the federal level, *regardless* of whether that [NOL] was calculated on a stand-alone or consolidated basis . . . ." Director's Answering Brief, at 14 (emphasis added) (Trans. ID. 66054582).

[43] Pre-Trial Stipulation, at 7 ¶ 8 (emphasis added) (Trans. ID. 66105127).

[44] *Id.* at 2.

[45] *Id.* (internal quotation marks omitted).

because the Director lacks a clear statutory directive to consult the regulations, she falls back on this Court's decision in *Cluett, Peabody, & Co., Inc. v. Director*,[46] a case that neither supports the Division's policy nor applies to Verisign's situation.[47]

The Director argues that the Division's policy is consistent with Delaware statute.[48] She notes that 30 *Del. C.* § 1903(a) requires a corporation only to "compute" its separate-company federal taxable income pursuant to the IRC.[49] According to the Director, nothing prevents the Division from then limiting that computed separate-company NOL to the NOL actually "recognized" on the federal return that the corporation files with the federal government.[50] The Director also asserts that the Court in *Cluett* "confirmed as consistent with 30 *Del. C.* § 1903" the Division's policy of "limiting [NOLs] to the amount that is available on the filed federal return."[51] Accordingly, the Director concludes, the Division stood on firm legal ground when it assessed income tax against Verisign.[52]

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[46] *Cluett, Peabody, & Co. v. Director of Revenue*, 1985 Del. Super. LEXIS 1089 (Del. Super. Ct. Jan. 22, 1985).
[47] Verisign's Supporting Brief, at 27–29 (Trans. ID. 66012510); Verisign's Reply Brief, at 10–12 (Trans. ID. 66089875); Verisign's Answering Brief, at 18–20 (Trans. ID. 66054682).
[48] Pre-Trial Stipulation, at 3–4; Director's Corrected Reply Brief, at 3 (Trans. ID. 66104712).
[49] Director's Supporting Brief, at 14 (Trans. ID. 66012318).
[50] *Id.* at 14–15. The Director explains the distinction between "computed" and "recognized" as follows: "In order for a deduction, such as a net operating loss, to be recognized for federal tax purposes, that deduction must actually have been reported and filed with the federal Internal Revenue Service ("IRS"). Therefore, a deduction can be computed under federal law[,] but the result of that computation is not 'recognized' for federal tax purposes until it is actually filed with the IRS." *Id.* at 14 n.4.
[51] Director's Supporting Brief, at 17 (Trans. ID. 66012318).
[52] *See id.* at 18.

2. The Division's Policy Is Consistent with Delaware Statute

Following the precedent set by this Court in *Cluett, Peabody, & Co. v. Director of Revenue*, the Court concludes that the Division's policy is consistent with Delaware statute.[53] *Cluett* involved a Delaware corporation ("Cluett") that elected to file consolidated federal income tax returns with an affiliated group of corporations.[54] One of those corporations was Van R Apparel Corporation ("Van"), a subsidiary of Cluett's.[55] From 1973 to 1977, Van sustained what would have amounted to about $32.7 million in separate-company NOLs.[56] But because Van filed with Cluett's consolidated group, its own NOLs were used to offset the group's consolidated taxable income.[57]

On December 31, 1977, Van merged into Cluett.[58] The merger was structured in a way that allowed Cluett to succeed to any NOL carry over that Van had at the time of the merger.[59] But Van did not have any NOLs at the time of the merger because Cluett's consolidated group had completely exhausted them.[60] Nonetheless,

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[53] *Cluett, Peabody, & Co. v. Director of Revenue*, 1985 Del. Super. LEXIS 1089 (Del. Super. Ct. Jan. 22, 1985).
[54] *Cluett*, 1985 Del. Super. LEXIS 1089, at *1–2.
[55] *Id*. at *2.
[56] *Id.* at *3.
[57] *Id.* at *3–4.
[58] *Id.* at *2.
[59] *Id.*
[60] *Id.* at *2–3.

Cluett decided to carry over and deduct Van's NOLs on the pro forma federal return that it filed with its 1978 Delaware income tax return.[61]

Citing 30 *Del. C.* § 1903(a), the Division disallowed the deduction.[62] The Division reasoned that because Cluett's consolidated group had already exhausted Van's losses, there were no federal NOLs for Cluett to carry over for Delaware income tax purposes.[63] Cluett requested a redetermination, but the Division refused.[64] Before Cluett appealed to the Tax Appeal Board, it stipulated with the Division that all of Van's NOLs had been used, so there were no NOLs for Cluett to claim on its 1978 federal income tax return.[65]

On appeal, the Board affirmed the Division's disallowance.[66] The Board noted that 30 *Del. C.* § 1903(a) "sets forth the starting point for the calculation of Delaware corporate income tax as the Federal Taxable income for such year as computed for purposes of Federal income tax."[67] Because the parties had stipulated that Van's NOLs had been exhausted, Cluett had no NOLs to claim on its federal

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[61] *Id.* at *3.
[62] *Id.* at *4.
[63] *Id.* at *3–4.
[64] *Id.* at *1.
[65] *See id.* at *1, *4. It appears that Cluett was comfortable stipulating what turned out to be a critical fact because its argument was based on unrelated grounds: the Division's allegedly unfair and arbitrary practices. *See id.* at *4–5, *8–10.
[66] *Id.* at *3–4.
[67] *Id.* at *4.

return and, consequently, no NOLs to claim for Delaware income tax purposes.[68]

The Court affirmed the Board's decision:

> Based on the language of § 1903 and [a prior Board decision], the Court finds that the decision of the Board is correct as a matter of law. Prior to the tax year in question, the taxpayer had exhausted the net operating losses of its subsidiary, the Van R Apparel Corporation, and therefore, in 1978, no net operating loss carry overs remained for the taxpayer to take advantage of in computing its Federal taxable income. The starting point for State taxable income being Federal taxable income, there was no net operating loss carry over for purposes of State income tax computation in 1978. Therefore, the deduction for such losses was properly disallowed.[69]

Predictably, the Director and Verisign disagree about *Cluett*'s relevance. The Director understands *Cluett* as an endorsement of the Division's policy.[70] But Verisign argues that *Cluett* is inapposite because of a factual difference.[71] According to Verisign, the Court was "constrained" to rule as it did because Cluett had

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[68] *Id.*

[69] *Id.* at *8.

[70] Pre-Trial Stipulation, at 3–4 (citing *Cluett, Peabody, & Co. v. Director of Revenue*, 1985 Del. Super. LEXIS 1089 (Del. Super. Ct. Jan. 22, 1985) ("[T]he Delaware Division of Revenue's . . . long-standing policy of limiting a corporate taxpayer's net operating loss to the amount recognized for federal purposes is in no way inconsistent with Delaware's tax code and, perhaps more importantly, is entirely consistent with the only case addressing this very issue . . . .") (Trans. ID. 66105127).

[71] *See* Verisign's Answering Brief, at 18 (Trans. ID. 66054682). Verisign also attempts to distinguish *Cluett* on the grounds that "Verisign's case does not involve a merger[,] and it does not involve a Delaware taxpayer seeking to shelter its income using losses of an entity outside Delaware." Verisign's Answering Brief, at 18 (Trans. ID. 66054682); *see also* Verisign's Supporting Brief, at 28–29 (Trans. ID. 66012510). Verisign bases these attempts to distinguish *Cluett* on language in the Director's brief to the Delaware Supreme Court in *Cluett.* Verisign's Answering Brief, at 18 nn.56–57 (Trans. ID. 66054682); Verisign's Supporting Brief, at 28 nn.90, 93; *id.* at 29 n.94 (Trans. ID. 66012510). But the Court need not address these other arguments; the *Cluett* decision does not hinge on the fact that there was a merger or the possibility that Cluett was trying to shelter its income.

stipulated that there were no NOLs for federal income tax purposes.[72] Verisign asserts that it, by contrast, "very much has NOLs for federal income tax purposes," so it should be able to use them for Delaware income tax purposes.[73]

The implication of Verisign's argument is that the Court in *Cluett* would have allowed Cluett to use Van's NOLs if (1) Van actually had NOLs at the time of the merger and (2) Cluett had not stipulated to the contrary. Even if this argument is correct, it does not address the question at issue: whether the Division's policy is consistent with (or contrary to) Delaware statute. Verisign addresses this question with its argument that the policy abandons Delaware statute by incorporating the consolidated NOL.[74] But if the policy were to abandon Delaware statute in this way, then the Court in *Cluett* would have disapproved of the Division's decision to consult the consolidated NOL that the Cluett group computed. Instead, the Court—and the Board below it—determined that the Division acted in accordance with Delaware statute.[75]

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[72] Verisign's Supporting Brief, at 28 (Trans. ID. 66012510).

[73] *Id.*; Verisign's Reply Brief, at 12 ("Verisign's case thus contrasts with *Cluett*. In Verisign's case, the record is abundantly clear that Verisign has an NOL for federal income tax purposes. Verisign is arguing that, since it had a $2.9 billion NOL carryover for federal income tax purposes, it therefore has an NOL for Delaware purposes.") (Trans. ID. 66089875).

[74] Pre-Trial Stipulation, at 2 (internal quotation marks omitted) (Trans. ID. 66105127); *see* Verisign's Supporting Brief, at 23 (Trans. ID. 66012510).

[75] *Cluett, Peabody, & Co. v. Director of Revenue*, 1985 Del. Super. LEXIS 1089, at *4, *8 (Del. Super. Ct. Jan. 22, 1985).

Van's NOLs had been extinguished before the merger "*as a result of [Cluett's] having filed consolidated Federal returns*."[76] Put differently, the Cluett group's consolidated returns showed that Van's NOLs had been extinguished, which is why the Board found that Van "did not have any [NOL] carry over for Federal income tax purposes at the time of merger."[77] And for that reason, the Court concluded that "the deduction for such losses was properly disallowed."[78] In affirming the Board's decision (and the Division's disallowance), the Court explicitly relied on "the language of § 1903."[79] The Court in *Cluett* therefore found that the Division's application of the policy—which included consulting the Cluett group's consolidated federal returns—was consistent with Delaware statute. Accordingly, following *Cluett* as precedent, the Court finds that the policy is consistent with Delaware statute.

B. Whether the Division's Policy Discriminates Against Interstate Commerce in Violation of the U.S. Constitution's Commerce Clause

1. Parties' Contentions

Verisign asserts—and the Director does not dispute—that the Division's audit manual carves out an exception that the auditors use when applying the policy.[80]

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[76] *Id.* at *2 (emphasis added).
[77] *Id.* at *2–3.
[78] *Id.* at *8.
[79] *Id.*
[80] *See* Pre-Trial Stipulation, at 8 ¶¶ 9–10 (Trans. ID. 66105127).

The manual provides: "If not all members file in Delaware, and taxpayer is attempting to utilize a previous NOL, [the Division] needs to ensure that the NOL amount does not exceed the consolidated amount of the current year NOL."[81] In Verisign's view, this exception discriminates in favor of Delaware taxpayers whose affiliates conduct business in Delaware and against Delaware taxpayers whose affiliates do not.[82] This favoritism, Verisign argues, violates the U.S. Constitution's Commerce Clause in the same way that the North Carolina statute did in *Fulton Corporation v. Faulkner*.[83]

The Director denies that the exception to the Division's policy discriminates against interstate commerce.[84] According to the Director, the exception does not impose any cost on group members that do not conduct business in Delaware.[85] The Director also argues that *Fulton Corp.* is factually distinguishable because "Verisign is not being made to pay any greater tax, nor is it being denied any deduction, based upon the amount of business it does in Delaware."[86]

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[81] *Id.* at 8 ¶ 9 (quoting Audit Manual (Ex. 5 to Verisign's Answering Brief), at 327) (Trans. ID. 66054682).

[82] Verisign's Answering Brief, at 23 (Trans. ID. 66054682). Corporations must file Delaware income tax only if they conduct business in Delaware. Delaware Division of Revenue, Corporate Income Tax FAQs (Ex. 3 to Verisign's Supporting Brief), at 1 ("Every domestic or foreign corporation doing business in Delaware, not specifically exempt under Section 1902(b), Title 30, Delaware Code, is required to file a corporate income tax return . . . .") (Trans. ID. 66012510).

[83] Verisign's Answering Brief, at 23 (citing *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996)) (Trans. ID. 66054682).

[84] *See* Director's Corrected Reply Brief, at 13–14 (Trans. ID. 66104712).

[85] *Id.* at 14.

[86] *Id.*

2. The Division's Policy Does Not Discriminate Against Interstate Commerce in Violation of the U.S. Constitution's Commerce Clause

The Commerce Clause grants Congress the power "[t]o regulate Commerce . . . among the several States."[87] But "the United States Supreme Court has consistently held that the Commerce Clause also contains a negative implication, known as the Dormant Commerce Clause, which prohibits certain state actions that interfere with interstate commerce."[88] Verisign's argument targets state action, so it is properly characterized as a Dormant Commerce Clause argument.

Verisign explains the facts of *Fulton Corp.* as follows: "North Carolina allowed a taxpayer to claim the deduction at issue if its affiliate did business in North Carolina[] but disallowed the deduction if the taxpayer's affiliate did not do business in North Carolina."[89] But the Court reads *Fulton Corp.* differently: North Carolina imposed an intangibles tax on the corporate stock that its residents owned.[90] Under the tax arrangement, the more North Carolina income tax a corporation paid, the greater the deduction the owners of its stock could claim on their intangibles taxes.[91] A corporation's North Carolina income tax exposure was a function of how much in-state business the corporation conducted.[92] In this way, North Carolina made it

[87] U.S. CONST. art. I, § 8, cl. 3.
[88] *Lehman Bros. Bank, FSB v. State Bank Comm'r*, 937 A.2d 95, 107 (Del. 2007).
[89] Verisign's Answering Brief, at 23 (Trans. ID. 66054682).
[90] *Fulton Corp. v. Faulkner*, 516 U.S. 325, 327 (1996).
[91] *See id.* at 328.
[92] *Id.*

more attractive for its residents to buy the stock of corporations that conducted greater amounts of business in North Carolina versus other states.[93] The U.S. Supreme Court concluded that North Carolina's "intangibles tax facially discriminate[d] against interstate commerce."[94] It reasoned that "[a] regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents . . . ."[95]

Here, the policy's exception does not work an analogous benefit to Delaware corporations at the expense of non-Delaware corporations. This is the kind of discriminatory treatment at the heart of the Dormant Commerce Clause: "economic protectionism—that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors."[96] Accordingly, the Court finds that the Division's policy does not discriminate against interstate commerce in violation of the U.S. Constitution's Commerce Clause.

C. Whether the Division's Policy Violates the Delaware Constitution's Uniformity Clause Under *Burpulis v. Director of Revenue*

1. Parties' Contentions

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[93] *See id.* at 333.
[94] *Id.*
[95] *Id.*
[96] *Dep't of Revenue v. Davis*, 553 U.S. 328, 337–38 (2008) (internal quotation marks omitted) (quoting *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 273–274 (1988)).

Next, Verisign argues that the Division's policy violates the Delaware Constitution's Uniformity Clause under *Burpulis v. Director of Revenue*.[97] According to Verisign, the Division's policy "use[s] a deduction available only to a federal consolidated group on a separate-company Delaware return—just like the taxpayers in *Burpulis* sought to use a deduction available only on a joint marital federal return on their individual Delaware returns."[98] Thus, Verisign contends that the Director is engaged in the same course of action that caused the *Burpulis* taxpayers to run afoul of the Uniformity Clause: taking a uniquely federal deduction that is available only to groups and applying it to the group members' separate Delaware income tax returns.[99] Verisign further argues that the Supreme Court in *Burpulis* "rejected creating two classes of Delaware individual taxpayers based on their joint or separate federal filing status," which analogizes to a prohibition on separating Delaware corporate taxpayers into those that file as members of consolidated groups and those that do not.[100]

The Director responds that *Burpulis* is irrelevant.[101] She asserts that "*Burpulis* is . . . limited to the common[-]sense conclusion that deductions exclusively available to joint, or consolidated filers, at the federal level cannot be

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[97] Verisign's Supporting Brief, at 29–30 (Trans. ID. 66012510); Verisign's Reply Brief, at 12–14 (Trans. ID. 66089875); Verisign's Answering Brief, at 22–23 (Trans. ID. 66054682).
[98] Verisign's Reply Brief, at 12 (Trans. ID. 66089875).
[99] *See id.*; Verisign's Supporting Brief, at 29–30 (Trans. ID. 66012510).
[100] Verisign's Answering Brief, at 22 (citation omitted) (Trans. ID. 66054682).
[101] Director's Answering Brief, at 19–20 (Trans. ID. 66054582).

claimed by taxpayers filing separate, or stand-alone, state returns."[102] The Director also argues that the Supreme Court in *Burpulis* was not concerned with whether allowing the deduction would create two classes of taxpayers.[103] Rather, according to the Director, the Supreme Court determined that "allowing a federal deduction designed to ameliorate the effects of a federal marriage tax penalty on a Delaware return" would violate the Uniformity Clause.[104] Lastly, the Director argues that even if the policy creates two classes of taxpayers as Verisign charges, the classification does not violate the Uniformity Clause because it is reasonable, and Verisign has not shown otherwise.[105]

2. <u>The Division's Policy Violates the Delaware Constitution's Uniformity Clause Under *Burpulis v. Director of Revenue*</u>

The Uniformity Clause provides that "[a]ll taxes shall be uniform upon the same class of subjects within the territorial limits of the authority levying the tax . . . ."[106] "Uniformity in taxes . . . is achieved when all taxpayers of the same general class and within the territorial limits of the authority are treated the same."[107] In *Burpulis v. Director*, the Delaware Supreme Court found that Tax Ruling 82-1,

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[102] *Id.* at 20.
[103] *See* Director's Corrected Reply Brief, at 11 ("As the reasoning of the *Burpulis* court makes clear, the ruling is not based on 'creating two classes' of taxpayers as Verisign claims . . . .") (citation omitted) (Trans. ID. 66104712).
[104] *Id.* (citation omitted).
[105] *Id.* at 12 (citing *Wilmington Med. Ctr., Inc. v. Bradford*, 382 A.2d 1338, 1344 (Del. 1978)).
[106] DEL. CONST. art. VIII, § 1.
[107] *Seaford Associates, L.P. v. Board of Assessment Review*, 539 A.2d 1045, 1049 (Del. 1988) (citing DEL. CONST. art. VIII, § 1).

issued by the Division, achieved such uniformity.[108] The tax ruling made the federal two-earner married couple deduction unavailable "for Delaware income tax purposes where a married couple filed a joint federal income tax return[] but elected to file separate state returns."[109]

The *Burpulis* taxpayers—a married couple—claimed the federal two-earner married couple deduction when they filed their joint federal income tax return.[110] For Delaware income tax return purposes, the taxpayers filed separately, and one of them claimed the deduction.[111] The Division disallowed the deduction under Tax Ruling 82-1.[112] The Tax Appeal Board allowed the deduction, but the Superior Court reversed.[113]

In affirming the Superior Court's decision not to allow the deduction, the Supreme Court concluded that permitting "the two-earner married couple deduction in Delaware would . . . introduce inequities in the tax system where none existed before."[114] The Supreme Court explained that Congress had created the federal two-earner married couple deduction to offset the federal marriage tax penalty—a penalty that Delaware does not impose.[115] So if Delaware were to allow married

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[108] *Burpulis v. Director of Revenue*, 498 A.2d 1082, 1087 (Del. 1985).
[109] *Id.* at 1084.
[110] *Id.* at 1083–84.
[111] *Id.* at 1084.
[112] *See id.*
[113] *Id.*
[114] *Id.* at 1087.
[115] *Id.*

taxpayers to claim the deduction on their separate Delaware returns, then married taxpayers "would benefit by virtue of their married status while single taxpayers would suffer."[116] This differential treatment would amount to a violation of the Uniformity Clause because Delaware does not treat taxpayers differently on the basis of their marital status.[117]

In light of the Supreme Court's reasoning in *Burpulis*, the Director's arguments fail. The Supreme Court certainly concluded that the two-earner married couple deduction was not available to Delaware taxpayers who filed separate returns.[118] At issue here, however, is the Supreme Court's insight into the Uniformity Clause.[119] The Supreme Court also recognized that because Delaware does not impose a marriage tax penalty, it would be fixing a problem that it did not have were it to introduce the federal two-earner married couple deduction. But this was the Supreme Court's explanation of the potentially "absurd result" that would ensue, not of the potential Uniformity Clause violation.[120]

Moving onto Verisign's arguments, Verisign first argues that the Uniformity Clause issue flowed from the *Burpulis* taxpayers' attempt to complete separate Delaware returns using a federal deduction available only to groups. But when the

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[116] *Id.*
[117] *Id.* (citation omitted).
[118] *Id.* at 1086.
[119] *Id.* at 1087.
[120] *Id.*

Supreme Court identified the potential Uniformity Clause violation, it appeared to be referring to the prospect of creating two groups of individual taxpayers who were separated on the basis of their marital status.[121] Verisign's second argument is relevant to that concern: the Division's policy divides a single group of taxpayers (Delaware corporate taxpayers) into two groups on the basis of their federal filing status (consolidated filers and separate filers) and then applies a limitation to one but not the other. The Court agrees and therefore finds that the policy creates two classes of Delaware corporate taxpayers.

The Director argues that even if this is so, a "classification regime meets the requirements of the Uniformity Clause if it is reasonable."[122] In support of this assertion, the Director cites *Wilmington Medical Center, Inc. v. Bradford*, a case decided by the Delaware Supreme Court.[123] In that case, the Supreme Court *does* declare that "[t]he test of constitutionality under the tax-uniformity provision of Art. VIII, § 1 is the reasonableness of the classification."[124] But the standard that the Supreme Court proceeds to quote makes clear that the "reasonableness" test is based on affording deference to the *General Assembly*, not an administrative agency like the Division:

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[121] *Id.*

[122] Director's Corrected Reply Brief, at 12 (citing *Wilmington Med. Ctr., Inc. v. Bradford*, 382 A.2d 1338, 1344 (Del. 1978)).

[123] *Id.* (citing *Wilmington Med. Ctr., Inc. v. Bradford*, 382 A.2d 1338, 1344 (Del. 1978)).

[124] *Wilmington Medical Center, Inc. v. Bradford*, 382 A.2d 1338, 1344 (Del. 1978) (citing *Tri-State Amusement, Inc. v. State Tax Dept.*, 254 A.2d 228 (1969)).

> There is of course a presumption that the statute is constitutional. *Legislatures* have a wide discretion in the matter of classification for the purpose of taxation which the courts will not disturb unless the statute is clearly arbitrary. . . . The existence of facts to support the classification of *the legislature* must be assumed if any set of facts can reasonably be conceived which will sustain such classification. . . . Generally, each case necessarily depends upon its own circumstances.[125]

Here, the Division has acted alone in treating Delaware corporate taxpayers differently depending on whether they file their federal returns as consolidated groups or separate corporations.[126] The Director has cited no authority to suggest that an administrative agency's classification should be afforded the same deference that the legislature is afforded when it faces a Uniformity Clause challenge. Accordingly, the Court finds that the policy violates the Delaware Constitution's Uniformity Clause, and summary judgment will be granted in favor of Verisign and against the Director on that basis. The Division therefore improperly limited the amount of the NOL that Verisign could claim for Delaware income tax return purposes to the amount of the Verisign Group's consolidated NOL.[127]

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[125] *Id.* (emphasis added) (internal quotation marks omitted) (quoting *Aetna Casualty & Surety Co. v. Smith*, 131 A.2d 168, 177 (Del. 1957)); *see also Conard v. State*, 16 A.2d 121, 125 (emphasis added) ("*The Legislature* has a broad discretion in the matter of classification, and the courts will not assume to review the classification unless it is clearly arbitrary.").

[126] Director's Answering Brief, at 13 (emphasis added) (citation omitted) ("[W]hile the starting point for all Delaware corporate income tax returns is a corporate taxpayer's stand-alone income calculated pursuant to the IRC, *the Division* then limits the net operating loss deduction that a taxpayer may claim to the amount recognized on its federal return.") (Trans. ID. 66054582).

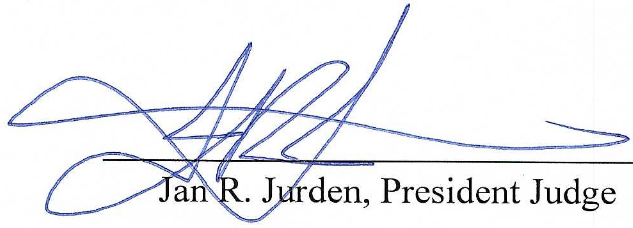
[127] Verisign's fourth and final argument is an argument in the alternative. Pre-Trial Stipulation, at 2–3 (Trans. ID. 66105127). The argument asserts that even if the Division properly limited Verisign's deduction to the amount of the Verisign Group's consolidated NOL, the latter amount was calculated in a manner that violates the U.S. Constitution's Foreign Commerce Clause. *Id.*

V. CONCLUSION

In sum, the Court concludes that the Delaware Division of Revenue's policy (1) is consistent with Delaware statute under the reasoning of *Cluett, Peabody, & Co. v. Director of Revenue*; (2) does not discriminate against interstate commerce in violation of the U.S. Constitution's Commerce Clause; but (3) does violate the Delaware Constitution's Uniformity Clause under the reasoning of *Burpulis v. Director of Revenue*. Accordingly, Verisign's Motion for Summary Judgment is **GRANTED**, and the Director's Motion for Summary Judgment is **DENIED**.

IT IS SO ORDERED.

The violation allegedly occurred because the Verisign Group was not allowed to deduct the dividends that members received from *foreign* subsidiaries in the same manner that it could deduct dividends that members received from *domestic* subsidiaries. *See* Verisign's Supporting Brief, at 30–31 (Trans. ID. 66012510). Verisign does not dispute that federal law governs the calculation of the consolidated NOL, so federal law causes the discrimination. *See* Verisign's Reply Brief, at 20–21 (Trans. ID. 66089875). Yet Verisign maintains that the Division cannot hide behind federal law because it has chosen to adopt a policy that violates the Foreign Commerce Clause. *Id.* at 21 ("[T]he discrimination is caused by the *Director's decision* to use the Verisign Group's consolidated NOL (which treats foreign dividends less favorably than domestic dividends) as her limitation."). On November 24, 2020, the Court requested supplemental briefing on this issue in the form of a Sur-Reply and a Sur-Sur-Reply from Verisign and the Director, respectively. *See* Judicial Action Form (Trans. ID. 66139304). On November 30, 2020, Verisign filed its Sur-Reply. Plaintiff's Sur-Reply in Further Support of Plaintiff's Motion for Summary Judgment (Trans. ID. 66146106). On December 7, 2020, the Director filed her Sur-Sur-Reply. Sur-Sur-Reply Brief in Support of Defendant Director of Revenue's Motion for Summary Judgment (Trans. ID. 66164679). After careful consideration of the parties' supplemental briefs, the Court concludes that it need not reach the Foreign Commerce Clause issue, having found that the policy violates the Delaware Constitution's Uniformity Clause.



Jan R. Jurden, President Judge

cc: Prothonotary