IN THE COURT OF APPEALS
OF THE STATE OF NEW MEXICO

Docket No. 21140

KMART PROPERTIES, INC.,

Protestant-Appellant,

v.

TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO,

Respondent-Appellee.

APPEAL FROM DECISION AND ORDER NO. 00-04
OF TAXATION AND REVENUE DEPARTMENT
HEARING OFFICER GERALD B. RICHARDSON

BRIEF OF *AMICUS CURIAE* MULTISTATE TAX COMMISSION

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES ii

INTEREST OF *AMICUS CURIAE* 1

ARGUMENT 2

I. LICENSOR OF TRADEMARK HAS DUE PROCESS NEXUS WITH STATES WHERE LICENSOR KNOWS AND INTENDS THAT LICENSEE WILL USE THE MARK 2

II. THE PHYSICAL PRESENCE REQUIREMENT FOR COMMERCE CLAUSE SUBSTANTIAL NEXUS UNDER *QUILL CORP*. v. *NORTH DAKOTA* WAS EXPLICITLY NOT EXTENDED TO INCOME AND OTHER TAXES 4

A. *Bellas Hess* Decision: Source of Physical Presence Requirement 5

B. The *Quill* Decision Re-Affirms Only the Commerce Clause Part of the *Bellas Hess* Decision. 6

C. The Court Used Specific Language in *Quill* Excluding Application of the Physical Presence Requirement to Other Taxes. 7

D. The Two Bases for the *Quill* Decision—*Stare Decisis* and Undue Burden—Reinforce its Limitation to the Use Tax Collection Obligation 8

1. Stare Decisis *Points the Other Way Since the Court Has Long Found Income Tax Nexus Without Physical Presence.* 9

2. *States Impose No Undue Compliance Burden on Multistate Taxpayers With Their Income Tax.* 13

III. DIVIDING KPI'S INCOME AMONG THE STATES BASED ON KPI'S RECEIPTS FROM LICENSING ITS TRADEMARKS TO KMART IS THE ONLY FAIR METHOD OF APPORTIONMENT 18

CONCLUSION 20

TABLE OF AUTHORITIES

Pages

Cases:

Barclay's Bank PLC v. Franchise Tax Bd., 512 U.S. 298 (1994) 16

Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985)..... 3

Commonwealth Edison Co. v. Montana, 453 U.S. 609 (1981)..... 7

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977)..... 6, 13

Container Corp. of America v. *Franchise Tax Bd.*, 463 U.S. 159 (1983)..... 17

Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207 (1980)..... 2

General Motors Corp. v. *Washington*, 377 U.S. 436 (1964)..... 17

Geoffrey, Inc. v. South Carolina Tax Comm'n, 437 S.E.2d 13 (S.C. 1993),
cert. denied, 510 U.S. 992 (1993)..... 12, 18

Hanson v. Denckla, 357 U.S. 235 (1958) 2

International Harvester Co. v. Wisconsin Dept. of Taxation,
322 U.S. 435 (1944)..... 10, 11, 12

Johnson v. J.C. Penney Nat'l Bank, 19 S.W.2d 832 (Tenn. Ct. App. 1999),
cert. denied, U.S. Sup. Ct. No. 00-205 (October 10, 2000)..... 12

National Bellas Hess, Inc. v. Dept. of Revenue, 386 U.S. 753 (1967)..... 5, 6, 7, 8, 9, 14

New York ex rel. Whitney v. Graves, 299 U.S. 366 (1937)..... 9, 10, 11, 12

Northwestern States Portland CementCo. v. Minnesota , 358 U.S. 450 (1959)..... 14, 15

Norton Co. v. *Dept. of Revenue*, 340 U.S. 534 (1951) 16

Oklahoma Tax Comm'n v. Jefferson Lines , Inc., 514 U.S. 175 (1995) 1

Quill Corp. v. North Dakota, 504 U.S. 298 (1992) .....*passim*

Sherwin Williams Co. v. Comm'r of Revenue (Massachusetts Appellate Tax Board,
Docket No. F322560, July 19, 2000, 2000 WL 1005799)..... 5, 18

Syms Corp. v. Comm'r of Revenue (Massachusetts Appellate Tax Board,
Docket Nos. F215484 & F228324, September 14, 2000)..... 5, 18

Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1941) 17

World-Wide Volkswagen Corp. v. Woodson 444 U.S. 286 (1980) 3

Statutes and Legislative History:

H.R. REP. NO. 952, 89th Cong., 1st Sess. (1965) 15

Lanham Act (15 U.S.C. §§1051-1127) 4

Multistate Tax Compact 1, 16

N.M. Stat. Ann. § 7-5-1 (1967) 1, 18

N.M. Stat. Ann. § 7-4-19 (1965) 2, 18

Pub. LAW 86-272, 73 STAT. 555 (1959) (15 U.S.C. §381) 14, 15

Uniform Division of Income for Tax Purposes Act 2, 15, 16, 17, 18

Section 18 ..... 2, 20

Administrative Regulations:

3 NMAC 5.19.12 19

3 NMAC 5.19.13 19

3 NMAC 5.19.14 19

3 NMAC 5.19.15 19

3 NMAC 5.19.17 19

3 NMAC 5.19.18 19

Rule 12-215 NMRA 2000 1

Treatises & Articles:

Michael T. Fatale, *Geoffrey Sidesteps Quill: Constitutional Nexus, Intangible Property and The State Taxation of Income*, 23 HOFSTRA L. REV. 407 (1994) 12-13

M. Carr Ferguson, *2000 Erwin N. Griswold Lecture Before the American College of Tax Counsel: How Will a Court Rule?*, 53 TAX LAW. 721 (2000) 5

Jerome R. Hellerstein and Walter Hellerstein, STATE TAXATION (3rd ed.1998) 12, 16

Jerome R. Hellerstein, *Geoffrey and The Physical Presence Nexus Requirement of Quill*, STATE TAX NOTES, February 13, 1995 12

Walter Hellerstein, *Supreme Court Says No State Use Tax Imposed on Mail-Order Sellers . . . for Now*, 77 J. TAX. 120 (1992)..... 8

Paull Mines, *Conversing with Professor Hellerstein: Electronic Commerce and Nexus Propel Sales and Use Tax Reform*, 52 TAX L. REV. 581 (1997)..... 8

William Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747 (1957) 18

Richard D. Pomp & Michael J. McIntyre, *State Taxation of Mail-Order Sales of Computers After Quill: An Evaluation of MTC Bulletin 95-1*, 11 STATE TAX NOTES 177 (July 15, 1996) 12

INTEREST OF *AMICUS CURIAE*

The Multistate Tax Commission ("MTC") files this brief pursuant to Rule 12-215, NMRA 2000, as *amicus curiae* in support of the Taxation and Revenue Department of the State of New Mexico ("Department"). The MTC is the administrative agency created by the Multistate Tax Compact ("Compact"). *See, e.g.*, N.M. Stat. Ann. § 7-5-1 (1967). Twenty-one States, including New Mexico, have legislatively established full membership in the Compact. In addition, two States are sovereignty members and nineteen States are associate members.[1]

The purposes of the Compact are to (1) facilitate proper determination of state and local tax liability of multistate taxpayers; (2) promote uniformity or compatibility in significant components of tax systems; (3) facilitate taxpayer convenience and compliance; and (4) avoid duplicative taxation. *Id*.

In furtherance of the identified goals of the Compact, the MTC seeks a correct and uniform understanding of the constitutional nexus standard for the imposition of state income taxes. A correct nexus standard ensures that interstate commerce pays its fair share of state taxes. *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 184 (1995). A uniform nexus standard facilitates taxpayer convenience and compliance because taxpayers will more readily understand constitutional limits on state income taxes. The MTC takes issue with the nexus standard employed by the hearing officer below, although the hearing officer reached the correct result. The hearing officer failed to follow longstanding U.S. Supreme Court precedent permitting States to impose income tax on taxpayers not physically present in the State and failed to recog-

[1] **Compact Members:** Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Maine, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. **Sovereignty Members:** Florida and Wyoming. **Associate Members:** Arizona, Connecticut, Georgia, Illinois, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, New Hampshire, New Jersey, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Wisconsin, and West Virginia.

nize the explicit limitation on the mail order safe harbor the Court set in *Quill Corp.v. North Dakota*, 504 U.S. 298 (1992). The appropriate standard is that reiterated by the U.S. Supreme Court in numerous corporate income tax cases: "nexus is established if the corporation 'avails itself of the "substantial privilege of carrying on business" within the State.'" *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 220 (1980).

In addition, the MTC seeks a correct and reasonable application of the apportionment provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA). Section 18 of UDITPA (N.M. Stat. Ann. § 7-4-19 (1965)) provides for modification of the standard three-factor formula in unusual circumstances where the formula does not fairly represent the extent of a taxpayer's business activity in the State. Protestant-Appellant Kmart Properties, Inc. ("KPI") is not the type of business for which the standard three-factor formula was developed. Rather it is a creation of the tax planning genius of tax lawyers and accountants intended specifically to undercut fair apportionment of KPI's income as well as that of its parent Kmart, Inc. ("Kmart"). Since the intangible trademarks given KPI by Kmart constitute 99.999% of KPI's property and since only five employees are able to conduct KPI's multi-million dollar, national business, the hearing officer was correct in upholding apportionment of KPI's royalty income on the same basis it was earned, the aggregate relative sales of the Kmart stores within New Mexico.

ARGUMENT

I. LICENSOR OF TRADEMARK HAS DUE PROCESS NEXUS WITH STATES WHERE LICENSOR KNOWS AND INTENDS THAT LICENSEE WILL USE THE MARK.

Modern due process nexus lies where a business "purposefully avails itself of the privilege of conducting activities within the forum State." *Hanson v. Denckla*, 357 U.S. 235, 253 (1958). A business that sends its product into a State has due process nexus with that State, re-

gardless of physical presence. *Quill*, 504 U.S. at 307-308. "The forum State does not exceed its powers under the Due Process Clause if it asserts personal jurisdiction over a corporation that delivers its products into the stream of commerce with the expectation that they will be purchased by consumers in the forum State." *World-Wide Volkswagen Corp. v. Woodson* 444 U.S. 286, 297-298 (1980). Thus, when a trademark licensor knows and intends that its licensee will use its marks within a State and bases its royalties partially on the receipts of the licensee in that State, the licensor undoubtedly has due process nexus with that State.

Amicus COST cites *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 478 (1985), for the proposition that a "contractual relationship [is] insufficient for Due Process personal jurisdiction." COST *amicus* brief at 4. Presumably COST is suggesting that the mere existence of the KPI and Kmart license agreement alone is insufficient to create due process nexus for KPI in New Mexico. But COST's use of this statement is mistaken and completely inverts the meaning intended by the Court. What the Court was actually referring to in that portion of its opinion was its *rejection* of "mechanical" tests or "conceptualistic . . . theories of the place of contracting or of performance." The Court looked instead to "these factors—prior negotiations and contemplated future consequences, along with the terms of the contract and the parties' actual course of dealing—that must be evaluated in determining whether the defendant purposefully established minimum contacts within the forum." *Id*. at 478-479. KPI knew from its inception, from even before its corporate documents and the trademark license agreements were drawn up, that it would be licensing all its trademarks back to Kmart, that Kmart would continue to operate its stores in New Mexico, that numerous KPI trademarks would be employed by Kmart in New Mexico, that KPI would earn substantial income from royalties from Kmart's use of its trademarks in New Mexico, and that KPI was responsible under trademark law for policing the use of

its trademarks in New Mexico (or, perhaps, having its parent Kmart to do that policing for it). It is not therefore the "contract" alone that provides due process nexus in these circumstances, but also the parties' contemplated future consequences and actual course of dealing.

II. THE PHYSICAL PRESENCE REQUIREMENT FOR COMMERCE CLAUSE SUBSTANTIAL NEXUS UNDER *QUILL CORP.* v. *NORTH DAKOTA* WAS EXPLICITLY NOT EXTENDED TO INCOME AND OTHER TAXES.

Amicus MTC agrees with the hearing officer's conclusion that KPI, through Kmart, had physical presence in New Mexico, but your *amicus* disagrees with the hearing officer's summary acceptance that the commerce clause "physical presence" requirement of *Quill* extends to income taxes as KPI argued. The hearing officer wrote:

> Although, in rendering its decision [in *Quill*], the Court was careful to narrowly draw this rule with respect to sales and use taxes only, I concur with KPI's arguments that I can find no principled basis to distinguish between sales and use taxes, and income taxes under the Commerce Clause. The relevant inquiry is whether the tax burdens interstate commerce, not what type of tax is being imposed.

Record Proper (RP) at 51-52. The hearing officer was wrong. There are both principled and compelling, practical bases upon which to distinguish the nexus standard for use tax collection responsibility on mail order sellers that requires "physical presence" from the nexus standard for income taxes that does not. Not the least of the distinctions is exactly that relevant inquiry the hearing officer suggested but failed to follow through on—the different tax burdens on interstate commerce imposed by different taxes. See below at 13-17. Because "physical presence" is not required for income taxes nexus, the entire discussion of trademark law and the extent to which Kmart functions as a representative of KPI in ensuring compliance with various Lanham Act requirements was unnecessary.[2]

[2] While the MTC believes the hearing officer was wrong in extending *Quill*'s physical presence requirement to income taxes, we nevertheless agree that his analysis using that requirement was correct—finding sufficient

To properly analyze the scope of the physical presence requirement, one must review its source. The physical presence requirement as a commerce clause nexus standard comes from the Supreme Court decision in *Quill* that re-affirmed this much of *National Bellas Hess, Inc. v. Dept. of Revenue*, 386 U.S. 753 (1967), to continue the safe harbor against a use tax collection obligation for mail-order firms.

A. *Bellas Hess* Decision: Source of Physical Presence Requirement

In *Bellas Hess*, the Supreme Court held that States could not require a mail-order company to collect and pay over a purchaser's use tax as long as its only contact with customers in a State was by United States mail and common carrier. 386 U.S. at 758. The Court determined that mail-order businesses without any other kind of physical presence in a State to which they sent their product lacked "nexus" with that State. The decision relied on both the Due Process Clause and the Commerce Clause. *Id.* at 756. The Court drew no distinction between due process nexus and commerce clause nexus.

> These two claims are closely related. For the test whether a particular state exaction is such as to invade the exclusive authority of Congress to regulate trade between the States, and the test for a

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nexus based upon Kmart's "representing" KPI by doing the actual policing of the use of KPI's trademarks in New Mexico. Most curious is *amicus* Lanco's suggestion that the decision relies, in some improper way, on "legal fictions," brief at 21. What could be more a legal fiction than a "corporation"? In point of fact Kmart owns and controls the trademarks through KPI as fully as before in spite of the legal fiction of the separate corporate entity. This trademark "entity isolation" ploy leads us beyond fiction into farce. See the clear thinking of the Massachusetts Appellate Tax Board in *Sherwin Williams Co. v. Comm'r of Revenue* (2000 WL 1005799, Docket No. F233560, July 19, 2000) and *Syms Corp. v. Comm'r of Revenue* (Docket Nos. F215484 & F228324, September 14, 2000) recognizing this trademark entity-isolation stratagem for the sham it is. By recognizing that Kmart is really doing the work of the highly fictional KPI in ensuring the correct and proper usage in New Mexico and elsewhere of the trademarks that Kmart created and gave value to—trademarks that remain central to the value of the Kmart Corporation whether held directly by Kmart or indirectly by its wholly-owned subsidiary—the decision below recognized economic and legal reality, not fiction. Even had the Supreme Court intended to create an income tax safe harbor for businesses whose only contacts with a State were by mail and common carrier, it is hardly likely the Court was interested in protecting major corporations like Kmart and their wholly owned subsidiaries from paying taxes on the full amount of their business activity in various States. We believe state taxes are suffering from the same malady federal taxes are. One distinguished tax practitioner has identified one cause of this malaise as the movement toward making corporate tax departments "profit centers." M. Carr Ferguson, *2000 Erwin N. Griswold Lecture Before the American College of Tax Counsel: How Will a Court Rule?*, 53 TAX LAW. 721, 723 (2000).

> State's compliance with the requirements of due process in this area are similar.

Id.

B. The *Quill* Decision Re-Affirms Only the Commerce Clause Part of the *Bellas Hess* Decision.

Twenty-five years later in *Quill*, North Dakota argued that the *Bellas Hess* holding no longer represented the Supreme Court's existing due process and commerce clause jurisprudence. It focused its argument on Court decisions in the intervening years under which businesses were found to have nexus with any State to which they intentionally directed their solicitation and their products—generally an economic presence concept. North Dakota argued that this modern economic nexus standard meant that the Quill Corporation had use tax nexus with North Dakota because it intentionally sent substantial amounts of product into the State, entering the economy of the State. According to North Dakota's argument, Quill should, therefore, have been required to collect use tax on its mail order sales.

The Supreme Court accepted part of North Dakota's argument. The Court found due process nexus because Quill intentionally solicited sales in North Dakota and sent its product into the State. "[I]f a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's in personam jurisdiction even if it has no physical presence in the State." 504 U.S. at 307. In making its ruling the Court overruled the due process aspect of *Bellas Hess*. 504 U.S. at 308.

But the Court went on to differentiate, for the first time, between due process nexus and commerce clause nexus, interpreting the "substantial nexus" standard under the Commerce Clause as continuing to require the apparent physical presence standard its previous cases applied. It reluctantly[3] continued the physical presence requirement as a bright-line test, but only

[3] "While contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today, *Bellas Hess* is not inconsistent with *Complete Auto* and our recent cases." *Quill*, 504

for commerce clause nexus and only as to use tax collection obligations for mail order sellers. It did so largely on a *stare decisis* basis in order to preserve "settled expectations" in the mail order industry. *See Quill*, 504 U.S. at 316 ("a bright-line rule in the area of sales and use taxes also encourages settled expectations"), *id*. ("it is not unlikely that the mail-order industry's dramatic growth over the last quarter century is due in part to the bright-line exemption from state taxation created in Bellas Hess"), and at 317 ("the *Bellas Hess* rule has engendered substantial reliance and . . . therefore counsels adherence to settled precedent.").

C. The Court Used Specific Language in *Quill* Excluding Application of the Physical Presence Requirement to Other Taxes.

Importantly, the Court in *Quill* was clear that *only* in the area of use tax collection did the safe harbor apply. The Court explicitly acknowledged that the bright line "physical presence" requirement did not extend to other taxes.

> Although we have not, in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule.

Quill, 504 U.S. at 314. Thus, we need not look anywhere else for authority that the physical presence requirement for substantial nexus is limited to the mail order, use tax situation. The very decision that retained the physical presence requirement for imposing the obligation to collect use tax from a remote seller told us that the bright-line rule applies only to that tax. Moreover, the Court reiterated that it had not adopted the bright-line physical presence requirement for other types of taxes.

> In sum, although in our cases subsequent to Bellas Hess and concerning other types of taxes we have not adopted a similar bright-

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U.S. at 311. "Indeed, even if we were convinced that *Bellas Hess* was inconsistent with our Commerce Clause jurisprudence, 'this very fact [might] giv[e us] pause and counse[l] withholding our hand, at least for now.'" *Id.* at 318 (alterations in original), quoting from *Commonwealth Edison Co. v. Montana*, 453 U.S. [609], at 637 (1981) in discussing Congress's independent power over interstate commerce.

> line, physical presence requirement, our reasoning in those cases does not compel that we now reject the rule that Bellas Hess established in the area of sales and use taxes.

Quill, 504 U.S. at 317. The Court could hardly have been more explicit. Accordingly, the Court's unequivocal statements in *Quill* compels the conclusion that the physical presence requirement for "substantial nexus" under the Commerce Clause applies only to use taxes obligations of mail-order sellers and does not extend to other taxes.[4]

D. The Two Bases for the *Quill* Decision—*Stare Decisis* and Undue Burden—Reinforce its Limitation to the Use Tax Collection Obligation.

The Court's underlying reasons for its decision in *Quill* are fully consistent with its express statements limiting the physical presence requirement to use tax collection for mail order sellers. The Court gave two principal reasons for retaining the bright-line physical presence requirement from *Bellas Hess*. First, the Court relied upon *stare decisis* that furthers the settled expectations of the mail order industry, and second, upon avoiding undue burdens on interstate

[4] Although some claim that the physical presence requirement is applicable to all aspects of sales and use taxes based upon the general language of the Supreme Court quoted above, the MTC does not subscribe to this view. A simple, but accurate, statement of the holding of *Bellas Hess*, which *Quill* reaffirmed, is that a State may not impose a *use tax collection obligation* on a remote seller whose contact is limited to common carrier and the U.S. mail. 386 U.S. at 758. *Quill* repeated this holding at least five times. 504 U.S. at 301 (first paragraph of opinion), 307, 311 (two occurrences), and 315. The Supreme Court describes this principle as the physical presence requirement. 504 U.S. at 311 ("*Bellas Hess*' 'sharp distinction'"), 314 (*Bellas Hess* established physical presence requirement), and 317 (*Bellas Hess* physical presence requirement).

In referring to "sales and use taxes" in the quotations cited in the text above, the Court was using a somewhat loose shorthand to refer to the limitation *Bellas Hess* placed upon States imposing a use tax collection obligation on a remote seller, only one part of the sales and use tax. There is no indication that the Court interpreted the *Bellas Hess* holding as extending beyond the issue of use tax collection obligation on a direct marketer, the only sales and use tax issue raised in *Bellas Hess* and *Quill*. Indeed, a preeminent scholar has suggested one interpretation of *Quill* is that it applies only to the direct marketing industry. See Walter Hellerstein, *Supreme Court Says No State Use Tax Imposed on Mail-Order Sellers . . . for Now*, 77 J. TAX. 120, 124 (1992). This interpretation is not far-fetched when one compares the burden placed upon a catalog seller to know the use tax collection obligations arising with each order that comes from all over the world against the burden placed upon a corporate enterprise to know the sales and use tax system of those limited localities where it has operating an affiliate with which it has an ongoing contractually-established relationship. The MTC sees no purpose of the Commerce Clause that would be vindicated by recognizing a sales tax exemption for sales occurring between self-dealing affiliates of a single corporate enterprise. Thus, even though this *amicus* brief focuses on the nexus requirement for the imposition of an income tax, the MTC does not concede that the physical presence requirement is applicable to all aspects of sales and use taxes. For further discussion of this understanding see Paull Mines, *Conversing with Professor Hellerstein: Electronic Commerce and Nexus Propel Sales and Use Tax Reform*, 52 TAX L. REV. 581, 589*ff.* (1997).

commerce that could some from requiring remote sellers to comply with the disparate use taxes of potentially 6,000 sales and use tax jurisdictions requiring monthly tax returns.

1. Stare Decisis *Points the Other Way Since the Court Has Long Found Income Tax Nexus Without Physical Presence.*

The Court seemed most concerned with *stare decisis* as noted above. In the 25 years after *Bellas Hess,* the mail order industry had relied on this bright-line rule and had not collected use tax from its customers. Even though the Court acknowledged that current Commerce Clause jurisprudence might lead it to a different conclusion if it were writing on a clean slate, see footnote 3 above, it felt constrained by industry's settled expectation.

When one shifts to income taxes, however, considerations of *stare decisis* lead to the opposite conclusion—no physical presence is required. Clear U.S. Supreme Court precedent has long supported the imposition of state income taxes on non-residents without the kind of physical presence in the taxing State for which KPI argues.

In *New York ex rel. Whitney v. Graves*, 299 U.S. 366 (1937), the Supreme Court upheld New York's authority to assess income tax on a non-resident with no physical presence in New York. The Court phrased the issues as follows: "The question here presented relates to the constitutional validity of a tax imposed by the State of New York upon the profits realized by a non-resident upon the sale of a right appurtenant to membership in the New York Stock Exchange." *Id.* at 369. The relator, Whitney, had "'contended that the assessment of the tax under the provisions of the state act contravenes the Fourteenth Amendment of the Federal Constitution as an extraterritorial tax.'" *Id.* at 370. The Court emphasized Whitney's assertion that he and his partners were neither residents of New York nor came to New York to transact business:

> The relator, in challenging the jurisdiction of the State of New York to lay the tax, stresses the points that the relator and his copartners have always been domiciled in Massachusetts; that they have never had an

> office or abode in New York and have never carried on business there; that while they advertise themselves in Boston as members of the New York Stock Exchange and accept orders from customers at their Boston office for execution on the New York Stock Exchange, none of that business is conducted by the relator or his copartners on the floor of that Exchange; that they do not buy and sell securities on the Exchange for their firm account; that orders requiring execution on the Exchange are telegraphed to members of the Exchange who have business offices in New York and who execute their orders on the Exchange in their own names, acting as correspondents, lending money on the security of the stock purchased and other collateral delivered to them.

Id. at 371. Unquestionably, the Court was dealing with a New York income tax imposed on someone lacking the kind of physical presence within that State for which KPI argues. The Court concluded that the source of the income, the seat on the NYSE, had a business situs in New York, and "that in laying the tax upon the profits derived by the relator from the sale of the right appurtenant to his membership the State did not exceed the bounds of its jurisdiction." *Id*. at 374.

Seven years later, the Supreme Court upheld another state tax imposed on non-residents with no physical presence within the State. *International Harvester Co. v. Wisconsin Dept. of Taxation*, 322 U.S. 435 (1944). The tax was for the privilege of receiving dividends measured by the Wisconsin portion of distributed earnings. Although there was some contention concerning on whom the incidence of the tax fell, the Court made clear that it was imposed on the stockholders. "For present purposes we assume that . . . the tax is thus, in point of substance, laid upon and paid by the stockholders." *Id.* at 440. The Court found no problem with Wisconsin's laying this tax on persons who had no physical presence within the State.

> Personal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them. A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers.

Id. at 441-442. The Court in essence relied on the existence of "doing business" to support its nexus finding. The Court was unequivocal. "And the fact that the stockholder-taxpayers never enter Wisconsin and are not represented in the Wisconsin legislature cannot deprive it of its jurisdiction to tax. It has never been thought that residence within a State or country is a sine qua non of the power to tax." *Id*. at 443. Finally, the Court concluded "that appellants' stockholders can have no constitutional objection to the withholding by Wisconsin of a tax measured by their dividends distributed from Wisconsin earnings." *Id.* at 445. While it is unclear whether the Court viewed the stockholders' intangibles, the shares of stock in International Harvester as having a business situs in Wisconsin, it is clear that the Court premised its decision on the reality that those intangibles were used in Wisconsin to earn the stockholders income from the doing business in Wisconsin.

Interestingly, in its attempt to alarm this court with a parade of horribles, *amicus* Lanco, Inc. asserts that "the implications of the *Kmart Properties* decision would radically alter the landscape for taxation among the states." Lanco *amicus* brief at 23. As its prime example, Lanco cautions that the *KPI* decision could lead to the conclusion that IBM's presence in New Mexico would allow New Mexico to tax dividends distributed to an IBM shareholder residing in Michigan. But wait, this alleged horrible turns out to be the exact holding of the *International Harvester* case. Perhaps it is Lanco's theories that would radically alter the landscape of solid U.S. Supreme Court precedent.

International Harvester and *New York ex rel. Whitney* found nexus over income of a person not physically present in a State based on Fourteenth Amendment challenges that raised only due process nexus issues. Commerce Clause "substantial nexus" was not discussed because there was no separate Commerce Clause "substantial nexus" until *Quill*. Prior to *Quill*, there was only

one kind of nexus.[5] That was the concept of nexus on which the Supreme Court was ruling in *New York ex rel. Whitey v. Graves* and *International Harvester*. No physical presence requirement of the kind sought by KPI was articulated as being applicable in those cases that involved taxes other than a use tax collection obligation. Indeed, these decisions are obvious examples of cases the Supreme Court could have had in mind when in stating in *Quill* that "we have not, in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes . . . ." 504 U.S. at 314. No Supreme Court decision has applied the *Quill* physical presence requirement to a state income tax.[6] No taxpayer could reasonably have expected constitutional protection from paying an income tax in States where her intangible property—be it a seat on the stock exchange, a share of stock, or a trademark—earns income for her.

Furthermore, any taxpayer that has read the scholarly commentary on the *Quill* decision would find little assurance that the same physical presence requirement applied to use taxes of mail-order sellers would be extended to income tax. *See, e.g.*, Jerome R. Hellerstein and Walter Hellerstein, STATE TAXATION, ¶ 6.02[2] (3rd ed.1998); Jerome R. Hellerstein, *Geoffrey and The Physical Presence Nexus Requirement of Quill*, STATE TAX NOTES, February 13, 1995; Michael T. Fatale, *Geoffrey Sidesteps Quill: Constitutional Nexus, Intangible Property and The State*

[5] Indeed, the physical presence requirement in *Bellas Hess*, affirmed in *Quill*, derives from due process nexus concepts. *See* Pomp & McIntyre, *State Taxation of Mail-Order Sales of Computers after Quill: An Evaluation of MTC Bulletin 95-1*, 11 STATE TAX NOTES 177, 180-181 (July 15, 1996). Although the Court in *Quill* recognized that it had long abandoned a physical presence requirement for due process nexus, it retained the requirement for commerce clause nexus for use tax collection obligations. The lack of any physical presence requirement in *New York ex rel. Whitney v. Graves* and *International Harvester* thus implicates both due process and commerce clause nexus with regard to state income taxes.

[6] Since the Court has denied review in both *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993), and *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.2d 831 (Tenn. App. 1999), *cert. denied*, U.S. Sup. Ct. No. 00-205 (October 10, 2000), it is up to the state courts in the first instance to determine whether the physical presence requirement applies to income taxes.

Taxation Of Income, 23 HOFSTRA L. REV. 407 (1994). Any reliance on *Quill* to defeat nexus for imposing an income tax would be risky at best.

Consequently, *stare decisis*, so strongly the basis for the Court's retaining the bright-line test in *Quill*, points the other way in the income tax area. Settled precedent supports nexus to impose income tax on nonresidents without physical presence in the taxing State. Such precedent removed any basis for "settled expectations" that physical presence in a State is a prerequisite to States' imposing income tax.

2. *States Impose No Undue Compliance Burden on Multistate Taxpayers with Their Income Tax.*

The second basis for the decision in *Quill* derived from the articulated distinction between due process and commerce clause nexus. The Court described the distinction as follows:

> Despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical. The two standards are animated by different constitutional concerns and policies.
>
> Due process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him. We have, therefore, often identified "notice" or "fair warning" as the analytic touchstone of due process nexus analysis. In contrast, the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy. . . . Accordingly, we have ruled that that Clause prohibits discrimination against interstate commerce [citation omitted] and bars state regulations that *unduly burden* interstate commerce.
>
> * * * The first and fourth prongs [of *Complete Auto Transit, Inc. v. Brady*], which require a substantial nexus and a relationship between the tax and state-provided services, limit the reach of state taxing authority so as to ensure that state taxation does not *unduly burden* interstate commerce.[6] Thus, the "substantial nexus" requirement is not, like due process' "minimum contacts" requirement, a proxy for notice, but rather a means for *limiting state burdens* on interstate commerce.

Quill, 504 U.S. at 312, 313 (emphasis added, footnote omitted). Emphatically, *undue burden* is the essence of commerce clause "substantial nexus." The Court commented in omitted footnote 6, above, that "North Dakota's use tax illustrates well how a State tax might unduly burden interstate commerce." After citing the burden that could arise for a remote seller to collect tax for North Dakota, it noted "similar obligations might be imposed by the Nation's 6,000 plus taxing jurisdictions. *See National Bellas Hess, Inc. v. Dept. of Revenue*, 386 U.S. 753, 759-760 (1967) (noting that the 'many variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements could entangle [a mail-order house] in a virtual welter of complicated obligations')."

No such undue compliance burden now exists with respect to state income taxes. The most salient distinction is the number of jurisdictions. Only some 46 States (including the District of Columbia) impose a state income tax. A far cry from the 6,000 plus jurisdictions cited in *Quill*.

A second significant distinction in the degree of burden on interstate commerce is the extent of uniformity among the States in their income tax laws. This uniformity was the salutary consequence of the 1959 Supreme Court decision in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), and federal and state legislative reactions to that decision. *Northwestern States Portland Cement* recognized for the first time that States had the sovereignty to impose an income tax on a nondomiciliary business engaged exclusively in interstate commerce. Within just over six months, Congress reacted by enacting Pub. LAW 86-272, 73 STAT. 555 (1959), codified in part at 15 U.S.C. §381*ff*, barring States from imposing a net income tax on income from the sale of tangible personal property where an out-of-state company's contacts with taxing State are limited to prescribed safe harbor.

Title II of PUB. LAW 86-272 also mandated a congressional review of state income taxes as applied to interstate commerce. In discharge of this mandate, Congress formed the Willis Committee (so named for the chair of what actually was a Special Subcommittee of the House Judiciary Committee). The Committee conducted extensive hearings as a part of its exhaustive review of state taxes as applied to interstate commerce. Consistent with the controversy that greeted *Northwestern States Portland Cement* surrounding the application of state income taxes to interstate commerce, the Willis Committee observed:

> While each of the State laws contains its own inner logic, the aggregate of these laws—comprising the system confronting the interstate taxpayer—defies reason. Indeed, so varied are the provisions concerning jurisdiction, division of income, and tax base, that it is rare to find a statement which is true of all income tax States. [H.R. REP. NO. 952, 89th Cong., 1st Sess., Pt. VI, at 1143 (1965)]

The Willis Committee made extensive recommendations for federal legislation to pre-empt and regulate the application of state taxes to interstate commerce, including state income taxes. *Id.* at 1139*ff*. The recommendations for state income taxes sought, among other things, more uniformity in the rules for the division of income among the States and in the starting point used to compute the state income tax, the tax base. These and other recommendations attempted to address numerous problems that flowed from a substantial lack of uniformity that resulted in complexity, uncertainty, compliance burden, administrative challenge, and overtaxation and undertaxation.

The enactment of PUB. LAW 86-272 and the recommendations of the Willis Committee galvanized the States into resolving a practical problem—state income taxes were not then well framed to be applied to interstate business. State income taxes required reform, especially in the development of substantial uniformity, in order for States realistically to exercise their sovereignty to impose income tax on interstate commerce. The States could not ignore the immediate

need for reform of state income taxes because Congress stood ready to enact the reform itself through federal legislation that would preempt and regulate these and other state taxes.

The need for the States to solve their own problems prompted States to enact the UDITPA, to adopt the Multistate Tax Compact, and to form the Multistate Tax Commission. Indeed, uniformity is now a significant part of the state income taxes. "Of the forty-six states (including the District of Columbia) with corporate income taxes, twenty-three have adopted UDITPA, and most other states have similar statutory schemes." Jerome R. Hellerstein & Walter Hellerstein, STATE TAXATION, ¶ 9.01 (3rd ed. 1998). Congressional action was forestalled. These enactments greatly simplified the burden for multistate corporations in filing income tax in numerous States. Consequently, the Supreme Court has never struck down the imposition of a fairly apportioned state income tax on a multistate business doing business within several States as unduly burdensome because of compliance difficulties.[7]

Not only have the Multistate Tax Compact and UDITPA created significant uniformity among the States in apportioning income among the States, but the starting point to figure the income tax is also generally uniform. Most States piggyback their state income tax on federal income tax calculations, further simplifying multistate compliance. Few of the definitional problems, the extensive varying exemptions and deductions, and the myriad of rates with fre-

[7] *See Barclay's Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 312-314 (1994). Barclay's had alleged that the undue burden for a large, multinational bank to prepare the records necessary to file California income tax on a worldwide combined basis discriminated against interstate commerce. The Court held the burden was not undue and found no discrimination. Conceptually, this is really where the Court in *Quill* was headed. The undue compliance burden on the mail order house having to file use tax in potentially 6000 jurisdictions ultimately would discriminate against interstate commerce. Unfortunately, the Court detoured into creating from whole cloth a separate commerce clause nexus standard based on an undue burden on interstate commerce. Nonetheless, the Court in *Barclay's* found no undue burden on the multinational bank to file state income tax, nor has it in any case before or since.

We also note the failure of KPI to meet its burden to establish the existence of any undue burden on interstate commerce that would flow from its obligation to pay the New Mexico income tax. See *Norton Co.* v. *Dept. of Revenue*, 340 U.S. 534, 537 (1951) (burden to establish exemption from state tax based upon constitutional principles rests on the taxpayer); *General Motors Corp.* v. *Washington*, 377 U.S. 436, 441-42 (1964) (to same effect); *Container Corp. of America* v. *Franchise Tax Bd.*, 463 U.S. 159, 175-76 (1983) (to same effect).

quent changes that are all characteristic of sales and use taxes apply to state income taxes. Furthermore, state income taxes require only one annual return, not monthly returns as sales and use taxes generally do. Finally, the calculations of the property, payroll and sales factors necessary for apportionment under UDITPA for one State furthers the calculations needed to determine other States' apportionment.

Ultimately, with regard to KPI whose entire income derives from royalties paid by Kmart based on Kmart's receipts at each of its locations, figuring the tax base and apportioning the tax is straightforward and simply done. Parent Kmart already employs tax accountants to file income tax returns in each of these States. Moreover, the only reasons for any additional burden on KPI to file separate income tax returns in each State is because Kmart chose to create the complication itself as a tax planning attempt to avoid paying tax on all of its income earned in each of these States. Any burden on the taxpayers here is entirely self induced.

In sum, no credible reason can be found to extend the physical presence nexus requirement to state income taxes imposed on multistate businesses doing business with customers within a State. This conclusion is based on the language of *Quill* itself limiting the physical presence requirement to mail-order sellers' use tax collection obligation. It is based on the reasons articulated by the Court in *Quill* for continuing the physical presence nexus requirement for mail order sellers, reasons that are clearly not applicable to the income tax area. And finally, it is based on clear Supreme Court precedent allowing States to impose income tax on persons who earn income from doing business within their jurisdiction but who are not physically present within the State. As the Court said in *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 445 (1941):

> We must be on guard against imprisoning the taxing power of the states within formulas that are not compelled by the Constitution but merely represent judicial generalizations exceeding the concrete circumstances which they profess to summarize.

III. DIVIDING KPI'S INCOME AMONG THE STATES BASED ON KPI'S RECEIPTS FROM LICENSING ITS TRADEMARKS TO KMART IS THE ONLY FAIR METHOD OF APPORTIONMENT.

The hearing officer agreed with the Department's use of the equitable apportionment provision in Section 18 of UDITPA[8] to replace the standard three-factor apportionment formula which did not fairly represent KPI's business activity in New Mexico. This decision was not surprising since Kmart created KPI specifically to ensure that its business activity was not fairly represented, to shield income earned in New Mexico from New Mexico income tax. *See Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993); *Sherwin Williams*, above; *Syms*, above.

When UDITPA was created, it was with the recognition that the standard three-factor formula would be inappropriate in certain situations, particularly for nonmanufacturing or nonmercantile industries. *See* William Pierce, *The Uniform Division of income for State Tax Purposes*, 35 TAXES 747 (1957). Pierce, the principal drafter of UDITPA, commented that the standard apportionment "formula [is] designed for manufacturing and merchandizing businesses." *Id.* at 749. Consequently, Pierce noted that Section 18 "gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved." *Id.* at 781. Inevitably, there are cir-

[8] Section 18, enacted in New Mexico's version of UDITPA found at NM Stat. Ann. § 7-4-19 (1965) and in the Multistate Tax Compact, found at N.M. Stat. Ann. § 7-5-1(Article IV, § 18) (1967), reads as follows:

> If the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> A. separate accounting;
>
> B. the exclusion of any one or more of the factors;
>
> C. the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

cumstances where a taxpayer earns its income in such a way that the three-factor formula fails to represent the extent of the taxpayer's activity in the State properly. Section 18 permits such a taxpayer to petition for the use of a different formula in those circumstances. Likewise, Section 18 permits the Department to require a different formula when the standard formula does not fairly represent where the taxpayer's income is earned.

Sometimes these are problems characteristic of an industry and they can be dealt with prospectively through the regulation process. *See* 3 NMAC 5.19.12 Special Rules - Construction Contractors; 3 NMAC 5.19.13 Special Rules - Railroads; 3 NMAC 5.19.14 Special Rules - Airlines; 3 NMAC 5.19.15 Special Rules - Trucking Companies; 3 NMAC 5.19.17 Special Rules - Financial Institutions; 3 NMAC 5.19.18 Special Rules - Television and Radio Broadcasting. But sometimes the issue arises because of a taxpayer's individual business characteristics, or when a taxpayer attempts through the use of various "tax planning" devices to shift income from where it is earned to where it will not be taxed. These situations must be dealt with in a case-by-case manner. As tax planners create stratagems to avoid tax, States respond with apportionment formulas that fairly reflect the business activity of the taxpayer within the State. There is no more appropriate use of Section 18 by the Department than in these situations.

KPI is a highly unusual corporation. Its property consist of between $2.7 and $4.1 billion worth of intangibles representing the various Kmart trademarks, RP at 10, and only some $82,000 worth of desks, chairs, computers and filing cabinets. It had only five employees, all transferees from Kmart. KPI's income derived solely from the royalties its parent Kmart paid for licensing the trademarks. The use of the standard three-factor formula including tangible property and payroll grossly distorted the extent of KPI's business activity in New Mexico, business

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D. the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

activity that consisted entirely of licensing the intangible trademarks for use in Kmart's New Mexico stores in return for a percentage of the receipts that Kmart generated in those New Mexico stores. The use of the single sales factor, exactly the kind of modification authorized under UDITPA Section 18, is an obvious and equitable method of apportionment here.

CONCLUSION

For the reasons stated above, *amicus* MTC urges this Court to affirm that KPI has both Due Process and Commerce Clause nexus with New Mexico for imposition of income tax on KPI's royalty earnings in New Mexico from its licensee Kmart, and that the use of the single sales factor accurately represents the extent of KPI's business activity in New Mexico.

Respectfully submitted,

MULTISTATE TAX COMMISSION

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CERTIFICATE OF SERVICE

I hereby certify that on the 12th day of October, 2000, I hand delivered a true and correct copy of the foregoing Brief of *Amicus Curiae* Multistate Tax Commission to:

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