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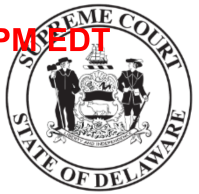

IN THE SUPREME COURT OF THE STATE OF DELAWARE

DIRECTOR OF REVENUE, Defendant-Below, Appellant/Cross-Appellee v. VERISIGN, INC., Plaintiff-Below, Appellee/Cross-Appellant	No. 18,2021 Court Below: Superior Court of the State of Delaware, C.A. No. N19C-08-093 JRJ **PUBLIC VERSION** **FILED MAY 25, 2021**

APPELLANT/CROSS-APPELLEE DIRECTOR OF REVENUE'S ANSWERING BRIEF TO APPELLEE/CROSS-APPELLANT VERISIGN, INC.'S OPENING BRIEF AND REPLY BRIEF IN SUPPORT OF APPELLANT DIRECTOR OF REVENUE'S OPENING BRIEF

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES v

NATURE OF PROCEEDINGS 1

SUMMARY OF ARGUMENT 2

I. ISSUE 1 ON CROSS-APPEAL: THE SUPERIOR COURT CORRECTLY FOUND THE DIVISION'S NET OPERATING LOSS POLICY IS CONSISTENT WITH DELAWARE LAW 2

   A. THE DIVISION'S SUMMARY OF ARGUMENT 2

   B. THE DIVISION'S RESPONSE TO VERISIGN'S SUMMARY OF ARGUMENT 2

II. ISSUE 2 ON CROSS-APPEAL: THE DIVISION'S POLICY DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE 6

   A. THE DIVISION'S SUMMARY OF ARGUMENT 6

   B. THE DIVISION'S RESPONSE TO VERISIGN'S SUMMARY OF ARGUMENT 7

III. ISSUE 3 ON CROSS-APPEAL: THE DIVISION'S POLICY DOES NOT VIOLATE THE U.S. CONSTITUTION'S FOREIGN COMMERCE CLAUSE 8

   A. THE DIVISION'S SUMMARY OF ARGUMENT 8

   B. THE DIVISION'S RESPONSE TO VERISIGN'S SUMMARY OF ARGUMENT 8

IV. SOLE ISSUE ON APPEAL: THE SUPERIOR COURT ERRED IN HOLDING THAT THE DIVISION'S POLICY VIOLATES THE DELAWARE CONSTITUTION'S UNIFORMITY CLAUSE 10

   A. THE DIVISION'S SUMMARY OF ARGUMENT 10

   B. THE DIVISION'S REPLY TO VERISIGN'S SUMMARY OF ARGUMENT 11

COUNTER-STATEMENT OF FACTS 13

ARGUMENT 14

I. ANSWER TO ISSUE I ON CROSS-APPEAL: THE SUPERIOR COURT CORRECTLY HELD THAT THE DIVISION'S POLICY IS CONSISTENT WITH DELAWARE LAW 14

A. QUESTION PRESENTED 14

B. SCOPE OF REVIEW 14

C. MERITS OF ARGUMENT 15

1. The Division's Policy is Consistent with 30 *Del. C.* § 1902 et seq. 15

2. Verisign's Characterization of the Division's Policy as an Audit Manual Limitation That "Is Not In The Statute" Is Erroneous 21

II. ANSWER TO ISSUE 2 ON CROSS-APPEAL: THE DIVISION'S POLICY DOES NOT VIOLATE THE U.S. CONSTITUTION'S INTERSTATE COMMERCE CLAUSE AND, IN ANY EVENT, INVALIDATING THE POLICY WOULD NOT BENEFIT VERISIGN. 26

A. QUESTION PRESENTED 26

B. SCOPE OF REVIEW 26

C. MERITS OF ARGUMENT 26

III. ANSWER TO ISSUE 3 ON CROSS APPEAL: THE DIVISION'S POLICY DOES NOT VIOLATE THE U.S. CONSTITUTION'S FOREIGN COMMERCE CLAUSE 29

A. QUESTION PRESENTED 29

B. SCOPE OF REVIEW 29

C. MERITS OF ARGUMENT 29

IV. REPLY IN SUPPORT OF SOLE ISSUE ON APPEAL: THE SUPERIOR COURT ERRED BY HOLDING THAT THE DIVISION'S POLICY VIOLATED DELAWARE'S UNIFORMITY CLAUSE 35

A. QUESTION PRESENTED 35

B. SCOPE OF REVIEW 35

C. MERITS OF ARGUMENT 35

1. The Division's Policy Does Not Divide Taxpayers "On The Basis Of Their Federal Filing Status" 36

2. To The Extent A Classification Is Created, It Is Reasonable and Therefore Constitutional 41

CONCLUSION 46

TABLE OF AUTHORITIES

Page(s)

Cases

Aetna Casualty & Surety Co. v. Smith,
131 A.2d 168 (Del. 1957) 42

Alfieri v. Martelli,
647 A.2d 52 (Del. 1994) 14

Burpulis v. Dir. of Revenue,
498 A.2d 1082 (Del. 1985) 36, 37

Cagle v. C.I.R.,
539 F.2d 409 (5th Cir. 1976) 39

Cluett, Peabody, & Co. v. Dir. of Revenue,
C.A. No. 83A-JN-4, 1985 Del. Super. LEXIS 1089 (Del. Super Ct. Jan. 22, 1985) ....*passim*

Colgate-Palmolive Co. v. Fla. Dep't of Revenue,
988 So. 2d 1212 (Fla. Dist. Ct. App. 2008) 33

Conard v. State,
16 A.2d 121 (Del. Super. Ct. 1940) 42, 43

Container Corp. of Am. v. Franchise Tax Bd.,
463 U.S. 159 (1983) 43

Doe v. Wilmington Hous. Auth.,
88 A.3d 654 (Del. 2014) 26, 29

Fisher v. Comm'r of Internal Revenue,
230 F.2d 79 (7th Cir. 1956) 39

Free-Flow Packaging Int'l, Inc. v. Sec'y of the Dep't of Natural Res. & Env't Control,
861 A.2d 1233 (Del. 2004) 35

Fulton Corp. v. Faulkner,
516 U.S. 325 (1996) 6, 27

Ind. Dep't of State Revenue v. Caterpillar, Inc.,
15 N.E.3d 579 (Ind. 2014) 33

In re Krafft-Murphy Co.,
82 A.3d 696 (Del. 2013) 35

Kraft Gen. Foods v. Iowa Dep't of Revenue,
505 U.S. 71 (1992).. *passim*

McKesson Corp. v. Div. of Alcoholic Beverages & Tobacco,
496 U.S. 18 (1990).. 28

Mobil Oil Corp. v. Comm'r of Taxes,
445 U.S. 425 (1980) 43

Public Water Supply Co. v. DiPasquale,
735 A.2d 378 (Del. 1999) 14

Richardson v. Bd. of Cosmetology & Barbering,
69 A.3d 353 (Del. 2013) 15

State Farm Mut. Auto. Ins. Co. v. Mundorf,
659 A.2d 215 (Del. 1995) 14

Wilmington Med. Ctr., Inc. v. Bradford,
382 A.2d 1338 (Del. 1978). Op. 36, 41, 42

World Fuel Servs. Corp. v. Fla. Dep't of Revenue,
23 So. 3d 1293 (Fla. Dist. Ct. App. 2010) 33

Statutes

Internal Revenue Code ("IRC") .... *passim*

29 *Del. C.* § 10113 35

30 *Del. C.* § 354 .... 42, 44

30 *Del. C.* § 1901(10)... 15

30 *Del. C.* § 1902(a).. *passim*

30 *Del. C.* § 1903(a).. *passim*

30 *Del. C.* § 1903(b)..3

Constitutional Provisions

U.S. Const. art. I, § 8, cl. 3 (Commerce Clause) ....*passim*

U.S. Const. art. I, § 8, cl. 3 (Foreign Commerce Clause) ....*passim*

Del. Const. art. VIII, § 1 (Uniformity Clause)...*passim*

Other Authorities

71 Am.Jur.2d State and Local Taxation § 518 (1973) 39

NATURE OF PROCEEDINGS

On December 17, 2020, the Superior Court issued its Opinion granting Verisign's Motion for Summary Judgment and denying the Director of Revenue's Motion for Summary Judgment. After finding that the Division of Revenue's ("the Division's") policy regarding the calculation of a corporate taxpayer's net operating loss is consistent with 30 Del. C. § 1903(a) and does not discriminate against interstate commerce in violation of the U.S. Constitution's Commerce Clause, the Superior Court then held that the policy violates the Delaware Constitution's Uniformity Clause. The Court explicitly declined to reach Verisign's arguments under the Foreign Commerce Clause of the U.S. Constitution.

The Superior Court issued a Final Order on December 23, 2020. The Director of Revenue filed its Notice of Appeal on January 15, 2021. Verisign filed its Notice of Cross-Appeal on January 20, 2021.

SUMMARY OF ARGUMENT

I. ISSUE 1 ON CROSS-APPEAL: THE SUPERIOR COURT CORRECTLY FOUND THE DIVISION'S NET OPERATING LOSS POLICY IS CONSISTENT WITH DELAWARE LAW

A. THE DIVISION'S SUMMARY OF ARGUMENT

This Court should affirm the Superior Court's holding that the Division's net operating loss policy ("Policy"), which limits the allowable net operating loss ("NOL") that a Delaware corporate taxpayer may claim on its state return to the amount reported on that taxpayer's filed federal return, "is consistent with Delaware statute." Op. at 16. The court below properly relied on the analysis in *Cluett, Peabody, & Co. v. Dir. of Revenue,* C.A. No. 83A-JN-4, 1985 Del. Super. LEXIS 1089 (Del. Super Ct. Jan. 22, 1985), which "explicitly relied on 'the language of [30 *Del. C.*] § 1903(a)'" to find "that the Division's application of the policy – which included consulting [the taxpayer's] consolidated federal returns – was consistent with Delaware statute." *Id.* Verisign's contrary assertion that the Division's Policy is an "audit manual limitation [that] is 'not in the statute'" is wrong and premised on unsupported and flawed assumptions. Verisign Br. at 19, 22, 32.

B. THE DIVISION'S RESPONSE TO VERISIGN'S SUMMARY OF ARGUMENT

1. DENIED. This litigation is a dispute over whether the Division's Policy is consistent with Delaware law. The Division's Policy is grounded in the language of 30 *Del. C.* § 1903(a) which limits discretionary deductions like an NOL

to the amount "computed for purposes of the federal income tax." There is no "extra-statutory limitation" in the Division's Audit Manual. The Audit Manual outlines how an auditor must process in the State's electronic filing system a tax return submitted by a Delaware corporate taxpayer who elected to file a consolidated federal return.

2. ADMITTED in part and DENIED in part: The Division admits that under 30 *Del. C.* § 1902(a) Delaware requires each corporation to file state income tax returns on a separate entity basis. The Division admits that under 30 *Del. C.* § 1903(b) the starting point of state taxable income is the corporation's federal taxable income as computed under the Internal Revenue Code ("IRC"). Stipulated Fact ("SF") ¶ 4, B34.[1] The Division denies that Verisign had [redacted] for the years at issue, since Verisign did not file federal tax returns for the years at issue on a stand-alone basis. Verisign calculated state taxable income for its Delaware state returns in the years at issue using the IRC as a starting point but then, consistent with Delaware's Policy, reported approximately [redacted] in 'federal taxable income' on line 1 of its Delaware state tax returns for 2015 and 2016, respectively. SF ¶¶ 33, 34, B43. Verisign's 'federal taxable' income reported on line 1 of its Delaware state returns in 2015 and 2016 was

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[1] Stipulated Facts are taken from the Parties' Pre-Trial Stipulation filed in the Superior Court. *See* Appellee's Appendix at B34-44.

computed using the NOL of Verisign Group on the federal 1120 Pro Formas Verisign filed with Delaware. *Id*.

3. DENIED. The issue in this litigation is the validity of the Division's Policy that limits allowable NOL deductions for state tax purposes to the "amount recognized for Federal purposes." SF ¶¶ 31, 32, B42-43; 30 *Del. C*. § 1903(a); Tax Instructions, A175; Deposition of Eliott Johns, ("Johns Depo.") 21:8-14, A155; 75:24-76:5, A165-166; 77:2-13, A167. Verisign's attempts to reframe the Division's Policy as an "audit manual limitation" that "adopted" a "consolidated NOL" as a limitation is inconsistent with, and appears to intentionally misconstrue, the record below. Verisign Br. at 15, 18, 22, 34. The Audit Manual language quoted by Verisign occurs at the end of a long decision tree narrowing the auditor's review down to only those NOLs claimed by corporations who filed as a member of a consolidated group at the federal level. *See* B123. The language quoted by Verisign thus merely describes to auditors how the Division's Policy applies to the state returns of a corporation which filed a federal consolidated return.

4. DENIED. The Division says to all taxpayers, including Verisign, in Delaware's published "Corporate Income Tax Instructions and Returns" ("Tax Instructions," A169-182) that "[e]ach corporation which is a member of a consolidated group must file a separate return reporting income and deductions as if a separate Federal income tax return was filed" but then explicitly states that "[t]he

amount of the net operating loss recognized for Delaware corporate income tax purposes is only to the extent of the amount recognized for Federal purposes." A170, 175. The Division instructs its internal auditors in its Audit Manual that, if a Delaware corporation filed federal consolidated returns, that corporation may not claim an NOL on its state tax returns which exceeds the consolidated loss "recognized for Federal purposes" on its federal returns.

5. ADMITTED.

6. ADMITTED.

7. DENIED. The Division does not have an "audit manual limitation." The Division's Policy limits the allowable discretionary NOL a Delaware corporate taxpayer may claim on its state returns to the amount that taxpayer "computed for purposes of the federal income tax" based on the explicit language of 30 *Del. C.* § 1903(a). As such, the Division's Policy is not only consistent with, but is derived from Delaware's statute. The fact that Delaware law disallows consolidated state income tax returns is not inconsistent with limiting a taxpayer's allowable NOL to an amount "computed for purposes of the federal income tax."

8. DENIED. The Division does not have an "audit manual limitation." The Division has a Policy and its Audit Manual merely contains processing instructions to auditors that ensure state corporate tax returns are submitted in a manner consistent with this Policy. The Division does not dispute for the purposes

of this litigation Verisign's calculations showing that Verisign's stand-alone taxable income, with a stand-alone NOL, under the IRC results in [redacted]

9. DENIED. The Division's Policy is consistent with Delaware law and is grounded in the language of 30 *Del. C.* § 1903(a). There is no "extra-statutory limitation" in the Division's Audit Manual.

II. ISSUE 2 ON CROSS-APPEAL: THE DIVISION'S POLICY DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE

A. THE DIVISION'S SUMMARY OF ARGUMENT

Verisign wrongly contends that excepting a Delaware taxpayer from the Division's Policy when all members of a consolidated group of which it is part files Delaware's tax returns represents discrimination against interstate commerce. The Policy exception does not discriminate against interstate commerce because it does not benefit Delaware corporations at the expense of non-Delaware corporations. Further, Verisign places heavy reliance upon the irrelevant case of *Fulton Corp. v. Faulkner,* 516 U.S. 325 (1996). In contrast to *Faulkner,* neither the Policy nor the Policy exception imposes a greater tax upon Verisign based upon the amount of business it does in Delaware. Lastly, even if the Policy exception were to be found unconstitutional (which it is not), that finding would only have the effect of extending the Division's Policy to all Delaware corporate taxpayers and would be of no benefit to Verisign.

B. THE DIVISION'S RESPONSE TO VERISIGN'S SUMMARY OF ARGUMENT

13. DENIED. Neither the Division's Policy, nor the exception to the Policy, discriminate against interstate commerce because neither imposes a tax burden on out-of-state commerce. The Division's Policy and any exceptions to it only affect Delaware corporate taxpayers, and only to the extent they do business in Delaware.

14. DENIED. Although the Division does not apply its Policy if all members of a consolidated group choose to file Delaware corporate tax returns, this does not favor in-state commerce over out-of-state commerce. This is because neither the Division's Policy, nor the exception to the Policy, impose any taxes upon an out-of-state corporation at all, much less do they impose greater taxes on out-of-state commerce relative to in-state commerce.

15. DENIED. Even if the Policy exception were to be found unconstitutional (which it is not), that finding would only have the effect of extending the Delaware Policy to all Delaware corporate taxpayers and would be of no benefit to Verisign.

III. <u>ISSUE 3 ON CROSS-APPEAL:</u> THE DIVISION'S POLICY DOES NOT VIOLATE THE U.S. CONSTITUTION'S FOREIGN COMMERCE CLAUSE

A. THE DIVISION'S SUMMARY OF ARGUMENT

Verisign contends that the Division's Policy violates the Foreign Commerce Clause because the Policy does not allow a deduction for foreign subsidiary dividends received by members of the Verisign Group other than Verisign. First, this contention is wrong as a factual matter, since the Division's Policy does not address the deductibility of dividends, whether foreign or domestic. The Policy simply takes Verisign Group's consolidated NOL as it appears on its federal return. The Division is unaware of how Verisign Group's NOL is calculated. Nothing Delaware has done causes Verisign Group's consolidated NOL to be lesser in amount because of the way federal law treats foreign subsidiary dividends. Second, Verisign incorrectly relies upon *Kraft Gen. Foods v. Iowa Dep't of Revenue*, 505 U.S. 71 (1992). In *Kraft,* it was Iowa law that imposed a burden on the foreign subsidiaries of the Iowa taxpayer. In this case, Delaware not only does not impose any burden on foreign entities, Verisign, the Delaware taxpayer, has no foreign subsidiaries.

B. THE DIVISION'S RESPONSE TO VERISIGN'S SUMMARY OF ARGUMENT

16. DENIED. The Division's Tax Instructions direct a Delaware corporate taxpayer to utilize, for purposes of calculating the corporate income tax, the NOL used by it on its federal tax return, whether the taxpayer chose to calculate the NOL

on a standalone or on a consolidated basis. *Kraft* does not prohibit Delaware from calculating its corporate income tax on that basis.

17. DENIED. Verisign inaccurately sets forth the parties' factual stipulation. The parties did **not** stipulate "that if its audit manual limitation were computed by treating foreign subsidiary dividends and domestic subsidiary dividends equally, Verisign's NOL would not be limited." Verisign Br. at 11. The stipulation states that "[i]f the Verisign Group's consolidated NOLs . . . were computed by allowing dividends from foreign subsidiaries to be deducted in the same manner as dividends from domestic subsidiaries, the Verisign's Group's consolidated NOL deduction . . . would have been greater than Verisign's separate-company NOL deduction . . . ." SF ¶ 29, B42. Neither the Delaware Policy nor the Audit Manual instructs a taxpayer on how to compute its NOL, much less do they instruct a taxpayer how to treat dividends from its subsidiaries for purposes of calculating its NOL. The Division has, therefore, not stipulated to the unequal treatment of dividends, and thus has no obligation to correct its alleged treatment by re-computing Verisign's consolidated NOL.

IV. SOLE ISSUE ON APPEAL: THE SUPERIOR COURT ERRED IN HOLDING THAT THE DIVISION'S POLICY VIOLATES THE DELAWARE CONSTITUTION'S UNIFORMITY CLAUSE

A. THE DIVISION'S SUMMARY OF ARGUMENT

The Superior Court's holding that the Division's limit on allowable NOLs divides taxpayers "on the basis of their federal filing status" in violation of Delaware's Uniformity Clause, Del. Const. art. VIII, § 1, should be reversed. Op. 24. To the contrary, the Division's Policy takes the NOL reported by corporate taxpayers to federal authorities as a singular limit on the allowable discretionary NOL deduction for state tax purposes for all Delaware corporate taxpayers irrespective of how the taxpayer computed that loss under the federal rules.

Verisign's alternate argument that because all Delaware corporations are entitled to an "NOL deduction computed under the IRC" the Division's Audit Manual "creates non-uniformity where none existed before" by adopting a "consolidated NOL" limitation should be rejected. Versign Br. at 33-34. Delaware law does not grant Verisign or any other Delaware corporation the right to claim an NOL calculated on a stand-alone basis under the IRC on their state tax returns. Nor is the Division's Policy a "consolidated NOL" limit adopted in the Division's Audit Manual.

B. THE DIVISION'S REPLY TO VERISIGN'S SUMMARY OF ARGUMENT

10. ADMITTED in part and DENIED in part. The Division admits that Delaware law and the Division's Policy uniformly applies corporate income tax to Delaware corporations. The Division denies that the Delaware statute "entitles all taxpayers to a NOL deduction computed in the same manner." Under Delaware's tax code, the starting point of state taxable income is stand-alone income computed under the IRC. Delaware law does not specifically authorize an NOL deduction and therefore an NOL deduction is a discretionary deduction that no Delaware corporation is automatically entitled to claim. The Division, however, under 30 *Del. C.* § 1903(a), permits all Delaware corporations to claim an NOL deduction in the amount "computed for purposes of the federal income tax." As such, Delaware law does not specify the "manner" in which a Delaware corporation computes its NOL, but rather limits all Delaware corporations to the NOL they computed on their filed, federal tax return. Consequently, in Delaware, it is the taxpayer's election of how to compute its NOL for its federal return that determines the "manner" in which an NOL is computed for Delaware state tax purposes.

11. DENIED. The Division does not have an "audit manual limitation." The Division's Policy limits the allowable discretionary NOL a Delaware corporate taxpayer may claim on its state returns to the amount that taxpayer "computed for purposes of the federal income tax" based on the explicit language of 30 *Del. C* .§

1903(a). For Delaware corporations that file federal tax returns as a member of a consolidated group, the NOL that may be claimed for the purposes of Delaware corporate income tax is the federally recognized consolidated NOL. For Delaware corporations that file stand-alone federal tax returns, the stand-alone NOL claimed on the federal return is the NOL that may be claimed on the Delaware return. The fact that a Delaware corporation may elect to compute its NOL under federal law using either of two methods does not convert the Division's Policy into a differential limit based upon the method the corporation elects to use.

12. DENIED. The Division's Policy does not create a classification based on federal filing status.

COUNTER-STATEMENT OF FACTS

The Division fully intended to rely upon the Parties' stipulated facts from the Pre-Trial Stipulation. The Division inadvertently included its statement of facts previously submitted in its Motion for Summary Judgment in its opening brief. The Division apologizes for the inconvenience this oversight may have caused. The Division submits at Exhibit A a copy of its opening brief with all factual citations corrected to the corresponding paragraphs from the Parties' Pre-Trial Stipulation and relies on those stipulated facts in the arguments below.

ARGUMENT

I. ANSWER TO ISSUE I ON CROSS-APPEAL: THE SUPERIOR COURT CORRECTLY HELD THAT THE DIVISION′S POLICY IS CONSISTENT WITH DELAWARE LAW

A. QUESTION PRESENTED

Did the Superior Court correctly hold that the Division's Policy, which limits a Delaware corporate taxpayer's discretionary NOL deduction for state tax purposes to the NOL "computed for purposes of the federal income tax," is consistent with Delaware law?

B. SCOPE OF REVIEW

This Court reviews an agency's interpretation of statutory law de novo, but "may accord due weight, but not defer, to an agency interpretation of a statute administered by it." *Public Water Supply Co. v. DiPasquale*, 735 A.2d 378, 382-83 (Del. 1999). "[W]here an agency interpretation is longstanding and widely enforced, a reviewing court would ordinarily accord greater weight to the underlying agency interpretation of the statute in determining, for itself, the optimal interpretation." *Id.* at 382 n.8. When interpreting statutes "the courts of Delaware employ the plain meaning rule." *State Farm Mut. Auto. Ins. Co. v. Mundorf*, 659 A.2d 215, 220 (Del. 1995) (citing *Alfieri v. Martelli*, 647 A.2d 52, 54 (Del. 1994)).

C. MERITS OF ARGUMENT

This Court should affirm the Superior Court's holding that the Division's Policy "is consistent with Delaware statute." Op. at 16.

1. The Division's Policy is Consistent with 30 *Del. C.* § 1902 et seq.

The Division's Policy is based on the plain language of two provisions of Delaware's tax code. The Division is charged with interpreting and implementing these two related statutory requirements together in a manner that gives effect to each provision. *Richardson v. Bd. of Cosmetology & Barbering*, 69 A.3d 353, 357 (Del. 2013) (holding related statutes must be read together rather than in isolation, particularly when there is an express reference in one statute to another statute). First, Delaware's separate filing requirement at 30 *Del. C*. § 1902(a) requires every Delaware corporation to pay state corporate income tax on "its taxable income, computed in accordance with § 1903 of this title." Second, under 30 *Del. C*. § 1903(a) "[t]he 'entire net income' of a corporation for any income year means the amount of its federal taxable income for such year as computed for purposes of the federal income tax . . . ."[2]

In order to give effect to both provisions in a manner consistent with the plain language of the tax code, the Division requires Delaware corporate taxpayers to, as

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[2] The code defines federal income tax to "mean[] the tax imposed on corporations by the federal Internal Revenue Code of 1986 and amendments thereto." 30 *Del. C.* § 1901(10).

a starting point, compute stand-alone state taxable income under the IRC pursuant to 30 *Del. C*. § 1902(a) but, because state taxable income must be "computed in accordance with § 1903," the Division limits a taxpayer's discretionary NOL deduction for state tax purposes to the NOL "computed for purposes of the federal income tax" under the language of 30 *Del. C*. § 1903(a). As a result, the Division's limitation on a Delaware corporate taxpayer's allowable NOL for state tax purposes to the amount reported on that taxpayer's filed federal return is not only consistent with Delaware law but is directly tied to the statutory language enacted by Delaware's General Assembly in 30 *Del. C*. § 1903(a). *See Cluett,* 1985 Del. Super. LEXIS 1089, at *6-8. The Division's judicially approved Policy has been in place for over 30 years and is consistently enforced against all corporate taxpayers. *Id.*; SF ¶¶ 35, 36, B44.

The Division's Policy is explained to taxpayers in Delaware's published "Corporate Income Tax Instructions and Returns" ("Tax Instructions," A169-182) which requires "[e]ach corporation which is a member of a consolidated group [to] file a separate return reporting income and deductions as if a separate Federal income tax return was filed" but explicitly states that "[t]he amount of the net operating loss recognized for Delaware corporate income tax purposes is only to the extent of the amount recognized for Federal purposes." A170, 175. Thus, consistent with Delaware's tax code, the Division's Policy, and the Tax Instructions, a Delaware

corporation like Verisign which elects to file a federal consolidated return must calculate its stand-alone federal taxable income under the IRC pursuant to 30 *Del. C*. § 1902(a), but is prohibited from claiming an NOL deduction on its state tax return in excess of the NOL deduction reported on its federal consolidated return under 30 *Del. C*. § 1903(a).

In addition to the court below, multiple Delaware authorities have explicitly held that the Division's Policy is consistent with the language of 30 *Del. C*. § 1903(a). *Cluett,* 1985 Del. Super. LEXIS 1089, at *6-8 (analyzing Decision of State Tax Board, Docket Nos. 238, 239 (July 27, 1962)). Both the court in *Cluett* and the State Tax Board decision relied on by the *Cluett* court specifically rejected a Delaware corporation's attempt to claim on its stand-alone state income tax returns an NOL that had not been claimed on the taxpayer's federal returns. *Id*. In so doing, both found that while Delaware corporations must file as separate entities, the "for purposes of the federal income tax" language in 30 *Del. C*. § 1903(a) was correctly interpreted by the Division to limit the NOL deduction on a Delaware separate entity return to the deduction actually claimed on the taxpayer's federal return. *Id.*

In 1962, the Delaware State Tax Board, recognizing that deductions are not a matter of right, and "[i]n the absence of any provisions specifically authorizing particular deductions," interpreted § 1903(a) to mean that "Delaware law grants only those deductions which are allowable in computing a corporation's Federal taxable

income for the particular year." *Id.* at *7. The State Tax Board consequently approved the disallowance of a Delaware corporation's claimed NOL deduction for state tax purposes because the taxpayer had not reported an NOL deduction on its federal return. Similarly, the *Cluett* court reviewed the language of § 1903(a) and the 1962 decision of the State Tax Board and upheld the Division's disallowance of an NOL that a corporate taxpayer alleged it was entitled to as a separate entity because that same taxpayer's consolidated federal return had reported no NOL. The *Cluett* court specifically approved the Division's interpretation of § 1903(a) despite the fact that the separate entity filing requirement under 30 *Del. C*. § 1902(a) also requires Delaware corporations to file state corporate income tax returns using their stand-alone federal taxable income as calculated under the IRC.[3]

Despite the weight of this authority, Verisign argues "the Division's position cannot be reconciled with the language of Delaware's statute." Verisign Br. at 29. Verisign's conclusion is based on two erroneous assertions: (1) that Delaware law grants "corporations an NOL deduction by adopting federal taxable income as the starting point for the state tax base" and (2) that because "consolidated NOL" is not a defined term in the IRC but is rather derived from Federal Treasury Regulations,

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[3] The *Cluett* court also noted that any taxpayer concerns regarding the fairness of "the system created by § 1903 and the separate filing requirement . . . [are] more properly addressed to the Legislature." *Id*. at *8.

the Division's use of a "consolidated NOL" as a limit on allowable NOL deductions for state tax purposes is contrary to Delaware law. *Id*. at 21-24.

First, an NOL deduction is a discretionary deduction in Delaware and is not granted to taxpayers simply because Delaware elects to use the IRC as the starting point to compute stand-alone state taxable income. *See Cluett,* 1985 Del. Super. LEXIS 1089, at *7. The Tax Appeal Board determined nearly 60 years ago that, "[i]n the absence of any provisions specifically authorizing particular deductions," under 30 *Del. C.* § 1903(a), "Delaware law grants only those deductions which are allowable in computing a corporation's Federal taxable income for the particular year." *Id.* (discussing Decision of State Tax Board, Docket Nos. 238, 239 (July 27, 1962)). Therefore, because an NOL is not specifically authorized in Delaware's tax code it is a discretionary deduction. Verisign neither references this precedent nor cites authority for the proposition that because Delaware law specifies that the IRC is to be used as a starting point to compute stand-alone state taxable income, Delaware must then also allow Verisign to claim the NOL deduction it computes on a stand-alone basis under the IRC, rather than the deduction it used for computing federal income tax. SF ¶ 4, B34; Verisign Br. at 20.

Second, the fact that Verisign Group's consolidated NOL is computed under Federal Treasury Regulations and not the IRC is irrelevant to a consideration of whether the Division's Policy is consistent with Delaware law. As set out above,

the Division, the State Tax Appeal Board, and two Superior Courts interpret the language of 30 *Del. C*. § 1903(a) to limit a taxpayer's discretionary NOL deduction for state tax purposes to the amount "computed for purposes of the federal income tax." In analyzing *Cluett*, the Superior Court below rejected Verisign's argument that the Division's "policy abandons Delaware statute by incorporating the consolidated NOL" by stating:

> 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.

Op. at 15. The Superior Court therefore found that the Division's Policy which includes consulting the consolidated returns of a Delaware taxpayer is consistent with Delaware law. *Id*. at 16.

How a Delaware corporate taxpayer computes the NOL included in that "corporation's Federal taxable income for the particular year," is entirely a matter of how that taxpayer elects to file its federal returns. *Cluett*, 1985 Del. Super. LEXIS 1089, at *7, 9-10. Because the plain language of 30 *Del. C*. § 1903(a) limits allowable NOLs for purposes of Delaware state income tax to the losses "computed for purposes of the federal income tax" whether those federally reported losses were

calculated under the IRC or a Treasury Regulation is simply irrelevant to an analysis of Delaware law.[4]

2. Verisign's Characterization of the Division's Policy as an Audit Manual Limitation That "Is Not In The Statute" Is Erroneous

The Division's Policy limits allowable NOL deductions for state tax purposes to the "amount recognized for Federal purposes." SF ¶¶ 31, 32, B42-43; 30 *Del. C.* § 1903(a); Tax Instructions, A175; Deposition of Elliot Johns, ("Johns Depo.") 21:8-14, A155; 75:24-76:5, A165-166; 77:2-13, A167. For corporations like Verisign which elect to file on a consolidated basis at the federal level, the NOL "computed for purposes of the federal income tax" is a consolidated loss; however, that fact does not convert the Division's Policy into a "consolidated NOL" limitation. If Verisign elects to file on a stand-alone basis at the federal level in 2021, Verisign's allowable NOL "computed for purposes of the federal income tax" would be a stand-alone loss. And if the federal regulations change and there is a third way of

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[4] Verisign also argues *Cluett* is inapplicable because of factual differences. Verisign Br. at 30-31. When presented with the same arguments below, the Superior Court correctly noted that Verisign's factual arguments "do[] not address the question at issue: whether the Division's policy is consistent with (or contrary to) Delaware's statute." Op. at 15. As both the *Cluett* and Superior Courts recognized, the Division's Policy requires that the federal returns of Delaware corporate taxpayer be consulted to confirm that a taxpayer does not claim an NOL in excess of that loss "computed for purposes of the federal income tax" under the plain language of 30 *Del. C.* § 1903(a). How, or why, that federal NOL was calculated is not relevant to the operation of the Division's Policy and, as such, the factual distinctions raised by Verisign do not address the legal issue before this Court.

calculating Verisign's NOL that it elects to take advantage of in 2021, that third way of calculating the loss would be Verisign's allowable NOL "computed for purposes of the federal income tax." The Division's limit on the allowable NOL a Delaware corporation may claim for state tax purposes is, and has always been, determined by the taxpayer's election of how to file its federal returns.

Verisign attempts to sidestep this analysis by ignoring the Division's Policy as explained in the Tax Instructions and stipulated to by the parties. SF ¶¶ 31, 32, B42-43. Instead, Verisign attempts to reframe the Division's Policy as an "audit manual limitation" that "adopted" a "consolidated NOL" as a limitation. Verisign Br. at 15, 18, 22, 34. Verisign's pervasive contention that the Division's Policy imposes a "consolidated NOL" limitation under its Audit Manual is inconsistent with, and appears to intentionally misconstrue, the record below.

The Audit Manual referred to by Verisign is the Division's internal operations procedure for how to process corporate income tax returns in the Division's electronic "BMF Audit & Reconciliation System.". B109-132. The Audit Manual explains the process auditors must follow to confirm that state tax returns are filed consistently with Delaware law, Division policy, and taxpayer instructions.[5] The

[5] The Audit Manual consists primarily of screen shots of Delaware's electronic tax filing system with corresponding instructions and checklists for auditors to navigate the various data fields in the computer system.

manual does not "adopt" a "consolidated NOL" limitation. The Audit Manual delineates the steps auditors must take to review and confirm that the NOLs claimed by taxpayers are consistent with Delaware law and policy.

The portions of the Audit Manual cited by Verisign are from the section dealing with "Exception Code 55 - NOL Carryforward Claimed." As the Audit Manual explains, "[t]his exception is created whenever a company files a return and is claiming a Net Operating Loss (NOL) carry forward deduction and is requesting a refund. Processing this exception requires in-depth research to determine if the NOL is valid." B111. Thus, the Audit Manual section Verisign relies on explains how to audit and process claimed NOLs generally and is in no way limited only to the review of a claimed "consolidated NOL" by Delaware corporate taxpayers.

Specifically, the portions of the "Exception Code 55" section quoted by Verisign occur at the end of a long decision tree narrowing the auditor's review down to only those NOLs claimed by corporations who filed as a member of a consolidated group at the federal level but where not every member of the group files in Delaware. B123. When looking at the state return of a Delaware corporation who filed a consolidated federal return, the consolidated NOL reported on that corporation's consolidated federal return is by definition the NOL "recognized for Federal purposes." As a result, the Audit Manual unsurprisingly instructs that when reviewing the state tax return of a Delaware corporation who filed as a member of a

consolidated group at the federal level, the "DOR needs to ensure that the NOL amount does not exceed the consolidated amount of the current year NOL." *Id.*

The facts of this case serve to illustrate this exact point. Verisign's 2015 and 2016 state tax returns reported a "federal taxable income" on line 1 of Delaware form 1100 in the amount of $[redacted] respectively. SF ¶¶ 33, 34, B43. These amounts were computed on the Federal 1120 Pro Formas filed with Delaware using the consolidated NOL of Verisign Group. *Id.* As a result, the alleged "consolidated NOL audit manual limitation" that Verisign describes was not triggered by Verisign's returns because "line 30 of [Verisign's] pro-forma 1120 match[ed] line 1 of [Verisign's] CIT return (DE 1100)." Audit Manual, B123. Rather, Verisign's returns were flagged because Verisign attempted to claim an additional deduction on its state returns, in an amount it claims is equal to a stand-alone NOL, on line 2(g) of its state tax returns. The portion of the Audit Manual which addresses the processing of line 2(g) deductions begins on the page following the NOL language quoted by Verisign. B124.

Line 2(g) on Delaware's corporate income tax return form is for reporting an NOL deduction for a loss carried back for federal tax purposes and disallowed for Delaware tax purposes. Delaware denied Verisign's claimed Line 2(g) deduction on its 2015 and 2016 tax returns, and Verisign has conceded that it is not contending it is entitled to a line 2(g) deduction in those years. SF ¶ 20, B40. Rather Verisign

contends, then as it does now, that it is entitled to claim an NOL deduction computed on a stand-alone basis under the IRC. In response, the Division explained to Verisign that "[t]he amount of the net operating loss recognized for Delaware corporate income tax purposes is the net operating loss amount recognized for federal purposes." Ex. B to Am. Compl., A45. The Division then found that "[t]he amount claimed as a carryforward loss on line 2(g) must only be the amount of loss carried back for federal tax purposes and disallowed for Delaware tax purposes. There was no net loss on the taxpayer's consolidated federal return and so it could not take a loss on it Delaware return." *Id.* Verisign's 2015 and 2016 state tax returns were therefore required to be consistent with the Division's Policy restricting allowable NOLs for state tax purposes to those "recognized for federal purposes" and were not even subject to the supposed "audit manual limitation" Verisign describes in its brief.

The Superior Court's holding that the Division's Policy of limiting the allowable NOL that a Delaware corporate taxpayer may claim on its state return to the amount reported on that taxpayer's filed federal return "is consistent with Delaware statute" should be affirmed. Op. at 16.

II. <u>ANSWER TO ISSUE 2 ON CROSS-APPEAL</u>: THE DIVISION'S POLICY DOES NOT VIOLATE THE U.S. CONSTITUTION'S INTERSTATE COMMERCE CLAUSE AND, IN ANY EVENT, INVALIDATING THE POLICY WOULD NOT BENEFIT VERISIGN.

A. QUESTION PRESENTED

Did the Superior Court err when it held that the Division's Policy does not violate the U.S. Constitution's Interstate Commerce Clause?

B. SCOPE OF REVIEW

Questions of law and constitutional claims are reviewed de novo. *Doe v. Wilmington Hous. Auth.,* 88 A.3d 654, 661 (Del. 2014) (citations omitted).

C. MERITS OF ARGUMENT

Verisign contends that excepting a taxpayer from the Division's Policy when all members of a consolidated group of which it is a part file Delaware tax returns represents discrimination against interstate commerce in violation of the U.S. Constitution's Commerce Clause. For the reasons that follow, the Superior Court correctly held that this contention is without merit. Op. at 18-19.

To begin, the Policy exception "does not work . . . [a] benefit to Delaware corporations at the expense of non-Delaware corporations." *Id.* at 19. Neither the Policy, nor the exception, requires a non-Delaware corporation to pay a dollar more in taxes than a Delaware corporation. Indeed, neither the Policy nor the exception impose any Delaware income taxes at all on out-of-state corporations, which are neither required to file Delaware income tax returns nor pay Delaware income taxes.

At most, the Policy exception entitles Verisign, a Delaware taxpayer, to claim an NOL deduction without limitation when all members of a consolidated group file Delaware income tax returns. The Policy exception, thus, operates solely with respect to Delaware taxpayers and never affects non-Delaware taxpayers.

Verisign places heavy reliance upon *Fulton Corporation v. Faulkner*, 516 U.S. 325 (1996) to support its claim that the Policy exception violates the Interstate Commerce Clause. As the Superior Court concluded, *Faulkner* has no relevance to this case. The Superior Court set forth the facts and holding of *Faulkner* as follows:

> North Carolina imposed an intangibles tax on the corporate stock that its residents owned. 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. A corporation's North Carolina income tax exposure was a function of how much in-state business the corporation conducted. In this way, North Carolina made it more attractive for its residents to buy the stock of corporations that conducted greater amounts of business in North Carolina versus other states. The U.S. Supreme Court concluded that North Carolina's "intangibles tax facially discriminate[d] against interstate commerce." It reasoned that [a] regime that taxes 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 . . . .

Op. at 18-19 (citations omitted).

In contrast to *Faulkner*, 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. Neither does the Policy exception, “condition[] a taxpayer’s deduction on the in-state activity versus out-of-state activity of its affiliates.” Verisign Br. at 51.

Lastly, although there is no basis for finding the Policy exception unconstitutional, even if the Policy exception were to be found unconstitutional, that would be of no benefit to Verisign. If the exception were found unconstitutional, it would have the effect of extending the Division’s Policy to all Delaware corporate taxpayers regardless of whether they all filed Delaware tax returns or not. In such event, Verisign would derive no benefit and would be in exactly the same position it is currently. A finding that a State has adopted a discriminatory tax does not limit the State’s flexibility of responding by eliminating the discriminatory aspect of the tax and allowing the tax imposed on the domestic taxpayer to remain the same. *McKesson Corp. v. Div. of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 39-40 (1990). Therefore, a finding that the Policy exception violates the Interstate Commerce Clause – which it does not – would produce no different result for Verisign.

III. <u>ANSWER TO ISSUE 3 ON CROSS APPEAL</u>: THE DIVISION'S POLICY DOES NOT VIOLATE THE U.S. CONSTITUTION'S FOREIGN COMMERCE CLAUSE

A. QUESTION PRESENTED

With respect to a question not reached by the Superior Court, Op. 25–26, n.127, does the Division's Policy violate the U.S. Constitution's Foreign Commerce Clause by treating foreign subsidiary dividends less favorably than domestic subsidiary dividends?

B. SCOPE OF REVIEW

Questions of law and constitutional claims are reviewed de novo. *Wilmington Hous. Auth.,* 88 A.3d at 661 (citations omitted).

C. MERITS OF ARGUMENT

Verisign describes its Foreign Commerce claim as follows: "[1] [E]ntities other than Verisign in the Verisign Group received foreign dividends . . . .[2] The Division's Audit Manual does not allow a deduction for those foreign subsidiary dividends. [3] [T]hose dividends . . . reduced Verisign Group's consolidated NOL. [4] [I]f those dividends had been from domestic subsidiaries, the Division would have allowed a deduction . . . ." Verisign Br. 53-54. Verisign's claim is wrong on multiple grounds and there is no basis for contending that the Division's Policy violates the Foreign Commerce Clause.

To begin, none of the actions Verisign attributes to the Division or to the Division's Audit Manual are, in fact, attributable to the Division or the State of

Delaware. The alleged difference in treatment complained of by Verisign between the dividends received from domestic subsidiaries and from foreign subsidiaries of Verisign Group is the product of federal law, *i.e.*, the IRC and related Treasury Regulations. There is nothing in the Division's Policy or Audit Manual that is responsible for any difference in the treatment of dividends that may take place in the calculation of Verisign Group's consolidated NOL. The Division's Policy simply takes Verisign Group's consolidated NOL as it appears on its filed federal return. Thus, it is federal law, and not anything Delaware has done, which causes Verisign's Group's consolidated NOL to be lesser in amount because foreign subsidiary dividends are treated less favorably than domestic subsidiary dividends.

The fact that Verisign Group's consolidated NOL is the product of federal law and not any action or calculation performed by the Division is amply supported by the record in this case. Verisign's Amended Complaint, thus, states that the "taxable income" imposed by Delaware's corporation income tax is ultimately derived from the "'entire net income of a corporation' [which] is defined as 'its federal taxable income for such year as computed for purposes of the federal income tax' subject to Delaware-specific modifications not relevant to this case. 30 *Del. C* § 1903(a)." Am. Compl. ¶ 5(a)(1), A26-27. Delaware's Rule 30(b)(6) witness testified (without contradiction) that for purposes of determining a consolidated group's NOL and an individual corporate taxpayer's NOL, the Division and its auditors look solely to the

NOL calculated by the taxpayer pursuant to the IRC. Johns Dep. 26:11-18. A156; 73:19-74:5, A163-164; 77:2-13, A167. The Division's Tax Instructions for the relevant years also require taxpayers to calculate the NOL under federal law, *i.e.*, under the IRC and related Treasury Regulations. *See* A175.

Moreover, as Verisign states in its brief, it was "entities other than Verisign in the Verisign Group [that] received foreign subsidiary dividends, including over ██████████ of dividends in 2014." Verisign Br. at 53 (citing SF ¶ 24, B40-41). Since the entities that received the foreign dividends were "other than Verisign," those foreign dividends received by Verisign Group were not before the Division when it issued its tax assessments to Verisign. Verisign's 2015 and 2016 Delaware corporate tax returns reported no dividends whatsoever from subsidiaries, whether foreign or domestic. A136, A145. Indeed, Verisign's Rule 30(b)(6) witness testified that the Division and its auditors do not have insight into the Verisign Group's calculation of its consolidated NOL. Deposition of Alison Malloy, 39:9-40:6, A122-123.

Verisign relies – incorrectly – on *Kraft Gen. Foods v. Iowa Dep't of Revenue,* 505 U.S. 71 (1992), to support its Foreign Commerce Clause claim. In *Kraft,* it was Iowa's tax laws that taxed the dividends received from foreign subsidiaries of the Iowa corporation but did not tax dividends received from domestic subsidiaries. 505 U.S. at 72-73. The Iowa taxpayer in that case operated a unitary business throughout

the United States and in several foreign countries, including six subsidiaries that were incorporated in and conducted their business in a foreign country. *Id*. at 72. The taxpayer before the Supreme Court, thus, was not comparable to Verisign, the Delaware corporate taxpayer in this case, which in the years in question reported no income from foreign subsidiaries.

The court in *Kraft* determined "that a State's preference for domestic commerce over foreign commerce is inconsistent with the Commerce Clause even if the State's own economy is not a direct beneficiary of the discrimination." *Id*. at 79. As the court repeatedly emphasizes, the constitutional violation derives from the fact "that *Iowa* imposes a burden on foreign subsidiaries that it does not impose on domestic subsidiaries." *Id*. at 80 (emphasis in original); *see also id.* at 81 ("[A] State may not advance its legitimate goals by means that facially discriminate against foreign commerce." (citations omitted)).

Verisign, in its brief, references no provision of Delaware law nor any Delaware policy that, on its face, discriminates against foreign subsidiaries of Delaware taxpayers, such as would make this case comparable to *Kraft.* By the same token, Verisign can point to no dividends from foreign subsidiaries of Verisign that were reported on its 2015 and 2016 Delaware corporate tax returns, because no such dividends were reported. Therefore, there could not have been any imposition of a discriminatory Delaware tax on foreign dividends as was the case in *Kraft*.

Two states have rejected Verisign's proposed extension of *Kraft* to a State's use of federal NOLs. In the first case, a Florida taxpayer contended that Florida's limitation of an NOL on a state return to the federal NOL claimed on its federal return discriminated against foreign corporate dividends. *Colgate-Palmolive Co. v. Fla. Dep't of Revenue,* 988 So. 2d 1212 (Fla. Dist. Ct. App. 2008); *accord World Fuel Servs. Corp. v. Fla. Dep't of Revenue*, 23 So. 3d 1293 (Fla. Dist. Ct. App. 2010). The Florida court upheld the State's use of the federal NOLs as a limitation on state returns from attack under *Kraft,* since the Florida law did "not treat domestic subsidiaries [of Florida taxpayers] dissimilarly from foreign subsidiaries." 988 So. 2d at 1221. Similarly, in this case, Delaware's Policy does not favor domestic over foreign subsidiaries, since Verisign is not reporting income from any subsidiary.

In the second case, which is strikingly similar to this case, an Indiana taxpayer manually created a line on its Indiana tax return in order to deduct its foreign source dividends in calculating its NOLs, increasing the amount of NOLs it was claiming, relying upon *Kraft*. *Ind. Dep't of State Revenue v. Caterpillar, Inc.,* 15 N.E.3d 579 (Ind. 2014). The Indiana Supreme Court rejected the taxpayer's Foreign Commerce Clause claim, holding that "*Kraft* does not address how treatment of foreign source dividend deductions apply to NOLs, and we decline Caterpillar's invitation to extend *Kraft's* holding to the NOL context." *Id.* at 587.

For these reasons, the Division's Policy neither violates the Foreign Commerce Clause nor does it render Delaware's corporate income tax unconstitutional. Verisign, thus, fails to establish that the Division's assessment of additional taxes on Verisign for calendar years 2015 and 2016 violates the U.S. Constitution's Foreign Commerce Clause.

IV. <u>REPLY IN SUPPORT OF SOLE ISSUE ON APPEAL</u>: THE SUPERIOR COURT ERRED BY HOLDING THAT THE DIVISION'S POLICY VIOLATED DELAWARE'S UNIFORMITY CLAUSE

A. QUESTION PRESENTED

Did the Superior Court err by holding that the Division's Policy violates Delaware's Uniformity Clause, Del. Const. art. VIII, § 1?

B. SCOPE OF REVIEW

The Delaware Supreme Court reviews a trial court's decision to grant summary judgment de novo. *In re Krafft-Murphy Co.,* 82 A.3d 696, 702 (Del. 2013). Courts recognize that when implementing a specific and detailed statutory directive, an agency like the Division has the authority and discretion to adopt policies and practices implementing judicial principles of decision derived from previous decisions and rulings. *Free-Flow Packaging Int'l, Inc. v. Sec'y of the Dep't of Natural Res. & Env't Control*, 861 A.2d 1233, 1236 (Del. 2004); 29 *Del. C.* § 10113.

C. MERITS OF ARGUMENT

Both the Superior Court and Verisign wrongly assert that the Division's limit on allowable NOLs divides taxpayers "on the basis of their federal filing status" in violation of Delaware's Uniformity Clause, Del. Const. art. VIII, § 1. Op. at 24; Verisign Br. at 34. As explained at length above, all Delaware corporate taxpayers are permitted to claim an NOL on their state tax returns but, under 30 *Del. C.* § 1903(a), that claimed loss may not exceed the amount computed and reported by the taxpayer "for purposes of the federal income tax" on their filed federal return. This

is a uniform limitation applied to all Delaware corporate taxpayers irrespective of whether the taxpayer elected to compute their federal returns on a stand-alone or consolidated basis. A taxpayer's maximum allowable NOL on its state return is therefore exclusively the result of a taxpayer's choice and is not the result of the Division imposing a differential limit on allowable NOLs. To the extent a classification is created, however, the Superior Court also erred in holding that because the Division "acted alone" in establishing the Policy, the Division could not rely upon the "reasonableness of the classification" standard established in *Wilmington Med. Ctr., Inc. v. Bradford,* 382 A.2d 1338, 1344 (Del. 1978). Op. at 24-25.

1. The Division's Policy Does Not Divide Taxpayers "On The Basis Of Their Federal Filing Status"

The Division's Policy takes the NOL reported by corporate taxpayers to federal authorities as a singular limit on the allowable discretionary NOL deduction for state tax purposes for all Delaware corporate taxpayers irrespective of how the taxpayer computed that loss under the federal rules and even though that taxpayer must report stand-alone corporate income on their Delaware state income tax return. The Superior Court's reliance on the reasoning in *Burpulis v. Dir. of Revenue,* 498 A.2d 1082 (Del. 1985) to hold that this Policy unconstitutionally divides taxpayers "on the basis of their federal filing status . . . and then applies a limitation to one but not the other" is misplaced. Op. 24. In *Burpulis*, this Court found that allowing the

"two-earner married couple deduction in Delaware" would benefit taxpayers "by virtue of their married status while single taxpayers would suffer" because only married individuals can claim the federal deduction, and then subsequently use that federal deduction to their advantage on separate state income tax returns. 498 A.2d at 1087. The situation in *Burpulis* is manifestly not analogous to this case.

Unlike the two-earner married couple deduction in *Burpulis*, the availability of an NOL deduction at the federal level is not dependent on whether a corporation files as a single corporation or as a member of a consolidated group. Nor does federal tax filer status prevent Delaware corporations from claiming the benefit of an NOL deduction on their Delaware state tax returns "to the extent of the amount recognized for Federal purposes." Tax Instructions, A175. A Delaware corporation's NOL "recognized for Federal purposes," and therefore allowable on state returns, is not dictated by Delaware law or Division policy.

Verisign, like any Delaware corporation, is free to file stand-alone federal tax returns and compute its stand-alone NOL for federal tax purposes under the IRC and subsequently claim that same IRC-computed stand-alone NOL on its state returns. Verisign elected to file federal consolidated returns (SF ¶ 3, B34) – presumably because that was financially advantageous to Verisign and Verisign Group's members. As a consequence, since Delaware only recognizes NOLs in Delaware "to the extent of the amount recognized for Federal purposes," Verisign was unable to

claim an NOL greater than the consolidated loss it reported at the federal level. In no sense has Verisign, therefore, been forced by Delaware to "suffer" by virtue of its federal tax election, given that its election was entirely voluntary and presumably made after consideration of the overall federal and state tax consequences of its election.

Rather than rely solely on the Superior Court's flawed reasoning, Verisign also argues that because all Delaware corporations are entitled to an "NOL deduction computed under the IRC," the Division's Audit Manual "creates non-uniformity where none existed before" by adopting a "consolidated NOL" limitation that "is very different than the NOL deduction under the IRC." Verisign Br. at 33-34. As demonstrated in Section I.C. of Appellant's Argument above, Verisign's assertion is both legally unsupported and factually incorrect. Consequently, Verisign's alternate argument that the Division's Policy creates differential treatment based on a taxpayer's federal filing status is equally flawed.

First, Delaware law does not grant Verisign or any other Delaware corporation the right to claim an NOL calculated on a stand-alone basis under the IRC on their state tax returns. *See* Section I.C. of Argument above. The Division need not recognize ***any*** NOL deduction for state tax purposes, much less an NOL calculated on a stand-alone basis. *See Cluett,* 1985 Del. Super. LEXIS 1089, at *7-8 (noting that the permissibility of a deduction such as an NOL is a discretionary matter and

is a matter "of legislative grace" (citing *Cagle v. C.I.R.,* 539 F.2d 409, 416 (5th Cir. 1976); *Fisher v. Comm'r of Internal Revenue*, 230 F.2d 79, 80 (7th Cir. 1956); 71 Am.Jur.2d State and Local Taxation § 518 (1973))). The Division could disallow deductions for NOLs altogether, and the fact that the Division has allowed, based on the text of 30 *Del. C*. § 1903(a), Delaware corporate taxpayers to claim an NOL not in excess of that "computed for the purposes of the federal income tax," does not give taxpayers the right to re-compute that federal deduction on a stand-alone basis for state tax purposes simply because Delaware law specifies the IRC as the starting point for computing income for state tax purposes. Verisign has cited no authority to support its contrary contention.

Second, Verisign's attempt to manufacture an alleged differential limit for NOLs by misrepresenting the Division's Policy as a "consolidated NOL" limit adopted in the Division's Audit Manual should be rejected.[6] The Division's Policy is not "adopted" in its Audit Manual nor does the Division's Policy impose a "consolidated NOL" limit. The Audit Manual language selectively quoted by

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[6] In all of its briefing below and in the Stipulated Facts, the Division has made clear that its Policy limits allowable NOLs "to the extent of the amount recognized for Federal purposes." SF ¶¶ 31, 32, B42-43; Tax Instructions, A175; Mem. in Supp. of Def.'s Mot. for Summ. J. at 14-18, 20; Answering Br. in Opp. to Pl.'s Mot. for Summ. J. at 13-19; 20-21; 22; Reply Br. in Supp. of Def.'s Mot. for Summ. J. at 3-6. The Division has never stipulated that its Policy comes from its Audit Manual or that the limitation is a "consolidated NOL" limitation.

Verisign speaks in terms of a "consolidated NOL" because that specific bullet point applies only to the review of state returns of Delaware corporations who elected to file as a member of a consolidated group at the federal level. *See* Section I.C.2 of Argument above. For those corporations, like Verisign, the NOL "recognized for Federal purposes" is a consolidated NOL.

Verisign's argument that "the Division's audit manual limits a taxpayer's NOL under the IRC to the 'consolidated NOL' only if the corporation files a consolidated federal return" therefore has it exactly backward.[7] Verisign Br. at 40. The Division's Audit Manual only speaks in terms of a consolidated NOL after confirming that the tax returns under review were filed by a corporation which elected to file federal consolidated returns. The portion of the Division's Audit Manual relied on by Verisign thus merely recognizes that the NOL "recognized for Federal purposes" for taxpayers that elected to file consolidated federal returns is a consolidated NOL. It is, in fact, only these taxpayers that have computed and reported a consolidated NOL for federal purposes in the first instance.

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[7] As explained above, the Division did not attempt to "distort the actual stipulated facts," Verisign Br. at 41, but rather inadvertently included the facts submitted with its Motion for Summary Judgment. The lack of the term "consolidated NOL" in the Division's opening brief is not "poignant." The Division's Policy limits allowable NOLs on state returns "to the extent of the amount recognized for Federal purposes." Tax Instructions, A175. Whether the federally recognized loss represents a consolidated or a stand-alone NOL is utterly independent of the Division's Policy and entirely the result of a taxpayer's federal income tax election.

Limiting the allowable NOL for state tax purposes under the Division's Policy to the taxpayer's federally reported loss that may be calculated under two different methods at the election of the taxpayer does not convert the results of that election into a classification created by the Division's Policy. Nor does the Audit Manual's direction to confirm that "the NOL amount does not exceed the consolidated amount of the current year NOL" when reviewing the state returns of corporations which elected to file consolidated federal returns adopt a "consolidated NOL" limitation. B123. There is nothing in Delaware's tax code or the Division's Policy that imposes a differential limit on NOLs based on federal tax filing status. The Superior Court should be reversed.

2. <u>To The Extent A Classification Is Created, It Is Reasonable and Therefore Constitutional</u>

Assuming the Division had adopted a classification (which it did not), the Superior Court wrongly held that the classification allegedly created by the Division's Policy is not entitled to the "reasonableness" standard of *Wilmington Med. Ctr.,* 382 A.2d at 1344. The Superior Court's refusal to apply this standard is premised on the erroneous conclusion that the Division "acted alone in treating Delaware corporate taxpayers differently depending on whether they file their federal returns as consolidated groups or separate corporations" and that therefore the Division is not entitled to the same deference as would be accorded the Delaware General Assembly under the Uniformity Clause. Op. 25. What both the Superior

Court's and Verisign's analysis fails to recognize is that having found that the Division's Policy is specifically grounded in the "for purposes of the federal income tax" language in 30 *Del. C.* § 1903(a), any classification created by the Division's Policy results from the application of legislatively-adopted statutory language. *See Cluett*, 1985 Del. Super. LEXIS 1089, at *6-8 (analyzing Decision of State Tax Board, Docket Nos. 238, 239 (July 27, 1962)); Op. at 16.

As a result, to the extent the Division's Policy creates a classification, because that classification results from the legislative language of 30 *Del. C.* § 1903(a) and, because Delaware law expressly authorizes the Secretary of Finance to "make rules, regulations and decisions not inconsistent with this title . . . as the Secretary deems necessary to enforce any state tax" under 30 *Del. C.* § 354, the classification is constitutional under Delaware's Uniformity Clause "if any set of facts can reasonably be conceived which will sustain such classification." *Wilmington Med. Ctr.*, 382 A.2d at 1344 (quoting *Aetna Casualty & Surety Co. v. Smith*, 131 A.2d 168, 177 (Del. 1957); *Conard v. State*, 16 A.2d 121, 125 (Del. Super. Ct. 1940)).

Verisign's argument that the Division does not adequately provide reasons sustaining the alleged classification created by the Policy should be summarily rejected. Under Delaware law, it is objectors like Verisign who assert that a tax scheme was enacted in violation of the Uniformity Clause that bear the burden of

establishing unconstitutionality, which in this case requires showing that the classification is unreasonable. *Conard*, 16 A.2d at 125.

Moreover, the U.S. Supreme Court has long recognized that tax regimes which rely on formal accounting are "subject to manipulation and imprecision and often ignore[] or capture[] inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 164-65 (1983) (citing *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 438-39 (1980)). As explained in its opening brief, the Division's Policy could thus be sustained on the ground that because the NOL of each member of a corporate group on a stand-alone basis is not reported to the IRS, and is therefore not subject to audit by the IRS, the Division's Policy attempts to limit (although not prevent) manipulation and imprecision in stand-alone reporting when a member of a consolidated corporate group files as a separate entity in Delaware. Appellant's Opening Br. at 27-28. Not only are these facts supporting the alleged classification created by the Division's Policy reasonably conceived, the facts have been recognized for decades by the U.S. Supreme Court.

Verisign's additional arguments that the Division "self-deputize[d] itself with rational basis deference" and that Division's Policy is "nonsensical," "irreconcilable" with the purpose of Delaware's tax code, "arbitrary" and "could not

pass any level of scrutiny" are not well founded. Verisign Br. at 43-44. First, Delaware's legislature specifically "deputized" the Secretary of Finance with the power to "make rules, regulations and decisions not inconsistent with this title . . . as the Secretary deems necessary to enforce any state tax." 30 *Del. C.* § 354.

Second, the Division's Policy has been in place since at least 1986, has been consistently enforced against corporate taxpayers since that time and has been found by the State Tax Board and two Delaware Superior Courts to be consistent with the language of *30 Del C.* § 1903(a). SF ¶¶ 35, 36, B44; *Cluett*, 1985 Del. Super. LEXIS 1089, at *6-8 (Del. Super Ct. Jan. 22, 1985) (analyzing Decision of State Tax Board, Docket Nos. 238, 239 (July 27, 1962)); Op. at 16. While Verisign may assert that the decisions specifically approving the Division's Policy were wrongly decided, Verisign cannot credibly claim that a 30+ year old policy that has been repeatedly held to be consistent with Delaware law was nevertheless enacted by the Division without authorization, is "irreconcilable" with the purpose of Delaware's tax code, or is "nonsensical," "arbitrary" or unable to "pass any level of scrutiny." To the contrary, the Division's Policy, which includes consulting the consolidated returns of a Delaware taxpayer, has twice passed judicial scrutiny and been found to be well within the Division's authority to grant discretionary deductions, reconcilable with the purpose of Delaware's tax code, and consistent with Delaware law. *Cluett*, 1985 Del. Super. LEXIS 1089, at *6-8; Op. at 16. In *Cluett*, the Division's Policy was

specifically found not to violate Delaware's Uniformity Clause, Del. Const. art. VIII, § 1. 1985 Del. Super. LEXIS 1089, at *9-10.

The Superior Court's determination that the Division's Policy violates Delaware's Uniformity Clause, Del. Const. art. VIII, § 1 should be reversed.

CONCLUSION

For the foregoing reasons, the Superior Court's determination that the Division's Policy violates the tax-uniformity provision of Article VIII, § 1 should be reversed, and Verisign should be ordered to pay its outstanding tax assessments for tax years 2015 and 2016.

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