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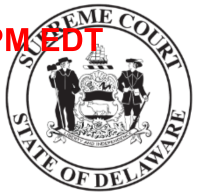

IN THE SUPREME COURT OF THE STATE OF DELAWARE

DIRECTOR OF REVENUE,	)	
	)	
Defendant-Below, Appellant/Cross-Appellee	)	Case No. 18, 2021
	)	
	)	Court Below:
v.	)	Superior Court of the
	)	State of Delaware
VERISIGN, INC.,	)	C.A. No. N19C-08-093 JRJ
	)	
Plaintiff-Below, Appellee/Cross-Appellant.	)	**PUBLIC VERSION** **FILED APRIL 23, 2021**
	)	

APPELLEE/CROSS-APPELLANT'S CORRECTED OPENING BRIEF AND ANSWERING BRIEF TO APPELLANT/CROSS-APPELLEE'S OPENING BRIEF

Dated: April 20, 2021

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NATURE OF PROCEEDINGS

VeriSign, Inc. ("Verisign") timely filed its Delaware corporate income tax returns for the years 2015 and 2016 with the Delaware Division of Revenue ("Division").[1] On October 23, 2018, the Division issued Tax Advisory Notices assessing tax against Verisign of [redacted] (plus interest and penalties).[2]

Verisign timely protested that assessment under 30 *Del. C.* § 523, which the Division denied on April 9, 2019.[3] On June 10, 2019, Verisign timely filed a petition with the Tax Appeal Board appealing the Division's assessment,[4] which Verisign removed to the Superior Court of the State of Delaware on August 8, 2019.[5] The parties filed cross-motions for summary judgment. Because the parties stipulated that there were no issues of material fact, the Superior Court issued a final decision on the merits based on the parties' stipulated facts and record submitted with the motions.[6]

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[1] Pre-Trial Stip. ¶ B.12, B36.
[2] Pre-Trial Stip. ¶ B.26, B41; Corp. Income Tax Advisory Notices to VeriSign, Inc. (Oct. 23, 2018), A40–43.
[3] Pre-Trial Stip. ¶ B.27, B41; Notice of Determination to VeriSign, Inc. (Apr. 9, 2019), A45–48.
[4] Pre-Trial Stip. ¶ B.28, B42; Form A-4, Petition Corporation Deficiency (Jun. 10, 2019), A50–51.
[5] Pre-Trial Stip. ¶ B.28, B42; 30 *Del. C.* § 333(b)(1); Notice of Removal (Aug. 8, 2019), A69–70.
[6] Pre-Trial Stip. ¶ C, B44–45; Sup. Ct. Op. 9, B10.

On December 17, 2020, the Superior Court issued its Opinion, and on December 23, 2020, its Final Order, granting Verisign's motion for summary judgment, and denying the Division's motion for summary judgment.[7] On January 15, 2021, the Division filed its Notice of Appeal to this Court. On January 20, 2021, Verisign filed its Notice of Cross-Appeal.

[7] Sup. Ct. Order 1, B1; Sup. Ct. Op. 26, B27.

SUMMARY OF ARGUMENT

I. ISSUE 1 ON CROSS-APPEAL: THE TRIAL COURT ERRED BY CONCLUDING THE DIVISION'S AUDIT MANUAL LIMITATION IS CONSISTENT WITH DELAWARE STATUTE.

1. This litigation is a dispute between Delaware statute and an extra-statutory limitation found in the Division's audit manual. The Division recognizes its audit manual limitation is "not in the statute,"[8] it is inconsistent with the Division's interpretation of Delaware law in every other context,[9] and no one at the Division knows why the limitation was adopted.[10] Yet, the Division seeks to impose its audit manual limitation on Verisign through this litigation.[11]

2. Title 30 Sections 1902(a) and 1903(b) impose a tax on each stand-alone corporation's "entire net income." Section 1903(a) defines entire net income as "federal taxable income," under the IRC.[12] Verisign's federal taxable income under the IRC for the years at issue was ███. The parties do not dispute these points.[13]

3. The issue in this litigation is the validity of the Division's audit manual limitation that seeks to limit one of Verisign's stand-alone deductions

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[8] Dep. of Div. of Revenue ("Div. Dep.") 64:13–64:23, Oct. 1, 2020, B69.
[9] *See, e.g.*, Pre-Trial Stip. ¶ B.7, B35.
[10] Div. Dep. 54:15–55:22, 63:1–63:12, B66–68.
[11] Pre-Trial Stip. ¶ B.8, B35, ¶ B.21, B40.
[12] *See also* 30 *Del. C.* § 1901(10).
[13] Pre-Trial Stip. ¶ B.7, B35 and ¶ B.17, B38.

under the IRC: the net operating loss or "NOL" deduction.[14] The Division's audit manual limitation states that "[i]f 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."[15]

4. The Division says Verisign must first compute its NOL under the IRC as required by Delaware statue, *but must then* apply its audit manual limitation to its NOL deduction.[16] Appling its audit manual limitation, the Division says Verisign must limit its own NOL deduction to the "consolidated net operating loss" computed by the federal consolidated group of which Verisign is a member (the "Verisign Group").[17]

5. The "consolidated NOL" deduction is available only to a group of affiliated corporations that join together to file a single consolidated federal income tax return as a taxable unit (a "consolidated group").[18] Rather than compute its

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[14] Pre-Trial Stip. ¶ B.8–10, B34–35. An NOL is, essentially, a loss in one year that may be carried over and deducted in a subsequent year. For example, if a taxpayer has a $100 loss in Year 1 and $100 of income in Year 2, the taxpayer may carry the $100 loss from Year 1 into Year 2 and deduct that loss against the $100 of income in Year 2. The overall result is zero taxable income in Year 2, which conforms the tax result with the economics of the business. *See* IRC § 172. All references to the IRC are to 26 USC § 1 *et seq.* in effect during the tax years at issue.
[15] Pre-Trial Stip. ¶ B.9 (emphasis added), B36; BMF Audit & Reconciliation System 327, B123.
[16] Pre-Trial Stip. ¶ B.8, B35, ¶ B.26, B41.
[17] *Id.*
[18] IRC § 1501.

own federal taxable income under the IRC, a consolidated group computes group-wide income and deductions as a single taxable unit under special regulations promulgated by the U.S. Treasury.[19] Rather than an "NOL" deduction under the IRC, the consolidated group is allowed a "consolidated NOL" under the Treasury Regulations.[20]

6. Because the consolidated NOL of a consolidated group is a function of the income and deductions of a group of corporations, the consolidated NOL deduction of the consolidated group is different (sometimes greater; sometimes lesser) than the NOL of each individual corporation that make up the group.[21]

7. The Division's audit manual limitation cannot be reconciled with its interpretation of the statute in every other context. The Division disallows corporations from filing a consolidated Delaware income tax return, so in every other context requires each taxpayer to compute its own income and deductions without regard to the income and deductions of its affiliates.[22] Yet, the Division

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[19] Treas. Regs. §§ 1.1502-2, -11. Consolidated tax returns are filed in accordance with federal tax regulations. *See* Treas. Regs. §§ 1.1502-0 *et seq*. Those regulations provide definitions for the tax base that are different from the statutory definitions under the Internal Revenue Code. For example, tax is imposed on "consolidated taxable income" as defined by Treas. Reg. § 1.1502-11, not "taxable income" under IRC § 63.

[20] *Compare* IRC § 172(c) (excess of deductions over gross income under IRC § 61), *with* Treas. Reg. § 1.1502-21(e) (excess of consolidated deductions over consolidated gross income computed under Treas. Reg. § 1.1502-11(a)).

[21] *Id.*

[22] Pre-Trial Stip. ¶ B.6–7, B35.

insists it may limit a taxpayer's own "NOL" deduction to the "consolidated NOL" that is reported on the consolidated federal income tax return of the federal consolidated group that the stand-alone Delaware corporation is a member, and is a function of the income and deductions of the taxpayer's affiliates.[23]

8. In this case, the Division's audit manual limitation works to Verisign's detriment because the Verisign Group's consolidated NOL was less than Verisign's own NOL computed under the IRC.[24] Without its audit manual limitation, the Division agrees that Verisign's NOL computed under the IRC reduces its federal taxable income, and its Delaware tax, to ███.[25]

9. The Division's audit manual limitation is "not in the statute," it is inconsistent with the Division's interpretation of Delaware law in every other context, and no one at the Division knows why they adopted it.[26] It must therefore be rejected.

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[23] Pre-Trial Stip. ¶ B.8, B35 (emphasis added).
[24] *Compare* Pre-Trial Stip. ¶ B.17, B38 *with* Pre-Trial Stip. ¶ B.25, B41.
[25] Pre-Trial Stip. ¶ B.17, B38, ¶ B.26, B41.
[26] Div. Dep. 54:15–55:22, 63:1–63:12, 64:13–64:23, B66–69; *see, e.g.*, Pre-Trial Stip. ¶ B.7, B35.

II. SOLE ISSUE ON APPEAL: THE TRIAL COURT WAS CORRECT THAT THE DIVISION'S AUDIT MANUAL LIMITATION VIOLATES THE DELAWARE CONSTITUTION'S UNIFORMITY CLAUSE.

A. VERISIGN'S SUMMARY OF ARGUMENT

10. Delaware statute is uniform in its application because it requires every corporation to file a stand-alone corporate income tax return and to compute its taxable income on the basis of its own income and deductions.[27] Thus, Delaware statute entitles all taxpayers to an NOL deduction computed in the same manner.

11. The Division's audit manual limitation upsets that uniformity by limiting the NOL deduction by reference to the income earned by affiliates for some, but not all taxpayers. The Division applies its audit manual limitation to those that file a consolidated federal income tax return with its affiliates, but does not apply its limitation to those that do not.[28] Applying the Division's audit manual limitation, a taxpayer's NOL deduction is computed on the basis of its own income and deductions—unless the taxpayer files a consolidated federal return with its affiliates. In that case, a taxpayer's NOL is limited to the "consolidated" NOL that is based on the income and deductions of a taxpayer's affiliates. The Division's audit manual limitation bases its differential treatment on a taxpayer's

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[27] Pre-Trial Stip. ¶ B.6–7, B35.
[28] Pre-Trial Stip. ¶ B.6–8, B35.

federal filing status (stand alone or consolidated) even though Delaware statute and the Division do not permit corporations to file consolidated Delaware income tax returns.[29]

12. Because the Division does not have authority to create a classification based on federal filing status that Delaware statute eschews, the Division's audit manual limitation violates the Delaware Constitution's Uniformity Clause.[30]

B. VERISIGN'S RESPONSE TO DIRECTOR'S SUMMARY OF ARGUMENT

I. Denied. The Superior Court was correct that the Division's audit manual limitation that limits a taxpayer's own NOL deduction to the consolidated NOL deduction of a consolidated group divides corporate taxpayers into groups on the basis of federal filing status. The Division seeks to avoid the uniformity violation by recharacterizing its audit manual limitation as a single limitation that applies equally to all taxpayers. That recharacterization is directly contradictory to the Division's own audit manual, and its stipulations and testimony in this case. The Division cannot avoid the consequences of its audit manual limitation by recharacterizing it for this litigation.

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[29] *Id.*

[30] Sup. Ct. Op. 25, B26; Del. Const. art. VIII, § 1; *see Burpulis v. Dir. of Revenue*, 498 A.2d 1082 (Del. 1985).

II. Denied. The Superior Court was correct that the classification created by the Division's audit manual limitation violates the Uniformity Clause. By adopting 30 *Del. C.* §§ 1902(a) and 1903(a)–(b), the General Assembly granted every taxpayer an NOL deduction computed on the basis of its own income and deductions, and for that reason, is uniform in its application. The Director's audit manual limitation creates non-uniformity where none existed before because it seeks to limit some (but not all) taxpayers' own NOL deductions to a consolidated NOL deduction that is computed on the basis of affiliate income. The Director does not have authority to create such a classification.

III. ISSUE 2 ON CROSS-APPEAL: THE TRIAL COURT ERRED BY CONCLUDING THE DIVISION'S AUDIT MANUAL LIMITATION DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE.

13. Even if the Division's audit manual limitation were consistent with Delaware law, the audit manual limitation violates the U.S. Constitution's Commerce Clause's "virtually *per se*" prohibition against favoring in-state over out-of-state commerce.[31]

14. The Division applies its audit manual limitation only to taxpayers that choose to be affiliated with a corporation that does no business in Delaware,

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[31] *See Or. Waste Sys. v. Dep't of Envtl. Quality*, 511 U.S. 93, 100–01 (1994).

thereby facially favoring in-state over out-of-state commerce.[32] Because there is no de minimis defense to facial discrimination, the Division's limitation is invalid under the U.S. Constitution's Commerce Clause.[33]

15. Verisign is entitled to be treated the same as taxpayers who choose to be affiliated solely with corporations that do business in Delaware, and deduct its own NOL without regard to the Division's audit manual limitation.

IV. ISSUE 3 ON CROSS-APPEAL: THE DIVISION'S AUDIT MANUAL LIMITATION CREATES AN UNCONSTITUTIONAL RESULT UNDER THE U.S. CONSTITUTION'S FOREIGN COMMERCE CLAUSE.

16. The Division's audit manual limitation adopts the federal consolidated NOL that treats foreign subsidiary dividends less favorably than domestic subsidiary dividends, and the Division does not correct that disparate treatment.[34] The Supreme Court's decision in *Kraft General Foods v. Iowa Department of Revenue* prohibits the Division from adopting a federal provision that treats foreign

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[32] Pre-Trial Stip. ¶ B.9–11, B36; U.S. Const. art. I, § 8, cl. 3; *see Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

[33] *Associated Indus. v. Lohman*, 511 U.S. 641, 648–649 (1994); *Fulton Corp.*, 516 U.S. at 334 n.3 (1996).

[34] This brief refers to dividends from subsidiaries incorporated under U.S. state law engaged in domestic commerce as "domestic subsidiary dividends," and refers to dividends from subsidiaries incorporated under laws other than U.S. state law engaged in foreign commerce as "foreign subsidiary dividends."

subsidiary dividends less favorably than domestic subsidiary dividends without correcting the disparate treatment.[35]

17. The Division has stipulated 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.[36] Because the Division has stipulated to the unequal treatment that renders the statute unconstitutional, this Court must reject the Division's audit manual limitation. Alternatively, the Division must correct the unequal treatment by recomputing its limitation in a manner that treats foreign subsidiary dividends and domestic subsidiary dividends equally.

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[35] 505 U.S. 71 (1992); U.S. Const. art. I, § 8, cl. 3.
[36] Pre-Trial Stip. ¶ B.29, B42.

COUNTER-STATEMENT OF FACTS

The Stipulated Facts. The parties stipulated to the facts in this case in the Pre-Trial Stipulation.[37] The Division's Opening Brief incorrectly calls its Statement of Facts "[t]he stipulated facts."[38] The actual stipulated facts in the Pre-Trial Stipulation are very different than the so-called "stipulated facts" the Division lists in its opening brief.

Verisign is attaching a chart that compares how the Division's so-called "stipulated facts" are inconsistent with the parties *actual* stipulated facts contained in the Pre-Trial Stipulation.[39]

One focus of the Division's changes was to eliminate the distinction between the "net operating loss" deduction and the "consolidated net operating loss" deduction. As explained in this brief, this word choice is important because a "consolidated net operating loss" and a "net operating loss" are defined terms that mean very different things.[40]

Further, the Division in its Statement of Facts ¶¶ 16 and 19 makes flat-out false statements, contrary to the stipulation of facts, that Verisign computed

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[37] Pre-Trial Stip. ¶ B, B34–44.
[38] Div. Opening Br. at 6 (emphasis added).
[39] *See* Ex. A.
[40] *Compare* IRC § 172(c) (NOL is excess of deductions over gross income under IRC § 61), *with* Treas. Reg. § 1.1502-21(e) (consolidated NOL is excess of *consolidated* deductions over *consolidated* gross income computed under Treas. Reg. § 1.1502-11(a)).

hundreds of millions of dollars of federal taxable income. It did no such thing. As stipulated by the parties in Pre-Trial Stipulation ¶ B.18, Verisign "completed its 2015 and 2016 Delaware corporate income tax return, form 1100, by reporting ██ federal taxable income."[41]

Verisign's Counter-Statement of Facts. Verisign and its affiliates operate critical internet infrastructure within the global Domain Name System ("DNS"). That includes, among other things, (i) operating two of the internet's 13 root servers; (ii) being the authoritative registry operator for the .com and .net generic top-level domains; and (iii) administering the operational systems for the .gov and .edu generic top-level domains.[42] Verisign was incorporated in Delaware in 1995, and is headquartered in Virginia.[43]

Verisign's income and deductions (not taking into account the net operating loss deduction itself) computed under the IRC on a stand-alone basis, and the resulting NOL generated, are summarized in Table 1.[44]

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[41] B38.
[42] A website's domain, such as "delaware.gov", indicates where it can be found on the internet.
[43] Pre-Trial Stip. ¶ B.1, B34.
[44] Pre-Trial Stip. ¶ B.13, B36–37.

Table 1: Verisign's own NOL generated 2005–2013

Tax Year	Gross Income (IRC § 61) (A)	Deductions (Allowable under the IRC) (B)	NOL (IRC § 172(c)) (B-A)
2005			
2006			
2007			
2008			
2009			
2010			
2011			
2012			
2013			

Therefore, Verisign had approximately [redacted] of losses generated in the years 2005 through 2013.[45]

As permitted under the IRC, and as adopted into Delaware law by 30 *Del. C.* §§ 1902(a) and 1903(a)–(b), Verisign carried forward its approximately [redacted] of NOLs generated in those years into the years 2014 through 2016 (years when it earned income) and deducted those NOLs on its Delaware returns in those years.[46] Verisign's taxable income before NOL deduction, its NOL deduction, and its taxable income computed under the IRC on a separate-company basis in 2015 and 2016 is summarized in table 2 below.[47]

[45] *Id.*
[46] Pre-Trial Stip. ¶ B.14–16, B37–38.
[47] Pre-Trial Stip. ¶ B.17, B38.

Table 2: Verisign's separate-company taxable income

	Taxable income before NOL deduction (A)	NOL deduction (IRC § 172) (B)	Taxable income (IRC § 63) (A-B)
2015	[redacted]	[redacted]	[redacted]
2016	[redacted]	[redacted]	[redacted]

In this way, Verisign filed its original Delaware tax returns by following 30 *Del. C.* §§ 1902(a) and 1903(a)–(b) and using its own federal taxable income under the IRC.[48]

The Division then applied its audit manual limitation by limiting Verisign's NOL deduction to the Verisign Group's "consolidated NOL" deduction, and assessed tax against Verisign.[49]

The Verisign Group's "consolidated NOL" deduction adopted by the Division's audit manual was very different than Verisign's own NOL deduction because other members of the Verisign Group had gross income and deductions much different than Verisign's.[50] This is because the Verisign Group's gross income and deductions included income and deductions from corporations other than

[48] Verisign's NOL carried out of the 2016 tax year was [redacted] That is because Verisign used NOL of [redacted] in 2014, [redacted] in 2015, and [redacted] in 2016 by claiming NOL deductions in each of those years to reduce its federal taxable income in each of those years to [redacted] Pre-Trial Stip. ¶ B.14–16, B37–38.

[49] Pre-Trial Stip. ¶ B.26, B41.

[50] Pre-Trial Stip. ¶ B.24, B40–41.

Verisign, and its income and deductions were computed under the Treasury Regulations (not the IRC).[51] (For example, other corporations in the Verisign Group received substantial dividend income, including over [redacted] of foreign dividend income in 2014.)[52] As a result, the Verisign Group's consolidated NOLs generated in prior years available as a deduction in 2015 and 2016 totaled only [redacted].[53]

The Division applied its audit manual limitation to disallow Verisign's own NOL deduction in 2015 and 2016 by limiting it to the consolidated NOL of the Verisign Group.[54] On that basis, the Division assessed tax against Verisign of [redacted] (plus interest and penalties).[55]

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[51] Pre-Trial Stip. ¶ B.22, B40.
[52] Pre-Trial Stip. ¶ B.24, B40–41.
[53] Pre-Trial Stip. ¶ B.25, B41.
[54] Pre-Trial Stip. ¶ B.26, B41.
[55] *Id.*; Corp. Income Tax Advisory Notices to VeriSign, Inc. (Oct. 23, 2018), A40–43.

ARGUMENT

I. ISSUE 1 ON CROSS-APPEAL: THE TRIAL COURT ERRED BY CONCLUDING THE DIVISION'S AUDIT MANUAL LIMITATION IS CONSISTENT WITH DELAWARE STATUTE.

A. Questions Presented

1. Is Verisign's Delaware tax computed on the basis of Verisign's own federal taxable income, taking into account Verisign's own net operating loss deductions, without regard to the Division's audit manual limitation that seeks to apply the consolidated net operating loss deductions of the Verisign Group?[56]

B. Scope of Review

This issue involves interpretations and applications of statutory provisions. Those determinations are questions of law that this Court reviews de novo.[57] This Court does not defer to interpretations of an administrative agency or the Trial Court.[58]

C. Merits of Argument

Delaware statute imposes tax under 30 *Del. C.* §§ 1902(a) and 1903(b) on each stand-alone corporation's "entire net income," which under 30 *Del. C.* § 1903(a), is "federal taxable income" under the IRC.[59] Federal taxable income is

[56] Pre-Trial Stip. ¶ D.1, B45.
[57] *Pub. Water Supply Co. v. DiPasquale*, 735 A.2d 378, 380–81 (Del. 1999).
[58] *Del. Dep't of Natural Res. & Envtl. Control v. Sussex Cnty.*, 34 A.3d 1087, 1090 (Del. 2011).
[59] *See also* 30 *Del. C.* § 1901(10).

gross income less deductions under the IRC, including the NOL deduction. In this way, Delaware's General Assembly allows each corporation an NOL deduction computed under the IRC.

Verisign computed and reported ███ federal taxable income under the IRC for the years at issue.[60] That is because Verisign generated NOL carryforwards of approximately ████████ in the years 2005 through 2013.[61] Verisign carried those NOLs into the years 2014 through 2016 to compute its NOL deduction in those years.[62] In those years, Verisign's own NOL deduction under the IRC reduced its taxable income under the IRC to ███.[63]

The Division's audit manual limitation seeks to limit a taxpayer's own NOL under Delaware statute and the IRC to the "consolidated NOL" deduction reported on the consolidated group of which the taxpayer is a member.[64] Although the Division argues its audit manual limitation is consistent with Delaware statute, the Division agrees with Verisign's statutory interpretation for the purpose of computing *every other* item of income and deduction.[65]

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[60] Pre-Trial Stip. ¶ B.17–18, B38.
[61] Pre-Trial Stip. ¶ B.13, B36–37.
[62] Pre-Trial Stip. ¶ B.14–17, B37–38.
[63] *Id*.
[64] Pre-Trial Stip. ¶ B.8, B35.
[65] *See, e.g.*, Pre-Trial Stip. ¶ B.7, B35.

The Superior Court did not reconcile how the Division's audit manual limitation is consistent with Delaware statute when the Division interprets the statute in every other context to require a corporation to compute its own income and deductions. The Superior Court simply "follow[ed] the precedent" of a prior 1985 Superior Court decision that is not relevant to the outcome of this case.[66]

The Division's audit manual limitation "is not in the statute," cannot be reconciled with its statutory interpretation in every other context, and must be rejected.[67]

1. Delaware imposes an income tax on each corporation based on that corporation's own federal taxable income, as defined by the Internal Revenue Code.

Title 30 Section 1902(a) imposes an income tax on the "taxable income" of "[e]very … corporation …." Title 30 Section 1903(b) defines Delaware "taxable income" of a corporation as that "portion of the entire net income of a corporation which is … apportioned to" Delaware.[68] In turn, 30 *Del. C.* § 1903(a) defines "entire net income," as "the amount of its federal taxable income" determined under the

[66] Sup. Ct. Op. 16, B17.
[67] Div. Dep. at 64:13–64:23, B69; *see, e.g.*, Pre-Trial Stip. ¶ B.7, B35.
[68] 30 *Del. C.* § 1903(b).

federal IRC.[69] Thus, Delaware's General Assembly set the starting point for computing the Delaware tax base as "taxable income" defined in the IRC.[70]

Under IRC § 63, "taxable income" is defined as a corporation's "gross income [under IRC § 61] minus the deductions" allowed by the IRC.[71] Relevant here, the IRC allows a deduction for losses incurred by the corporation in a prior year.[72] A prior year loss is called a "net operating loss" or "NOL" under the IRC.[73]

The definition of an NOL is simple: A corporation generates an NOL if that corporation's deductions exceed its income.[74] A corporation may then "carry over" that NOL to a future year in which that corporation has income.[75] The corporation may deduct the NOL in a future year in computing its "taxable income."[76] The idea behind the NOL deduction is to "permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year."[77]

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[69] *See also* 30 *Del. C*. § 1901(10) (defining "federal income tax" as the "tax imposed on corporations by the federal Internal Revenue Code….").
[70] The parties do not dispute these points. *See* Pre-Trial Stip. ¶ B.4, B34.
[71] The IRC imposes tax on a corporation's taxable income. IRC § 11(a).
[72] IRC § 172(a).
[73] *Id.*
[74] IRC § 172(c) (defining "net operating loss" as the "excess of … deductions allowed by [the IRC] over … gross income.")
[75] IRC § 172(b)(1)(A)(ii).
[76] IRC § 172(a) ("There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year….").
[77] *Libson v. Koehler*, 353 U.S. 382, 386 (1957).

The General Assembly granted corporations an NOL deduction by adopting federal taxable income as the starting point for the state tax base. That NOL deduction works because it is a function of the taxpayer's own income and deductions in prior years. Although Delaware law modifies that starting point through ten statutory additions and subtractions, none of those statutory modifications prevent a taxpayer from "set[ting] off its lean years against its lush years."[78]

Verisign incurred approximately of NOLs from 2005–2013 that Verisign carried into the 2014 year and beyond.[79] That is because Verisign's deductions allowed under the IRC exceeded its gross income under IRC § 61 for

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[78] 30 *Del. C.* § 1903(a) ("The 'entire net income' of a corporation . . . means the amount of its federal taxable income . . . increased by: (1) Any interest income . . . on [US] obligations . . . and (2) The amount of any deduction allowed for purposes of the federal income tax pursuant to [IRC] § 164 . . . federal taxable income shall be further adjusted by eliminating: a. Dividends . . . of foreign corporations . . . b. Interest income . . . from securities issued by the United States . . . c. Gains and losses from the sale or other disposition of securities issued by the United States . . . d. Any deduction allowed for depletion of oil and gas wells under [IRC] § 611 . . . e. . . . wages paid or accrued under . . . [IRC] § 280C . . . f. The cost . . . . of a renovation project to remove physical design features in a building that restrict the full use of the building by physically handicapped persons. . . . g. The "eligible net income" of an Edge Act corporation . . . . h. Any deduction, to the extent such deduction exceeds $30,000, for a net operating loss carryback as provided for in [IRC] § 172 . . . .").

[79] Pre-Trial Stip. ¶ B.13, B36–37.

each year from 2005 to 2013.[80] As a result, as defined by IRC § 172, Verisign generated an NOL for each year 2005 to 2013.[81]

In 2014, 2015, and 2016, Verisign's federal "taxable income" (before taking into account the NOL deduction itself) was [redacted] and [redacted] respectively.[82] Verisign carried its [redacted] of NOLs generated in the 2005–2013 periods to 2014, 2015, and 2016, and deducted them against its income in those years.[83] In this way, Verisign's stipulated NOL deduction computed under the IRC, as adopted into Delaware law by 30 *Del. C.* §§ 1902(a) and 1903(a)–(b), reduced its federal taxable income to [redacted] in these years.[84]

2. The Division's audit manual limitation "is not in the statute."

Applying its audit manual limitation, the Division says that regardless of whether Verisign itself had an NOL under the IRC, Verisign's NOL is limited to the <u>consolidated NOL</u> of the <u>Verisign Group</u>.[85] The parties have stipulated that "[i]t is the validity of this [limitation] that is the issue in this litigation."[86] The "consolidated NOL" the Division's audit manual adopts is not determined under the IRC but is

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80 *Id.*
81 *Id.*
82 Pre-Trial Stip. ¶ B.14–16, B37–38.
83 *Id.*
84 Pre-Trial Stip. ¶ B.17, B38.
85 Pre-Trial Stip. ¶ B.8, B35, ¶ B.21, B40.
86 Pre-Trial Stip. ¶ B.8, B35.

determined under Treasury Regulation § 1.1502-21, a special regulation that applies only to a group of corporations that file a consolidated return.[87] Therefore, we pause to explain the federal consolidated return regime to show its inapplicability under Delaware law.

a. The Division's audit manual limitation adopts a component of consolidated taxable income imposed on a group of corporations, which is entirely different from the taxable income imposed on a stand-alone corporation.

Under federal law, a group of affiliated corporations may elect to file a single, consolidated federal income tax return. If a group makes that election, the group is effectively treated as a single aggregate entity—distinct from the separate corporations that make up the group. The consolidated group thus does not compute and pay tax on the basis of any one member's federal "taxable income" under IRC § 63.

Instead, the group applies over 400 pages of special "consolidated return regulations" to compute "consolidated taxable income" on which tax is based.[88] Although that term sounds similar to the statutory term "taxable income," the term "consolidated taxable income" is not a term found in the IRC. Instead, "consolidated

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[87] Treas. Reg. § 1.1502-12.
[88] Treas. Regs. §§ 1.1501-2 to 1.1504-4. *See also* Treas. Reg. § 1.1502-2(a) ("The tax liability of a group for a consolidated return year is … The tax imposed by section 11(a) … on the consolidated taxable income for the year.").

taxable income" is a term defined entirely by the United States Treasury under a detailed set of Treasury regulations.[89]

"Consolidated taxable income" is essentially a composite of various items of income and deduction of all of the corporations that are members of the consolidated group as a whole.[90] For example, relevant here, the Treasury Regulations define the concept of a "consolidated NOL," which is computed on a different basis than the NOL computed under IRC § 172.[91] Naturally, therefore, the "consolidated NOL" of any group of affiliated corporations is different (sometimes greater; sometimes lesser) than the NOLs of the individual corporations that make up the group.

b. Delaware statute requires each corporation to compute its own stand-alone federal taxable income.

Delaware statute requires a corporation to compute its taxable income on a stand-alone basis, and does not adopt federal "consolidated taxable income" or the federal consolidated NOL computed and reported on a federal consolidated return filed with the federal government.

Title 30 Section 1902(a) imposes an income tax on the "taxable income" of "[e]very … corporation …." Here, the statutory language is important: Delaware

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[89] Treas. Regs. §§ 1.1502-0 *et seq.*
[90] Treas. Reg. § 1.1502-11(a).
[91] *Compare* IRC § 172(c) (excess of deductions over gross income under IRC § 61), *with* Treas. Reg. § 1.1502-21(e) (excess of consolidated deductions over consolidated gross income computed under Treas. Reg. § 1.1502-11(a)).

computes tax on a corporation-by-corporation basis (*i.e.*, "every corporation"); Delaware does not "require or permit the filing of a consolidated corporate income tax return."[92]

Then, 30 *Del. C.* § 1903(b) defines the Delaware "taxable income" of a corporation as that "portion of the entire net income of <u>a</u> corporation which is … apportioned to" Delaware.[93] Again the statutory language is clear, the "entire net income" is the income of "a" corporation—not a group of corporations.

In turn, 30 *Del. C.* § 1903(a) defines "entire net income" as "the amount of <u>its</u> federal taxable income" determined under the IRC.[94] The use of the singular pronoun is important ("…*its* federal taxable income")—the Delaware tax is imposed on each corporation on its own, not groups of corporations.

Delaware's statutory reference to the IRC is also important. As discussed above, the IRC defines federal "taxable income" for an individual corporation. Under IRC § 63, "taxable income is a corporation's "gross income [under IRC § 61] minus the deductions" allowed by the IRC. The IRC does not, as discussed above, define "consolidated taxable income" or a "consolidated NOL." Therefore,

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[92] *See, e.g.*, Del. Tax Ruling 89-1 (Jun. 1, 1989) at 2, B88.
[93] Emphasis added.
[94] *See also* 30 *Del. C.* § 1901(10) (defining "federal income tax" as the "tax imposed on corporations by the federal Internal Revenue Code…."). References to the IRC are replete throughout Delaware's statutory definition of the tax base. *See, e.g.*, 30 *Del. C.* § 1903(a)(2), (a)(2)(a), (a)(2)(d), (a)(2)(e), (a)(2)(g).

Delaware law is clear, each corporation must compute tax on its own, separate federal "taxable income"—a term that is defined under the IRC. Under the IRC, a taxpayer's taxable income (including its NOL deduction allowed by IRC § 172) is computed as if a corporation filed a stand-alone federal income tax return, and without regard to the Treasury Regulations governing the computation of the consolidated NOL or consolidated taxable income.

c. The Division agrees with Verisign's statutory interpretation in all other contexts.

For all purposes other than the narrow issue in this litigation, the Division agrees that the consolidated returns of a group of corporations are irrelevant. Consider the following:

- The Pre-Trial Stipulation provides: "Consistent with Delaware statute, the Division of Revenue requires that a corporation that files its federal income tax return as a member of a federal consolidated group to 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."[95]
- In its responses to Verisign's Interrogatories, the Division stated that "it is the policy and the practice of the … Division of Revenue to

[95] Pre-Trial Stip. ¶ B.7 (emphasis added), B35.

compute the 'entire net income' of a … corporation which is a member of a federal consolidated group without regard to the provisions of Federal Treasury Regulations 1.1502-0 et seq. … ."[96]

- In Tax Ruling 89-1, the Division advised taxpayers that "The State of Delaware does not require or permit the filing of a consolidated corporate income tax return. Each corporation doing business in the State must file a separate corporate income tax return."[97]
- In published guidance, the Division instructed taxpayers that "[c]onsolidated corporate income tax returns are not permitted under Delaware law. Each 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."[98] In this litigation, the Division admitted that this guidance "accurately reflects the policy and practice of the Division of Revenue for the periods at issue in that the State of Delaware does not permit the filing of a consolidated corporate income tax return and requires that each corporation doing business in the State to file a separate corporate income tax return."[99]

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[96] Def.'s Interrog. Resp. 2 (emphasis added), A184.
[97] Del. Tax Ruling 89-1 at 2, B88.
[98] Del. Div. of Revenue, Corp. Income Tax FAQs 1 (emphasis added), B80.
[99] Def.'s Req. for Admis. Resp. 5, B76.

- On its tax return instructions, the Division has expressly indicated that a corporation's tax base is to be calculated on a separate company basis, providing that "[a] corporate taxpayer may file a claim for refund" resulting from certain deductions "on a separate return basis …."[100]
- In deposition testimony, the Division confirmed that it requires every item of income and deduction—except the NOL deduction—to be computed as if the taxpayer filed a separate non-consolidated return with the federal government.[101]

Even the Division's notice to Verisign in this matter stated "[t]he 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."[102]

The Division interprets Delaware statute as requiring taxpayers to compute taxable income on a separate-company basis, and prohibiting taxpayers from using consolidated income or deductions in any way (except for the consolidated NOL deduction that is the subject of this litigation). Yet, the Division simultaneously

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[100] Del. Form 1100i (2016) 7, Del. Form 1100i (2015) 7 (emphasis added), A175, A182.
[101] Div. Dep. 20:5–22:13, B60–B62.
[102] Notice of Determination to VeriSign, Inc. at 1, A64.

argues that the law somehow allows it to lift one single deduction (the consolidated NOL deduction) from the consolidated federal return.

The Division asks this Court to read Delaware law as saying two things simultaneously: first, that a taxpayer must compute its taxable income under the IRC by computing every item of income and deduction on a separate-company basis; and second, that a taxpayer *must then* limit one separate-company deduction (the NOL deduction) to an amount (the consolidated NOL deduction) that is reported on the consolidated federal tax return of a different taxpaying unit (the consolidated group).

The Division's position cannot be reconciled with the language of Delaware's statute, or its position in every other context.

d. The Superior Court chose not to reconcile the statute.

The Superior Court found that the Division's interpretation was "consistent with the statute." But the Court did not analyze the statute. It simply "follow[ed] the precedent" of a prior Superior Court decision in *Cluett, Peabody, & Co., v. Director of Revenue*.[103] That case has never been reviewed by this Court.

Like the Division's brief in this case, *Cluett* failed to reconcile how 30 *Del. C.* §§ 1902(a) and 1903(a)–(b) can impose tax on a separate-company basis under the IRC and can simultaneously limit a taxpayer's NOL deduction to the

[103] Sup. Ct. Op. 12, B13; *Cluett, Peabody, & Co. v. Dir. of Revenue*, 1985 Del. Super. LEXIS 1089 (Del. Super. Ct. Jan. 22, 1985).

consolidated NOL deduction of a different taxpaying unit. Even if *Cluett* were relevant, it is inapplicable here.

Cluett was a taxpayer that was the successor in a merger with another taxpayer that had generated NOLs. The question was whether the successor could use those losses. The Superior Court in *Cluett* concluded, correctly, that the "starting point for State taxable income [is] Federal taxable income."[104] However, the parties stipulated that there was no "net operating loss carry over for Federal income tax purposes at the time of the merger."[105] For that reason, the court was constrained to recognize that "no net operating loss carry overs remained for the taxpayer to take advantage of in computing its Federal taxable income."[106] Based on this limiting stipulation (that there were "no net operating loss carry overs" to compute "Federal taxable income"), the *Cluett* court had no choice but to conclude that "there was no net operating loss carry over for purposes" of Cluett's Delaware Tax calculation.[107]

Those are simply not the facts of Verisign's case. The parties have stipulated that Verisign very much had NOLs for federal income tax purposes.[108] NOLs are

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[104] *Cluett*, 1985 Del. Super. LEXIS 1089 at *4.
[105] Appellee's Answering Br. at 7, *Cluett, Peabody, & Co., Inc. v. Director*, Del. C.A. No. 63, 1985 (Del. May 13, 1985), B100.
[106] *Cluett*, 1985 Del. Super. LEXIS at *8.
[107] *Id.*
[108] Pre-Trial Stip. ¶ B.13–17, B36–38.

defined by the IRC as the excess of deductions over gross income; Verisign had approximately ████████ of these losses.[109]

Further, the *Cluett* court was faced with other inequities. The Division in *Cluett* pointed out to the court that the NOLs at issue were generated by a "subsidiary [that] was never required to file a Delaware tax return."[110] On that basis, the Division argued that "[i]ncome earned in Delaware … should not be reduced artificially by non-Delaware losses …."[111] In other words, the company that generated the losses had nothing to do with Delaware, yet Cluett wanted to use those losses to shelter Delaware income. The *Cluett* court's decision prevented Cluett from doing that.

Again, those inequities are not at issue here. Verisign's case does not involve a Delaware taxpayer seeking to shelter its income using losses of an entity outside Delaware. Verisign's NOL computed under 30 *Del. C.* §§ 1902(a) and 1903(a)–(b) was generated by a company that has always done business in Delaware.[112]

Even if the Division is correct that *Cluett* allowed its audit manual limitation, *Cluett* was wrongly decided. The decision is conclusory. Like the Division's brief before this Court and the Superior Court's decision below, *Cluett* does not explain how 30 *Del. C.* §§ 1902(a) and 1903(a)–(b) can require a corporation to compute its

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[109] Pre-Trial Stip. ¶ B.13, B36–37.
[110] Appellee's Answering Br. at 12, *Cluett, Peabody, & Co., Inc. v. Director*, Del. C.A. No. 63, 1985 (Del. May 13, 1985), B105.
[111] *Id.*
[112] Pre-Trial Stip. ¶ B.1–2, B34.

own income and deductions under the IRC, and simultaneously limit one deduction and only one deduction (the NOL deduction) to a different deduction (the "consolidated NOL") reported on the consolidated federal return of a different taxpayer (the consolidated group).

The Division's audit manual limitation is "not in the statute," it is inconsistent with the Division's interpretation of Delaware law in every other context, and no one at the Division knows why they adopted it.[113] It must therefore be rejected.

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[113] Div. Dep. 54:15–55:22, 63:1–63:12, 64:13–64:23, B66–69; *see, e.g.*, Pre-Trial Stip. ¶ B.7, B35.

II. <u>SOLE ISSUE ON APPEAL:</u> THE TRIAL COURT WAS CORRECT THAT THE DIVISION'S AUDIT MANUAL LIMITATION VIOLATES THE DELAWARE CONSTITUTION'S UNIFORMITY CLAUSE.

A. Questions Presented

Whether the Superior Court was correct that the Division's audit manual limitation violates the Delaware Constitution's Uniformity Clause.[114]

B. Scope of Review

This issue involves interpretations and applications of statutory and constitutional provisions. Those determinations are questions of law that this Court reviews de novo.[115] This Court does not defer to interpretations of an administrative agency or the Trial Court.[116]

C. Merits of Argument

By enacting 30 *Del. C.* §§ 1902(a) and 1903(a)–(b), and adopting federal taxable income, Delaware's General Assembly granted all corporations subject to the corporate income tax an NOL deduction computed under the IRC.[117] Because

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[114] Pre-Trial Stip. ¶ D.3, B45.
[115] *Pub. Water Supply Co.*, 735 A.2d at 380-81.
[116] *Del. Dep't of Natural Res. & Envtl. Control v. Sussex Cnty.*, 34 A.3d 1087, 1090 (Del. 2011).
[117] *See also* 30 *Del. C.* § 1901(10) (defining "federal income tax" as the "tax imposed on corporations by the Internal Revenue Code"); IRC § 63 (defining federal taxable income as "gross income" minus "deductions"); IRC § 172 (allowing NOL deduction); Pre-Trial Stip. ¶ B.7, B35.

the statute entitles all taxpayers an NOL deduction computed in the same manner, Delaware's statute is uniform in its application.

The Division's audit manual limitation creates non-uniformity where none existed before. The "consolidated NOL" the Division adopts through its audit manual limitation is very different than the NOL deduction under the IRC granted by Delaware's General Assembly. The NOL deduction is based on a taxpayer's own income and deductions, whereas the consolidated NOL deduction is based on the income and deduction of a taxpayer's affiliates.[118]

By adopting the consolidated NOL as its limitation, the Division's audit manual limits the NOL for some taxpayers (those that file a consolidated federal return with affiliates) but not others (those that file a separate-company federal return).[119] The classification violates the Delaware Constitution's Uniformity Clause because it treats taxpayers differently based on federal filing status.[120]

The Division has no authority to create such classifications.[121] Even if it did, the classification is unjustifiable because it is nonsensical, irreconcilable with the

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[118] *Compare* IRC § 172(c) (excess of deductions over gross income under IRC § 61), *with* Treas. Reg. § 1.1502-21(e) (excess of consolidated deductions over consolidated gross income computed under Treas. Reg. § 1.1502-11(a)).
[119] Pre-Trial Stip. ¶ B.8, B35.
[120] *See Burpulis*, 498 A.2d. at 1087.
[121] *See Wilmington Med. Ctr., Inc. v. Bradford*, 382 A.2d 1338, 1344 (Del. 1978) ("Legislatures have a wide discretion in the matter of classification" (emphasis added)).

purpose of the NOL deduction, and results in an arbitrary windfall to the state. There can be no justification for the audit manual limitation, particularly given no one at the Division even knows why it was adopted.[122]

1. The Division's audit manual limitation classifies corporations based on federal filing status that Delaware eschews.

A taxpayer's NOL deduction is computed using *its own* income and losses. The consolidated NOL deduction of a consolidated group is computed by aggregating the income and losses of *all affiliated corporations*.[123] The uniformity problem arises because the Division's limitation diminishes a taxpayer's NOL by the income of its affiliates only if it files its federal tax return as a member of a federal consolidated group. As the Superior Court put it: "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…. and therefore … creates two classes of Delaware corporate taxpayers."[124]

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[122] Div. Dep. 54:15–55:22, 63:1–63:12, B66–68.
[123] Treas. Reg. § 1.1502-21(e) (consolidated NOL is excess of *consolidated deductions* over *consolidated gross income* computed under Treas. Reg. § 1.1502-11(a)).
[124] Sup. Ct. Op. 24, B25.

Verisign's own NOL under the IRC reduced its taxable income to ███ for the tax years at issue.[125] The Verisign Group's consolidated NOL was less than Verisign's NOL because of income earned by Verisign's affiliates (for example, a Verisign affiliate received ███████ of dividend income from a foreign subsidiary in 2013).[126] The Division's audit manual limitation reduced Verisign's NOL on the basis of income earned by affiliates.[127] By contrast, the Division allowed other corporations' NOL deductions without regard to the income earned by affiliates. In this way, the Division's audit manual limitation classifies corporations based on federal filing status, and limits the NOL of one class, but not the other.

2. The Division's audit manual limitation violates Delaware's Uniformity Clause.

Delaware's 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

[125] Pre-Trial Stip. ¶ B.17, B38.
[126] Pre-Trial Stip. ¶ B.24, B40–41.
[127] Pre-Trial Stip. ¶ B.26, B41.

…."[128] "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."[129]

As this Court explained in *Burpulis v. Director of Revenue*, creating two classes of taxpayers based on their federal income tax filing status violates the Uniformity Clause. The statute at issue in that case required every taxpayer filing a stand-alone Delaware tax return to report all income and deductions on a separate basis under the IRC. This Court reasoned that a taxpayer could not use a deduction that was a consequence of filing a joint federal filing on its stand-alone Delaware tax return. To do so would treat taxpayers filing stand-alone Delaware returns differently based on how they filed their federal income tax return.

The deduction at issue in *Burpulis* was the federal two-earner married couple deduction available to taxpayers filing a joint federal income tax return, but unavailable to taxpayers filing separate federal income tax returns. The taxpayers claimed the deduction on their federal joint tax returns, and sought to claim that deduction computed for federal purposes on their separate Delaware tax returns.

This Court held that allowing the deduction computed for federal purposes would create non-uniformity. Delaware's tax required all taxpayers filing stand-alone returns to compute every item of income and deduction on a stand-alone basis

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[128] Del. Const. art. VIII, § 1.
[129] *Seaford Assocs., L.P. v. Bd. of Assessment Review*, 539 A.2d 1045, 1049 (Del. 1988) (citing Del. Const. art. VIII, § 1).

under the IRC. Allowing taxpayers to claim a deduction computed on joint/consolidated basis because they filed their federal income tax return on a joint/consolidated basis would result in unequal treatment in violation of the Uniformity Clause.

Following *Burpulis,* the Superior Court in this case concluded that the Division's audit manual limitation creates differential treatment based on federal filing status, and therefore violates the Uniformity Clause. The Division's audit manual limitation divides a single group of taxpayers—corporations subject to Delaware's income tax—into two groups based on their federal filing status: those that file a consolidated federal return with affiliates, and those that file a separate federal return. The Division's audit manual then limits the NOL of one group based on the income and deductions of their affiliates (consolidated federal return filers) but not the other (separate federal return filers). That differential treatment based on federal filing status violates the Uniformity Clause.

The Superior Court was correct. Requiring every taxpayer, including Verisign, to deduct its own NOL preserves uniformity in Delaware's corporate income tax system because all taxpayers get an NOL deduction computed in the same manner—on a separate-company basis under the IRC, without regard to the income and deductions of affiliates. The Division's audit manual limitation creates

non-uniformity where none existed before by diminishing the NOLs of some (but not all) taxpayers by affiliate income.

3. The Division's audit manual limitation is not a single limitation applied to all taxpayers.

We pause here to address the Division's re-characterization of its audit manual limitation in its opening brief. Facing the adverse decision below, the Division seeks to recharacterize its audit manual limitation as a single limitation that applies equally to all taxpayers. The Division now says its audit manual limitation "applies the same [NOL] limit to all corporate taxpayers."[130] That characterization is directly contrary to its own audit manual, and the Division's stipulations[131] and testimony in this case.

- The Division's audit manual states: "DOR needs to ensure that the NOL amount does not exceed the consolidated amount of the current year NOL."[132] The Division stipulated that it enforces its limitation as described in the manual.[133]

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[130] Div. Opening Br. at 21.
[131] In referring to the "stipulations," we mean the Pre-Trial Stipulation that the parties entered into and filed with the Superior Court (attached at B29–49) not the "stipulated facts" that the Division of Revenue misleadingly refers to and treats as the stipulated facts in its opening brief at pages 6–12. The "stipulated facts" in the Division's Opening Brief are not the facts actually stipulated to in this case. Again, the actual Stipulated Facts to which the parties stipulated can be found at B34–44.
[132] Pre-Trial Stip. ¶ B.9 (emphasis added), B36; BMF Audit & Reconciliation System 327, B123.
[133] Pre-Trial Stip. ¶ B.10, B36.

- The Division stipulated that it requires "a taxpayer [to] compute its NOL on a separate-company basis under the IRC, [then] limit that separate-company NOL to the consolidated NOL deduction of the federal consolidated group of which the taxpayer is a member." The Division further stipulated that "It is the validity of this second step that is the issue in this litigation."[134]
- The Division stipulated: "Verisign is not the only corporate tax payer that has been audited and assessed taxes as a result of the Division's policy and practice of limiting the net operating loss of a Delaware corporation which is a member of a consolidated group to the consolidated net operating loss reported by the consolidated group on the filed consolidated group's federal return."[135]
- The Division testified that its practice was to compute "the 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."[136]

As these points make clear, 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.

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[134] Pre-Trial Stip. ¶ B.8 (emphasis added), B35.
[135] Pre-Trial Stip. ¶ B.36 (emphasis added), B44.
[136] Div. Dep 70:22–71:1 (emphasis added), B70–71.

Yet the term "consolidated NOL" is entirely absent from the Division's brief. This is especially poignant given that it attempts to distort the actual stipulated facts below (contained in the Pre-Trial Stipulation) in its Statement of Facts by removing any distinction between the NOL and the consolidated NOL. The Division then misleadingly describes the distorted stipulations as "The stipulated facts" in this case.[137]

Even if the Division did—as it now claims—limit every taxpayer's NOL to the amount reported on the taxpayer's federal return, the audit manual limitation would still create an unconstitutional classification based on federal filing status. Taxpayers filing a separate-company federal return would be allowed a separate-company NOL computed under the IRC on the basis of its own income and deductions, whereas taxpayers filing a consolidated federal return would be limited to the "consolidated NOL" that is computed on the basis of its affiliates' income and deductions.

The Division cannot avoid the consequences of its audit manual limitation under either: 1) the facts as actually stipulated to by the parties; or 2) the misleadingly characterized "stipulated facts" created in its opening brief.

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[137] Div. Opening Br. at 6.

4. This Court should not adopt the sweeping administrative deference the Division seeks.

The Division argues its "classification regime meets the requirements of the Uniformity Clause if it is reasonable."[138] The Superior Court rejected that argument because the "reasonableness" test applies to "affording deference to the *General Assembly*, not an administrative agency like the Division …."[139] The Superior Court relied on this Court's decision in *Wilmington Medical Center, Inc. v. Bradford*, which explained:

> There is of course a presumption that the statute is constitutional. <u>Legislatures</u> 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 <u>the legislature</u> 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.[140]

The Superior Court reasoned that in this case, "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."[141] Because the Division "cited no authority to suggest that an administrative agency's classification should be afforded the same deference that the legislature is afforded

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[138] Sup. Ct. Op. 24, B25; *see also* Div. Opening Br. at 14, 27.
[139] Sup. Ct. Op. 24 (citing *Wilmington Med. Ctr.*, 382 A.2d at 1344), B25.
[140] Sup. Ct. Op. 25 (quoting *Wilmington Med. Ctr.*, 382 A.2d at 1344) (emphasis added), B26.
[141] Sup. Ct. Op. 25, B26.

when it faces a Uniformity Clause challenge …. the [Superior] Court [found] that the policy violates the Delaware Constitution's Uniformity Clause ….”[142]

The Division now seeks to self-deputize itself with rational basis deference using its 30 *Del. C.* § 354 authority to issue tax regulations. The Division cites no authority to explain how regulatory authority equates to unfettered rational basis deference to an audit manual. Contrary to its assertion, blanket rational basis deference to administrative agency action is wholly inconsistent with the General Assembly's finding that its "delegation of authority [to administrative agencies has] resulted in regulations being promulgated without effective review, or oversight and conformity to legislative intent."[143] If ever there was an example of the legislature's concern for administrative action taken without review or conformity to legislative intent, this case is the poster child.

First, the Division's audit manual limitation is nonsensical. The Division seeks to limit a taxpayer's own deduction to a "consolidated" deduction of a different taxpayer (the consolidated group). That consolidated deduction that is a consequence of the income and deductions of the taxpayer's affiliates—not the taxpayer's own income and deductions.

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[142] *Id.*
[143] 69 Del. Laws, c. 107, 1993 Del. HB 209 (Jul. 9, 1993) § 4.

Second, the Division's audit manual limitation is irreconcilable with the purpose of the NOL deduction the General Assembly granted taxpayers by enacting 30 *Del. C.* §§ 1902(a) and 1903(a)–(b) and adopting federal taxable income under the IRC. The Division's audit manual limitation disallows Verisign from carrying forward its [REDACTED] of losses generated from 2005 through 2013, thus preventing it from "set[ting] off its lean years against its lush years."[144]

Third, the Division's audit manual limitation is arbitrary. The Division seeks to adopt the consolidated NOL only when it is to a taxpayer's detriment (but does not adopt the consolidated NOL when it would be advantageous for the taxpayer).[145] Through this case the Division is fighting for the same arbitrary windfall it fought to prevent in *Burpulis*.

Finally, the Division's audit manual limitation could not pass any level of scrutiny given the uncontroverted testimony that no one at the Division even knows why the limitation was adopted in the first place.[146]

Lacking any record of the administrative rule-making process, the Division says its limitation "may be … to limit … manipulation and imprecision inherent in

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[144] *Libson*, 353 U.S. at 386.
[145] Div. Dep. 64:13–64:23, B69.
[146] Div. Dep. 54:15–55:22, 63:1–63:12, B66–68.

stand-alone reporting ….”[147] The Division asserts that such concerns are "especially heightened with regard to reporting" NOLs.[148]

The Division does not provide any support for these assertions, and they are incorrect. An NOL is simply a taxpayer's deductions exceeding its gross income in prior years.[149] Because an NOL is computed using income and deductions in prior years (prior years that are subject to audit by the IRS and Division), the NOL carried into a subsequent year and claimed as a deduction is simple math.[150] For this reason, the Division had no problem testifying that it audits the correctness of a taxpayer's stand-alone NOL simply by looking at the income and deductions on prior year returns.[151]

Even if the Division's audit manual limitation is entitled to some deference (it is not), ignoring a taxpayer's own NOL under the IRC and replacing it with the consolidated NOL that is a consequence of the income and deductions of affiliates creates the "imprecision" the Division purports to correct. It is also irreconcilable with the "basic tax principle" the Division argued to this Court in its *Burpulis* brief: that "one taxpayer cannot claim the deductions and income of another taxpayer."[152]

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[147] Div. Opening Br. at 27–28.
[148] Div. Opening Br. at 28.
[149] *See* IRC § 172(c) (NOL is excess of deductions over gross income).
[150] The math in this case is described in the Pre-Trial Stip. ¶ B.13–17, B36–38.
[151] Div. Dep 46:21–48:14, B63–65.
[152] Appellee's Answering Br. at 21 filed Jul 27, 1984), *Burpulis v. Dir. of Revenue*, 498 A.2d 1082 (Del. 1985). Verisign asks this Court to take judicial notice of this

The conclusion is simple. 30 *Del. C.* §§ 1902(a) and 1903 (a)–(b) uniformly require every corporation to compute its taxable income under the IRC using its own income and deductions. The Division's audit manual limitation introduces non-uniformity by requiring some (but not all) taxpayers to limit their own NOL deduction to a consolidated NOL deduction that is computed on the basis of the income and deductions of affiliates. The Uniformity Clause prohibits the Division from introducing that non-uniformity into Delaware's tax.

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document filed by the Division with this Court. *See Walker v. City of New Castle*, 2015 WL 10132340, at *1 n.1 (Del. Dec. 31, 2015) (taking judicial notice of docket and pleadings filed in another case).

III. <u>ISSUE 2 ON CROSS-APPEAL:</u> THE TRIAL COURT ERRED BY CONCLUDING THE DIVISION'S AUDIT MANUAL LIMITATION DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE.

A. Questions Presented

Whether the Division's audit manual limitation discriminates against interstate commerce in violation of the U.S. Constitution's Commerce Clause. [153]

B. Scope of Review

This issue involves interpretations and applications of statutory and constitutional provisions. Those determinations are questions of law that this Court reviews de novo.[154] This Court does not defer to interpretations of an administrative agency or the Trial Court.[155]

C. Merits of Argument

The Division applies its audit manual limitation in a manner that violates the *per se* rule of invalidity for taxes that discriminate against interstate commerce. The Division does limit the NOL of a taxpayer whose affiliates do business in Delaware. But if the taxpayer chooses to operate an affiliate wholly outside of Delaware, the Division punishes that decision by limiting its NOL.

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[153] Pre-Trial Stip. ¶ D.4, B45.
[154] *Pub. Water Supply Co.*, 735 A.2d at 380–81.
[155] *Del. Dep't of Natural Res. & Envtl. Control v. Sussex Cnty.*, 34 A.3d 1087, 1090 (Del. 2011).

Because taxes that disfavor out-of-state commerce over in-state commerce are "virtually *per se* invalid" and the Division has not shown that its audit manual limitation advances a legitimate local purpose that can be adequately served by reasonable nondiscriminatory alternatives, the limitation must be stricken.

To remedy the discrimination in this case, Verisign is entitled to be treated in the same manner as the Division treated taxpayers who did not choose to operate affiliates without any activity in Delaware: allow Verisign to deduct its own NOL computed under the IRC.

1. The Division's audit manual limitation favors in-state activity over out-of-state activity.

The Division does not apply its audit manual limitation "to a taxpayer that is a member of a federal consolidated group if each consolidated group member files a Delaware corporate income tax return."[156] Corporations that do business in Delaware must file a Delaware tax return; corporations that do not do business in Delaware do not.[157] That means the Division does not apply its audit manual limitation to an entirely intra-state business. And the Division does not apply its audit manual limitation to an interstate business as long as every affiliated group member does at least some Delaware business. But if a taxpayer chooses to operate

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[156] Pre-Trial Stip. ¶ B.9–10, B36.

[157] *See* 30 *Del. C.* § 1902 (tax imposed on businesses earning "income derived from business activities carried on and property located within the State.").

any affiliate entirely outside Delaware, then the Division applies its audit manual limitation to the taxpayer's NOL deduction.

2. The Commerce Clause prohibits a state from favoring in-state activity over out-of-state activity.

The Commerce Clause provides "Congress shall have Power . . . to regulate Commerce . . . among the several States."[158] The "negative" aspect of that clause "denies the States the power unjustifiably to discriminate against … the interstate flow of articles of commerce."[159]

The "first step" in determining whether a state tax violates the negative Commerce Clause is "to determine whether it … discriminates against interstate commerce."[160] A discriminatory tax is "virtually *per se*" invalid because it will be upheld only if it withstands strict scrutiny (advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives).[161] The Division has not argued its audit manual limitation passes strict scrutiny. So the sole question is whether the audit manual limitation is facially discriminatory. If it is, the audit manual limitation cannot be sustained.

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[158] U.S. Const. art. I, § 8, cl. 3.
[159] *Or. Waste Sys. v. Dep't of Envtl. Quality*, 511 U.S. 93, 98 (1994).
[160] *Id.* at 99.
[161] *Id.* 100–01; *see, e.g.*, *Associated Indus.*, 511 U.S. at 648–649 ("Under our cases, unless one of several narrow bases of justification is shown … actual discrimination, wherever it is found, is impermissible ….") ; *see Dep't of Revenue v. Davis* (special treatment when state is market participant).

Discrimination is "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter."[162] Because there is no de minimis defense to discrimination," the "magnitude and scope of the discrimination" is not relevant.[163] And discrimination does not depend on a state's intent or purpose.[164] Thus, the only question is whether the Division's audit manual limitation favors in-state commerce over out-of-state commerce on its face.

3. The Division's audit manual limitation is *per se* invalid under the Commerce Clause.

The Division's audit manual limitation facially favors in-state activity over out-of-state activity because the Division does not apply its audit manual limitation as long as every affiliate does at least some Delaware business. But if a taxpayer chooses to operate an affiliate entirely outside Delaware, then the Division applies its audit manual limitation to the taxpayer's NOL deduction.

The Division's discrimination based on the affiliate activity is like the discrimination prohibited by the U.S. Supreme Court in *Fulton Corporation v. Faulkner*.[165] That case involved North Carolina's net worth tax that allowed a

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[162] *Oregon Waste*, 511 U.S. at 99.
[163] *Lohman*, 511 U.S. at 650; *Fulton*, 516 U.S. at 333 n.3.
[164] *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 72 (1963) (commerce clause violation notwithstanding that the offending statute "may have been an accident of statutory drafting"); *Philadelphia v. New Jersey*, 437 U.S. 617, 626 (1978) ("[P]urpose need not be resolved, because its resolution would not be relevant to the [commerce clause] issue to be decided in this case.").
[165] 516 U.S. 325 (1996).

deduction for subsidiary stock based on the in-state versus out-of-state activities of the subsidiary. The deduction was inversely proportional to the extent of the subsidiary's North Carolina activities: the greater the subsidiary's in-state activity, the greater the deduction. The Commerce Clause violation arose because the deduction was dependent on the in-state versus out-of-state activity of the taxpayer's subsidiary corporation. For that reason, "[t]here [was] no doubt that the [] tax facially discriminates against interstate commerce."[166]

The unconstitutional feature of the North Carolina tax exists in the Division's audit manual limitation, which conditions a taxpayer's deduction on the in-state activity versus out-of-state activity of its affiliates. Courts have consistently struck down state tax regimes where a benefit is tied to the conduct of affiliates' in-state versus out-of-state activity.[167]

To remedy the Constitutional infirmity of the Division's audit manual limitation, Verisign is entitled to be treated in the same manner the Division would have treated a Delaware taxpayer whose affiliates all do business in Delaware: allow it to claim its own NOL under the IRC without regard to the consolidated NOL that is a function of the income and deduction of a taxpayer's affiliates.

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[166] *Id.* at 333.

[167] *See, e.g.*, *Gen. Motors Corp. v. Dir. of Revenue*, 981 S.W.2d 561 (Mo. 1998) (state consolidated return permitted only if affiliated group meets in-state activity threshold violates Commerce Clause).

IV. <u>ISSUE 3 ON CROSS-APPEAL:</u> THE DIVISION'S AUDIT MANUAL LIMITATION CREATES AN UNCONSTITUTIONAL RESULT UNDER THE U.S. CONSTITUTION'S FOREIGN COMMERCE CLAUSE.

A. Questions Presented

Whether the Division's audit manual limitation must be rejected because it violates the U.S. Constitution's Foreign Commerce Clause by treating foreign subsidiary dividends less favorably than domestic subsidiary dividends.[168]

B. Scope of Review

This issue involves interpretations and applications of statutory and constitutional provisions. Those determinations are questions of law that this Court reviews de novo.[169] This Court does not defer to interpretations of an administrative agency or the Trial Court.[170]

C. Merits of Argument

The Division's audit manual limitation creates an unconstitutional result under the U.S. Constitution's Foreign Commerce Clause. Because "courts should avoid interpretations that would render a statute unconstitutional," this Court should reject the Division's interpretation of the statute through its audit manual limitation.[171] Alternatively, if this Court adopts the Division's audit manual

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[168] Pre-Trial Stip. ¶ D.2, B45.
[169] *Pub. Water Supply Co.*, 735 A.2d at 380-81.
[170] *Del. Dep't of Natural Res. & Envtl. Control v. Sussex Cnty.*, 34 A.3d 1087, 1090 (Del. 2011).
[171] *See Hazout v. Ting*, 134 A.3d 274, 287 (Del. 2016).

limitation, the limitation must be recomputed so that the constitutional defect is corrected.

The Foreign Commerce Clause prohibits a state from treating foreign subsidiary dividends less favorably than domestic subsidiary dividends.[172] The parties have stipulated that the Verisign Group's consolidated NOL that the Division used as its limitation was less because the Division treated foreign subsidiary dividends less favorably than domestic subsidiary dividends. If foreign and domestic dividend income had been treated equally, the Division's audit manual limitation would not have limited Verisign's NOL under the IRC.[173] By adopting the consolidated NOL, the Division's audit manual limitation violates the Foreign Commerce Clause.

1. The Division's audit manual limitation treats foreign subsidiary dividends less favorably than domestic subsidiary dividends.

The Foreign Commerce Clause problem arises because entities other than Verisign in the Verisign Group received foreign subsidiary dividends, including over [redacted] of dividends in 2014.[174] The Division's audit manual limitation does not allow a deduction for those foreign subsidiary dividends.[175] Thus, those

[172] *Kraft*, 505 U.S. at 82.
[173] Pre-Trial Stip. ¶ B.29, B42.
[174] Pre-Trial Stip. ¶ B.24, B40–41.
[175] The Division's limitation is the consolidated NOL computed under Treas. Reg. § 1.1502-21, which is a product of consolidated taxable income. Except in limited

dividends substantially reduced the Verisign Group's consolidated NOL. But if those dividends had been from domestic subsidiaries, the Division would have allowed a deduction, and the Verisign Group's consolidated NOL deduction would have been substantially increased.[176] Treating foreign subsidiary dividends less favorably than domestic subsidiary dividends is prohibited by the U.S. Constitution's Foreign Commerce Clause under *Kraft General Foods v. Iowa Department of Revenue*.[177]

2. The Foreign Commerce Clause prohibits a state from treating foreign subsidiary dividends less favorably than domestic subsidiary dividends.

Kraft involved Iowa's income tax, which allowed a deduction for domestic subsidiary dividends, but not for foreign subsidiary dividends. The question was whether Iowa could disfavor the foreign subsidiary dividends. The U.S. Supreme Court concluded that Iowa could not. The Supreme Court held that Iowa's tax discriminated against foreign commerce because "Iowa impose[d] a burden on foreign subsidiaries that it d[id] not impose on domestic subsidiaries."[178] To resolve

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circumstances, consolidated taxable income does not allow a deduction for foreign dividends. *See* Treas. Reg. § 1.1502-26(a).

[176] *See id.*

[177] 505 U.S. 71 (1992).

[178] *Id*. at 80.

the discrimination, Kraft was allowed to deduct foreign subsidiary dividends in the same manner as Iowa allowed it to deduct domestic subsidiary dividends.

3. The Division's audit manual limitation violates the Foreign Commerce Clause.

Just like Iowa's statute adopted a discriminatory aspect of federal taxable income, the Division adopts a discriminatory aspect of federal consolidated taxable income. The consolidated NOL is computed by disallowing a deduction for dividends received by the Verisign Group from foreign subsidiaries—even though a deduction for those dividends would have been allowed had the Verisign Group received them from domestic subsidiaries.[179] There is no dispute on this point; the parties have stipulated:

> If the Verisign Group's consolidated NOLs generated in prior years were computed by allowing dividends from foreign subsidiaries to be deducted in the same manner as dividends from domestic subsidiaries, the Verisign Group's consolidated NOL deduction in each of 2015 and 2016 would have been greater than Verisign's separate-company NOL deduction in each of 2015 and 2016.[180]

Thus, the parties have stipulated to the unequal treatment that is unconstitutional under *Kraft*.

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[179] Just like in *Kraft*, the problem arises in this case because the federal computation adopted by the state allows a deduction for domestic, but not foreign, subsidiary dividends.

[180] Pre-Trial Stip. ¶ B.29, B42.

Because the Division's audit manual limitation renders the statute unconstitutional, Verisign asks this Court to reject the Division's interpretation of the statute.

Alternatively, if this Court adopts the Division's interpretation, the Division must recompute Verisign's consolidated NOL that it adopts as its limitation by allowing a deduction for foreign subsidiary dividends on the same basis as domestic subsidiary dividends. Equalizing the treatment between foreign subsidiary and domestic subsidiary dividends would result in the Verisign Group's consolidated NOL being greater than Verisign's NOL, which means Verisign's NOL would not be limited.[181]

[181] *Id.*

CONCLUSION

Verisign asks this Court to affirm the Superior Court's decision to grant Verisign's motion for summary judgment on the basis that the Division's audit manual limitation violates the Delaware Constitution's Uniformity Clause. Alternatively, Verisign asks this Court to strike the Division's assessment against Verisign on any (or for that matter all) of these basis: that the Division's audit manual limitation is contrary to Delaware statute; that the Division's audit manual limitation violates the U.S. Constitution's Commerce Clause; or that the Division's audit manual limitation violates the U.S. Constitution's Foreign Commerce Clause.

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