

**BEFORE THE HEARING OFFICER
OF THE TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO**

IN THE MATTER OF
KMART PROPERTIES, INC.,
NM ID. NO. 01-287446-00 6,
PROTEST TO ASSESSMENT
NOS. 2134646 AND 2134647

NO. 00-04

DECISION AND ORDER

This matter came on for formal hearing on November 17, 18, 19 and 20, 1998 before Gerald B. Richardson, Hearing Officer. Kmart Properties, Inc., hereinafter, "KPI", was represented by Curtis W. Schwartz, Esq., Timothy Van Valen, Esq. and Christopher P. Muirhead, Esq., of Modrall, Sperling, Roehl, Harris & Sisk, P.A. The Taxation and Revenue Department, hereinafter, "Department", was represented by Bruce J. Fort, Esq. After the hearing was adjourned, the parties were granted leave to file briefs. The final briefs were filed on February 15, 1999, and the matter was considered submitted for decision at that time. Since that time, supplemental authority has been filed by the parties, with the last submission being on December 21, 1999. Based upon the evidence and the arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. KPI's headquarters, principal place of business and commercial domicile are located in Michigan.
2. KPI is a wholly-owned subsidiary of Kmart Corporation, hereinafter, "Kmart".
3. Kmart is engaged in the general retail business.

4. At the end of 1991, Kmart operated 2,249 general merchandise stores in the United States and 126 stores in Canada. Kmart owned an additional 2,022 specialty retail subsidiaries throughout the United States and Canada, including but not limited to, Borders Books, Builders Square, Office Max, Pace, Pay Less Drugs, Sports Authority and Walden Books.

5. During the audit periods, February 1991 through January 1996 for the Corporate Income Tax Assessment and November 1991 through January 1996 for the Gross Receipts Tax Assessment, Kmart owned and operated approximately 22 general merchandise stores in New Mexico.

6. In 1991, Kmart's total sales from its general merchandise stores in the United States was \$24.448 billion, with an operating income of \$1.367 billion.

7. In 1991, Kmart's specialty retail subsidiaries had total sales of \$9.032 billion and operating income of \$0.345 billion.

8. James Misplon joined Kmart in 1983. In 1987, he became director of corporate tax and comptroller, effectively placing Mr. Misplon in charge of Kmart's tax department. In 1993, he became Divisional Vice-President for Corporate Taxes. In 1998, he became Kmart's Vice-President-Tax.

9. Sometime in late 1990, Mr. Misplon met with a longtime friend of his, Jim VanDeVelde, who held a similar position to his at Hillenbrand Industries.

10. During Mr. Misplon's conversation with Mr. VanDeVelde in late 1990, Mr. VanDeVelde informed Mr. Misplon of a tax planning opportunity involving a subsidiary corporation which would own and license intellectual property transferred from Kmart.

11. Mr. Misplon himself, and others in Kmart's tax department under his supervision, direction and control, investigated the tax planning opportunity involving a subsidiary corporation which would own and license intellectual property transferred from Kmart.

12. Kmart's Tax Department, under Mr. Misplon's supervision and control, is responsible for Kmart's tax planning and compliance. Kmart's Tax Department prepared KPI's state and federal income tax returns.

13. After a tax planning opportunity is identified and researched within Kmart's Tax Department, it is presented to the persons within Kmart with responsibility for the area of business to which the tax planning opportunity relates.

14. After Kmart's Tax Department had completed its analysis with regard to the tax planning opportunities which an intellectual property management and protection corporation provided, Mr. Misplon took the idea to Nancie LaDuke, Vice President and Secretary of Kmart for her consideration from a non-tax business perspective.

15. Ms. La Duke supervised the commercial law, trade regulation, international law and intellectual property sections within Kmart's Legal Department. Ms. LaDuke was consulted because her responsibilities as Vice President of Kmart's Legal Department include oversight of Kmart's intellectual property.

16. Ms. LaDuke concluded that the creation of an intellectual property management company would make sense from a non-tax business perspective in that it would provide greater focus, responsibility and accountability for management of Kmart's intellectual property and would reduce the expense of outside legal fees which Kmart historically incurred in relation to the management of its intellectual property. On that basis, Ms. LaDuke recommended the establishment of an intellectual property management and protection corporation to her superiors,

Mr. Anthony Palizzi, General Counsel and former acting Chief Executive Officer of Kmart, and Mr. Thomas Murasky, then Chief Financial Officer of Kmart.

17. Ms. LaDuke was unable to explain how the non-tax business advantages of creating a separate intellectual property management company could not have been accomplished just as well by creating a separate division within Kmart to manage its intellectual property.

18. The transfer of Kmart's trademarks to KPI for use by third parties actually created a greater risk of abandonment of Kmart's intellectual property than would have existed if Kmart had held and managed the trademarks itself. The transfer required not only the execution of the License Agreement, but also the implementation of procedures to ensure that the terms of the License Agreement were met with respect to policing the use of the intellectual property and ensuring the quality of the products and services with which the intellectual property was associated.

19. Sometime before April 3, 1991, Kmart approached Price Waterhouse, LLP with respect to the tax implications of the creation of a separate corporation to which Kmart's domestic trademarks would be transferred. A meeting was held on April 17, 1991 with a representative of Price Waterhouse, several employees of Kmart's Tax department and Michael Lisi and Lisabeth Coakley, Kmart's in house intellectual property attorneys.

20. At some time in 1991, Kmart prepared or received a summary of its estimated savings in state income taxes in 33 states which allowed separate entity filing, including New Mexico. The summary estimated state income tax savings of approximately \$12 million for the fiscal year ending 1/30/90 and assumed a royalty deduction of \$250,000,000.

21. The Detroit office of Price Waterhouse prepared a memorandum dated July 10, 1991, entitled Utilization of an Investment Holding Company to Minimize State and Local Income

Taxes. It concluded that if structured properly, a company formed to hold and license Kmart's intellectual property could generate significant state and local income tax savings for Kmart in states which allow separate entity filing for corporate income taxes as well as other non-tax benefits. The memorandum outlined that Kmart's tax savings could be achieved by transferring the intellectual property owned by Kmart's operating companies to a properly structured holding/investment company and charging a royalty for use of the intellectual property. Kmart would then reduce its taxable income by the royalty expense. The memorandum further advised that the royalty income generated by the investment/holding company could be transferred to Kmart or the operating companies through properly structured cash advances, loans or dividends. If the royalty income is loaned to Kmart, the interest on such loans would provide additional tax reduction benefits to Kmart by the amount of interest paid on such loans. The memorandum further recommended that the holding/investment company be organized as a Michigan Realty and Investment Company located in Michigan. Michigan's Single Business Tax, which is imposed on Michigan domestic corporations, excludes from taxable income interest and royalty income, thus shielding the interest and royalty income of the holding/investment company from taxation. The memorandum also recommended that the holding/investment company refrain from performing any activity which may result in establishing a taxable connection outside the state in which it is located.

22. Subsequent to the receipt of the Price Waterhouse memorandum, Mr. Palizzi and Mr. Murasky authorized the formation of a subsidiary of Kmart Corporation which became known as KPI.

23. The idea of creating a separate corporate entity to hold and license the intellectual property of Kmart originated in the Kmart Tax Department, not its Legal Department.

24. Before the idea of creating a separate corporate entity to hold and license the intellectual property of Kmart was raised by the head of the Kmart Tax Department, Ms. LaDuke had never considered establishing separate office space for the purpose of allowing Kmart's intellectual property lawyers to better focus on their intellectual property work, nor had Ms. LaDuke considered creating separate software and data bases for Kmart's intellectual property legal staff.

25. Kmart had never considered the creation of a separate corporate entity to hold and license its intellectual property prior to the issue being raised by Mr. Misplon of Kmart's Tax Department.

26. None of the other seven practice sections in Kmart's legal department have been split out or assigned to separate corporate subsidiaries.

27. In spite of the non-tax business reasons cited by Ms. LaDuke for creating a wholly owned intellectual property management company to more efficiently hold and manage Kmart's intellectual property, Kmart never transferred its foreign trademarks and tradenames to KPI to be managed or were the trademarks and tradenames of its specialty retail subsidiaries, such as Borders Books, Builders Square, Office Max, Pace, Pay Less Drugs, Sports Authority and Walden Books transferred to KPI for management.

28. The non-tax business purposes cited by Ms. LaDuke for Kmart to create KPI to own and manage Kmart's intellectual property could have been met by creating a separate division within Kmart focused solely upon the management of its intellectual property. The real reason for the formation of KPI was to reduce Kmart's state corporate income taxes in states which allow separate entity filing, including New Mexico.

29. At some time before July 9, 1991, Kmart solicited proposals from third parties for the purpose of establishing a valuation of the trade names and trademarks which were to be transferred to a separate corporate entity and to establish an arm's length royalty rate. Arthur Consulting Group submitted a proposal on July 9, 1991. Price Waterhouse was subsequently selected to prepare the valuation report. On August 1, 1991, Price Waterhouse provided Kmart with a written Estimation of a Range of Royalty Rates and Fair Market Values for the Kmart Trade Name.

30. Price Waterhouse estimated that the range of fair market values of the Kmart trade names owned by Kmart and used in the United States as of August 1, 1991 was between \$2,734,100,000 and \$4,101,200,000. It further estimated that the range of royalty rates for the use of such tradenames to be between 1% and 1.5% of net sales. Net sales were defined as the gross sales of the Hardlines, Fashions and Reader's Market divisions of the General Merchandise Group of Kmart, less returns and allowances.

31. Robert Reilly, a trademark, intellectual property and intangible property valuation expert, independently determined that Price Waterhouse's study arrived at a reasonable arm's length royalty rate for licensing the various trademarks and service marks licensed by KPI to Kmart.

32. Prior to the formation of KPI, Kmart's trademarks were registered, monitored, policed and defended against infringement by Kmart's legal department. At the time Kmart's trademarks were assigned to KPI, KPI had incurred none of the costs and had performed no activities which, in any manner created, enhanced or protected any of the value of those trademarks.

33. Prior to the formation of KPI, Kmart employed two attorneys specializing in intellectual property law: Lisabeth H. Coakley and Michael Lisi. Lisabeth H. Coakley was given

the responsibility for establishing the new office of KPI, including selection of a location, negotiating a lease, buying furniture and fixtures, setting up payroll and accounting systems. Michael Lisi was responsible for selecting computer systems and other tasks.

34. Prior to the formation of KPI, Michael Lisi and Lisabeth H. Coakley reported to Ms. LaDuke as their supervisor. Ms. LaDuke's duties included setting salaries for Ms. Coakley and Mr. Lisi.

35. After KPI was formed, the two attorneys who did the intellectual property work at Kmart became the attorney staff for KPI.

36. In deciding to physically segregate KPI from Kmart's offices, Ms. LaDuke was aware that the physical segregation of the intellectual property management subsidiary from the offices of its parent company was an important aspect of the tax planning benefits which accompany the formation of a separate intellectual property subsidiary and Ms. LaDuke took that into consideration when making her decision to locate KPI apart from the offices of Kmart.

37. In creating KPI in Michigan, Kmart closely followed the recommendations of the Price Waterhouse memorandum dated July 10, 1991, entitled Utilization of an Investment Holding Company to Minimize State and Local Income Taxes.

38. In creating KPI, the recommendations of the Price Waterhouse memorandum dated July 10, 1991 to establish an independent and substantial separate corporate entity to hold and manage Kmart's intellectual property were followed. A separate physical location for KPI was established, stationery and business cards were procured with KPI's own address, a separate telephone listing was created, bookkeeping and banking functions were confined to Michigan and storage was arranged for within Michigan for the physical storage of KPI's investment securities.

39. On September 27, 1991, Articles of Incorporation were filed with the Michigan Department of Commerce incorporating KPI.

40. On October 15, 1991, an oral presentation was made to the Board of Directors of Kmart recommending the formation of KPI. No written reports were submitted for consideration by the Board. That same day, the Board of Directors of Kmart authorized the formation of KPI.

41. On October 17, 1991, KPI was duly organized. An Action in Writing by Sole Incorporator of KPI was executed adopting and approving KPI's Bylaws. A Consent in Writing in Lieu of a Meeting of the Board of Directors of KPI was executed, taking appropriate action to organize KPI.

42. On October 28, 1991, a Consent in Writing in Lieu of a Meeting of the Board of Directors was executed by the KPI Directors further implementing the organization of KPI.

43. In its creation, and in operation, KPI observed all corporate formalities required by Michigan law.

44. KPI had its own duly elected Board of Directors, which consisted of three persons, the composition of which changed from time to time during the audit periods.

45. KPI's Board of Directors either held special board meetings, or in the alternative and lieu thereof, executed written consents adopting from time to time resolutions relating to the operations and management of KPI, as required and permitted by Michigan law and KPI's Bylaws.

46. Annually, KPI's Board of Directors adopted appropriate resolutions including the election of officers.

47. At all times during the audit periods, KPI had its own duly elected officers, which consisted of a President, two Vice Presidents, a Treasurer, two Assistant Treasurers and a Secretary and an Assistant Secretary.

48. At all times during the relevant audit periods, James Misplon was a KPI Assistant Treasurer. At all times during the relevant audit periods, James Misplon was an Assistant Treasurer of most, if not all, Kmart subsidiaries. At all times during the relevant audit periods, Frank McClure was a KPI Assistant Treasurer. At all times during the relevant audit periods Frank McClure was an Assistant Treasurer of most, if not all, Kmart subsidiaries. At all times during the relevant audit periods, Nancie LaDuke was KPI's Assistant Secretary.

49. The Corporation Company was KPI's registered agent in Michigan for 1992. For 1993 and 1994, Michael A Lisi was the registered agent. For 1995 forward, Gerald T. Tschura was the registered agent.

50. On October 30, 1991, KPI and Kmart entered an Agreement Regarding Capital Contribution.

51. The Capital Contribution Agreement memorialized a tax-free exchange of assets for stock between parent and subsidiary corporation in accordance with the United States Internal Revenue Code § 351, which is a common method of capitalizing corporate subsidiaries.

52. On October 30, 1991, KPI issued to Kmart 100 shares of KPI common stock thereby making Kmart the sole shareholder of KPI, in exchange for Kmart's capital contribution of certain of its intellectual property to KPI.

53. On October 30, 1991 by a written Assignment entered into by and between Kmart and KPI, Kmart transferred to KPI all of its domestic service marks, trademarks and tradenames,

together with goodwill symbolized by those service marks, trademarks and tradenames, making KPI the owner of all of Kmart's domestic intellectual property.

54. Kmart and KPI expressly agreed that the value of the stock transferred to Kmart had the same value as the intellectual property transferred to KPI.

55. Included in the intellectual property Kmart assigned to KPI was the Kmart logo, which is a significant intellectual property represented by a number of trademarks.

56. Kmart's initial plan was to transfer all of its international marks to KPI, but the international marks were not transferred because of costs and shifting priorities within Kmart.

57. Most of the intellectual property transferred to KPI by Kmart, including the domestic service marks, the trademarks and the trade names, were registered with or registration was pending with the United States Patents and Trademarks Office. KPI and Kmart filed registration statements with the U.S. Patents and Trademarks Office indicating the change of ownership from Kmart to KPI.

58. KPI generally did not register trade names and trademarks with state offices, relying instead on registrations with the U.S. Trademark and Patent Office. At no time during the audit periods or otherwise was any of the intellectual property transferred by Kmart to KPI ever registered by KPI with the State of New Mexico.

59. The Boards of Directors of both KPI and Kmart adopted resolutions allowing KPI employees to participate in Kmart-sponsored retirement plans, insurance benefits and other employee benefits. Certain of the Specialty Retail Subsidiaries participated in Kmart-sponsored retirement plans, insurance coverage and other employee benefits while others, such as Borders Books, Pay Less Drugs and Office Max did not.

60. Any 51% or more owned subsidiary of Kmart could participate in Kmart-sponsored employee benefits plans upon the adoption of a resolution authorizing such by the Boards of Directors of both Kmart and its subsidiary.

61. At no time during the audit periods or otherwise was KPI ever a party to any litigation in the State of New Mexico with respect to its intellectual property.

62. At no time did Kmart's annual reports disclose the formation of KPI and the transfer of assets valued at between \$2.7 Billion and \$4.1 Billion between the two entities.

63. KPI initially employed two attorneys, a legal secretary and an office manager to conduct its business affairs. Later, a legal secretary and paralegal were added to the staff. During the audit periods, KPI's staffing remained substantially the same. All of KPI's initial employees were transferred from Kmart. All received the same initial salary they had been earning at Kmart.

64. Although Kmart and KPI have corporate officers in common, KPI does not have any joint or shared employees with Kmart or others. All KPI employees are employed exclusively by KPI. KPI employees often perform work for Kmart and its subsidiaries, but they do so as employees of KPI.

65. KPI management, e.g., Lisabeth Coakley and/or Gerald Tschura, made the decisions whether to hire additional employees and who would be hired.

66. KPI management supervised KPI's staff, evaluated their performance and determined pay increases.

67. Ms. Coakley served as Vice President, Treasurer and legal counsel for KPI.

68. On October 31, 1991, KPI leased office space in Troy, Michigan by entering into a lease with Sheffield Office Park. KPI's office is approximately one block away from Kmart's

headquarters, also located in Troy Michigan. Ms. Coakley selected the Sheffield Office Park location because of its close proximity with Kmart, for whom KPI performed legal services.

69. Sheffield Office Park is not in any way related to Kmart or KPI except for its lease agreement with KPI. KPI's name appeared on the office directory at Sheffield Office Park.

70. KPI purchased all office furniture, supplies, stationery, business cards and office equipment necessary for its operation, such as file cabinets, computers, a photocopier, a fax machine and calculators. KPI paid for the office furniture, supplies, stationery, business cards and equipment with its own funds drawn from its own bank accounts.

71. KPI's office space includes four offices, a conference room, lunchroom, file room and reception area.

72. When it commenced business operations and throughout the audit periods, KPI has had an identifiable place of business with supporting business records, including its own stationery and business cards.

73. KPI does its own bookkeeping and maintains its own books of account.

74. KPI's bookkeeping and accounting software is not compatible with Kmart's. To incorporate KPI's books of account into that of Kmart, Kmart's financial reporting employees download the accounting information and convert the information so that it is compatible with Kmart's software.

75. KPI employed the services of independent payroll companies, Automated Data Processing and Payroll One, to perform its payroll functions, including but not limited to, preparation of payroll checks for KPI's employees and preparation of state and federal employment and unemployment tax reports and returns. The independent payroll companies are also unrelated to and independent of Kmart and Kmart does not utilize their services itself.

76. KPI incurred and paid its own operating expenses such as salaries and wages, equipment rental, maintenance and repair, rent, state and federal payroll taxes, property taxes, utilities, office supplies, dues and subscriptions, insurance, postage, telephone, meals and travel, data processing and printing.

77. KPI maintained bank accounts in its own name.

78. KPI has a payroll checking account at National Bank of Detroit which is separate and apart from its operating business account. All KPI payroll checks are written on KPI's payroll account.

79. KPI did not incur any operating or other expenses in New Mexico.

80. Before formation of KPI, Kmart's tax department researched whether any states could assert the ability to tax a subsidiary corporation which holds Kmart's intellectual property based only upon the subsidiary's use of the intellectual property within such state and it was determined that such a subsidiary would lack taxable nexus.

81. KPI, in accordance with federal law, filed all required IRS forms 941, Employer's Quarterly Federal Tax Return, remitting income and FICA taxes withheld from its employees and its employment taxes.

82. KPI, in accordance with federal law, filed all required IRS forms 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, remitting its federal unemployment taxes.

83. KPI, in accordance with Michigan law, filed all required Michigan forms C-3200, Combined Returns for Michigan Taxes, remitting Michigan income taxes withheld from its employees.

84. KPI, in accordance with Michigan law, filed all required Michigan forms MESC 1020, Employer's quarterly Tax Report, remitting its Michigan unemployment taxes. KPI, in

accordance with Michigan law, filed all required Personal Property Statement, forms STC 632, with the City of Troy, rendering its personal property for personal property tax purposes.

85. KPI, in accordance with Michigan law, filed its Single Business Tax Annual Return, Forms C-8000, and supporting schedules with the Michigan Department of Treasury.

86. KPI, in accordance with Michigan law, filed all required Michigan Annual Report Domestic Profit Corporations, form C&S 2500, with the Michigan Department of Consumer and Industry Services Corporation, Securities and Land Development Bureau.

87. From 1991 to 1995, KPI paid Michigan single business tax of \$100 per year. KPI paid no other state income taxes as a separate corporate entity. On its proforma Federal Corporation Income Tax Form 1120 for 1994, KPI reported a state income tax expense of \$5,337,546.00, representing KPI's portion of taxes paid on a combined filing basis in states where KPI's income was combined with Kmart's income.

88. KPI relied on Kmart's tax department to prepare its various tax documents because KPI did not have the requisite expertise in that area and KPI believed that Kmart's tax department was competent to handle KPI's tax matters.

89. The Kmart tax department is available to provide assistance to any of Kmart's subsidiaries.

90. On the same day, October 30, 1991, on which Kmart assigned its domestic service marks, trademarks and tradenames and related goodwill to KPI, KPI and Kmart entered into a license agreement whereby KPI granted an exclusive license to use all of the service marks, trademarks and trade names which it owned to Kmart, for Kmart's use in the United States and its territories. If KPI had not been created as a separate subsidiary to hold Kmart's service marks,

trademarks, tradenames and related goodwill, a licensing agreement would not have been necessary for protection of Kmart's intellectual properties.

91. Under the License Agreement, KPI receives consideration from Kmart, in the form of royalties, for the grant of the license. The royalty rate which KPI receives from Kmart equals 1.1% of Kmart's net sales.

92. The License Agreement was negotiated and executed in Michigan and by its terms, the agreement is governed by Michigan law and all disputes are to be resolved in Michigan courts.

93. KPI, as owner of the service marks, trademarks and tradenames, had the power to determine where it would license Kmart to use those properties. In granting a license to Kmart to use those properties in the United States, KPI knowingly granted Kmart a license to use those properties in connection with its retail store operations in New Mexico and elsewhere in the United States.

94. Under the terms of the License Agreement, Kmart warrants that all products and services bearing the trademarks, and service marks, ("the Marks") will be consistent with the high standards of quality and excellence established over the years by Kmart with respect to the Marks. Kmart further agreed to comply with any quality standards set by KPI with regard to the products or services bearing the Marks. It was further agreed that the initial quality standards would be those currently maintained by Kmart, but should Kmart wish to add a new product or service or change the quality of an existing product or service, Kmart must so advise KPI and advise it of the description of the new product or service, or the revised quality standard. Unless KPI provides written notice of objection to the new product, service or revised quality standard

within thirty days, KPI is deemed to have approved the new product, service, or revised quality standard.

95. Under the terms of the License Agreement, Kmart must furnish or make available to KPI representative samples of the products and services bearing KPI's Marks to permit KPI to determine if they meet quality standards. KPI is also given the right to inspect Kmart's places of business. If notified in writing by KPI, Kmart must not offer or provide services or products whose nature or quality does not comply with the quality standards established by KPI.

96. Under the terms of Paragraph 6 of the License Agreement, Kmart acknowledges the great value of the goodwill associated with the Marks, acknowledges that the goodwill belongs to KPI and acknowledges that actions taken by Kmart may affect the value of the goodwill associated with those marks. Kmart agrees not to take or continue any action which it would have reason to know could cause injury to the Marks or to KPI.

97. The terms of Paragraph 9 of the License Agreement require that Kmart distribute or sell the products or services bearing KPI's marks only from establishments maintaining a good business reputation and that are not associated with illegal, vulgar, obscene, immoral, unsavory or offensive activities in order to maintain and enhance the goodwill and image of quality associated by the public with KPI's Marks.

98. Under the terms of Paragraph 10 of the License Agreement, KPI acknowledges that Kmart obtains products from manufacturers of its own choice and contracts with contractors of Kmart's own choice to perform services and that such products and services associated with KPI's marks may be sold or used only in Kmart's stores. In addition, Kmart agrees to be fully responsible to KPI for the conduct of those with whom it contracts to ensure compliance with the License Agreement.

99. Paragraph 11 of the License Agreement requires that Kmart periodically inform persons from whom it obtains products or services bearing KPI's Marks of the appropriate trademark and copyright notices to be used in connection with the advertising, promotion, display and sale of the products and services.

100. Paragraph 7 of the License Agreement provides that the parties (Kmart and KPI) are independent contractors and are not agents, employees, partners, joint venturers or in a franchisor/franchisee relationship.

101. Paragraph 7 of the License Agreement requires that Kmart cooperate with and assist KPI in protecting and defending the Marks and requires that Kmart inform KPI of any infringements upon the Marks.

102. KPI's primary objective in entering into the License Agreement which allowed Kmart the use of KPI's trademarks and service marks was the further protection and enhancement of its valuable trademarks and service marks.

103. KPI relied on Kmart and its employees to comply with the terms of the License Agreement, which protect and enhance the value of its intellectual property.

104. KPI's business operations involved management of the trademarks, service marks and trade names that it owned, as well as providing legal services for its clients, Kmart and its specialty retail Kmart subsidiaries.

105. KPI did not provide legal services to any persons or entities other than Kmart and its specialty retail subsidiaries.

106. About half of the time of the attorneys employed by KPI was devoted to providing legal services to Kmart and its specialty retail subsidiaries.

107. KPI monitored the use of KPI's intellectual property by Kmart, actively protecting its intellectual property from infringement by others, continually updating filings and registrations to assure that its rights in and to the intellectual property was preserved, and conducting trademark and trade name searches.

108. To the extent it deemed necessary and appropriate, KPI employed and compensated outside, independent intellectual property counsel to represent it.

109. KPI monitored the use of its trademarks and service marks by Kmart by reviewing advertising Kmart submitted for review and by examining samples of products Kmart submitted for review. At times, KPI denied Kmart the use of its trademarks and service marks for specific applications and recalled products which did not meet its quality standards.

110. In reviewing the advertising submitted by Kmart, KPI looked to ensure that its trademarks were used in a consistent manner and to ensure that the use did not infringe on other trademarks or tradenames. If Kmart's advertising was not in compliance with proper use of its intellectual property, KPI would stop the advertisement and require that it be revised so that it was in compliance with KPI's guidelines and standards.

111. If KPI did not take measures to monitor the use of its intellectual property, it risked abandonment of the intellectual property, thereby permitting third parties to use the trademarks or tradenames in whatever manner they desired.

112. KPI required of Kmart that its vendors of products and services bearing the Marks sign a purchase agreement document attached to the License Agreement.

113. KPI interviewed and corresponded with product testing laboratories to determine that they had adequate testing procedures to ensure that the quality standards required under the Licensing Agreement would be met with respect to merchandise sold by Kmart.

114. KPI's paralegal also went to Kmart stores to obtain samples of merchandise.
115. KPI regularly monitored five or six stores located in Michigan to inspect how its intellectual property was being used.
116. KPI did not physically inspect any stores in New Mexico and rarely, if ever, visited any stores outside of Michigan.
117. KPI maintained a calendaring or docketing schedule to ensure that the intellectual property did not lapse.
118. It is common for owners of intellectual property to exploit it through licensing agreements.
119. It is also common for companies owning intellectual property to set up separate subsidiaries for the purpose of licensing intellectual property.
120. One expert, Ruurd Leegstra of the Price Waterhouse firm, has been associated with between 50 and 100 companies similar to KPI which were created to hold the intellectual property of its parent corporation and license that property to its parent as part of a state tax planning strategy marketed by Mr. Leegstra's employer to its state tax clients.
121. Intellectual property licensing is common and there is a substantial industry of professionals and a number of professional organizations involved in some aspect of licensing intellectual property.
122. It is common for licensees of intellectual property to pay for advertising the products and services associated with the trademarks and tradenames associated with those services, together with the associated trademarks and tradenames.

123. KPI receives a royalty from Kmart on a quarterly basis, in consideration for KPI's grant of the license to use KPI's intellectual property to Kmart. The royalty rate equals 1.1% of Kmart's net sales.

124. During the audit periods, KPI received royalty payments from Kmart totalling \$1,274,327,721, broken down as follows:

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|------|------------------|
| 1991 | \$ 82,380,841.00 |
| 1992 | 274,488,001.00 |
| 1993 | 292,128,653.00 |
| 1994 | 307,783,055.00 |
| 1995 | 317,547,171.00 |

1. Throughout the audit period, KPI maintained two bank accounts with the National Bank of Detroit, a Michigan bank. Account No. 905005958 was used primarily to pay KPI's payroll expenses. Account No. 9488-23 was used to hold the royalty payments KPI received from Kmart, together with earnings from short term investments. Operating expenses as well as loans to Kmart were paid from this account.

2. Kmart paid KPI the royalty payments via wire transfers from Kmart's operating account into KPI's separate bank account on a quarterly basis, with both accounts being located in Michigan. KPI also utilized wire transfers to effectuate the loans it made to Kmart and to transfer and receive funds from the banks with which it placed short term investments.

3. Frank McClure, as the Assistant Treasurer for both Kmart and KPI, oversaw the investment of corporate monies for both entities.

4. Kmart, through its treasurer's office, provides cash management services for all Kmart subsidiaries.

5. Teresa Mulawa was an Assistant Treasurer for Kmart who handled the day to day cash management and was supervised by Frank McClure.

6. Once KPI received the quarterly royalty payment, Frank McClure would typically instruct Teresa Mulawa to invest the monies in short term investments. These short terms investments were typically for terms of overnight to ten days, but could be for periods up to sixty days. Ultimately, the royalties received by KPI, less any operating expenses, were loaned back to Kmart, usually within two or three days from when they were received.

7. Mr. McClure directed the investment of KPI's funds pursuant to KPI's investment policy, which was essentially the same as the investment policy of Kmart's other subsidiaries. Pursuant to that investment policy, excess funds were invested in time deposits with quality, low risk banks from an approved list.

8. During the audit period, KPI and the specialty retail subsidiaries of Kmart did not declare and/or pay a dividend to Kmart. This was in accord with the standard practice of Kmart subsidiaries not to declare or pay dividends to Kmart.

9. Excess funds on hand of subsidiaries are routinely transferred into Kmart accounts for cash management purposes.

10. Such funds swept into Kmart accounts are booked and treated for all purposes as a loan from the respective subsidiary to Kmart.

11. All such loans bear market rate interest.

12. Kmart and KPI entered into a loan agreement in the amount of \$500,000,000, whereby KPI loaned its excess funds to Kmart.

13. KPI earned interest income from its own investments and from its loan to Kmart.

14. During the audit periods, KPI reported on its proforma federal form 1120 the following amounts of interest income:

| | | |
|------|----|--------------|
| 1991 | \$ | .00 |
| 1992 | | 2,509,094.00 |

| | |
|------|---------------|
| 1993 | 8,934,166.00 |
| 1994 | 18,771,119.00 |
| 1995 | 48,516,828.00 |

15. Interest paid by Kmart to its subsidiary lenders is reflected on the books of account of both Kmart and the lending subsidiary.

16. The loan agreement between KPI and Kmart expired on March 12, 1997. KPI did not notice that the loan agreement had expired until after that date, and no action was taken to execute a new loan agreement until sometime after the loan agreement had expired.

17. At the end of 1995, KPI's balance sheet indicated that it was owed \$797,170,000 in notes receivable from Kmart. This amount far exceeds the \$500,000,000 amount of the loan agreement between Kmart and KPI. No action was taken by KPI during the audit period to amend the loan agreement to cover the amounts it had loaned Kmart in excess of the stated amount of the loan agreement.

18. Lisabeth Coakley, KPI's Treasurer, did not consider other ways of investing KPI's excess capital, other than to allow it to be invested in short term time deposits and to loan it to Kmart. Although Ms. Coakley reviewed the loan agreement on behalf of KPI, she did not negotiate its terms.

19. The loan agreement contains no mechanism by which KPI can collect the loan debt from Kmart.

20. KPI doesn't know if the loan will ever be repaid, and has not asked that Kmart repay its loan.

21. During the audit periods, KPI reported the following amounts as income and the following amounts as deductions on its proforma federal corporate income tax returns:

Income

Deductions

| | | |
|------|------------------|---------------|
| 1991 | \$ 82,380,841.00 | \$ 123,425.00 |
| 1992 | 277,152,761.00 | 275,085.00 |
| 1993 | 302,057,826.00 | 1,362,051.00 |
| 1994 | 326,564,763.00 | 6,334,699.00 |
| 1995 | 366,079,858.00 | (854,922.00) |

22. KPI's income statement for the period through December 31, 1995 indicate that KPI's actual operating expenses were \$1,118,544.

23. KPI also performed intellectual property legal services for Kmart and its specialty retail subsidiaries. These legal services included defending Kmart against trademark infringement claims brought by third parties against Kmart not related to the marks KPI licenses to Kmart.

24. KPI billed and was paid for legal services rendered for Kmart and its specialty retail subsidiaries. These bills were paid by the entity for whom the legal services were performed.

25. About one-half of KPI's attorney time was billed to Kmart or its subsidiaries. Ms. Coakley billed her time at \$175/hour, based on comparable rates within the legal community, and Mr. Lisi's time was billed out at \$150/hour.

26. All legal services performed by KPI for others occurred in Michigan, with no legal services being performed in New Mexico.

27. KPI does not own, rent, lease nor license real or tangible personal property in New Mexico.

28. KPI has never had any employees or offices in New Mexico.

29. KPI has no bank accounts, addresses, post office boxes or offices in New Mexico.

30. KPI has never owned any vehicles used in New Mexico.

31. KPI has never had any equipment it owns used in New Mexico.

32. KPI performed no services in New Mexico.

33. All costs and expenses of KPI's business operations are incurred in states other than New Mexico.

34. KPI licenses its intellectual property to Kmart for use in New Mexico as well as the other forty nine states.

35. Kmart uses KPI's intellectual property and associated goodwill in New Mexico to promote and enhance its sales revenues.

36. KPI's logo is displayed on Kmart's stores in New Mexico.

37. Kmart requires that its employees wear either a smock or a shirt with the KPI logo displayed on it at all times while working in Kmart stores.

38. Kmart trains and requires its employees to maintain clean stores.

39. Kmart requires that its store employees be trained to be friendly to customers.

40. Kmart's activities, including marketing products and services bearing KPI's trademarks and tradenames, maintaining the quality of the products and services it sells, and otherwise providing its customers with a quality shopping experience inure to and enhance the value of KPI's trademarks and tradenames.

41. Will Baca, an assistant store manager for Kmart in New Mexico, was unaware of KPI or its role as licensor of the trademarks, tradenames and service marks which it owns to Kmart.

42. The Department conducted its audit of KPI through a review of Kmart and KPI documents.

43. The Department's auditor, Frank Schaffer, in selecting companies for audit, looked for companies which created subsidiaries to hold and license back intellectual property in order to create royalty expense deductions for the parent company.

44. Prior to attempting to audit KPI and to the assessments at issue herein, the Department's auditor had contacted Kmart's Tax Department to request a copy of the Licensing Agreement. Kmart's Tax Department responded that it would not provide the Licensing Agreement except in the context of an on-premises viewing.

45. The Department scheduled an audit with Kmart's Tax Department and requested, prior to the auditor's arrival, that certain documents relating to the royalty payments made by Kmart to KPI be made available to the auditor at the time the audit commenced. Kmart agreed to make the documents available to the auditor when he arrived.

46. When the Department's auditor arrived at Kmart's Tax Department at the appointed time for the audit, Kmart would not provide the documents which the Department's auditor had requested.

47. Ultimately, the Department only obtained the documents upon which the Department's assessments were based by enforcing a subpoena issued to Kmart in the District Court for Santa Fe County.

48. KPI furnished the Department's auditor with a breakdown of Kmart's sales revenues attributable to its New Mexico stores. The auditor then applied the 1.1% royalty rate to Kmart's New Mexico sales revenues to determine the royalties attributable to the licensing of KPI's trademarks in New Mexico. Broken down by calendar year, KPI's royalties from licensing its trademarks in New Mexico are as follows:

| | |
|-----------|------------|
| 1991 | \$ 497,251 |
| 1992 | 2,076,460 |
| 1993 | 2,231,215 |
| 1994 | 2,277,093 |
| 1995 | 2,289,144 |
| Jan. 1996 | 190,828 |

173. The Department's auditor used the amount of royalties attributable to the licensing of KPI's trademarks in New Mexico as the base upon which gross receipts tax was calculated for purposes of the Department's gross receipts tax assessment.

174. In 1991, by Laws 1991, ch. 203, § 1, the New Mexico legislature amended § 7-9-3(J) NMSA 1978, the definition of a lease, to provide that the granting of a license to use property is the sale of a license and not a lease.

175. In its audit, the Department determined that the three-factor formula was an inappropriate formula to apportion KPI's income which it determined was apportionable.

176. In its audit the Department utilized a single-factor formula based upon sales to apportion KPI's income which it determined to be apportionable.

177. The Department's auditor utilized the Department's corporate income tax instructions in determining that the three-factor formula was inappropriate to apportion KPI's income.

178. The Department's auditor used the amount of royalties attributable to the licensing of KPI's trademarks in New Mexico, modified to reflect the amounts received during each of KPI's fiscal years, which end in January of each year, and divided it by the amount of KPI's total royalties from licensing its trademarks to Kmart, broken down by fiscal year, to arrive at a percentage, which was the New Mexico apportionment factor. This apportionment factor was applied to the amount of tax calculated under the tax tables in the New Mexico Corporate Income and Franchise Tax Act, to calculate the amount of corporation income tax, by year, for purposes of the Department's corporation income tax assessment.

179. In formulating the sales factor, the Department's auditor departed from the standard sales factor formula calculation under § 7-4-18, which, for sales of other than tangible personal property, sources the sales to one state only, either the state where all of the taxpayer's income

producing activity occurs, or the state where the taxpayer incurs the greatest proportion of the costs of performing the income producing activity. Instead, the Department's auditor applied the method set forth in Regulation 3 NMAC 5.19.11.1(3), which provides that where the income producing activity with respect to business income from intangible property can be readily identified, if the income producing activity occurs in-state, it is included in the numerator of the sales factor.

180. The apportionment percentages arrived at by the Department's auditor for each of KPI's fiscal years is as follows:

| | |
|-------------|--------|
| FYE 1-29-92 | .7911% |
| FYE 1-27-93 | .8072% |
| FYE 1-26-94 | .7788% |
| FYE 1-26-95 | .7332% |
| FYE 1-31-96 | .6568% |

181. Kmart's New Mexico apportionment factor arrived at by using the standard UDITPA three factor formula for the years covered by the Department's audit was approximately .7%. This closely corresponds to KPI's apportionment factor under the Department's single factor methodology during the audit years.

182. On May 12, 1997, the Department mailed Assessment No. 2134646 to KPI, assessing \$250.00 of franchise tax, \$758,142.00 of corporation income tax, \$75,839.20 of penalty, and \$309,356.25 of interest for a total assessment of \$1,143,577.45 for the periods of February, 1991 through January, 1996.

183. On May 12, 1997, the Department mailed Assessment No. 2134647 to KPI, assessing \$478,099.55 of gross receipts tax, \$47,810.02 of penalty, and \$238,063.85 of interest for a total assessment of \$763,973.42 for reporting periods November, 1991 through January, 1996.

184. On August 8, 1997, KPI timely protested both the Corporate Income Tax Assessment and the Gross Receipts Tax Assessment.

185. On June 5, 1997, KPI requested that the Department grant a sixty day extension of the time for KPI to protest the assessments.

186. On June 12, 1997, the Department granted KPI until August 10, 1997 to file protests to the assessments.

DISCUSSION

INTRODUCTION

This case presents issues which call for a determination of the constitutional limits of state jurisdiction to impose taxes on a non-domiciliary corporation which licenses its intellectual property for use in its parent corporation's merchandising operations within the state. The constitutional limits of state jurisdiction to tax out-of-state corporations, and the limits on the nature and character of activities in which such corporations may engage without subjecting themselves to the State's taxing jurisdiction, have been the subject of extensive Supreme Court jurisprudence. This case adds elements not heretofore addressed by the Court, namely, the licensing of intellectual property in the form of trademarks and tradenames for use in the taxing state by a licensee to generate royalty income for the owner of the trademarks and tradenames, where the owner of the intellectual property benefits from the state's markets but has meticulously avoided directly engaging in activities which are known to subject it to the state's taxing jurisdiction.

The genesis of this case is a tax minimization strategy marketed by the Price Waterhouse accounting and consulting firm to clients with valuable intellectual property in the form of

trademarks and tradenames. This strategy purports to shield substantial amounts of income from taxation by states which allow tax reporting by corporations on a separate corporate entity basis.¹ Kmart hired Price Waterhouse to advise it about the tax benefits of such a strategy and how to implement the strategy should it undertake to do so. Price Waterhouse prepared a report to Kmart outlining the strategy (Exhibit S-108), which Kmart then implemented. Based on the advice received from Price Waterhouse, Kmart formed a wholly owned subsidiary, KPI, in Michigan and transferred its domestic trademarks and tradenames to KPI, (“the Marks”), together with the goodwill associated with the Marks. KPI then licensed the Marks back to Kmart for use in Kmart’s domestic operations and charged Kmart a fair market royalty for their use. KPI manages its intellectual property with a small staff of trademark attorneys and their support staff from its office located in Michigan. Michigan imposes a tax denominated the Single Business Tax, on domestic corporations for the privilege of doing business within the state. Michigan excludes from the tax base upon which tax is calculated both royalty and interest income. KPI generates about \$300 million a year in royalty income, but has little use for it, because of KPI’s minimal expenses when compared to this income. Kmart does have a use for the funds, however. KPI makes the funds available to Kmart by “loaning” them at market interest rates in transactions in which there is no indication that the loans will ever be repaid. The net effect of these transactions for Kmart is that its taxable income in the states in which it does business which allow it to report on a separate corporate entity basis is reduced by both the royalties and

¹ New Mexico allows taxpayers to elect, with certain limitations, from four different income tax reporting methods for reporting corporation income tax; separate accounting, separate corporate entity, combination of unitary corporations and federal consolidated group. *See, Exhibits S-110 through S-113A.* Under the separate corporate entity method of filing, corporations are allowed to file separate returns as a stand-alone entity with the state even though they may be part of a group of affiliated corporations which may be considered to be part of a group of unitary corporations or of a group of corporations which file as part of a federal consolidated group with the Internal Revenue Service. Under the separate corporate entity filing method, only those corporations who are part of a

interest it pays to KPI. Although this income has been effectively transferred to KPI, Michigan does not tax KPI on this income. KPI does not have employees or tangible property in states other than Michigan and so hopes to avoid being subject to the taxing jurisdiction of those states in which it licenses its intellectual property and which allow its parent to report taxes on a separate entity basis. At the time Kmart implemented this strategy, it was estimated to save Kmart approximately \$12 million a year in state corporation income taxes.

New Mexico has assessed KPI corporation income tax and corporate franchise tax based upon KPI's receipt of royalty income from licensing its intellectual property to Kmart for use in New Mexico or otherwise engaging in business in New Mexico. Additionally, the Department has assessed gross receipts tax upon KPI's gross receipts from those royalties generated by New Mexico sales. KPI has challenged New Mexico's jurisdiction to assess the taxes under both the Due Process Clause and the Commerce Clause of the United States Constitution. Alternatively, it has challenged New Mexico's methodology for imposing such taxes.

As noted above, this case involves matters not previously addressed by the United States Supreme Court in its cases addressing the constitutional limitations upon the taxing powers of the states with regard to non-domiciliary corporations, namely, the nature of the class of intellectual property known as trademarks and tradenames and the body of law which governs their use and the relationships between licensors and licensees of such property. An understanding of the nature of such property and the law relating to such property is important to determining the issues raised by this litigation, and so, it will be addressed first.

unitary or federal consolidated group which have sufficient activities or contacts with a taxing state so as to meet the nexus requirements under the Due Process Clause are required to file with that taxing state.

OVERVIEW OF TRADEMARK LAW

Trademarks, tradenames and service marks are a distinct form of intellectual property which are generally regulated under the Trademark Act of 1946, also known as the Lanham Act, 15 U.S.C. §§1051-1127, and are also recognized and protected under the common law. Trademarks are defined to include any word, name, symbol or device used by a person to identify and distinguish his or her goods from those manufactured or sold by others. 15 U.S.C. § 1127. Tradenames are defined to mean any name used by a person to identify his or her business or vocation. 15 U.S.C. § 1127. Service marks are defined to mean any word, symbol or device used by a person to identify and distinguish the services of one person from the services of others. 15 U.S.C. § 1127. Collectively, they will be referred to as trademarks.

Trademarks have a unique status as property because they do not exist as a stand-alone property right. They have been characterized as follows:

There is no such thing as property in a trade-mark except as a right appurtenant to an established business or trade in connection with which the mark is employed. The law of trade-marks is but a part of the broader law of unfair competition; the right to a particular mark grows out of its use, not its mere adoption; its function is simply to designate the goods [or services] of a particular trader and to protect his good will against the sale of another's product as his; and it is not the subject of property except in connection with an existing business.

United Drug Co. v. Theodore Rectanus Co., 249 U.S. 90, 97, 39 S.Ct. 48, 50 (1918). Thus, it is through the use of a trademark in conjunction with a product or service that the real value of a trademark, as a communication device, is created. As noted in J. Gilson, Trademark Protection and Practice, Vol. 1, § 1.03[6][a]:

Indeed, to the marketer of products in a competitive society the trademark is an indispensable means of communication. He uses it to stimulate brand loyalty and greater sales by establishing

purchase-motivating associations among consumers....Once such favorable associations are established, through such factors as effective advertising, high quality and, at times, price competition, further trademark use on products and in advertising ordinarily continues and enhances the sales momentum. *To the extent the trademark owner succeeds in creating such a psychological current, his trademark will function to symbolize good will, i.e., consumer willingness to purchase and repurchase trademarked products and services.* (emphasis added).

Thus, there is a special relationship between a trademark and the goodwill of a business owning the trademark. As further noted in J. Gilson, Trademark Protection and Practice, Vol. 1, § 1.03[7][b]:

There is a highly unique legal relationship between trademarks and the good will they come to represent. This relationship is fundamental to the law of trademarks, and several important consequences flow from it. *First, a trademark may not be assigned apart from the good will it symbolizes. Second, a trademark cannot exist apart from the going business in which it is used. The trademark and the good will it represents can thus be said to be inseparable.* Since there can be no good will for the trade mark to symbolize without such a going business and corresponding use of the trademark, trademark rights in the United States, at least, are wholly dependent on actual use. (emphasis added).

Thus, not only are trademarks inseparable from the goodwill of the business with which they are associated, they must continue to be used in association with that business to retain their status as a protected property right. Otherwise they may be considered to be abandoned. *Hanover Star Milling Co. v. Metcalf*, 240 U.S. 403, 36 S.Ct. 357 (1916). The basis for this rule relates to the nature of trademarks as a device to communicate or symbolize a certain product or service. If a mark is not used for a long enough period of time, it loses its ability to communicate information as to the quality, price, or nature of a business' product or service and to distinguish

it from the products or services of others. *See*, definition of “abandoned” in Lanham Act, 15 U.S.C. 1127.

The nature of trademarks as instruments which identify a particular product or service and which symbolize the goodwill of the business selling the product or service also creates certain legal requirements when trademarks are sold or licensed for use by others. The term used in trademark law to signify the transfer of title to a trademark is “assignment”. Because the trademark and the goodwill it symbolizes are inseparable, the law requires that they both be transferred by the assignment. A naked transfer of the mark alone, known as a transfer in gross, is invalid. *Visa, U.S.A., Inc. v. Birmingham Trust National Bank*, 696 F.2d 1371, (C.A. Fed., 1982), *cert. denied*, 464 U.S. 826, 104 S.Ct. 98 (1983). *See, also*, 15 U.S.C. § 1060. The Assignment executed by Kmart in this case met that requirement. Exhibit S-12. The owner of a trademark may also allow others to use the trademark. The contractual agreement by which this is done is called a license. While the law does permit a trademark owner to license its use to others, the public interest in assuring that the public is not deceived with respect to the nature and quality of the goods or services carrying the trademark requires the licensor to control or police the nature and quality of the goods and services sold under the mark by the licensee. *See*, J. Gilson, Trademark Protection and Practice, Vol. 2, § 6.01[4]. The requirement of quality control was incorporated into the Lanham Act through what is called the “related company” doctrine. A “related company” is defined to mean:

Any person whose use of a mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services on or in connection with which the mark is used.

15 U.S.C. § 1127. Provided that a licensor sufficiently controls the nature and quality of the goods or services associated with the trademark, the licensee’s use of the trademark is attributed

to the licensor and protects the licensor against a claim of abandonment pursuant to 15 U.S.C. § 1055, which provides in pertinent part:

Where a registered mark or a mark sought to be registered is or may be used legitimately by related companies, such use shall inure to the benefit of the registrant or applicant for registration, and such use shall not affect the validity of such mark or of its registration, provided such mark is not used in such manner as to deceive the public.

As noted in findings 94-101, *supra.*, the License Agreement executed between KPI and Kmart imposes numerous obligations on Kmart to comply with quality standards set by KPI, to provide it samples of products bearing the marks, to protect the goodwill associated with the marks, to ensure proper use of the marks, etc. Thus, the fact that KPI does not directly use the marks itself, but licenses them to Kmart for its exclusive use, cannot be deemed an abandonment of the marks, provided the control exercised by KPI is considered to be adequate.

Finally, it should be noted that the arrangement in this case, wherein Kmart, the original owner of the marks, assigned them to KPI, which, in turn, licensed them back to Kmart for use in the same manner in which they had been previously used and in which the public had associated them, is apparently an accepted practice within the law of trademarks. Such transactions have been held valid against charges of trademark abandonment, provided the controls implemented by the licensing agreement ensure that the mark is used in such a manner that the consumer is not misled by a separation of the trademarked product or service from the goodwill it was associated with. *Visa, U.S.A., Inc. v. Birmingham Trust National Bank, supra.*, 696 F.2d at 1376-1377.

THE DUE PROCESS CLAUSE

The Due Process Clause requires “some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax.” *Miller Brothers Co. v.*

Maryland, 344 U.S. 340, 344-345, 74 S.Ct. 535, 539 (1954). The shorthand terminology for this concept is “minimum contacts” or “nexus”. It is comparable to concepts of nexus for purposes of the exercise of a forum state’s power to adjudicate controversies involving non-residents. *See, e.g. Quill Corp v. North Dakota*, 504 U.S. 298, 307-308, 112 S.Ct. 1904, 1910-1911 (1992) wherein the Court discusses its due process jurisprudence and makes no distinction between its tax decisions and its decisions with respect to the jurisdiction of state courts. The underlying concept which animates the Supreme Court’s due process jurisprudence is whether, given a party’s conduct and contacts with a state, the assertion of jurisdiction by a state offends traditional notions of fair play and substantial justice. *International Shoe Co v. Washington*, 310 U.S. 310, 66 S.Ct. 154 (1945).

KPI argues that it does not have the requisite minimum contacts with New Mexico for the imposition of tax to be sustained. It relies on the facts that it is a Michigan corporation which has never had employees, tangible or real property in New Mexico. The License Agreement by which it licensed its intellectual property to Kmart was negotiated and executed in Michigan. KPI’s management of its intellectual property occurs in Michigan where both corporations are located. Kmart makes its royalty payments to KPI in Michigan. In essence, KPI argues that KPI undertakes no activity in New Mexico which would provide the minimum contacts required for it to be subject to the state’s taxing jurisdiction.

The modern test to determine whether minimum contacts exist between a foreign corporation and a state is whether the corporation has purposefully availed itself of the benefits of an economic market in the forum state. *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 105 S.Ct. 2174 (1985). It does not matter that the foreign corporation has no offices, employees, or other indicia of a physical presence in the state. This was clearly established in the Court’s

subsequent decision in *Quill*, in which the Court quoted with approval the following language from *Burger King, supra.*:

Jurisdiction in these circumstances may not be avoided merely because the defendant did not *physically* enter the forum State. Although territorial presence frequently will enhance a potential defendant's affiliation with a State and reinforce the reasonable foreseeability of suit there, it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted. So long as a commercial actor's efforts are "purposefully directed" towards residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there.

Id., 471 U.S. at 476, 105 S.Ct. at 2184 (emphasis in original). The Court in *Quill*, then went on to explicitly overrule its previous decisions which indicated that the Due Process Clause requires physical presence in a state for the state to impose a duty on an out-of-state mail order house to collect a use tax with respect to sales to residents within the state. *Id.*, 504 U.S. at 307-308, 112 S.Ct. 1910-1911.

Applying this test to the instant matter, KPI has purposefully availed itself of the benefits of an economic market within New Mexico. KPI owns highly valuable intangible property, in the form of the trademarks and the goodwill associated with the Marks which it has licensed for use by Kmart within New Mexico². KPI would have us think that somehow it was solely up to Kmart to determine where the Marks would be used, and that KPI had no power in this regard. This is ridiculous. KPI, as owner of the Marks had the power to control the terms of the license

² While the License Agreement does not specifically mention New Mexico, it grants a license to use the Marks within the United States and its territories, which obviously includes New Mexico. Additionally, there can be no dispute that KPI's Marks are located in New Mexico. *See, e.g., Wheeling Steel Corporation v. Fox*, 298 U.S. 193, 56 S.Ct. 773 (1936) (intangible acquires situs of business location where intangible is used); *Curry v. McCannless*, 307 U.S. 357, 59 S.Ct. 900 (1939) (intangibles can be subject to taxation where they are used or where owner of intangible resides.) .

it granted, including where those Marks could be used by Kmart. Indeed, KPI's stream of anticipated royalty income to be generated under the terms of the License Agreement depended upon the use of the Marks by Kmart to generate sales revenues from its stores³. Given the fact that KPI and Kmart have common officers and directors⁴, it would be hopelessly naïve to assume that KPI had no idea that Kmart operated stores within New Mexico which could be anticipated to generate a stream of royalty income to KPI based upon Kmart's sales in New Mexico.

Additionally, KPI's arguments fail to take into account the substantial congruence of interest between Kmart and KPI which is created by both the License Agreement and the overlay of trademark law upon their relationship. Although KPI owns the trademarks and the goodwill associated with those marks, it grants Kmart the right to use them and to avail itself of the goodwill they represent to generate sales revenues which create the very revenue stream the Department seeks to tax.

KPI strongly objects to this characterization that it allows Kmart to use the goodwill associated with the marks, based upon the language in the License Agreement in ¶ 2(b) wherein Kmart acknowledges that all rights and goodwill relating to the marks are reserved by KPI except for the license granted to use and utilize the marks as expressly allowed under the terms of the License Agreement. *See*, KPI's Post-Hearing Response Brief, pp. 5-7.⁵ While this is an accurate summarization of the language of the contract, I am not sure that it is accurate to read it as preventing Kmart from utilizing the goodwill associated with the marks as part of its license to

³ See Schedule E of the License Agreement, Exhibit s-13, which sets the royalty rate as 1.1% of Kmart's net sales from its Kmart stores in the United States.

⁴ The initial directors of KPI included Anthony N. Palizzi, who was Senior Vice President and General Counsel for Kmart and Thomas F. Murasky, who was Executive Vice President and Chief Financial Officer of Kmart.

⁵ KPI also relied upon the testimony of its intellectual property valuation expert, Mr. Robert Reilly, that Kmart had substantial goodwill not associated with the trademarks, which it retained. While this may be true, it is irrelevant to the issue of whether Kmart uses the goodwill associated with the trademarks in its retail operations in New Mexico and elsewhere.

use the mark. Even if the License Agreement were read to do this, the parties to a contract cannot by contract, alter the very nature of the property with which they are dealing. Trademarks are a creature of law. It would be the purest of legal fictions to separate the trademarks from the goodwill they represent. As noted earlier in this decision in the overview of trademark law, pp. 33-36, a trademark is a communication device used to stimulate customer loyalty and sales by establishing purchase-motivating associations with consumers. Once such associations are established, continued use of the trademarks ordinarily enhances continued sales. Thus, the trademark is a communication device which symbolizes the goodwill of a business. It cannot exist apart from the going business in which it is used. A trademark and the goodwill it represents are inseparable. *See, J. Gilson, Trademark Protection and Practice*, Vol. 1, §§ 1.03 [6][a], 1.03 [7][b]. Indeed, in this case there was no separation of the marks and the goodwill they symbolized. Although assigned by Kmart to KPI and licensed back to Kmart by KPI in simultaneous transactions, (both documents were executed on October 30, 1991), this transaction was absolutely transparent or invisible to all but those within the highest echelons of Kmart.⁶ Kmart continued to use the trademarks as it always had and Kmart's customers continued to associate the trademarks with the same stores, same merchandise, same sales staff, same price range of merchandise and all of the other factors which go into a Kmart shopping experience. It is no mischaracterization of the reality of the relationship between Kmart and KPI with respect to the use of the KPI's trademarks to conclude that KPI allows Kmart to use the goodwill associated with the marks in Kmart's stores in New Mexico to generate a stream of royalty income arising from such sales.

⁶ Kmart made no public announcement of its formation of KPI or the transfer of billions of dollars of intellectual property to KPI, Kmart made no mention of the formation or existence of KPI in its annual reports to its

The New Mexico Supreme Court has recognized that when a substantive identity of interests exists between an in-state party conducting business in New Mexico and an out-of-state party, that the acts of the in-state party may be attributed to the out-of-state party such that nexus may be found with respect to the out-of-state party. In *FDIC v. Hiatt*, 117 N.M. 461, 872 P.2d 879 (1994), the Court ruled that the district court did not have jurisdiction over an out-of-state loan guarantor where the loan was executed in New Mexico, the guaranty was executed by the guarantor out-of-state, the guarantors had no other contacts with New Mexico and the guarantor had no interest in the debtor corporation. It noted, however, that its decision would have been different had the guarantors been officers or directors of the debtor corporation, such that the guarantors could be found to share in the economic benefits afforded to the debtor corporation, stating:

When a substantive identity between the guarantor and the debtor is shown, as in the above cases, the guarantor may be said to have purposefully availed himself of the benefits and protections of the laws of the forum state and may have the minimum contacts with the forum state sufficient to meet the due process requirements of the exercise of personal jurisdiction by the forum state.

Id., 117 N.M. at 466. In this case, as noted above, not only do we have a substantive identity between KPI and Kmart based upon the directors and officers they share in common, but more importantly, there is a direct correlation between Kmart's use of KPI's trademarks in New Mexico to promote sales and enhance its sales revenues and the revenues KPI receives in the form of royalties which are calculated as a percentage of those New Mexico sales. Additionally, as noted in the discussion of trademark law, above, KPI exercises substantial control under the terms of the License Agreement over the manner in which Kmart may use the trademarks, and

shareholders, and its store employees are unaware of the existence of KPI and that Kmart does not own the trademarks.

Kmart's use of the trademarks inures to the benefit of KPI, not only in terms of protecting KPI's trademarks from claims of abandonment, but more importantly, also in terms of protecting and enhancing the goodwill associated with those trademarks⁷. On this basis alone, one can easily distinguish *World-Wide Volkswagen v. Woodson*, 444 U.S. 286, 100 S.Ct. 559 (1980), upon which KPI relies for the proposition that the unilateral acts of a related third party with a state do not constitute constitutionally required minimum contacts over a nonresident. In no way are Kmart's acts in promoting and enhancing KPI's trademarks unilateral acts. They are acts which Kmart and KPI have mutually agreed upon and which they understand are undertaken with the acknowledged purpose of enhancing the value of KPI's property, wherever it is used. Where KPI has entered into a Licensing Agreement which authorizes Kmart to use its valuable trademarks to promote sales of merchandise in markets, including New Mexico, which will generate royalty income for KPI, there is nothing fundamentally unfair or which would offend notions of substantial justice, to find that KPI has sufficient contacts with New Mexico for the purpose of finding jurisdiction to impose taxes on the revenue generated by those royalties.

THE COMMERCE CLAUSE

While the Due Process Clause is concerned with the fairness of subjecting persons to state jurisdiction, given the extent of their contacts with a given jurisdiction, the Supreme Court's Commerce Clause jurisprudence is concerned with whether state actions interfere with or unconstitutionally burden interstate commerce. Although the Commerce Clause, Article I, §8, cl. 3, only speaks to the authority of Congress to regulate commerce with foreign nations and among

⁷ Paragraph 6 of the License Agreement recites that "Licensor's primary objective in entering into this Agreement is the further protection and enhancement of its uniquely valuable trademarks and service marks." It further provides that "Licensee recognizes the great value of the goodwill associated with the Marks and acknowledges that the Marks and all the rights therein, and the goodwill attached thereto, inure to, benefit and belong exclusively to Licensor." Exhibit S-13

the states, and says nothing about protecting interstate commerce in the absence of congressional action, it has been recognized since *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, (1824) that even in the absence of congressional action, the Clause, by its own force, can act to prohibit state actions that are considered to interfere with or burden interstate commerce. This is called the “negative” or “dormant” Commerce Clause.

Probably no other clause of the Constitution has generated as much Supreme Court jurisprudence over the years concerning the limitations on the power of states to impose taxes. There has been a substantial evolution in the Court’s view as to the operation of the dormant Commerce Clause, from early cases holding that the clause acts as an absolute bar to state taxation of interstate commerce, to the modern view, articulated in *Complete Auto Transit v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079 (1977) which permits such taxation so long as the terms of its four pronged test are met: that tax is applied to an activity with a “substantial nexus” with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the state.

It is the first prong of the *Complete Auto* test that we are concerned with in this matter. KPI argues that because it lacks employees, real or tangible property within New Mexico, it also lacks the substantial nexus required under the Commerce Clause for New Mexico to impose a tax. Until the Court’s 1992 decision in *Quill, supra.*, the Court had never drawn a distinction between the “nexus” required under the Due Process Clause and the “substantial nexus” required under the Commerce Clause. In fact, in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 754, 87 S.Ct. 1389 (1967), the Court had found that claims that imposition of a state tax violate the Due Process Clause and the Commerce clause “are closely related”, and likened the tests to be applied, stating:

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 state's compliance with the requirements of due process in this area are similar. [citations omitted] As to the former, the Court has held that 'State taxation falling on interstate commerce . . . can only be justified as designed to make such commerce bear a fair share of the cost of the local government whose protection it enjoys.' [citations omitted] And in determining whether a state tax falls within the confines of the Due Process Clause, the Court has said that the 'simple but controlling question is whether the state has given anything for which it can ask return.' [citations omitted].

Id., 386 U.S. at 756, 87 S.Ct. at 1391. In *Quill*, however, the Court departed from this view, in which both tests looked at the fairness of subjecting a person to a state's taxing jurisdiction. It noted the different concerns which animated the Due Process Clause and Commerce Clause. Citing to its four prong test in *Complete Auto*, it stated:

The first and fourth prongs, 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 burden interstate commerce. 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. Accordingly, contrary to the State's suggestion, a corporation may have the "minimum contacts" with a taxing State as required by the Due Process Clause, and yet lack the "substantial nexus" with that state as required by the Commerce Clause.

Quill, 504 U.S. at 313, 112 S.Ct. at 1913-1914. In fact, this was precisely the result in *Quill*, in which the Court found that Due Process Clause minimum contacts had been satisfied but that substantial nexus under the Commerce Clause was lacking for North Dakota to impose a duty upon Quill Corporation to collect use taxes on its mail order sales.

In order to understand the Court's current test to determine whether a tax imposition complies with its Commerce Clause substantial nexus requirement, a review of *Quill* and its

predecessor, *National Bellas Hess*, will be helpful. *National Bellas Hess* involved an attempt by the state of Illinois to impose a use tax collection obligation upon Bellas Hess, an out-of-state mail order house. Bellas Hess had no office, distribution house, warehouse or any other place of business in Illinois. It had no agents, salesmen, canvassers solicitors or other types of representatives to sell or take orders or deliver merchandise in Illinois, nor did it own any tangible property, either real or personal, located in Illinois. Its only contact with Illinois was to mail catalogues and occasional supplemental flyers to its customers and to ship any merchandise orders, which were accepted out-of-state, to Illinois customers by mail or common carrier. The Court ruled that imposition of the obligation to collect use taxes for Illinois violated the Commerce Clause. In arriving at its decision, the Court reviewed its prior decisions, which had upheld the power of a state to impose a use tax collection on an out-of-state seller where the sales were arranged by local agents in the taxing state or where the mail order seller maintained local retail stores, such as Sears Roebuck & Company does. It noted that the furthest extension of a state's power to impose a use tax collection obligation on an out-of state seller which the Court had sustained was in *Scripto, Inc. v. Carson*, 362 U.S. 207, 80 S.Ct. 619 (1960), where the out-of-state seller had a group of salesmen, working as independent contractors on a commission basis, conducting continuous solicitation in the taxing state on behalf of the seller, who accepted the orders and then shipped the goods into the state. The Court then stated:

In order to uphold the power of Illinois to impose use tax burdens on National [Bellas Hess] in this case, we would have to repudiate totally the sharp distinction which these and other decisions have drawn between mail order sellers with retail outlets, solicitors or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business. But this basic distinction, which until now has been generally recognized by the

state taxing authorities, is a valid one, and we decline to obliterate it.

Id., 386 U.S. 758, 87 S.Ct. 1392. Of special concern to the Court were the burdens on mail order sellers of complying with similar use tax collection obligations in other state and local tax jurisdictions, noting:

And if the power of Illinois to impose use tax burdens on National [Bellas Hess] were upheld, the resulting impediments upon the free conduct of its interstate business would be neither imaginary nor remote. For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district and every other political subdivision throughout the Nation with power to impose sales and use taxes. The many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government.'

The very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements.

Id., 386 U.S. at 759-760, 87 S.Ct. 1392-1393.

Twenty-five years later, the Court agreed to revisit this issue in *Quill*. Like Bellas Hess, Quill Corporation was an out-of-state mail order company that had no sales outlets, employees or contract sales representatives in North Dakota, and either insignificant or non-existent tangible property in the state⁸. It solicited sales in North Dakota through catalogs and flyers, advertisements in national periodicals and telephone calls, and it delivered the merchandise ordered to its North Dakota customers by mail or common carrier. Like Illinois, North Dakota had sought to impose an obligation upon Quill to collect and remit a use tax on its sales of merchandise to in-state customers. The North Dakota Supreme Court, while acknowledging

⁸ Quill did license a computer software program to some of its North Dakota customers that enabled them to check Quill's current inventories and prices, but the State of North Dakota had conceded that the existence of a few floppy

National Bellas Hess, declined to follow it. It concluded that extensive changes in the national economy, such as the explosive growth of the mail order business and advances in computer technology, which eased the burden of compliance with the laws of multiple taxing jurisdictions, made it inappropriate to follow *National Bellas Hess*. Equally important to the North Dakota court's refusal to follow *National Bellas Hess* was what it saw as a significant shift in the Supreme Court's nexus jurisprudence. It noted that the Court's subsequent *Complete Auto Transit* decision had overruled the Court's previous decisions rejecting direct taxation of interstate commerce and changed the focus to a rational inquiry into the practical effect of the challenged tax and that in *Burger King v. Rudzewicz*, the Court had abandoned its physical presence nexus requirement. *Quill Corporation v. North Dakota*, 470 N.W. 2d 203.

The Supreme Court overruled the North Dakota Supreme Court. As noted above, for the first time, it drew a distinction between Due Process Clause nexus and Commerce Clause substantial nexus and concluded that under the Due Process Clause, physical presence in the form of a business location, employees or contract salespersons, was not required, so long as a business has purposefully availed itself of the benefits of the state's markets. *Quill*, 504 U.S. at 307-308, 112 S.Ct at 1910-1911. Under the Commerce Clause, however, the Court declined to abandon the "bright-line" physical presence test of *National Bellas Hess*, stating:

In sum, although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-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. To the contrary, the continuing value of a bright-line rule in this area and the doctrine and principles of *stare decisis* indicate that the *Bellas Hess* rule remains good law. For all these reasons, we disagree with the

diskettes which Quill owned was an insufficient basis upon which to base a finding of nexus. *Quill*, 504 U.S. at 315, n.8, 112 S.Ct. at 1914.

North Dakota Supreme court's conclusions that the time has come to renounce the bright-line test of *Bellas Hess*.

Quill, 504 U.S. at 317-318, 112 S.Ct. at 1916 (emphasis in original). Significant to the Court's adherence to the bright line physical presence requirement of *National Bellas Hess* were the benefits of a clear rule which firmly established the boundaries of legitimate state authority to impose taxes and the business investment decisions which may have been based upon the settled expectations engendered by such well established rules on the basis of the principles of *stare decisis*. *Quill*, 504 U.S. at 315-316, 112 S.Ct. at 1914-1915. Otherwise, the Court conceded, its contemporary Commerce Clause jurisprudence might not have compelled the same result were the issue to have first arisen at the time it rendered its decision in *Quill. Id.*, 504 U.S. at 311, 112 S.Ct. at 1912.

Quill, thus establishes a bright-line physical presence requirement under the Commerce Clause for states to impose sales and use taxes upon those who are availing themselves of a state's economic markets. Although, in rendering its decision, the Court was careful to narrowly draw this rule with respect to sales and use taxes only⁹, 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 Clause¹⁰. The relevant inquiry is whether the tax burdens interstate commerce, not what type of tax is being imposed. I disagree, however, with KPI's allegation that it lacks such physical presence in New Mexico.

⁹ The decision is full of statements such as, "a bright-line rule *in the area of sales and use taxes...*", 504 U.S. at 316, 112 S.Ct. at 1915, and, "we have never intimated in our review of *sales or use taxes* that *Bellas Hess* was unsound." 504 U.S. at 317, 112 S.Ct. at 1915-1916.

¹⁰ On this basis, I disagree with the portion of the South Carolina Supreme Court's decision in *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 SC 15, 437 SE2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992, 114 S.Ct. 550 (1993), which upheld the imposition of an income tax, under facts nearly identical to this case involving the taxation of royalty income of Geoffrey, Inc., derived from the licensing of the trademarks of Toys "R" Us for use in the Toys "R" Us stores, on the basis that the Commerce Clause physical presence requirement announced in *Quill*, was limited to sales and use taxes.

In *Quill*, the court discussed the cases in which it had found physical presence:

Prior to *Bellas Hess*, we had held that that requirement was satisfied in a variety of circumstances involving use taxes. For example, the presence of sales personnel in the State or the maintenance of local retail stores in the State justified the exercise of that power because the seller's local activities were 'plainly accorded the protection and services of the taxing State.' [citation omitted] *The furthest extension of that power was recognized in Scripto, Inc. v. Carson*, [citation omitted] in which the Court upheld a use tax despite the fact that all of the seller's in-state solicitation was performed by independent contractors. *These cases all involved some sort of physical presence within the State...*(emphasis added).

Id., 504 U.S. at 306, 112 S.Ct. at 1910¹¹. An examination of *Scripto, Inc. v. Carson*, 362 U.S. 207, 80 S.Ct. 619 (1960) will be helpful to this discussion. *Scripto* involved a Georgia corporation which sold pens in Florida through continuous solicitation by salesmen or "jobbers" who were not employees, but rather, were independent contractors who were compensated on a commission basis. Florida sought to impose a use tax to be collected and paid by Scripto, Inc. on pens sold to Florida customers. Scripto, Inc. had no office, distribution house or other place of business in Florida. It accepted the pen orders in Georgia and shipped them from Georgia. In rejecting Scripto's claim of lack of nexus, the Court stated:

True, the 'salesmen' are not regular employees of appellant devoting full time to its service, but we conclude that such a fine distinction is without constitutional significance. The formal shift in the contractual tagging of the salesman as 'independent' neither results in changing his local function of solicitation nor bears upon its effectiveness in securing a substantial flow of goods into Florida. ... To permit such formal 'contractual shifts' to make a constitutional difference *would open the gates to a stampede of tax avoidance.* (emphasis added).

Id., 362 U.S. at 211, 80 S.Ct. at 622.

I have little difficulty determining that the contractual relationship between KPI and Kmart under the License Agreement creates the requisite physical presence required to subject KPI to New Mexico's taxing jurisdiction under the Commerce Clause. As noted in the Court's discussion in *Scripto*, the fact that KPI does not use its own employees to utilize its trademarks to generate sales to New Mexico residents, to enhance the associated value of its trademarks by utilizing them as a marketing tool, and to generate a stream of royalty income for itself should not be given constitutional significance. The License Agreement, with its attendant obligations upon Kmart to protect and enhance the value of KPI's trademarks, creates a contractual relationship between the parties in which Kmart uses the trademarks and their associated goodwill as a marketing tool to continuously solicit New Mexico residents to purchase merchandise associated with the trademarks, thereby creating the very income stream New Mexico seeks to tax. Kmart's relationship to KPI, particularly in light of the requirements of trademark law which render the trademarks inseparable from the goodwill of the business they are associated with, places Kmart in the same position as the salesmen in *Scripto* and the independent salesmen in *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232, 107 S.Ct. 2810 (1987). Kmart is contractually obligated to do the very things which establish, maintain and enhance the market for KPI's trademarks in New Mexico in order to generate a revenue stream for KPI derived from those marketing activities.¹² These contractual

¹¹ Although this discussion occurred in the context of the Court's discussion of Due Process Clause nexus, and the Court ultimately determined that physical presence was no longer required by the Due Process Clause, the court made no distinction as to what constitutes physical presence in the Commerce Clause portion of its decision.

¹² The fact that Kmart also directly benefits from these activities does not negate the benefits its activities provide to KPI, any more than the fact that the independent salesmen marketing for *Scripto, Inc.* or *Tyler Pipe Industries, Inc.* also benefited from the sales they generated by earning commissions on such sales. The Court found no constitutional significance to the manner by which the salesmen operated and were compensated.

obligations give KPI a presence in New Mexico which goes far beyond those of *Bellas Hess* and *Quill Corporation*, whose only contacts with the taxing states were by mail and common carrier.

Not only is KPI's physical presence established by its contractual agreement with Kmart sufficient under the Supreme Court's bright-line physical presence requirement under the Commerce Clause, but this conclusion also does no violence to the considerations relied upon by the Court in *Quill* in its reaffirmation of the physical presence requirement. As noted above, KPI's relationship with Kmart with respect to the market for its trademarks goes far beyond the limited common carrier and mail contacts the Court found so prevalent for the mail order industry. Additionally, KPI cannot legitimately claim to have the substantial reliance interests the court found so persuasive in the context of the mail order industry and under the principles of *stare decisis*. The concept that a contractual relationship with an in-state party tied to the establishment and maintenance of in-state markets can create sufficient physical presence in the state has been the law since the Court issued its *Scripto* decision in 1960, long before the present strategy involving the assignment and licensing of intellectual property was ever conceived in state tax circles or considered by Kmart and KPI. This principle was reaffirmed in 1987 when the Court decided *Tyler Pipe Industries*. In spite of the Court's warning in *Scripto* that it would not grant constitutional significance to the shifting of obligations onto contractors lest it open the gates to a "stampede of tax avoidance", the tax professionals at Price Waterhouse, as well as Kmart, Toys "R" Us, and a host of other corporations¹³ apparently failed to heed its warning.

In fact, in New Mexico, there are three cases, all predating the formation of KPI, which rejected the taxpayers' Due Process Clause and Commerce Clause arguments and permitted the

¹³ Apparently, the transfer and licensing back of intellectual property is the hot new state taxation issue around the country. See, *Geoffrey, Inc. v. South Carolina Tax Commission, supra.*, and *Syl, Inc. v. Comptroller of the Treasury Compliance Division*, Maryland Tax Court Case No 96-0154-01, (April 26, 1999).

imposition of gross receipts tax upon franchise fees generated by New Mexico sales and received by out-of-state franchisors. *AAMCO Transmissions, Inc. v. Taxation and Revenue Department*, 93 N.M. 389, 600 P.2d 841 (Ct. App., 1979), *cert. denied*, 93 N.M. 205, 598 P.2d 1165 (1979), *American Dairy Queen Corp. v. Taxation and Revenue Department*, 93 N.M. 743, 605 P.2d 252 (Ct. App. 1979) and *Baskin-Robbins Ice Cream Co. v. Revenue Division, Taxation & Revenue Department*, 93 N.M. 301, 599 P.2d 1098 (Ct. App. 1979). In each of those cases, the court was not persuaded that because the franchise agreements were negotiated and executed out-of-state, the imposition of tax violated the Constitution. In each case, the court found significant that the companies, through their franchise agreements, permitted the use of their intangible property in New Mexico. Although the franchise agreements involved different obligations and relationships than the License Agreement herein¹⁴, they both involve the licensing of trademarks and their use in New Mexico to generate a revenue stream the state seeks to tax. Because they were decided before *Quill* and because *Quill* represents the most recent and highest authority with regard to the federal constitutional questions presented, my analysis herein has focused on *Quill* and the authority it relies upon, but I have no doubt that the three New Mexico franchise cases, cited above, remain good authority today. The franchise agreements amount to another type of contractual agreement which create the requisite physical presence under the Commerce Clause. Thus, any claims to upsetting settled expectations in the context of the facts of this case are groundless.

Finally, the Court in *Quill* was concerned with the burdens on interstate commerce which would be created by requiring out-of-state mail order companies to comply with the “virtual welter of complicated obligations” to the many state and local taxing jurisdictions which could

¹⁴ In the typical franchise agreement, the franchisee receives substantial services to assist them in their business from

seek to impose a tax. That concern should be of little concern in the context of this case. Kmart, which already provides tax preparation services to KPI, should be intimately familiar with the operation of New Mexico's tax provisions because of its numerous stores in New Mexico for which it already reports and pays taxes. Given the fact that the taxes involved herein arise from those same sales from those same stores, and those sales are already used by Kmart in calculating its royalty payments to KPI, the filing of an additional monthly CRS-1 return¹⁵ and an annual corporate income tax return on behalf of KPI should hardly be considered an undue burden.

In rendering this decision, I am also well aware of the Tennessee Court of Appeals decision, provided to me by KPI's counsel on December 21, 1999, *J.C. Penney National Bank v. Ruth E. Johnson, Commissioner of Revenue, State of Tennessee*, Tennessee Court of Appeals, Appeal No. M1998-00497-COA-R3-CV, decided December 17, 1999. In that case the Tennessee court found that Tennessee lacked substantial nexus under the Commerce Clause to impose income tax upon J.C. Penney National Bank's income from credit card activities in Tennessee based upon the activities conducted by its parent company, J.C. Penney Company, which operated retail stores in Tennessee. The Tennessee Court of Appeals conclusion was based upon the fact that J.C. Penney's retail stores conducted no activities which assisted J.C. Penney National Bank in maintaining its credit card business in Tennessee. It thus distinguished *Scripto* and *Tyler Pipe Industries*. As noted above, Kmart, pursuant to the terms of the License Agreement, uses the licensed trademarks to promote and enhance their value and to generate sales which generate royalty revenue for KPI and maintain a market for KPI's trademarks, in New Mexico and elsewhere where Kmart operates in the United States. I believe that given these

the franchisor, a feature not present in the licensor-licensee agreement herein.

activities which substantially contribute to KPI's ability to maintain a market in New Mexico for its trademarks, the Tennessee Court of Appeals would concur that substantial nexus exists under the facts of this case.

KPI'S ROYALTIES ARE SUBJECT TO NEW MEXICO GROSS RECEIPTS TAX

Even if the imposition of New Mexico's corporation income and gross receipts taxes are not prohibited by the Due Process Clause or the Commerce Clause, KPI argues that its royalty receipts are not subject to gross receipts tax in New Mexico. It bases its argument on the 1991 amendment to the definition of "leasing" enacted by Laws 1991, Ch. 203, effective July 1, 1991. Specifically, the definition of leasing was amended to define leasing to mean, "any arrangement whereby, for a consideration, property is employed for or by any person other than the owner of the property, *except that the granting of a license to use property is the sale of a license and not a lease.*" (emphasis supplied to language added by amendment). KPI then refers to the definition of "gross receipts", which provides in pertinent part:

'gross receipts' means the total amount of money or the value of other consideration received *from selling property in New Mexico*, from leasing property employed in New Mexico, from selling services performed outside New Mexico the product of which is initially used in New Mexico or from performing services in New Mexico....(emphasis added).

Section 7-9-3(F) NMSA 1978. KPI argues that because the License Agreement was negotiated and executed between KPI and Kmart in Michigan, that the sale of the license to use KPI's trademarks occurred in Michigan and therefore does not fall within the definition of gross receipts from selling property¹⁶ in New Mexico.

¹⁵ In New Mexico, both state and local option gross receipts taxes are reported to the Department on a monthly return under New Mexico's combined reporting system and the Department handles the distribution of the local share of the taxes collected. §§ 7-1-6.12 and 6.13 NMSA 1978.

¹⁶ The definition of "property" specifically includes licenses. § 7-9-3(I) NMSA 1978.

This argument fails to take into account the intangible property characteristics of a license and involves a far too simplistic view of what constitutes a sale. Although the change in the definition of leasing reflects a legislative intention that license agreements not be considered leases, it does not change the nature of a license. In its simplest terms, a license is a granting of permission or authorization to do some act which, without such authorization, would be illegal. *New Mexico Sheriffs & Police Association v. Bureau of Revenue*, 85 N.M. 565, 514 P.2d 616 (Ct. App. 1973). Although a license can be limited to a single, one-time permission to do something, licenses more commonly involve an ongoing permission, for a specified period of time¹⁷. KPI's argument conceives of a sale as a single, one-time event. While, especially with tangible property, sales are often isolated, single events in which the passing of title and/or risk of loss and the delivery of property occur simultaneously, there are also sales which are conditional or involve the purchase of property over time. In those cases, the passage of title and the delivery of the property may not occur until all conditions of the sale, such as payment in full, are met. The definition of "gross receipts" specifically recognizes such conditional sales contracts and specifies how receipts from such contracts may be reported. It provides:

When the sale of property or service is made under *any type of charge, conditional or time-sales contract* or the leasing of property is made under a leasing contract, the seller or lessor may elect to treat all receipts, excluding any type of time-price differential, under such contracts as gross receipts as and when the payments are actually received....(emphasis added).

Section 7-9-3(F)(3) NMSA 1978. In fact, KPI's License Agreement qualifies as a conditional contract because one of the grounds it specifies for termination is the failure or inability of Kmart

¹⁷ In the case of the License Agreement in this matter, its term is until January 1, 2002, with an automatic renewal for ten year periods thereafter, unless the parties notify each other at least six months prior to the expiration of the current term. Exhibit S-13.

to make any payments due under the agreement. Thus, any grant of a license by KPI is conditioned upon Kmart continuing to meet its payment obligations under the agreement.

The concept of where a sale occurs also involves considerations such as where the passage of title and/or risk of loss and where delivery of the property sold occurs. *Proficient Food Co. v. New Mexico Taxation & Revenue Dept.*, 107 N.M. 392, 758 P.2d 806 (Ct. App. 1988). These concepts can be applied far more neatly when the property involved is tangible than when an intangible, such as a license, is involved. This is probably due to the unique characteristics of intangible property. Unlike tangible property, which can be in only one place at one time, intangible property can be used in many places simultaneously. In determining where the sale occurred in this case, the first element of that determination, ascertaining where title and/or risk of loss passed, has no applicability. This is because the License Agreement is only the grant of the right, license and privilege to use KPI's trademarks. The agreement specifically provides:

Nothing contained in this Agreement shall be construed as an assignment or grant to Licensee of any right title or interest in or to the Licensed Properties, it being understood and acknowledged by Licensee that all rights and goodwill relating thereto are reserved by Licensor except for the license granted hereunder to Licensee of the right to use and utilize the Marks only as specifically and expressly provided in this Agreement or amendments hereto.

Exhibit S-13, ¶ 2(b). Thus, we must examine the second element of a sale, the delivery, to determine where the sale occurs. In this matter, permission has been given to use KPI's trademarks not only in Michigan, but everywhere in the United States and its territories, including New Mexico. As discussed earlier in this decision, intangible property can acquire a business situs for tax purposes wherever it is used. Because the nature of intangible property allows it to be used in many places simultaneously, and because KPI allows Kmart to use its

trademarks in New Mexico, it can be considered that the delivery of the license at issue herein occurred, at least in part, in New Mexico.

The Department does not have any regulations directly on point addressing the specific situation presented in this case. It does have, however, regulations that may be considered analogous. They address the treatment of lease receipts. Lease receipts are analogous in at least two respects: like a license, a lease generally involves a relationship which is continuous or ongoing in time; and leases, like licenses, do not involve the passage of title but involve the transfer of a lesser interest in property. Regulation 3 NMAC 2.1.17.1 provides that, “[R]eceipts derived from the rental or leasing of property employed in New Mexico are subject to the gross receipts tax. Example 2 under that regulation, provides:

Y, a New York corporation, leases four block-making machines to X who uses the machines in X’s block-making business in New Mexico. The rental contract is signed in Nebraska. The receipts which Y receives from the rental of the equipment employed in New Mexico are taxable.

Thus, even though the lease agreement is executed out-of-state and Y is an out-of-state corporation, the receipts from the rental agreement are still considered gross receipts subject to tax in New Mexico based upon the property being used in New Mexico. Conversely, Regulation 3 NMAC 2.1.17.5 provides that, “[R]eceipts derived from the rental or leasing of property employed outside New Mexico are not subject to the gross receipts tax.” The example given under this regulation states:

L, a resident of Hobbs, New Mexico, owns a sawmill in Wyoming which is leased to S for \$3,000 per year. These receipts are not derived from selling property in New Mexico, leasing property employed in New Mexico, performing services outside of New Mexico the product of which is initially used in New Mexico or performing services in New Mexico. These receipts are not includable in L’s gross receipts

The License Agreement in this matter involves the licensing of property throughout the United States. Thus, we are dealing with a transaction in interstate commerce and any tax imposed on the licensing transaction must meet each of the prongs of the four part test specified in the Supreme Court's *Complete Auto* decision in order to withstand scrutiny under the Commerce Clause. Assuming that states attempt to tax transactions in interstate commerce to the extent allowed under the law¹⁸, and given the unusual characteristic of intangible property that it can exist and be used, simultaneously, in more than one locale, it makes sense to take those factors into consideration in determining where and to what extent a taxable sale occurs in the various states in which the trademarks are licensed. The second prong of the *Complete Auto* test requires that a tax be fairly apportioned. Because the License Agreement contemplates the use of KPI's trademarks throughout the United States, and the fee arrangement under the agreement calculates the royalties based upon net sales generated wherever the trademarks are used, it makes no sense to treat the license as a single, one-time sale occurring wholly in Michigan. It would also violate the fair apportionment requirement of the Commerce Clause for Michigan to tax KPI's receipts under the License Agreement based upon the use of the licensed trademarks in states other than Michigan. This effect of the requirement of fair apportionment is reflected in the Department's regulations involving leasing, discussed above. In the transaction at issue, New Mexico only seeks to impose gross receipts tax on an apportioned part of the consideration for the license, KPI's receipts from licensing its trademarks for use by Kmart in its New Mexico operations.

¹⁸ New Mexico does this. Although it provides for a deduction from gross receipts tax for transactions in interstate commerce, the deduction is limited "to the extent that the imposition of the gross receipts tax would be unlawful under the United States Constitution." § 7-9-55 NMSA 1978.

Kmart argues that the New Mexico royalties are only the *measure* of the tax and the fact that the royalties are calculated based upon Kmart's New Mexico sales does not make this a sale occurring in New Mexico. As discussed above, however, the royalties are more than just a measure of the tax, payment of those royalties is also a condition of the sale and is the consideration for the sale, to the extent the sale occurs in New Mexico. Given the fact that the sales transaction at issue involves the granting of permission to use KPI's marks in New Mexico and given the fact that New Mexico only seeks to tax its apportioned share relating only to the use of the trademarks in New Mexico, the granting of the license, to the extent the marks are used in New Mexico, should be considered to be the sale of property in New Mexico.

THE DEPARTMENT ACTED PROPERLY IN MODIFYING THE APPORTIONMENT FORMULA

New Mexico, like many other states, has adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA") §§7-4-1 to 7-4-21 NMSA 1978, which provides for how taxpayers having income which is taxable both within and without the state shall allocate and apportion their income among the states in which they earn income. Crucial to the determination of whether income is allocable to a single taxing jurisdiction or whether it is to be apportioned among the various taxing jurisdictions is whether the income is classified as business income or non-business income. Business income is defined as:

...income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Section 7-4-2(A) NMSA 1978. Nonbusiness income is defined as "all income other than business income." Section 7-4-2(E) NMSA 1978. There is no dispute in this matter that KPI's

income to which the Department's apportionment formula was applied is business income. The dispute between the parties is whether the Department's method of apportioning that income is proper.

UDITPA was adopted by the National Conference of Commissioners on Uniform State Laws in 1957. UDITPA was designed to provide a uniform method for taxing the income of multistate businesses among the various states. Such a uniform method would assure that no more and no less than 100 percent of the income of a multistate business is taxed. Because the national economy was primarily based upon manufacturing and merchandising businesses, the allocation and apportionment provisions of UDITPA were designed with those types of businesses in mind. W.J. Pierce, The Uniform Division of Income for State Tax Purposes, 35 Taxes 747 (1957). Income from the licensing of intangibles was not a significant part of the income tax base, and under UDITPA, it was normally allocated to a single jurisdiction. Report of Benjamin F. Miller, Exhibit S-128.

Pursuant to § 7-4-10(B) NMSA 1978, business income is to be apportioned to New Mexico "by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor and the denominator of which is three." The three factors are fractions in which the numerator is the taxpayer's tangible property, sales and payroll in New Mexico and the denominator is the taxpayer's tangible property, sales and payroll, everywhere, respectively. Sections 7-4-11 (property factor), 7-4-14 (payroll factor) and 7-4-16 (sales factor) NMSA 1978. Thus, the three-factor formula takes into account a taxpayer's activities in a given taxing state, measured by its payroll, tangible property and sales in the state, as compared to its payroll, tangible property and sales everywhere to arrive at an apportionment factor which is applied to a taxpayer's income from everywhere to arrive at the income to be

apportioned to the taxing state. The Supreme Court has noted that the UDITPA three-factor formula has become so widely accepted that it has become “something of a benchmark against which other apportionment formulas are judged.” *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 170, 103 S.Ct. 2933, 2943 (1983). It further noted that the three-factor formula has gained such wide approval “because payroll, property and sales appear in combination to reflect a very large share of the activities by which value is generated.” *Id.*, 463 U.S. at 183, 103 S.Ct. at 2949.

Since its enactment, however, UDITPA has recognized that the three-factor formula will not always operate to fairly apportion a business’ income and that some provision must be made for unusual cases or business activities that depart from those normally contemplated by the formula, which relies upon property, payroll and sales to reflect the manner in which the value taxed is generated. For this reason, §18 of UDITPA, codified at § 7-4-19 NMSA 1978 was included in UDITPA from the outset. It provides:

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

Professor William J. Pierce, the drafter of UDITPA, stated that this provision:

necessarily must be used where the statute reaches arbitrary or unreasonable results so that its application could be attacked

successfully on constitutional grounds. Furthermore, it 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. Of course, departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle the constitutional problem as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problem for the multitude of taxpayers with individual business characteristics.

W.J. Pierce, *supra*, at 781.

As noted above, departures from the basic formula should be avoided except where reasonableness requires. The Department has adopted Regulation 3 NMAC 5.19.8.2 under § 7-4-19. It provides:

Section 7-4-19 permits a departure from the allocation and apportionment provisions of Sections 7-4-2 to 7-4-18 only in limited and specific cases. Section 7-4-19 may be invoked *only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring)* produce incongruous results under the apportionment and allocation provisions contained in 7-4-2 to 7-4-18. (emphasis added).

KPI argues that its case is neither unique nor nonrecurring and, because a taxpayer may claim estoppel against the Department when its actions are contrary to any regulation pursuant to § 7-1-60 NMSA 1978, that the Department is estopped from applying the provisions of § 7-4-19 to depart from the three-factor formula. I disagree. KPI reads too much into the regulation. It speaks of unusual fact situations which *ordinarily* will be unique and nonrecurring. It does not state that they must *always* be unique and nonrecurring. If that were the case, it would only require that two taxpayers of the thousands who report and pay taxes subject to apportionment be in the same situation to create an absolute bar, prohibiting the Department from addressing their situations to ensure that they pay an amount of tax which is reasonable and fair. The regulation

limits the application of § 7-4-19 to “unusual situations.” As will be discussed in more detail below, the facts of this case are more than sufficient to be considered unusual. The Department is not estopped from applying § 7-4-19.

Before discussing whether the Department acted properly in using an alternative formula for apportioning KPI’s income, an explanation of what the Department did to arrive at its corporate income tax assessment will be helpful. Although KPI did not furnish the Department’s auditor with a schedule of its royalties, broken down by state, it did provide a breakdown of Kmart’s New Mexico sales, broken down annually. The Department’s auditor applied the 1.1% royalty fee to these sales to arrive at KPI’s New Mexico sales revenues. The Department’s auditor also had available KPI’s pro-forma federal income tax returns for the audit years which broke out KPI’s royalty income. The auditor then compared KPI’s New Mexico royalty income to its total royalty income to arrive a ratio, called the New Mexico percentage. Tax was computed by using New Mexico tax tables to calculate the tax on KPI’s federal taxable income from its federal pro-forma returns, and applying the New Mexico percentage¹⁹. Because the auditor only considered royalty revenues to determine the New Mexico percentage or apportionment factor, and because the royalties were KPI’s sales for purposes of calculating the sales factor, in effect, the auditor used a single factor (sales) to arrive at the New Mexico apportionment factor, disregarding property and payroll. The sales factor the Department used was a modified sales factor. KPI correctly points out that under the standard UDITPA provision for calculating the numerator of the sales factor for sales of “other than tangible personal property”, codified at § 7-4-18 NMSA 1978, the numerator of its New Mexico sales factor would

¹⁹ KPI has not challenged the numbers the Department used to calculate its corporate income tax assessment, only the Department’s methodology and the constitutionality of imposing such a tax. Because there is a presumption of

be zero. Subsection A of that provision requires that if a taxpayer's income producing activity with regard to intangible property is performed wholly within a state, the taxpayer's receipts from intangible property are attributed to that state. If, however, a taxpayer performs activities generating receipts from intangible property in more than one state, under Subsection B, its receipts are attributed to the single state in which a greater proportion of the income producing activity takes place, based on costs of performance. Under either scenario, all of a taxpayer's receipts attributable to intangible property are sited to only one state, for purposes of inclusion in the numerator of the sales factor. Because KPI had income producing activity resulting from the licensing of its trademarks throughout the United States, § 7-4-18(B) would be applied, which requires an examination of where KPI would have incurred the greatest proportion of the costs attributable to managing its trademarks. Presumably, this would be in Michigan, where its staff and offices are located. In his treatise on corporation income taxes, KPI's own expert witness, Walter Hellerstein, has criticized this "all-or-none" approach under UDITPA with respect to sourcing income from intangibles such as licenses as "distorting" and one which "ordinarily will not reflect fairly the source of income" because "[S]ervices by the licensor's employees and agents are likely to be of comparatively minor importance in the realization of income from such intangible property, except in some types of franchising arrangements requiring inspection or supervision of the franchisees' operations." *See, Hellerstein and Hellerstein, State Taxation: Corporate Income and Franchise Taxes*, Vol. 1, 2nd edition, ¶9.09[4], p. 9-44. Indeed, he cites to the Multistate Tax Commission special rule for apportionment of business income from intangible property, adopted in New Mexico as Regulation 3 NMAC 5.19.11.1(3) as one response to the problem and agrees that it is a more reasonable way to source income from

correctness which attaches to any assessment of tax, § 7-1-16 NMSA 1978, the tax calculations, in the absence of

intangibles. This regulation, adopted under the equitable adjustment provisions of § 7-4-19, provides:

Where the income producing activity in respect to business income from intangible personal property can be readily identified, such income is included in the denominator of the sales factor and, if the income producing activity occurs in this state, in the numerator of the sales factor as well....

Because the income producing activity, the licensing of KPI's trademarks, can be readily identified, the Department followed the regulation methodology by including KPI's royalty income from licensing its trademarks in New Mexico in the numerator of the sales factor and its total royalty income in the denominator.

New Mexico courts have adopted the Supreme Court's standard as to the burden a taxpayer must meet to challenge a state's apportionment formula as violating the Due Process Clause and the Commerce Clause of the United States Constitution. *See, Taxation and Revenue Department v. F.W. Woolworth Co.*, 95 NM. 519, 624 P.2d 28 (1981), reversed on other grounds, 458 US. 354, 102 S.Ct. 3128 (1982), (one who attacks the apportionment formula must show by clear and cogent evidence that it results in taxing extraterritorial values). *NCR Corp. v. Taxation & Revenue Department*, 115 N.M. 612, 856 P.2d 982 (Ct. App., 1993), cert. denied, 512 U.S. 1245, 114 S.Ct. 2763 (1994) (in order to successfully challenge state apportionment of corporate income the taxpayer must prove by clear and cogent evidence that the income attributed to the state is in fact out of all appropriate proportion to the business transacted in the state or has led to a grossly distorted result). Our courts have not been confronted with determining what is required, however, when there is not a challenge of constitutional proportion to the apportionment factor, but a party seeks to apply the provisions of § 7-4-19 in order to

evidence from KPI that they are erroneous, are presumed to be correct.

depart from the standard three-factor UDITPA apportionment formula. Case law from other states that have adopted UDITPA indicates that the party who desires to depart from the standard three-factor formula has the burden of proving that 1) the three-factor formula does not fairly represent the taxpayer's business activity in the state and, 2) the alternative formula is reasonable. *Twentieth Century-Fox Film Corp. v. Department of Revenue*, 700 P.2d 1035, 1042-1043. (Ore. 1985).

In this case, the Department has met its burden of proving that the three-factor formula does not fairly represent KPI's business activity in the state. As discussed above, the three factor formula was developed when the country's economy was largely based upon manufacturing and merchandising. The underlying assumption of the three-factor formula is that the business activities generally employed by a taxpayer to generate income are a function of the property and personnel employed to generate sales revenues, wherever it conducts business. Thus, those are the three factors the formula employs to measure a taxpayer's business activities as a means of apportioning its income among the taxing jurisdictions where it engages in business. Section 7-4-19 requires that we focus on a taxpayer's "*business activity within this state*"(emphasis added) to determine whether the UDITPA three-factor formula fairly represents that activity before another apportionment method may be used. With respect to KPI, its only business activity in New Mexico is the licensing of its trademarks for use in New Mexico. As explained above, this is the source of its revenues accounted for in the sales factor. What is the relationship between KPI's business activity in New Mexico and its property and payroll factors? In this case, there is no relationship whatsoever. Significantly, the property factor only considers real and tangible

property,²⁰ reflecting the fact that at the time UDITPA was drafted, income from intangible property, such as intellectual property, was not a significant portion of the national economy. Thus, the very property KPI employs to generate the sales revenues for inclusion in the three-factor formula is not even considered by the formula. This fact alone plainly indicates that inclusion of the property factor would not fairly represent KPI's business activities in New Mexico. Focusing on KPI's business activities in New Mexico, KPI has no employees, real or tangible property in New Mexico that play any role whatsoever in carrying out KPI's business activity in New Mexico, the licensing of its trademarks for use here. KPI has contracted with Kmart, under the Licensing Agreement, to perform any activities related to the use of its trademarks here. Kmart uses *its* employees and property to advertise, market, display and perform other activities in relationship to the use of KPI's trademarks in New Mexico to ensure that the trademarks and their associated goodwill are protected and enhanced by the manner in which Kmart puts them to use. Thus, the numerator of both the property and the payroll factors for KPI is zero. An examination of the factors going into the denominator of the property and payroll factors and their relationship to KPI's business activities is also revealing. Any way you look at it, KPI is highly unusual with respect to its ability to generate revenue compared to its costs of payroll and tangible property.²¹ It generates approximately 300 million a year in royalties based upon a payroll of less than \$200,000 per year for its two attorneys and their support staff, and tangible property valued at between \$40,000 and \$85,000. The ratio of its payroll to sales and its property to sales is measured in the hundredths of a percent. *See*, Exhibit

²⁰ § 7-4-11 lists property to be included in the numerator and denominator of the property factor as "real and tangible property".

²¹ KPI rents its offices. There is nothing in the record to indicate that it owns any real property. Presumably, then, the property to be included in its property factor is limited to tangible property and would represent such things as office furniture, computers, and office equipment such as phone systems, copying and fax machines, etc.

S-114, p. D1.1. Rounding the payroll and property factors up to \$300,000 per year, this still represents a profit factor of \$1,000 for every one dollar of payroll and property expense. This kind of profitability ratio is simply unheard of in the normal course of business. It is indicative of the fact that KPI's personnel and tangible property costs have little to do with its ability to earn the royalties it does.²² It largely earns those royalties based upon the value²³ of the trademarks it owns. Those trademarks were simply transferred to KPI by Kmart. Of course, Kmart received 100% ownership of the shares of KPI in exchange for the assignment of the trademarks, and as between a parent and a wholly owned subsidiary, for Internal Revenue Service purposes, the transaction is a wash. But in the context of the issues in this case, where KPI and Kmart are considered as separate corporate entities, the effect of the transfer between Kmart and KPI was that extremely valuable trademark property was simply transferred to KPI. KPI had incurred none of the attendant costs incurred by Kmart over the years to develop the products, services and goodwill associated with those trademarks to create their value. KPI had no investment in the Marks, yet they returned an incredible profit to KPI when compared to the relatively small investment KPI was required to make in them to maintain and increase their value subsequent to their transfer. This is the reason that there is such a disconnect between KPI's business activities which generate sales and the other factors, property and payroll, generally associated with the generation of sales. It is also the reason that even were we to calculate KPI's property and payroll factors, they would represent such a small fraction that they can be considered *de minimis*

²² As noted above in the discussion on page 65, Walter Hellerstein's treatise recognizes that with respect to royalty income from intangibles, the activities "of a licensor's employees are likely to be of comparatively minor importance in the realization of income from such intangible property." Recognizing this potential to distort the apportionment formula, Mr. Hellerstein recommends instead, the approach taken by the Department in its audit, which is to source royalties to a state by inclusion in the numerator of the sales factor "to the extent of the use by the payor of the rights granted under the license..." in the state. Hellerstein and Hellerstein, supra., ¶ 9.09[4], p. 9-44.

²³ At the time of their assignment to KPI, Kmart's trademarks were valued at a range between \$2.7 billion and \$4.1 billion.

and the inclusion of them into the apportionment factor would only serve to dilute²⁴ and distort the apportionment factor ultimately applied to apportion KPI's income to New Mexico. The distortion created by the inclusion of factors which are *de minimis* is the reason that the Department's instructions²⁵ contained in New Mexico's corporation income tax returns during each of the audit years instruct taxpayers to exclude any factors if the denominator (sales, property or payroll everywhere) is less than 3% of net income.

It being established that the three-factor UDITPA formula does not fairly represent KPI's business activity in New Mexico, it must also be established that the alternative methodology is reasonable. In its *20th Century Fox* decision, *supra.*, the Oregon Supreme Court set forth the following test for reasonableness:

We believe that in the context of UDITPA, reasonableness has at least three components: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of taxpayer's income; (2) the division of income does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in Oregon.

Id., 700 P.2d at 1043. Parts 1 and 3 of the Oregon court's test are really merely restatements of the standard for judging the fairness of an apportionment formula under the Due Process and Commerce Clauses of the Constitution, as set for in *Container Corp. of America*, *supra.* In that decision, the Court described its "internal consistency" and "external consistency" tests thusly:

The first, and again obvious, component of fairness in an apportionment formula is what might be called internal

²⁴ For each factor included in the apportionment factor calculation, the denominator by which the sum of the factor numerators is divided is increased by one. Thus, with the inclusion of each factor which has little or no relation to the in-state business activities of a taxpayer, the denominator is increased by one, which reduces the ultimate apportionment factor by one-third.

²⁵ The Department's instructions are presumed to be a proper implementation of the laws that are charged to the Department. § 9-11-6.2(G) NMSA 1978.

consistency—that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed. The second and more difficult requirement is what might be called external consistency—the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.

Id., 463 U.S. at 169, 103 S.Ct. 2942. The Department’s apportionment formula easily meets the internal consistency test. If every state in which KPI licenses its trademarks applied New Mexico’s single sales factor formula to apportion KPI’s income, because the formula is based upon KPI’s royalties received from licensing its trademarks in the taxing state divided by its royalty income from everywhere, no more than 100% of KPI’s income would be subject to tax.

The external consistency test is also easily met. The factor used in the apportionment formula closely reflects how KPI’s income is generated since it is tied directly into the activity which generates all but the smallest fraction of KPI’s income, the licensing of its trademarks. Additionally, the formula is designed to source income to New Mexico in proportion to the royalty income KPI derives from licensing its trademarks in New Mexico compared to its total licensing royalties. Thus, the formula reflects the economic reality of how KPI earns its income in New Mexico.

Finally, the formula does not create or foster a lack of uniformity among UDITPA jurisdictions. The Department’s method for creating KPI’s sales factor to source its income derived from licensing its intangible property is in accordance with the Multistate Tax Commission’s regulation, a regulation which is likely to be implemented and followed by UDITPA jurisdictions. As discussed earlier in this decision, this regulation specifically addresses sourcing income from intangibles because the “all or none” sourcing approach taken by the more general sales factor formula for sourcing income from “other than tangible personal

property” does not accurately reflect that a taxpayer’s activities generating income from intangibles can occur in many taxing jurisdictions simultaneously. It would also be reasonable to expect other taxing jurisdictions to eliminate the property factor and the payroll factor, given the fact that the property factor does not take into account the very property KPI uses to generate its income and because of the almost non-existent relationship between KPI’s property and payroll in Michigan and its ability to generate revenues from the licensing of its intangible property throughout the country, which intangible property it acquired at no real cost.

Lest there be the slightest doubt about the reasonableness of the Department’s formula, one need only consider the fact that the apportionment factor arrived at under the formula to apportion KPI’s income closely tracks the apportionment factor for Kmart during the audit years. Thus, had Kmart not formed KPI to shift a portion of its income to avoid state taxation in states like New Mexico, that income would end up being taxed at essentially the same rate. Given the fact that Kmart uses KPI’s property and the goodwill which is inseparable from that property to generate its apportionable income in New Mexico, the fact that that income ends up being taxed in the same ratio, no matter which entity it is attributed to, confirms the reasonableness of the Department’s formula.

THE DEPARTMENT WAS NOT REQUIRED TO PROCEED BY PROSPECTIVE RULE-MAKING

KPI argues that the Department’s modification of the apportionment formula pursuant to the authority of § 7-4-19 to a single sales factor formula, which also departed from the standard sales factor formula, is illegal because it amounts to the establishment of policy of general application by adjudication rather than through the statutory procedures outlined for rule-making. In making this argument, KPI relies upon a New Jersey decision, *Metromedia, Inc. v. Director*,

Division of Taxation, 478 A.2d 742 (N.J. 1984), in which the court invalidated the New Jersey tax department's attempt to adjust the sales factor of a multi-state broadcaster to reflect audience share, finding that it was a form of rule-making which should have been accomplished by regulation, notice and a public hearing. In *Metromedia*, the court held that statutory rule-making procedures rather than adjudication must be used when an agency determination 1) is intended to be a general standard applicable to all similarly situated taxpayers in an industry; 2) addresses broad policy issues; 3) prescribes a legal standard not expressly provided by statutory authority; 4) reflects an administrative policy not previously expressed or effects a material change in the law and; 5) is intended to be prospective, notwithstanding attempted retroactive enforcement in the pending litigation. *Metromedia* is distinguishable from the facts of this case. In that case, the New Jersey Tax Commissioner testified that the sales factor modification at issue was intended to be "of unvarying application" to other broadcasters, establishing that the Department was proposing an industry wide rule. *Id.*, 478 A.2d at 753. We have no such evidence in this matter. Only the facts pertinent to KPI and its relationship with Kmart were presented in this case, and the Department's basis for the modification of the apportionment factor was expressly tied in to the facts pertaining only to KPI's property, payroll and royalties. This case does not amount to a rule-making in which the Department is attempting to create an industry standard through litigation. The Department's auditor testified that after he became aware of the *Geoffrey* case²⁶, he reviewed the returns of about two dozen large retailers to determine whether there were

²⁶ *Geoffrey v. South Carolina Tax Comm'n*, 437 S.E. 2d 13 (S.C. 1993) cert. denied 510 U.S. 992, 114 S.Ct. 550 (1993). *Geoffrey* was the first state tax case which addressed the same nexus issues presented herein with reference to a company set up to hold and manage the parent company's trademarks and license them back for use in the parent's in-state retail operations. As noted earlier in this decision in footnote 8, this decision maker does not agree with the South Carolina Supreme Court's reasoning in support of its conclusion that substantial nexus existed under the commerce clause, although he would agree that substantial nexus existed for the same reasons stated herein with regard to KPI.

any with substantial royalty deductions which might indicate the sort of trademark assignment and license back situation presented herein. He found Kmart and only one other company. Two retailers out of the many multistate retail businesses operating in New Mexico hardly constitutes an “industry”. Even were we to consider licensing of intellectual property an “industry”, the fact situation in this case, in which a parent assigns its intellectual property to a subsidiary which licenses it back to the parent to be used in the same manner it was previously, is a far cry from the far more ordinary intellectual property licensing situations in which such property is licensed between unrelated parties. The decision in this case hinges on the practically alter-ego relationship created under the relatively uncommon facts of this case. Nothing in this decision is intended to address other intellectual property licensing situations which involve far different relationships.²⁷ This case, which has been argued, presented and decided upon its specific facts should not be read as any sort of industry-wide rule of unvarying application amounting to a rule-making.²⁸

Also significant to the court’s decision in *Metromedia*, as well as another case relied upon by KPI, *CBS v. Comptroller of the Treasury (Maryland)*, 575 A.2d 324 (1990), were the taxpayer’s reliance interests. I find it difficult to give any weight to any presumed reliance interests of KPI with respect to the apportionment of its royalty income in New Mexico. In the first place, KPI appears to have relied on the advice of Price Waterhouse that such income would not be subject to any sort of apportionment based upon lack of nexus with the state. There was

²⁷ KPI’s parade of horrors in which states will seek to tax celebrity sponsors, such as Michael Jordan, wherever their name is used in association with products marketed, involves a far different relationship than the one addressed herein.

²⁸ The definition of “rule” in the State Rules Act states that a “..decision or other document issued ...in connection with the disposition of any case...or agency decision upon a particular matter as applied to a specific set of facts shall not be deemed such a rule nor shall it constitute specific adoption thereof by the agency.” § 14-4-2 NMSA 1978.

no evidence whatsoever that KPI (or Kmart) even considered the issue of how KPI's royalty income might be apportioned among the separate entity reporting states where it paid no taxes. Additionally, I find it difficult to find any substantial reliance interests for KPI when New Mexico has enacted § 7-4-19, which puts all taxpayers on notice that if the application of the standard three-factor formula does not fairly represent a taxpayer's activities in a state, that the Department can seek to modify the apportionment formula. Section 7-4-19 even expressly mentions that one form of modification which can be sought is the elimination of one or more factors.²⁹ Finally, the Department did apply one of its regulations, 3 NMAC 5.19.11.1(3), to modify the sales factor with respect to income from intangibles. Any taxpayer with income from intangibles should have been aware of this regulation and would have been on notice that it could be applied if its sales factor under the standard formulation did not fairly reflect its in-state activities with respect to its receipt of income from intangibles.

Even though the cases cited by KPI are distinguishable from the matter presented herein, the most important reason why they are not persuasive is that New Mexico law is not in accord with those decisions. New Mexico's courts have wisely endorsed the concept that it should be left it to the informed discretion of the administrative agency to determine whether to proceed through rulemaking or adjudication. This concept was endorsed by the New Mexico Supreme Court in *Hobbs Gas Co. v. Public Service Commission*, 115 NM 678,682, 858 P.2d 54, 58 (1993), wherein it cited to *SEC v. Chenery Corp.*, 332 U.S. 194, 67 S.Ct. 1575 (1947) for that

²⁹ In a related argument, KPI argues that the Department is estopped from applying its corporate income tax instruction which directs the elimination of factors from the apportionment factor calculation if the denominator of the factor is less than 3% of a taxpayer's net income because the Department's instruction was not enacted through a rulemaking proceeding. While the Department's actions in eliminating the property and payroll factors may have followed the terms of its instructions, they also were done pursuant to the explicit authority of § 7-4-19. KPI can't honestly claim a failure of notice, which is the purpose of a rulemaking, when a statute authorizes the action complained of.

proposition. *Hobbs Gas Co.* was an appeal from a Public Service Commission ruling imposing a new sales ratio calculation methodology upon a utility whose sales ratio methodology had been tacitly approved in two prior commission cases and making the new interpretation retroactive to past periods. The result of changing the sales ratio calculation methodology resulted in the gas company having to refund over \$ 1.5 million in overcollections from its customers. Rather than striking down the commission's new methodology as an unauthorized rulemaking by adjudication, the court cited to *Chenery Corp.*, effectively upholding the commission's authority to impose a new rule by adjudication. The court, however applied the test set out in *Chenery Corp.* to determine whether an adjudicatory rulemaking should be applied prospectively only. Because of the substantial reliance interests of the gas company upon its former tacitly approved methodology, the court prohibited the retroactive application of the new methodology.

The United States Supreme Court's analysis of the tension between adjudication and rule-making by administrative agencies in *Chenery Corp.* is quite illuminating:

Since the Commission, unlike a court, does have the ability to make new law prospectively through the exercise of its rule-making powers, it has less reason to rely upon ad hoc adjudication to formulate new standards of conduct within the framework of the Holding Company Act. The function of filling in the interstices of the Act should be performed, as much as possible, through this quasi-legislative promulgation of rules to be applied in the future. *But any rigid requirement to that effect would make the administrative process inflexible and incapable of dealing with many of the specialized problems which arise.* ...Not every principle essential to the effective administration of a statute can or should be cast immediately into the mold of a general rule. Some principles must await their own development, while others must be adjusted to meet particular, unforeseeable situations. In performing its important functions in these respects, therefore, *an administrative agency must be equipped to act either by general rule or by individual order.* To insist upon one form of action to the exclusion of the other is to exalt form over necessity.

In other words, problems may arise in a case which the administrative agency could not reasonably foresee, problems which must be solved despite the absence of a relevant general rule. Or the agency may not have had sufficient experience with a particular problem to warrant rigidifying its tentative judgment into a hard and fast rule. Or the problem may be so specialized and varying in nature as to be impossible of capture within the boundaries of a general rule. In those situations, the agency must retain power to deal with the problems on a case-to-case basis if the administrative process is to be effective. There is thus a very definite place for the case-by-case evolution of statutory standards. *And the choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency.* (emphasis added).

Id., 332 U.S. at 202-203, 67 S.Ct. at 1580. Under the circumstances of this case, where the Department found through audit a situation in which KPI acquired its income producing property in a transaction without true economic substance (having incurred none of the costs which made Kmart's trademarks valuable) in a tax-motivated transaction designed to shift profits beyond a tax jurisdiction, where the scope of the problem was apparently small (two taxpayers) and the case required extensive factual development, the Department was well-justified in addressing the problem through application of the equitable provisions of § 7-4-19 in a context of adjudication, rather than through prospective rule-making.

THE IMPOSITION OF PENALTY IS IMPROPER

KPI challenges the Department's imposition of penalty with respect to both its assessment of corporation income tax and gross receipts tax. The Department assessed penalty pursuant to § 7-1-69(A) NMSA 1978, which imposes a penalty "in the case of failure *due to negligence or disregard of rules and regulations*, but without intent to evade or defeat any tax, to pay when due any amount of tax required to be paid...." (emphasis added). Taxpayer "negligence" for purposes of assessing penalty is defined in Regulation 3 NMAC 1.11.10 as:

1. failure to exercise that degree of ordinary business care and prudence which reasonable taxpayers would exercise under like circumstances;
2. inaction by taxpayers where action is required;
3. inadvertance (sic), indifference, thoughtlessness, carelessness, erroneous belief or inattention.

The Department's regulations also provide examples of situations which may indicate that a taxpayer has not been negligent. The example pertinent to this case is found at 3 NMAC 1.11.11.4, which indicates a taxpayer is not negligent where:

[T]he taxpayer proves that the failure to pay tax or to file a return was caused by reasonable reliance on the advice of competent tax counsel or accountant as to the taxpayer's liability after full disclosure of all relevant facts;...

Applying this provision, KPI was not negligent for purposes of the imposition of penalty.

The evidence established that Kmart received advice from Price Waterhouse that if it structured its intellectual property subsidiary in accordance with its report to Kmart, (Exhibit S-108) that separate corporate entity states would not have nexus to tax a properly structured intellectual property investment/holding company. Kmart followed the advice in the report carefully when it created KPI. Given the shared directors and officers between KPI and Kmart, the advice given to Kmart may also be considered to have been received by KPI's management. I have little doubt given all of the facts and circumstances in this case, that KPI relied upon the advice from Price Waterhouse, which is an accounting firm. Under these circumstances, KPI was not negligent in failing to report and pay either corporation income, franchise or gross receipts tax based upon its understanding that New Mexico, which is a separate corporate entity reporting state, would not have nexus to impose those taxes.

CONCLUSIONS OF LAW

1. KPI filed timely, written protests, pursuant to § 7-1-24 NMSA 1978, to Assessment Nos. 2134646 and 2134647 and jurisdiction lies over both the parties and the subject matter of this protest.

2. During the audit years, KPI had property in New Mexico in the form of trademarks, tradenames and service marks and their associated goodwill which it licensed for use by Kmart in New Mexico.

3. Trademarks symbolize the goodwill of the business with which they are associated and are inseparable from that business.

4. By virtue of its ownership of the tradenames, trademarks and service marks, KPI has the right to control where its marks were used.

5. KPI has actual and imputed knowledge of where its trademarks, tradenames and service marks are used.

6. KPI has purposefully directed its efforts towards residents of New Mexico and availed itself of the benefits of New Mexico's markets by licensing its trademarks to Kmart for use in New Mexico. Therefore, KPI has sufficient minimum contacts with New Mexico to be subject to New Mexico's tax jurisdiction under the Due Process Clause of the United States Constitution.

7. The contractual relationship between KPI and Kmart under the License Agreement and the relationship created between KPI and Kmart under the principles and concepts of trademark law are such that KPI has the requisite physical presence of KPI in New Mexico and substantial nexus exists under the Commerce Clause of the United States Constitution for KPI to be subject to New Mexico's taxing jurisdiction.

8. KPI did not have a justified reliance interest through established precedent in not being subject to New Mexico's tax jurisdiction.

9. Because Kmart already provides tax preparation services for KPI and because Kmart already files taxes in New Mexico and is familiar with the requirements of New Mexico tax law, it would not burden interstate commerce to require KPI to file and report New Mexico taxes.

10. KPI's grant of a license to Kmart to use KPI's intellectual property constitutes the sale of property in New Mexico to the extent that KPI's intellectual property is used by Kmart in New Mexico.

11. KPI's royalty receipts attributable to Kmart's sales in New Mexico are gross receipts from the sale of property in New Mexico pursuant to § 7-9-3(F) NMSA 1978.

12. This case presents an unusual fact situation which warrants the modification of the UDITPA three-factor apportionment formula under the provisions of § 7-4-19, as applied to KPI.

13. The Department is not estopped by Regulation 3 NMAC 5.19.8.2 from invoking the provisions of § 7-4-19 to modify the apportionment formula applied to KPI.

14. Application of the standard three-factor UDITPA apportionment formula to KPI under the facts of this case would not fairly represent KPI's business activities in New Mexico.

15. The Department's modification of the apportionment formula to be applied to KPI to modify the sales factor in accordance with 3 NMAC 5.19.11.1(3) and to eliminate the property and payroll factor was reasonable in that the Department's formula meets the test of internal consistency, external consistency and the division of income under the formula reflects the economic reality of KPI's business activities in New Mexico.

16. This litigation does not amount to an industry-wide rulemaking, but is limited to the specific facts and circumstances of this taxpayer.

17. The Department had the discretion to determine whether to address the situation presented herein through rule-making or ad hoc litigation.

18. KPI had actual and imputed knowledge of the advice contained in the Price Waterhouse report and it relied upon that advice in determining that it was not subject to the taxing jurisdiction of New Mexico.

19. KPI was not negligent in failing to report and pay taxes to New Mexico. Therefore the assessment of penalty by Assessment Nos. 2134646 and 2134647 was improper.

For the foregoing reasons, KPI's protest is hereby granted with respect to the assessment of penalty and in all other respects its protest is denied.

Done, this 1st day of February, 2000.