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

IN THE MATTER OF THE PROTEST OF
RAUSCHER, PIERCE, REFNES, INC. **NO. 98-36**
ID. NO. 01-718277-00 8, PROTEST
TO ASSESSMENT NO. 1670445

DECISION AND ORDER

This matter came on for formal hearing on February 10, 1998 before Gerald B. Richardson, Hearing Officer. Rauscher, Pierce, Refsnes, Inc., hereinafter, "Taxpayer", was represented by Mary E. McDonald, Esq. The Taxation and Revenue Department, hereinafter, "Department", was represented by Bridget A. Jacober, Esq. Following the hearing the parties submitted post-hearing memoranda of law, with the final brief being submitted on April 10, 1998. The parties have graciously allowed additional time, beyond the 30 days specified in Section 7-1-24(H) for the decision to be rendered in this matter. Based upon the evidence and the arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. The Taxpayer is a national brokerage firm whose corporate headquarters are located in Dallas, Texas. The Taxpayer has one office in New Mexico, located in Albuquerque. The Albuquerque office is staffed with approximately fourteen sales representatives, a manager and several support personnel.

2. The Taxpayer is licensed as a "broker-dealer" under the New Mexico Securities Act of 1986.

3. Following an audit in September, 1992, on June 3, 1993 the Department mailed Assessment No. 1670445 to the Taxpayer in the amount of $87,995.55 in gross receipts tax (less a credit of $465.97 of overwithholding of income tax), $ 8,755.35 in penalty and $38,921.23 in interest for the reporting periods of January 1987 through June 30, 1992.

4. On June 21, 1993, the Taxpayer filed a timely, written protest to Assessment No. 1670445.

5. The basis for the Department's assessment was the auditor's finding that the Taxpayer had erroneously deducted what the auditor considered to be commissions generated by the sale of mutual funds and commissions from the sale of commodities. On March 31, 1993 the Taxpayer paid $21,600.62 for payment of the gross receipts tax assessed on commissions from the sale of commodities. Thus, the only portion of the assessment remaining under protest is that which is attributable to the revenues the Taxpayer generated from mutual fund transactions which the Department considers to be commissions.

6. The Taxpayer had two separate revenue streams attributable to its activities with respect to mutual funds. The first of these streams of revenue are variously described in the Taxpayer's agreements with the underwriters through whom mutual fund shares were purchased as "dealer discounts", "concessions" or "commissions" (hereinafter, "dealer concessions"). The second of those streams of revenues are called "trails" or "12b-1 fees".

7. During the audit period the Taxpayer did not account separately on its books and records for the two revenue streams.

8. During calendar year 1997, the Taxpayer's revenues from trails or 12b-1 fees represented approximately 37% of its mutual fund revenues. It is reasonable to use this figure to allocate the Taxpayer's mutual fund revenue stream during the audit years at issue.

9. Mutual funds are pooled investments whereby the mutual fund invests in various securities and manages those investments for the benefit of the shareholders of the mutual funds. Mutual funds are valued at their "net asset value", which represents the cumulative value of all of the securities owned by the mutual fund, less any liabilities of the fund, calculated on a daily basis. Mutual fund shares are priced at the net asset value per share, which is computed by dividing the net asset value of the fund by the number of outstanding shares, on a daily basis.

10. Mutual funds market and sell shares in their fund through separate businesses, usually affiliated with the mutual fund, which are called principal underwriters.

11. The Investment Company Act of 1940,("Investment Company Act") 15 USCA § 80a-1, *et seq.* regulates open end investment companies, commonly known as mutual funds. It was enacted to remedy certain abusive practices in the management of investment companies.

12. The Investment Company Act defines brokers and dealers separately. Brokers are defined as persons engaged in the business of effecting transactions in

securities for the account of others. Dealers are defined as persons regularly engaged in the business of buying and selling securities for his own account.

13. Provisions of the Investment Company Act authorize the Securities and Exchange Commission ("SEC") and the National Association of Securities Dealers ("NASD") to regulate certain pricing and trading practices to eliminate abusive practices in pricing of mutual funds when they are sold. One of those provisions was Section 22 of the Investment Company Act, 15 USCA § 80a-22. Mutual fund shares are priced by computing the net asset value of the underlying securities held by the mutual fund, computed per share on a daily basis. An active secondary market in mutual fund shares had arisen whereby market professionals and insiders were able to take advantage of their knowledge of the timing when share values were calculated and their knowledge of market trends and conditions to make quick trades and profits, which resulted in the dilution of the value of shares held by the general public. To eliminate this secondary market, 15 USCA § 80a-22(d) prohibits principal underwriters and dealers from selling mutual fund shares to any person other than another dealer, the principal underwriter or the fund except at the current offering price described in the fund prospectus, which would be the net asset value per share, plus any sales charge specified in the prospectus.

14. The Taxpayer is a member of NASD. NASD regulates the conduct of its members with respect to the manner in which they market securities, including mutual funds.

15. Rule 2830(C) of the NASD manual requires that principal underwriters of mutual funds may only sell mutual fund securities to brokers or dealers with whom they

have a sales agreement in effect which establishes the concessions to be received by the dealer or broker.

16. Rule 2830(g) of the NASD manual requires that no NASD member may purchase from a principal underwriter mutual fund securities except to cover purchase orders previously received from its customers, or for the member's own investment.

17. Each of the Taxpayer's sales agreements with mutual fund principal underwriters requires that when making a purchase of mutual fund securities, that the Taxpayer is acting as a principal for its own account, either for resale to its customers or for the Taxpayer's own investment.

18. During the audit period the Taxpayer did not make purchases of mutual fund shares for its own investment. All purchases were made as a result of the placement of an order for purchase of shares by the Taxpayer's clients and the Taxpayer's client name was provided to the mutual fund principal underwriter.

19. The public offering price or prospectus price of mutual funds consists of the net asset value of the fund shares computed upon a per share basis on any given day together with a sales charge. Sales charges are intended to compensate the principal underwriter and the broker-dealer involved in the purchase transaction. Sales charges are also called "sales loads" and "front-end loads" and are calculated as a percentage of the share offering price. Front-end sales charges are included in the cost of the shares to the purchaser at the time of purchase and are shared between the principal underwriter and the broker-dealer in accordance with the terms of the prospectus and the sales agreement between them.

20. During the audit period the Taxpayer only handled transactions for the purchase of mutual funds which carried a front end sales charge or load.

21. Mutual funds are also permitted to charge their shareholders ongoing fees called 12b-1 fees during the time that they hold shares of the fund. A 12b-1 fee is an amount deducted from the net asset value of the mutual fund under a written plan for distribution authorized under 17 CFR § 270.12b-1. This provision authorizes mutual funds to use fund assets to finance any activity which is primarily intended to result in the sale of shares issued by the fund, including compensation of principal underwriters, dealers and sales personnel.

22. Many funds also charge shareholders a contingent or deferred sales charge on certain classes of shares when they are sold or redeemed, under certain conditions as set forth in the prospectus. Generally, contingent or deferred sales charges are charged when shares are redeemed in a relatively short period of time (such as 18 months or less) from the date of purchase. The size or amount of the investor's investment and the class of shares purchased may also affect whether contingent or deferred sales charges will be imposed. Contingent or deferred sales charges are imposed on share redemptions in order to recover the sales charges paid to dealers and principal underwriters when the shares were originally purchased in situations where the shares were not held for a sufficient amount of time for the ongoing 12b-1 fees to compensate the funds for the sales charges paid at the time of purchase.

23. Many mutual funds offer various types or classes of shares to investors to provide an array of investment choices which may be attractive to investors under any number of different situations, depending upon the amount of money the investor will be

investing and the length of time the investor anticipates holding the mutual fund shares. These various classes of shares can involve any combination of front end sales charges, deferred or contingent sales charges and 12b-1 fees. Generally, share classes with low front end sales charges usually have higher ongoing 12b-1 fees, while share classes with higher front end charges generally have lower ongoing 12b-1 fees. Thus, shares with lower front end charges may be more attractive for investors who do not plan to hold the mutual fund shares for a long time because they will bear a lower front end charge. However, over the long term, shares carrying a higher front end load will be priced more attractively for a long term investor because of the lower ongoing 12b-1 fees.

24. During the audit period the Taxpayer's typical agreement with principal underwriters was that it would receive a concession representing a percentage of the public offering price of the mutual fund securities purchased. Most commonly, the percentage was approximately 5% although the percentage varied depending upon the terms of the fund prospectus, the sales agreement with the principal underwriter, and the type or class of mutual funds purchased.

25. When the Taxpayer executes a purchase of shares of a mutual fund with a principal underwriter, the underwriter charges the Taxpayer the public offering price of the shares purchased (net asset value on the trade date plus any front end sales charge) less the amount of dealer concession specified in the agreement between the Taxpayer and the principal underwriter. The Taxpayer collects the full public offering price from its customers for the shares purchased. Thus, the dealer concession represents the difference in the price the Taxpayer paid to the principal underwriter for the purchase of

the mutual fund shares and the price the Taxpayer received from its customers for those shares.

26. The dealer concession represents the portion of the front end sales charge included in the prospectus price or public offering price at which the mutual fund shares are sold to the Taxpayer's customers which the Taxpayer receives as the dealer handling the mutual fund purchase transaction.

27. NASD Rule 2830(B)(2) defines "brokerage commissions" to include dealer concessions such as those the Taxpayer receives as the dealer handling mutual fund purchase transactions.

28. SEC Rule 10b-10 (17 CFR §240.10b-10(a)(2)) requires broker dealers to disclose to their customers no later than the confirmation of each transaction whether the broker or dealer is acting as agent for the customer, as agent for some other person, as agent for both the customer and some other person or as principal for its own account.

29. The Taxpayer discloses to its clients making mutual fund purchases that it has acted as a principal for its own account in the confirmation notice sent to the client after each trade has been executed.

30. Under the various agreements the Taxpayer has with the various mutual fund underwriters, the Taxpayer may be held financially responsible for any losses incurred should a purchase transaction fail due to the failure of payment for the shares purchased within the specified time for payment.

31. The confirmation statement provided by the Taxpayer to its customers notifies them that if they do not make payment for the securities by the settlement date the

Taxpayer reserves the right to sell the securities purchased and hold the customer liable for any losses incurred, or to cancel the transaction.

32. Less than one percent of the mutual fund purchase transactions handled by the Taxpayer fail due to the failure to pay for the purchase by the Taxpayer's customer.

33. A mutual fund purchase transaction is handled by the Taxpayer in the following manner. A customer's order is taken by a sales representative at the Taxpayer's New Mexico branch office and is entered into a computer by a wire operator at the office. The order is electronically transmitted from the branch to the Taxpayer's clearing office located in Texas. The clearing office reviews the order and electronically transmits batches of orders to the National Securities Clearing Corporation ("NSCC") in New York. The NSCC sorts the orders received from broker-dealers and electronically re-transmits batches of orders to the appropriate mutual fund underwriters. The underwriter reviews the orders and transmits to the NSCC confirmation of its acceptance of the purchase order. The NSCC sorts the confirmations and re-transmits the Taxpayer's confirmations to the Taxpayer's clearing office. The Taxpayer then mails out a document entitled "transaction confirmation" to its customer confirming the mutual fund purchase, showing the net amount due and the settlement date. The Taxpayer transmits the payment for the mutual fund shares to the principal underwriter by the settlement date and the Taxpayer's customer transmits payment to the Taxpayer for the mutual fund shares. The Taxpayer then registers the shares in its customer's name and the transaction is completed.

34. Under some arrangements between the broker dealer and the principal underwriter for a mutual fund, the broker dealer of record for customers holding shares in

the fund is periodically paid a portion of the 12b-1 fee charged to shareholders. The broker-dealer's share of the fee is usually stated as a percentage from the net asset value of each customer's shares. The broker-dealer's share of the 12b-1 fee is called a "trail" because it follows the shareholder, regardless of whether the shareholder moves its account to another broker-dealer other than the one through whom the shares were purchased.

35. The trails are variously described in the mutual fund prospectuses as "distribution fees" or "service fees" and can cover various services provided to shareholders such as processing purchase and redemption transactions, maintaining shareholder accounts and providing information and assistance with respect to the funds, maintaining regular contact with customers, supporting the fund's marketing efforts by distributing literature from the funds, etc. Whether a broker-dealer may continue to receive trails under the sales agreements with principal underwriters or the funds may also depend upon the levels of shareholder redemptions. Many of the agreements require that a portion of the trail actually be paid by the broker-dealer to the account representatives of customers holding shares of the funds.

36. The primary reason broker-dealers are paid trails is to provide an incentive to them to not encourage their customers to redeem their shares. Mutual funds are a class of investments generally designed for holding for a longer term than other securities, such as investments in individual stocks. Because they are held for longer term, a customer's account will have less turnover of its holdings, resulting in fewer transactions which would otherwise be generating commissions for the broker-dealer. The trails provide an incentive to the broker-dealers (and their account representatives having direct contact

with customers) to refrain from steering customers to owning other types of securities which would generate more commission revenue.

DISCUSSION

This case presents difficult issues of first impression regarding how the New Mexico gross receipts tax applies to the revenues received by the Taxpayer with respect to mutual fund shares which were purchased by customers of the Taxpayer through the Taxpayer's relationship with the principal underwriters who distribute mutual funds and revenues received by the Taxpayer with respect to mutual fund shares owned by customers of the Taxpayer. The two streams of revenue will be referred to herein as "dealer concessions" and "trails".

The gross receipts tax is imposed upon a taxpayer's "gross receipts". Section 7-9-4 NMSA 1978. "Gross receipts" is defined at § 7-9-3(F) NMSA 1978 (1986 Repl. Pamp.) as:

> 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 or from performing services in New Mexico.[1]

"Property" is defined at § 7-9-3(I) NMSA 1978 to mean "real property, tangible personal property, licenses, franchises, patents, trademarks and copyrights." While intangible

[1] In 1989, during the period covered by the assessment at issue, the definition of gross receipts was amended to include consideration received "from selling services performed outside New Mexico, the product of which is initially used in New Mexico." Laws 1989 , ch. 262, § 1. The 1989 act also enacted § 7-9-13.1, which exempts from gross receipts tax receipts from performing services outside of New Mexico, except for certain research and development services not relevant to the Taxpayer's activities herein. Because the activities at issue herein are not research and development services, the 1989 amendments

property in the form of licenses, franchises, patents, trademarks and copyrights are specifically included in the definition, intangible property in the form of stocks, bonds and shares of mutual funds are not listed and so, under the doctrine of construction of *ejusdem generis exclusio unis*, intangible property of a kind not listed, such as securities, would not be included in the definition. Thus, receipts from selling securities would not be included in gross receipts. Lest there be any doubt about this, the legislature provided a specific exemption from gross receipts tax for "receipts from the sale of stocks, bonds or securities." Section 7-9-25 NMSA 1978.

While the receipts from the sale of a security, itself, are exempt from gross receipts tax, receipts in the form of commissions or fees from performing services as an agent or broker with respect to the sale or purchase of securities are expressly included in the definition of gross receipts:

> 'Gross receipts' for the purpose of the business of buying, *selling*, or promoting the purchase, sale or leasing, *as an agent or broker, on a commission or fee basis, of any* property, service, *stock, bond or security, includes the total commissions or fees* derived from the business. (emphasis added).

Section 7-9-3(F) NMSA 1978 (1986 Repl. Pamp.). Reading § 7-9-25 and § 7-9-3(F) together, when one acts as an agent or broker for the sale of services, property or securities, only the commission or fee received for performing the service of acting as an agent or broker is subject to the gross receipts tax, and not the amount representing reimbursement from the principal for the property, service or security. Consistent with

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made no change to the previously existing rule that in order to be subject to gross receipts tax, the receipts of a taxpayer performing services must be from services performed in New Mexico.

this, the Department also had a regulation in effect, Regulation GR 25:1 (now 3 NMAC 2.25.8) which provided as follows:

GR 25:1 - STOCKBROKER'S COMMISSIONS.

> Commissions received by stockbrokers, located in New Mexico, are not receipts from the sale of stocks, bonds or securities. The commissions are receipts from the performance of a service in New Mexico and are subject to the gross receipts tax.

Thus, the issue, with respect to the dealer concessions received by the Taxpayer for its role in transacting the sale of mutual funds is whether those are properly classified as commissions the Taxpayer received as an agent or broker for the sale of mutual funds, which are taxable, or whether they represent receipts from the sale of the mutual fund shares, themselves, and are exempt from gross receipts tax.

Before examining the specifics of the mutual fund transactions at issue and determining how the gross receipts tax should be applied, it is also important to understand how mutual funds are valued, the overlay of federal law regulating securities transactions and specifically, how the Investment Company Act of 1940, hereinafter, the "Investment Company Act", 15 USCA § 80a-1, *et seq.*, affects the manner in which mutual fund sales transactions are structured. A clarification of the terms used to refer to those, such as the Taxpayer, who buy and sell securities will also be helpful to this discussion.

While the gross receipts tax statutes and the Department's regulations use the terms "broker" "agent" and "stockbroker", the laws regulating securities transactions and stockbrokers use more specific terms. The Taxpayer is licensed under the New Mexico Securities Act of 1986, §§ 58-13B-1 through 57 NMSA 1978, as a "broker-dealer." "Broker-dealer" is defined in pertinent part as follows:

> "broker-dealer" means a person engaged in the business of effecting transactions in securities for the account of others or for the persons own account.

Section 58-13B-2(B) NMSA 1978. This definition encompasses both the definition of a "broker" and a "dealer" in federal law. Specifically, a "broker" is defined in the Securities Exchange Act of 1934 as follows:

> The term "broker" means any person engaged in the business of effecting transactions in securities *for the account of others*, but does not include a bank. (emphasis added).

15 USCA § 78c(a)(B)(4). The same act defines a "dealer" as follows:

> The term "dealer" means any person engaged in the business of buying and selling securities *for his own account,* through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business. (emphasis added).

15 USCA § 78c(a)(B)(5). The Investment Company Act maintains the same distinction in its definitions of "broker" and "dealer", the distinction being whether one is effecting securities transactions for the account of others (brokers) or for his own account (dealers). ***See,*** 15 USCA § 80a-2(a) (4) and (5).

The Investment Company Act regulates "investment companies", which, generally, are entities that invest in the securities of other corporations and issue securities of their own. "Open end" investment companies are commonly called mutual funds. ***See, United States v. National Association of Securities Dealers, Inc.***, 422 U.S. 694, 95 S.Ct. 2427,2432, 45 L.Ed. 2d 486 (1975)(hereinafter, ***U.S. v. N.A.S.D)***. This case involved antitrust actions brought against NASD by the United States challenging

contract restrictions imposed on principal underwriters by mutual funds and on broker-dealers by the principal underwriters, including provisions such as exist in this case whereby broker-dealers were required to act only as dealers purchasing securities for their own account as principal when transacting purchases of mutual funds. The Court found that these contract provisions, although they act to eliminate price competition in the sale of mutual fund shares, do not violate the Sherman Act because they are protected by the antitrust immunity provided in the Investment Company Act. Although the antitrust matters at issue in that case are not pertinent to this case, the decision explains the operation of the Investment Company Act and why mutual fund purchase transactions are structured in a manner unique in the securities industry to mutual funds.

The Investment Company Act was enacted to curb certain abuses in the way investment company issued securities were traded which diluted the value of shares held by the general investing public. Shares in a mutual fund represent proportionate interests in its investment portfolio, and their value fluctuates constantly, reflecting the changes in the value of the securities in the portfolio held by the mutual fund. Thus, the value of a share of a mutual fund is the net asset value of the securities held by the fund, divided by the number of shares outstanding. Share prices were calculated on a daily basis. An active secondary market in mutual fund shares had arisen whereby market professionals and insiders were able to take advantage of the timing when share values were calculated and their knowledge of market trends and conditions to make quick trades and profits, to the detriment of the other shareholders in the fund. All of this is described more thoroughly in ***U.S. v. N.A.S.D.,*** 95 S.Ct. at 2436-2438. Section 22 of the Investment Company Act, 15 USCA § 80a-22 addressed this problem by imposing the requirement

that mutual fund shares could only be sold at the public offering price described in the fund prospectus, when such shares were sold by principal underwriters and dealers. 15 USCA § 80a-22(d). The public offering price in the fund prospectus is the net asset value per share, plus any sales charges described in the prospectus. Because the language of § 80a-22(d) only restricts the price at which a principal underwriter or a "dealer" may sell mutual fund securities, it would not apply to purchases or sales by "brokers". The mutual fund industry adopted contract provisions which require broker-dealers to act only as a principal in buying and reselling mutual fund shares, so as to be subject to the resale price restrictions of § 80a-22(d). In its decision the Court agreed these contract provisions were also immune from antitrust law under the Investment Company Act because of the unique problems of the mutual fund industry which Congress sought to remedy under the Investment Company Act. ***Id.,*** 95 S.Ct. at 2443-2448. Those same contract provisions exist in the Taxpayer's contracts with principal underwriters with whom it transacted the mutual fund purchase transactions pertinent to the issues in this case. With that background, we can now examine the arguments of the parties.

TAXABILITY OF DEALER CONCESSIONS

As noted above, 15 USCA 80a-22(d) prohibits principal underwriters and dealers from selling mutual fund shares to any person other than another dealer, the principal underwriter or the fund except at the current offering price described in the fund prospectus. This is commonly called the "public offering price." Because the Taxpayer acts as a dealer or principal for its own account in making mutual fund purchases under its agreements with principal underwriters, it is required to sell the mutual fund shares to its customers at the public offering price. The public offering price is the net asset value

per share plus any sales charge specified in the fund prospectus. Sales charges are also called "sales loads" or "front-end loads," and are calculated as a percentage of the share offering price. These are divided between the principal underwriter and the dealer and are designed to encourage vigorous sales efforts on their part and to compensate them for their sales efforts. ***U.S. v. N.A.S.D.***, 95 S.Ct. at 2433, n. 4. The Taxpayer sold only mutual funds carrying loads.

The portion of the load which the Taxpayer received from sales transactions is variously described in the sales agreements with principal underwriters as "dealer discounts", "concessions" and "commissions" (hereinafter "dealer concessions") and is specified by the terms of the sales agreements the Taxpayer had with the principal underwriters. They represent the difference between the price the mutual fund shares are sold to the Taxpayer by the principal underwriter and the price the Taxpayer receives from its customers for those shares.

Under its sales agreements with the principal underwriters, the Taxpayer purchases mutual fund shares as a principal or dealer, purchasing the shares for its own account. This is disclosed to the Taxpayer's customer on the sales confirmation notice sent to the customer at the time the sale is confirmed by the principal underwriter. The Taxpayer then charges the customer the public offering price for the shares they purchase. The Taxpayer argues that because it charges its customers the public offering price for the shares and because it purchases the shares from the principal underwriter as principal acting for its own account, that it is purchasing and then reselling the mutual fund shares. Thus, all of its receipts from its customers represent receipts from the sale of securities, which are exempt from tax pursuant to § 7-9-25 NMSA 1978.

The Department argues that the dealer concessions are actually commissions, which the Taxpayer received for performing the service of acting as an agent, and that they are thus gross receipts which are subject to tax pursuant to § 7-9-3 (F) NMSA 1978. The Department argues that the transaction should not be judged by the structure of the transaction, which was designed to prevent a secondary market in mutual funds in accordance with the federal Investment Company Act. Rather, the Department argues that the transaction should be judged by the reality of the transaction, which is that the Taxpayer is providing the same services to its mutual fund clients as to its other clients. It advises them about investment decisions and assists them in making securities transactions by executing securities trades, and is compensated for these services by the receipt of a commission which is subject to tax.

In order for the Department's position to be sustained, the concessions received by the Taxpayer must be able to be characterized as commissions or fees from the business of selling securities "as an agent or broker". Section 7-9-3(F) NMSA 1978.
The Department argues that the Taxpayer acts as an agent of both the mutual funds and its customers.

An agent is one authorized by another to act on his behalf and under his control. ***Western Electric Co. v. New Mexico Bureau of Revenue,*** 90 N.M. 164, 561 P.2d 26 (Ct. App. 1976). Two recent decisions from the Court of Appeals provide further illumination of this principal in the context of gross receipts taxes. Both of those cases involved a determination of whether funds received as reimbursement for payroll expenses pursuant to a contract to provide management services were received merely as an agent, and thus not subject gross receipts tax. In ***Carlsberg Management Co. v. Taxation and Revenue***

Department, 116 N.M. 247, 861 P.2d 288 (Ct. App, 1993) the court stated that "a principal's control over the agent is the key characteristic of an agency relationship." ***Id.,***116 N.M. at 250 (citations omitted). It then examined the contracts between the parties to determine whether an agency relationship existed. It found that the agreements demonstrated pervasive control over the taxpayer and concluded an agency relationship existed so as to render the taxpayer's payroll reimbursements immune from tax. A significant factor in the court's decision was the indemnification clause of the contracts, requiring the owner to pay the taxpayer for employment expenses. The court read this to indicate that the payment of wages was ultimately the duty of the owner. ***Id.***, at 251-252. Subsequent to ***Carlsberg,*** the Court of Appeals decided ***Brim Healthcare v. Taxation and Revenue Department***, 119 N.M. 818, 896 P.2d 498 (Ct. App. 1995). That case involved the same issue, whether payroll reimbursements received by the taxpayer were received as agent or were they gross receipts subject to tax. The court found that Brim Healthcare was not "merely a conduit for funds to be paid to third parties", as Carlsberg was. Rather, it found that Brim Healthcare received the payments "for its own account" and spent them "to meet its own responsibilities." ***Id.*** at 820. Additionally, the court found that the most significant distinction between the two cases was that in ***Brim***, there was no broad indemnification clause which had the effect of shifting the duty to pay wages to the employees to the parties with whom Brim Healthcare contracted.

Applying these considerations to the case at bar, we must examine the degree of control over the Taxpayer manifested in the relationship of the parties to the securities purchase agreements and determine whether the Taxpayer's receipts from its customers were received for its own account and to meet its own responsibilities. We must also

determine which entity, if any, the Taxpayer could be considered to have acted as agent for. As noted earlier, the Department argues that the Taxpayer acted as agent for both the mutual funds and its customers.

With respect to the Department's argument that the Taxpayer acted as agent for the mutual funds, the Department argues that because the mutual fund controlled the price, manner and type of shares that the Taxpayer could sell, the Taxpayer had receipts as an agent. This argument has no application to the case at bar. The receipts at issue are those the Taxpayer received from its customers, representing a portion of the purchase price of the mutual fund shares it received from its customers. The Taxpayer is not being taxed upon any "gross receipts" from the mutual funds while acting as agent on behalf of the mutual funds. Besides, a customer purchasing goods in a retail transaction is not an agent for the store selling the goods merely because the store controls the price, manner and type of goods sold. Thus, if an agency relationship exists, the relevant one for purposes of the issues in this case is whether the Taxpayer was acting as agent for its customers in making the mutual fund purchases, rendering the dealer concessions it received commissions or fees[2] from acting as an agent or broker in the transaction.

A review of the contractual documents evidencing the sales transactions at issue leads to the conclusion that the Taxpayer did not act as agent for its customers in the

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[2] The Taxpayer, in arguing that it is not an agent for its customers, points out that although "commissions" are not defined in the Gross Receipts and Compensating Tax Act, the dictionary definition of commissions calls them a fee paid to an agent or employee, thus bolstering its argument that an agency relationship must exist to consider the dealer concessions to be commissions. The Department points out, however, that many of the agreements with principal underwriters call the concessions a "commission" and the Taxpayer's own books referred to them as commissions. It is not necessary to determine whether an agency relationship must exist for the concessions to be considered "commissions", however, because the legislature also used the broader term "fees" in § 7-9-3(F). This term is certainly broad enough to cover dealer concessions, no matter how they are termed.

mutual fund purchase transactions at issue. The Taxpayer's agreements with the principal underwriters require that in making mutual fund purchases, the Taxpayer act as principal. The Taxpayer, as required by SEC Rule 10b-10, discloses to its customers at the time it confirms the transaction, that it has acted as principal. Additionally, the risk of loss, should a customer fail to fund a purchase transaction falls upon the Taxpayer. The agreements with the principal underwriters hold only the Taxpayer responsible for any losses incurred should the transaction not be funded prior to the settlement date and the shares be returned to the underwriter. Although the Taxpayer's sales documents with its customers inform them that should a transaction fail to be funded, that the Taxpayer reserves the right to sell the securities purchased and hold the customer liable for any losses incurred, this falls far short of an agreement by the customer to indemnify the Taxpayer for the losses. It merely notifies the customer of a potential claim for loss. Just as the existence of an indemnification clause in ***Carlsberg*** weighed heavily in the court's determination that an agency relationship existed, the absence of an indemnification clause covering the transactions at issue in ***Brim Healthcare*** were critical to the court's determination that no agency relationship existed. The fact that the risk of loss in the mutual fund purchase transactions at issue herein falls upon the Taxpayer strongly indicates that the Taxpayer receives the mutual fund purchase price from its customers "for its own account" and it spends the portion it remits to the principal underwriters "to meet its own responsibilities." ***Id.*** Additionally, the fact that fewer than less than one percent of mutual fund purchase transactions handled by the Taxpayer fail does not change the fact that when a transaction does fail, the risk of loss remains with the Taxpayer.

The Department relies upon the fact that the Taxpayer had a pre-determined purchaser who is disclosed to the principal underwriter and an established fee between the principal underwriter and the Taxpayer as a strong indication that an agency relationship existed between the Taxpayer and its customer. These features of the transaction are a result of the regulatory overlay of the Investment Company Act, the Securities and Exchange Commission and the NASD, all of which are designed to prevent a secondary market in mutual fund shares to protect and benefit the individual investor. The fact that the customer is revealed to the principal underwriter would not be sufficient to impose third-party liability upon such customer under the contractual documents of these transactions. In fact, had the Taxpayer purchased to shares as an agent for its customers, 15 USCA 80a-22(d) would have required the principal underwriter to charge the Taxpayer the full public offering price for the shares. Nor does the fact that the Taxpayer purchased the shares for resale to its customers transform the relationship into an agency relationship. As noted by the Taxpayer, an automobile dealer may purchase a vehicle from the manufacturer in order to fill a customer order, but that does not make the dealer an agent for the customer. In short, although these transactions are structured differently than the normal securities transactions handled by brokerage houses such as the Taxpayer, because of problems unique to the mutual funds industry, nonetheless, the structure of these transactions is consistent throughout the transactions between the Taxpayer and the principal underwriters and the Taxpayer and its customers with the conclusion that the elements of an agency relationship do not exist.

Although the Taxpayer did not act as an agent for its customers in the mutual fund purchase transactions at issue, that does not necessarily resolve the issue of the taxability

of the dealer concessions the Taxpayer received. This is because § 7-9-3(F) includes in gross receipts the commissions or fees received as an "agent *or* broker". (emphasis added). The word "or" in a statute is given a disjunctive meaning unless the context of the statute demands otherwise. ***Public Service Company of New Mexico v. New Mexico Public Service Commission,*** 106 N.M. 622, 747 P.2d 917 (1987). It is not at all apparent from the context of the statute that the words agent and broker are used interchangeably rather than disjunctively. While the term broker is commonly used to refer to those handling securities and real estate transactions, and perhaps some other types of transactions not so commonly thought of, Section 7-9-3(F) speaks of commissions or fees derived from the business or buying selling or promoting the purchase, sale or leasing of *any* property, service, stock, bond or security. Thus, the legislature's choice of the work "any" would indicate a legislative intent to cover a much broader range of transactions than only those in which the middleman is commonly known as a "broker". Given the apparent legislative intent to broadly encompass all transactions in which a taxpayer received commissions or fees for acting as an agent or broker, the words should be construed disjunctively.

If the words are construed disjunctively, the dealer concessions received by the Taxpayer could still be considered gross receipts if the legislature intended to include within the term broker, those persons commonly known as brokers, such as securities broker-dealers, regardless of whether an actual agency relationship existed in a securities transaction. The term "broker" is not defined in the Gross Receipts and Compensating Tax Act. In the absence of a statutory definition, words in statutes are presumed to have been used in their ordinary sense. ***Bettini v. City of Las Cruces,*** 82 N.M. 633, 485 P.2d

967 (1971). Courts will often consult dictionary definitions to find the ordinary meaning of a word. Webster's Third New International Dictionary defines a broker as both one who acts as an agent and as one who simply deals in property. Under the category of negotiator or intermediary it defines a broker as:

> an agent middleman who for a fee or commission negotiates contracts of purchase and sale (as of real estate, commodities or securities) between buyers and sellers without himself taking title to that which is the subject of negotiation and usually without having physical possession of it.

Under the category of dealer, it defines a broker as:

> a dealer who for his own profits negotiates purchases and sales (as of negotiable instruments or commodities) himself taking or holding title to and often physical possession of that which is the subject of negotiation but usually without altering or processing it--not used technically in fields in which a broker is primarily an agent.

Black's Law Dictionary (5th Ed. 1979) also makes it clear that a broker is not limited to those acting solely as agent, for it defines a broker variously as:

> An agent employed to make bargains and contracts for a compensation. A dealer in securities issued by others.

It is also noteworthy that the New Mexico Securities Act of 1986 does not contain a definition of a "broker". It does, however, define a "broker-dealer" to include persons engaged in the business of effecting securities transactions both for the account of others and for the person's own account.

Article 8 of the Uniform Commercial Code also defines a broker to include those acting as agent for others as well as those buying and selling securities on their own behalf. As defined at 55-8-303 NMSA 1978 (original pamphlet):

> "Broker" means a person engaged for all or part of his time in the business of buying and selling securities, who in the transaction concerned acts for or buys a security from or sells a security to a customer. Nothing in this article determines the capacity in which a person acts for purposes of any other statute or rule to which such person is subject.

The current definition in Article 8 can be found a 55-8-102(a)(3) NMSA 1978 (1997 Repl. Pamp.) and reads as follows:

> "broker" means a person defined as a broker or dealer under the federal securities laws, but without excluding a bank acting in that capacity;

This definition thus encompasses both those acting as brokers for the account of others, as well as dealers acting for their own account. ***See,*** 15 USCA §§ 78c(a)(B)4 and 5 and 15 USCA §§ 80 a-2(a) (4) and (5). Although both this definition and the original definition contain language cautioning that this article does not determine the capacity in which a person acts for purposes of any other statute, it is, at least indicative, as are the dictionary definitions quoted above and the definition of "broker-dealer" in the New Mexico Securities Act of 1986, that the term broker is not commonly understood to only mean those who act as agents for others in securities transactions, but also includes those dealing with securities for their own account.

Given that the ordinary meaning of "broker" is not limited to those acting as agent, it is reasonable to conclude that in enacting § 7-9-3(F), the legislature did not intend to limit its applicability to only those acting as agents. If it had, there would have been no need to even mention brokers because they would already have been encompassed in the broader definition of agent.

Perhaps the strongest reason to construe the term broker broadly is that there is nothing in § 7-9-3(F) to indicate that the legislature intended to distinguish, for gross receipts taxation purposes, the fees or commissions received by securities broker-dealers from mutual fund transactions and those they receive for their role in handling transactions in any other types of securities, stocks or bonds. It is highly doubtful that the legislature was so intimately familiar with securities law that it would even have occurred to them that mutual fund transactions, as opposed to other securities transactions, are structured uniquely because of the federal regulatory overlay designed to curb abuses in the way mutual funds were priced, resulting in broker-dealers assuming a different role vis-à-vis their customers than they do in other securities transactions. It is thus doubtful that the legislature intended that the term "broker" be construed narrowly to only include transactions where an actual agency relationship existed, thus creating an exception from taxation for only those commissions earned by broker-dealers for handling mutual fund transactions. If it was the intention of the legislature to specifically exempt commissions or fees earned by broker-dealers from mutual fund transactions, it is far more likely that they would have done so by specifically excepting them from the language of § 7-9-3(F). It thus appears reasonable to conclude that the dealer concessions received by the Taxpayer are gross receipts within the meaning of § 7-9-3(F) because they qualify as "commissions or fees" received as a "broker" from selling securities and that portion of the Department's assessment was therefore proper.

TAXABILITY OF "TRAILS"

The Taxpayer also disputes the gross receipts tax imposed upon the trails it received from the mutual funds during the audit period. Trails represent a portion of the "12b-1"

fees that mutual funds are permitted to charge their shareholders on an ongoing basis during the time that they hold shares of the fund. 12b-1 fees are deducted from the net asset value of the mutual fund under a written plan for distribution authorized under 17 CFR § 270.12b-1. This provision authorizes mutual funds to use fund assets to finance any activity which is primarily intended to result in the sale of shares issued by the fund, and it may be used to compensate principal underwriters, dealers and sales personnel.

The trails are variously described in the mutual fund prospectuses as "distribution fees" or "service fees" and can cover various services provided to shareholders such as processing transactions for the purchase or redemption of shares, establishing and maintaining shareholder accounts, providing information and assistance with respect to the funds, assigning a sales representative to each account and maintaining regular contact with account holders, assisting shareholders in making administrative changes, etc. Many of the agreements with principal underwriters also provide that whether a broker-dealer continues to receive trails under the agreements may depend upon the levels of shareholder redemptions. Many of those agreements also require that a portion of the trail received by the broker-dealer actually be paid to the account representatives of customers holding shares of the funds.

The Department imposed tax upon the Taxpayer's trail receipts on the basis that they represented gross receipts from performing services. The Taxpayer argues that either the trails are not taxable because no real services were provided, or alternatively, if services were provided, no more than ten percent of the services were performed in New Mexico and only that portion performed in New Mexico may be taxed.

Before discussing the arguments of the parties, one preliminary matter must be discussed. The Taxpayer concedes that during the audit period, it did not distinguish its revenue stream from trails from its revenue stream from dealer concessions. At the formal hearing, the Taxpayer attempted to introduce Exhibit 25 , which established that during 1997, trails represented 37% of its mutual fund revenue stream. The Taxpayer testified that this was representative, if not somewhat of overstatement of the portion of its revenue stream attributable to trails during the audit period. The Department objected to the exhibit and testimony on the grounds of hearsay and relevancy. Ruling was reserved on the Department's objection until the decision was issued. Exhibit 25 and Mr. Larkin's testimony about the exhibit and its basis are admitted. Hearsay is admissible in administrative hearings and I found the exhibit and testimony to be relevant to the issue of what portion of the mutual fund revenues are attributable to trails. I also found the Taxpayer's methodology for apportioning the revenue stream and its explanation of why its percentage of trails in 1997 would, if anything, be higher than it would have been during the audit years to be quite plausible and reliable.

First, the Taxpayer argues that the sorts of activities listed in the prospectuses for which the trails are allegedly paid, such as distributing fund literature, maintaining customer accounts, assisting shareholders in making administrative changes, etc. are services the Taxpayer already provides all of its customers, without consideration. Thus, these activities are not performed for the mutual funds paying the trails and are not performed because of the trails. The Taxpayer also provided testimony that if these activities are considered to be services for which the trails are consideration for their performance, no more than ten percent of the shareholder services occurs at the

Taxpayer's New Mexico branch office, thus requiring apportionment of the other ninety percent to services performed out of state, and therefore not subject to gross receipts tax.

The Taxpayer also provided testimony, however, that the actual reason broker-dealers are paid trails is to provide them an incentive to not encourage their customers to redeem their shares and invest in other types of securities, which tend to be traded more often, thereby generating more commission revenue for the Taxpayer. This testimony is supported by the fact that many of the Taxpayer's sales agreements with underwriters mention that the fund may monitor shareholder redemptions in determining whether trails would continue to be paid, and many of the agreements also require that the Taxpayer share its trail revenues with the account representatives who have contact with fund investors. Although the Taxpayer argues that, in effect, the Taxpayer is compensated for doing nothing with regard to its shareholders who own mutual fund shares and thereby it has not engaged in any activities which could be considered to be a service subject to gross receipts tax, this is too narrow a view of what the Taxpayer is providing the funds. The service provided is, in effect, not encouraging investors to move their investments into other securities or funds. This "activity" is not necessarily passive, as the Taxpayer would suggest. Account representatives could advise their customers about the long-term nature of investing in mutual funds and actively encourage them to invest in and hold funds for the long term, even though the market might be experiencing a decline during a particular time in the market cycle. Because the advising of its customers occurs in New Mexico at the Taxpayer's branch office, this activity occurs in New Mexico and the trails received by the Taxpayer are fully subject to gross receipts tax.

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely, written protest, pursuant to § 7-1-24 NMSA 1978, to Assessment No. 1670445 and jurisdiction lies over both the parties and the subject matter of this protest.

2. The dealer concessions the Taxpayer received can be fairly characterized as "commissions or fees" under § 7-9-3(F) NMSA 1978.

3. The Taxpayer did not receive the dealer concessions at issue in the capacity of an agent for the principal underwriters of the mutual funds purchased and sold.

4. The Taxpayer did not receive the dealer concessions at issue in the capacity of an agent for its customers making purchases of mutual fund shares.

5. The Taxpayer acted a "broker" when making mutual fund purchases and sales under § 7-9-3 (F) NMSA 1978.

6. The dealer concessions received by the Taxpayer with respect to its role in the sale and purchase of mutual funds are gross receipts as commissions or fees from the business of selling mutual fund securities on a commission or fee basis pursuant to § 7-9-3(F) NMSA 1978.

7. The trails received by the Taxpayer represent gross receipts from the performance of services for mutual funds. Because the services performed, the advising of its customers, either actively or passively, to retain and hold their positions in mutual funds, were performed in New Mexico, those gross receipts are not apportionable and are fully subject to New Mexico gross receipts tax.

For the foregoing reasons, the Taxpayer's protest IS HEREBY DENIED.

DONE, this 6th day of July, 1998.