

**IN THE
SUPREME COURT OF MISSOURI**

No. 84225

ACME ROYALTY COMPANY, INC.,

and

BRICK INVESTMENT COMPANY,

APPELLANTS,

v.

DIRECTOR OF REVENUE, STATE OF MISSOURI,

RESPONDENT.

**ON PETITION FOR REVIEW
FROM THE MISSOURI ADMINISTRATIVE HEARING COMMISSION
THE HONORABLE SHARON M. BUSCH, COMMISSIONER**

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TABLE OF CONTENTS

TABLE OF AUTHORITIES	3
INTRODUCTION.....	7
ARGUMENT.....	8
I. The Trademark License Royalties Are Not Missouri Source Income of Appellants.....	8
A. Appellants Engage In No Missouri Income-Producing Activities.....	10
B. <i>A.P. Green</i> and <i>Brown Group</i> Do Not Support Taxation of Appellants.....	12
C. The Lanham Act Does Not Serve as a Basis to Tax Appellants.....	13
II. Appellants Are Not Subject to Missouri Income Tax Because They Have No Substantial Nexus With Missouri	14
A. Appellants Have No Physical Presence in Missouri.....	14
B. Even Without a Physical-Presence Requirement, Appellants Do Not Have Substantial Nexus With Missouri.....	20
C. The Nexus of ABC May Not Be Attributed to Appellants.....	22
III. The Assessment Violates the Uniformity and Equal Protection Clauses.....	27
IV. The Commission Is Not Free to Exclude Apportionment Factors	

That the Commission Concludes Are “Minimal”	28
V. The Commission’s Decision Is An Unexpected Decision.....	30
CONCLUSION.....	32
CERTIFICATE OF SERVICE.....	33
CERTIFICATE REQUIRED BY SPECIAL RULE 1(C).....	33

TABLE OF AUTHORITIES

Missouri Cases

<i>A.P. Green Fire Brick Co. v. Missouri State Tax Comm’n,</i>	
277 S.W.2d 544 (Mo. 1955).....	12, 31
<i>Blackwell Printing Co. v. Blackwell-Wielandy Co.,</i>	
440 S.W.2d 433 (Mo. 1969).....	25
<i>Brown Group, Inc. v. Admin. Hearing Comm’n,</i>	
649 S.W.2d 874 (Mo. banc 1983)	12
<i>Central Cooling & Supply Co. v. Director of Revenue,</i>	
648 S.W.2d 546 (Mo. 1982).....	24
<i>Collins v. Director of Revenue,</i>	
691 S.W.2d 246 (Mo. banc 1985)	11
<i>Grease Monkey Int’l, Inc. v. Godat,</i>	
916 S.W.2d 257 (Mo. App. E.D. 1995).....	24
<i>Langley v. Admin. Hearing Comm’n,</i>	
649 S.W.2d 216 (Mo. banc 1983)	11, 14
<i>Maxland Development Corp. v. Director of Revenue,</i>	
960 S.W.2d 503 (Mo. banc 1998)	12
<i>Medicine Shoppe Int’l, Inc. v. Director of Revenue,</i>	
75 S.W.3d 731 (Mo. banc 2002)	8, 12
<i>Mid-Missouri Telephone Co. v. Alma Telephone Co.,</i>	

18 S.W.3d 578 (Mo. App. W.D. 2000)	25
<i>Morrison v. Labor and Industrial Relations Commission,</i>	
23 S.W.3d 902 (Mo. App. W.D. 2000)	25
<i>Osler v. Joplin Life Ins. Co.,</i>	
164 S.W.2d 295 (Mo. 1942).....	26
<i>Schnorbus v. Director of Revenue,</i>	
790 S.W.2d 241 (Mo. banc 1990)	27
<i>United Air Lines, Inc. v. State Tax Comm’n,</i>	
377 S.W.2d 444 (Mo. banc 1964)	11
Missouri Constitution, Missouri Statutes and Other Missouri Authority	
Mo. Const. art. IV, § 22.....	31
Mo. Const. art. X, § 3	27
Section 32.053, RSMo	30-31
Section 32.200, RSMo	28
Section 32.200, art. IV, § 18, RSMo	29
Section 143.431, RSMo	8, 27
Section 143.441.2, RSMo	14, 19
Section 143.451, RSMo	8, 28
Section 143. 903, RSMo	30-31
H.B. 1877, 91 st Gen. Assem. (proposed section 143.435)	12

Federal Cases

Exxon Corp. v. Eagerton,

462 U.S. 176 (1983).....	27
<i>Mobil Oil Corp. v. Comm’r of Taxes,</i>	
445 U.S. 425 (1980)	14
<i>National Bellas Hess, Inc. v. Dep’t of Revenue,</i>	
386 U.S. 753 (1967).....	17
<i>Quill Corp. v. North Dakota,</i>	
504 U.S. 298 (1992).....	16-17, 19-21
<i>Red Wing Shoe Co. v. Hockerson-Halberstadt, Inc.,</i>	
148 F.3d 1355 (Fed. Cir. 1998).....	9, 21-23
Federal Constitution, Federal Statutes and Other Federal Authority	
U.S. Const. amend. XIV, § 1.....	27
Lanham Act, 15 U.S.C. § 1127	13
Other States’ Authority	
<i>American Dairy Queen Corp. v. Taxation and Revenue Dept.,</i>	
605 P.2d 251 (N.M. Ct. App. 1979).....	15
<i>America Online, Inc. v. Johnson,</i>	
__ S.W.3d __, 2002, WL 1751434 (Tenn. Ct. App. 2002)	16
<i>Cerro Copper Products v. Alabama,</i>	
Docket Number F94-444 (Ala. Dept. Rev. 1995).....	15
<i>Couchot v. State Lottery Comm’n,</i>	
659 N.E.2d 1225 (Ohio 1996)	15
<i>Crown Cork & Seal (Delaware) Inc. v. Comptroller,</i>	

1999 Md. Tax LEXIS 4 (Md. Tax Ct. 1999).....	15
<i>Geoffrey v. South Carolina</i> , 437 S.E.2d 13 (S.C. 1993), <i>cert. denied</i> , 510 U.S. 992 (1993)	14-15, 21-22, 30
<i>In re A&F Trademark, Inc.</i> , Administrative Decision No. 381 (North Carolina Tax Review Bd. May 7, 2002).....	16
<i>J.C. Penney National Bank v. Johnson</i> , 19 S.W.3d 831 (Tenn. Ct. App. 1999), <i>cert. denied</i> , 531 U.S. 927 (2000)	14
<i>Syl, Inc. v. Comptroller</i> , Case Number C-96-0154-01 (Md. Tax Ct. 1999).....	14-15

INTRODUCTION

The issue presented by this case is whether the Missouri Director of Revenue may tax a foreign corporation's royalty income from trademarks utilized in Missouri when that corporation – the owner of the trademarks – has no employees, property, or sales activity in Missouri. The Director asks this Court to hold Appellants liable for Missouri income tax – even though they are engaged in no income-producing activity in this state – because the royalty income comes from a related non-resident company whose sales of trademarked goods include sales to customers in Missouri (and even though that related company pays Missouri tax with respect to those sales).

For the reasons set forth below and in our opening brief, the Director's attempt to tax Appellants' trademark royalty income is without constitutional or statutory authority, and the decision of the Administrative Hearing Commission in favor of the Director should be reversed.

ARGUMENT

I. The Trademark License Royalties Are Not Missouri Source Income of Appellants.

Appellant Acme Royalty Company (“ARC”), and later Acme Royalty Company, L.P. (“ARCLP”), licensed trademarks that Acme Brick Company (“ABC”) used in making its sales in Missouri and elsewhere. The Director argues that Appellant ARC’s and later ARCLP’s royalty income “is derived from Missouri sources.” Yet the Director cites nothing that ARC, ARCLP, or Appellant Brick Investment Company (“BIC”), have done in Missouri to generate that royalty income. Rather, the focal point of her argument is **ABC’s** sales of products to Missouri customers. She reasons that because the amount of the royalty paid for the right to use the marks is calculated as a percentage of ABC’s sales of the products bearing the marks, the royalty income was derived by Appellants in Missouri (Dir. Br 13-14). But Appellants’ income is not derived from anything they do in Missouri ***because they engage in no income-producing activity in Missouri.***

As the Director concedes (Dir. Br. 24), Missouri law is clear that there must be some income-producing activity in Missouri to justify imposing the Missouri income tax upon Appellants’ income. Sections 143.431 and 143.451 R.S.Mo. This Court has just recently reaffirmed this fundamental proposition in *Medicine Shoppe Int’l, Inc. v. Director of Revenue*, 75 S.W.3d 731, 734 (Mo. banc 2002), where it said “[t]o be a [taxable] ‘transaction,’ there must be activity or effort in the taxing state that contributes to the production of income.” Unlike the taxpayer in *Medicine Shoppe*, Appellants engage in no income-producing activity in Missouri. Here, the Director seeks to tax the royalty income without identifying anything ***that Appellants have done in Missouri*** that produced

the income. She does not and cannot dispute Appellants' proof that they do no business in Missouri, own no real or personal property in Missouri, and have no agents or employees in Missouri. *ABC's* use of the trademarks pursuant to a trademark license is not a basis for concluding that Missouri may tax *Appellants'* income. *Red Wing Shoe Co. v. Hockerson-Halberstadt, Inc.*, 148 F.3d 1355, 1359-62 (Fed. Cir. 1998). Faced with these dispositive realities, the Director devotes substantial discussion to ABC's, rather than Appellants', activities, even though ABC is not a party to the Assessment or to this case.

The Director argues that ABC's "stream of revenue" was diverted from Missouri because ABC paid a royalty, and took a deduction for royalty expenses, that lowered its Missouri tax liability. Accordingly, she reasons that Missouri is the "original source" of the royalty income, so Missouri has a right to tax it (Dir. Br. 14). Her actions in administering the tax laws are inconsistent with her arguments before this Court. If the Director believed that the royalty constituted a "diversion" of a "stream of revenue" that was already in Missouri, she should have challenged the royalty deduction taken by ABC on its returns, and assessed ABC based upon the effect of such a disallowance. Her failure to assess ABC, or even to question the propriety of the royalty rate, demonstrates that this was not her belief, and belies her arguments in this regard before this Court. Alternatively, the Director argues that because Appellants' activities in Texas and Delaware are insufficient, in her opinion, to generate their income, she is entitled to tax that income. But, as explained in detail below, these arguments ignore the requirement under Missouri law that *Appellants* engage in some income-producing activity in Missouri. Because they do not, they are not subject to Missouri income tax.

A. Appellants Engage In No Missouri Income-Producing Activities.

Appellants' royalty income derives from their activities outside of Missouri, primarily in Texas and Delaware, where their affairs are centered. There, they entered into the contract for licensing the trademarks, engaged in all conduct necessary to carry out the terms of that license, and otherwise carried on their business and affairs (Tr. 43-44, 46-51). The one fact that the Director continually recites—that ABC sells products to Missouri customers—is no basis for concluding that *Appellants* (or ARCLP) are doing anything in Missouri that is productive of the royalty income at issue.

Under the Director's theory, any taxpayer deriving income from a person or entity doing business in Missouri would be subject to Missouri income tax on the income derived from that person or entity. An author writing in Delaware would be taxed on royalties from a publisher that makes book sales to any Missouri customers, and a Brazilian soccer player would be subject to tax on endorsement income if the products endorsed are sold to any Missouri customers. The Director would impose an income tax on each of those persons even though they did absolutely nothing in Missouri.

This position is patently inconsistent with the view successfully advanced by the Director in a case in which the contract and all of the sales activities between two entities were held to occur solely within Missouri, even though the materials to be delivered to the purchaser were acquired by the seller from a third party outside this state. In *Langley v. Admin. Hearing Comm'n*, 649 S.W.2d 216 (Mo. banc 1983), this Court held that the sales activities between two entities in this state were to be taxed wholly within this state, even though the seller acquired the materials and had them shipped from a different state. This case presents the opposite situation in that the contract and sales activities between ABC and Appellant ARC or ARCLP took place outside of Missouri, and thus for income tax purposes, must be deemed to have occurred wholly outside the state. Accordingly, the position of the

Director in this case is at odds with her argument in *Langley*, which was adopted by this Court as its rule concerning the source of income.

The Director's position ignores the well-established rule of construction that tax statutes are to be strictly construed in favor of taxpayers, *United Air Lines, Inc. v. State Tax Comm'n*, 377 S.W.2d 444, 448 (Mo. banc 1964), and are to be given a reasonable construction, *Collins v. Director of Revenue*, 691 S.W.2d 246 (Mo. banc 1985). The Director's attempt to impose Missouri income tax upon anyone who does business with someone who in turn does business in Missouri is overreaching, is beyond the reasonable expectations of the Missouri legislature, and violates federal law.

Highlighting the legislative intent not to tax this type of income is the action taken on proposed legislation last session to disallow the royalty expense for any taxpayer that pays a royalty to a related company – legislation that no doubt was sponsored or supported by the Director. The Missouri Legislature, in tacit approval of Appellants' position herein, ***rejected*** this proffered legislation. *See* H.B. 1877, 91st Gen. Assem. (proposed section 143.435).¹

B. *A.P. Green and Brown Group Do Not Support Taxation of Appellants.*

¹ The Director's proposal to disallow the royalty expense only if paid to a related corporation contradicts the Director's claim and the Commission's Finding of Fact, in response to the uniformity and equal protection challenges, that she taxes all royalty income uniformly (Dir. Br. 31-33). Presumably, the Director would not be so arbitrary as to disallow the royalty expense deduction by the licensee, while also attempting to tax the royalties as income of the licensor.

The Director cites *A.P. Green Fire Brick Co. v. Missouri State Tax Comm’n*, 277 S.W.2d 544 (Mo. 1955), and *Brown Group, Inc. v. Admin. Hearing Comm’n*, 649 S.W.2d 874, 880 (Mo. banc 1983), as would-be authority for her position that she can tax the royalty income if the products bearing the marks are sold *by the licensee* to customers located in Missouri (Dir. Br. 14-21), *even where the taxpayers do nothing in Missouri to generate the royalty income*. But that is not the holding of those two cases. What this Court said in *A.P. Green* and *Brown Group*, consistent with the decisions in *Medicine Shoppe*, and *Maxland Development Corp. v. Director of Revenue*, 960 S.W.2d 503, 506 (Mo. banc 1998), is that the Director *could not tax royalty income* that was, in effect, passive investment income *from the licensee’s use of the taxpayers’ intangible assets outside of Missouri*. Nowhere did the Court suggest that a licensor is subject to Missouri income tax if its only claimed contact with Missouri is its licensee’s sales to Missouri customers. *A.P. Green* and *Brown Group* were Missouri-based taxpayers with royalty income, and the question was not whether those taxpayers were subject to tax in the jurisdictions where their licensees did business. Rather, the question was whether those royalties were subject to income tax in their home state.

C. The Lanham Act Does Not Serve as a Basis to Tax Appellants.

The Director argues that the Lanham Act, 15 U.S.C. § 1127, requires a trademark licensor to supervise its marks or risk abandonment (Dir. Br. 20). The Director then assumes that because the marks were not abandoned, and because supervision was required, that supervision must have occurred in Missouri. But that *assumption* is contrary to the sworn testimony in the record that Appellants’ activities were not carried on in Missouri, but rather in Texas and Delaware (Tr. 43-44, 46-51).

The Director also argues (Dir. Br. 20-21) that Appellants had the benefit of Missouri law, law enforcement, and courts in protecting its marks. The only fact in the record to justify such a statement is that Appellants registered one of their trademarks with the Secretary of State, but no “enforcement” or “court” activities have ever been initiated. Last, the Director references ABC’s activities that have utterly no connection to Appellants—ABC’s use of Missouri highways and stores—as a basis to tax Appellants. There is no authority, and the Director cites none, to support that claim. Indeed, it is novel to suggest that a state can impose a tax on a corporation because of a third party’s use of a state’s resources. In any event, the Director’s position in this case is inconsistent with her position in, and this Court’s holding in, *Langley*, discussed above.

The Director’s constructions of the tax statute in this regard are hardly reasonable constructions, much less strict constructions in favor of the taxpayer.

II. Appellants Are Not Subject to Missouri Income Tax Because They Have No Substantial Nexus With Missouri.

A. Appellants Have No Physical Presence in Missouri.

“It is fundamental that a State has no power to impose a tax on income that is earned outside of the State.” *Mobil Oil Corp. v. Comm’r of Taxes*, 445 U.S. 425, 451 (1980) (Stevens, J., dissenting). Nowhere does the Director dispute that: (1) Appellants had no physical presence in Missouri; and (2) if a physical presence is required, § 143.441.2 prohibits her from taxing Appellants (Dir. Br. 21-25). To avoid the obvious conclusion that she is prohibited from taxing Appellants, the Director argues that no physical presence is required under the Commerce Clause (Dir. Br. 21-25).

The only appellate authority cited to support the Director’s position is the controversial opinion in *Geoffrey v. South Carolina*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993). Other decisions, ignored by the Director, are to the contrary. *See J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *Syl, Inc. v. Comptroller*, Case Number C-96-0154-01 at 6 (Md. Tax Ct. 1999); and *Cerro Copper Products, Inc. v. Alabama*, Docket Number F94-444 (Ala. Dept. Rev. 1995) (cited in App. Br. 55-57).²

While *Geoffrey* admittedly bears a similarity to the present case, two of the key factors relied on by the South Carolina court are missing here. The trial judge in *Geoffrey* found that the relationship between licensor and licensee constituted a “franchise” and thus created a much tighter link to the non-resident licensor than would ordinarily exist. No such finding – or contention – exists here. The *Geoffrey* court also found that the licensor had accounts receivable located in South Carolina. Again, that factor is missing from this case. Moreover, as discussed in more detail below in subpart B, the *Geoffrey* opinion is pegged on a misimpression about the nature of a trademark license.

The Director also cites *Couchot v. State Lottery Comm’n*, 659 N.E.2d 1225, 1230 (Ohio 1996), which followed *Geoffrey* in *dicta*, but concluded that the physical presence standard was satisfied in any event by the out-of-state taxpayer lottery winner’s purchase and redemption of the winning lottery ticket in Ohio. Likewise, the Director’s reliance on *American Dairy Queen Corp.*

² The Director also references *Crown Cork & Seal (Delaware) Inc. v. Comptroller*, 1999 Md. Tax LEXIS 4 (Md. Tax Ct. 1999), holding, like *Syl*, that physical presence is required under the Commerce Clause in the absence of “phantom” corporation status.

v. Taxation and Revenue Dept., 605 P.2d 251 (N.M. Ct. App. 1979), is unavailing, as that case does not address the Commerce Clause issue, referring instead to earlier New Mexico decisions. As noted in our opening brief, New Mexico’s Supreme Court is currently considering the Commerce Clause nexus issue (App. Br. 53). The Director’s citation of *In re A&F Trademark, Inc.*, Administrative Decision No. 381 (North Carolina Tax Review Bd. May 7, 2002), does not aid her cause because the administrative law judge refused to rule on the Commerce Clause issue since “constitutional claims are not issues that the Tax Review Board is empowered to determine.” *Id.* at 38.³

Notwithstanding her citations of selected authorities from other states, the Director judicially admits that Appellants’ principal authority on this issue, *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), is “[t]he closest the U.S. Supreme Court has come to dealing with [this issue] in an analogous case” and that *Quill* requires a physical presence under the Commerce Clause before a state can

³ Just as this brief was being finalized, we learned of the July 30, 2002, decision of the Tennessee Court of Appeals in *America Online, Inc. v. Johnson*, __ S.W.3d __, 2002 WL 1751434 (Tenn. Ct. App. 2002). There, the court reversed a summary judgment that had found as a matter of law that AOL’s various internet and online services, including e-mail and internet access, did not constitute adequate nexus to subject it to unspecified state taxes. The appellate court emphasized numerous contacts with the state, including the leasing of tangible property (modems), the supplying of services, and the conduct of various activities by agents that furthered AOL’s business in the state. Noting, though, that “the **activity** taxed must have a substantial nexus with the state,” the court remanded the case for further development of the nexus issue, which it ruled was “still open.”

impose its sales and use taxes (Dir. Br. 23). The Director contends, however, that there is a constitutionally significant difference between the protections afforded income taxpayers and those afforded sales and use taxpayers, saying that the “physical-presence requirement makes little sense when a corporation’s business is entirely the management of property that has no real physical existence” (Dir. Br. 23). But that lack of physical location of intangible property is exactly why “substantial nexus” under the Commerce Clause requires *the taxpayer* to be physically present.

First, the physical-presence test under the Commerce Clause is consistent with the Supreme Court’s preference for a “bright line” rule. In *Quill*, the Supreme Court stated that it had never intimated a desire to reject “bright-line” tests in all instances, and reinforced the bright-line rule of *National Bellas Hess, Inc. v. Dep’t of Revenue*, 386 U.S. 753 (1967):

“Like other bright-line tests, the *Bellas Hess* rule appears artificial at its edges:

Whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant or office.

This artificiality, however, is more than offset by the benefits of a clear rule.” *Id.* at 315-16, emphasis added.

A bright-line test is critical in the context of taxation of income, particularly income claimed to be related to the use of intangible property. A nexus standard efficiently operates in an all-or-nothing fashion; either a corporation is subject to tax in a state, or it isn’t. Yet, under the Director’s reasoning, virtually any state could tax Appellants so long as one of the licensee’s customers is located there. Such an unreasonable construction is not a principle of nexus, but rather an invitation to chaos—exactly what the Commerce Clause was designed to prevent!

Second, adequate nexus exists when an activity has a close enough connection with the taxing state that interstate relations will not be frayed and the sovereignty of one state will not be infringed by another. No one – including the Director – has ever explained why the connection required to protect those interests in the sales and use tax context – physical presence – should be any different with regard to an income tax.

Third, physical presence is more consistent with business's settled expectations. The United States Supreme Court has never held that nexus is satisfied by a metaphysical presence, and the Director has cited no authority so holding. Many corporations have been careful to steer clear of certain unfavorable jurisdictions and deliberately to concentrate their activities in business-friendly states. Such tax planning is perfectly legitimate; indeed, many of Missouri's tax statutes are designed to lure businesses to Missouri by providing favorable tax treatment. The Director's search for additional revenue has undermined confidence in the integrity of Missouri's taxing scheme and has caused businesses to rethink decisions previously made. Indeed, Appellant ARC and/or ARCLP have conducted their activities under the license agreement with ABC since 1992, and a change in the rules at this stage of the game would be unseemly and inhospitable. If a metaphysical presence standard having such broad-reaching impact is to determine nexus under the Commerce Clause, only Congress has the power to impose it.

Fourth, the physical-presence nexus standard has the weight of history, tradition, and certainty behind it. It has been litigated, and its boundaries are well known and accepted. Metaphysical nexus, by its very nature, is amorphous and portends an abundance of litigation. Most businesses will not know exactly where their licensees have done or will do business. The uncertainty and unpredictability

of a business's tax status would only serve to discourage interstate investments and thereby thwart the ultimate goal of the Commerce Clause.

Finally, *Quill* itself rejected the notion that nexus could be based on the licensing of intangible property (software) directly to “some” of *Quill*'s 3000 customers in the state and the presence there of tangible property (disks) containing that software. *Id.* at 302 n.1, 315 n.8. Surely, then, the licensing of intangible property to a non-resident of Missouri is even less indicative of nexus.

Under any fair and reasonable reading of *Quill*, and the Supreme Court's Commerce Clause jurisprudence, a physical presence in Missouri is required for income taxation. Because Appellants have no physical presence in Missouri, they are exempt from income tax. Section 143.441.2.

B. Even Without a Physical-Presence Requirement, Appellants Do Not Have Substantial Nexus With Missouri.

The only relevant “contact” that Appellants have with the State of Missouri arises from the fact that one of their many trademarks has been registered with the Secretary of State. To that extent, Appellants could arguably be said to have availed themselves of the protections of Missouri law, and therefore to have sufficient minimum contacts – though barely – to satisfy due process. But that is a far cry from the “substantial nexus” necessary to justify taxation of their royalties under the Commerce Clause.

In *Quill*, the Supreme Court found that the mail-order house taxpayer had engaged in the “continuous and widespread solicitation of business” within North Dakota, through a “deluge of catalogs,” and therefore had purposefully directed its activities at North Dakota residents to such an extent that the Due Process Clause did not bar enforcement of the state's use tax. *Quill*, 504 U.S. at 308. The Court went on to emphasize, however, that the Commerce Clause analysis was very different:

“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.” *Id.* at 313.

We submit, of course, that physical presence is required under the Commerce Clause for any kind of taxation. But even if some lesser contact is deemed sufficient to create nexus, it does not exist here. The solitary fact that one of Appellants’ trademarks is registered in Missouri may arguably satisfy due process, but it falls way short of constituting a nexus substantial enough to meet the strictures of the Commerce Clause. The mere filing of one trademark registration with the State of Missouri is considerably more benign than the flurry of activity directed at North Dakota residents by the taxpayer in *Quill*. Furthermore, as observed earlier, *Quill* also held that the licensing of “some” software within the state, embodied in tangible property physically present there, was likewise too insubstantial to create nexus. *Id.* at 315 n.8. Hence, *Quill* compels the conclusion that Appellants do not have substantial nexus with Missouri – no matter how defined.

The Director’s reliance on *Geoffrey* for the supposed proposition that the intangible property in question is present wherever trademarked goods are sold (Dir. Br. 24) is misplaced. To the extent that the South Carolina court so held, its analysis has been refuted by the federal appellate court that has exclusive jurisdiction over patent cases and concurrent jurisdiction over trademark cases. In *Red Wing Shoe Co. v. Hockerson-Halberstadt, Inc.*, 148 F.3d 1355 (Fed. Cir. 1998), the court ruled that a patent holder who had 34 licensees selling the patented products in Minnesota could

nevertheless not be subjected to personal jurisdiction there because it lacked sufficient minimum contacts to satisfy due process. *A fortiori*, Commerce Clause nexus was also wanting.

The Federal Circuit in *Red Wing* pointed out that a patent license constitutes “a covenant not to sue, not a [product] incorporating the patented technology. As such, [licensor’s] product never enters the stream of commerce.” *Id.* at 1362. Likewise, by granting a trademark license, the licensor merely agrees that the licensee may use the mark, in return for a royalty, without being subject to a suit for infringement. It is the license agreement – and not the mere existence of the trademark itself – that entitles Appellants to royalty payments, and is therefore the intangible property that the Director is trying to tax. But, contrary to the argument at page 24 of the Director’s brief, Missouri is no more the situs of the intangible property in issue here (an intellectual property license) than was Minnesota the situs of the comparable property (an intellectual property license) in *Red Wing*. The Federal Circuit also held that the defendant-licensor’s receipt of royalty income for sales made in Minnesota was irrelevant to the due process analysis in that it was a financial benefit that did not stem from a “constitutionally cognizable contact with the state.” *Id.* at 1361-62. The court further expressly rejected the “stream of commerce” argument. *Id.* In its totality, therefore, *Red Wing* completely knocks the props out from under the *Geoffrey* decision and rationale.

Accordingly, the only constitutionally relevant contact by Appellants with Missouri – the registration of one trademark – does not satisfy the Commerce Clause even if something less than physical presence will do the job.

C. The Nexus of ABC May Not Be Attributed to Appellants.

In apparent recognition of her frail position on the basic nexus issue, the Director devotes a substantial portion of her brief to an attempt to disregard the separate corporate existences of

Appellants, Justin Industries, Inc. (the parent) and ABC, and the separate existence of ARCLP (Dir. Br. 26-30). The alter ego theory of attack was not raised in the Director’s audit report, her final decision, or her answer (Exs. 1, 3, 5, and C-D).⁴ As pointed out above, Appellants cannot be charged with the Missouri-based activities of their licensees under the *Red Wing* decision. The Director’s fall-back attempt to pierce Appellants’ corporate veils is equally lacking in merit.

To support her argument for the extreme measure of disregarding Appellants’ separate existences, the Director claims that “[e]very fact in this case points to the conclusion that Acme Royalty and BIC are *alter egos of Justin Industries*,” the parent corporation (Dir. Br. 26). Yet, the Director cites only the following two “facts” to support that theory: (1) the original creation of ARC for the purpose of exclusively licensing marks to ABC; and (2) the subsequent formation of Justin Management, Inc., to handle “management functions” of Justin subsidiaries (Dir. Br. 26).

First, while ABC admittedly does business in Missouri, nothing in the record shows that Justin Industries – the parent – did business in Missouri during the Tax Periods. Indeed, Exhibit B, and the lack of any audit of Justin, would indicate that it did no business in Missouri at that time. We are therefore bemused how piercing Appellants’ corporate veils would be a basis for imposing Missouri income tax when they are alleged alter egos of a corporation that itself does no business in Missouri.

Second, the Director never explains how the alleged “facts” are sufficient under Missouri law to support her request to disregard the Appellants’ separate existences.

⁴ Indeed, if Appellants really were Justin’s and ABC’s alter ego, the posture of this case would have been much different. If the Director really believed the theory she is now advancing, she would have attempted to disallow ABC’s royalty expense, thereby increasing ABC’s tax liability.

Third, contrary to the Director's assertion, Appellants were not formed for the purpose of having one Justin subsidiary "solely" license the marks to another Justin subsidiary. Judy Hunter testified that one of the purposes for forming Appellants was "to be able to license those names to other parties outside of our company and make money off of doing that" (Tr. 39). While Appellants did not accomplish that goal with the building brands, their counterparts in the footwear business were successful in that endeavor to the tune of more than \$1,000,000.00 annually (Tr. 39-40). Thus, the Director's factual assertion not only disregards Ms. Hunter's testimony, but it is contrary to the fact that a similar related royalty company is actually licensing to unrelated parties.

The Director apparently concedes the governing axiomatic legal standards (Dir. Br. 26): (1) that even when the stock of one corporation is owned partly or wholly by another, the two separate corporations are to be regarded as distinct legal entities, *Central Cooling & Supply Co. v. Director of Revenue*, 648 S.W.2d 546, 547-48 (Mo. 1982); (2) that corporations are not responsible for the acts of related entities, *Grease Monkey Int'l, Inc. v. Godat*, 916 S.W.2d 257, 262 (Mo. App. E.D. 1995); (3) that the existence of a partnership is never presumed, and the burden is on the party asserting a partnership to prove its existence by clear, cogent, and convincing evidence, *Morrison v. Labor and Industrial Relations Commission*, 23 S.W.3d 902 (Mo. App. W.D. 2000); (4) that a partnership consists of partners placing their money, efforts, labor, and skill in lawful commerce and dividing the resulting profits and losses; (5) that mere ownership of all the stock of one corporation by another, and the common identity of officers with another, are not alone sufficient to create an identity of corporate interests between two companies; and, (6) that to pierce the corporate veil, there must be such dominion and control that the controlled corporation has, so to speak, no separate mind, will, or existence of its own, *Blackwell Printing Co. v. Blackwell-Wielandy Co.*,

440 S.W.2d 433, 437 (Mo. 1969); *Mid-Missouri Telephone Co. v. Alma Telephone Co.*, 18 S.W.3d 578, 582 (Mo. App. W.D. 2000).

As demonstrated at the trial and in our opening brief (App. Br. 15-16), Appellants were formed for a variety of legitimate business reasons: (1) eliminating confusion caused by the Justin division names; (2) protecting corporate assets by limiting liabilities; (3) facilitating the sale of lines of business; (4) creating administrative efficiencies and expertise; (5) accurately reflecting contributions to the bottom line; and (6) fostering marketing of valuable intellectual properties (Tr. 31-42). The Director, while presenting no evidence to dispute the sworn testimony on this subject (Tr. 59-62), pooh-poohs these corporate business objectives by characterizing them as “self-serving,” and by incorrectly claiming that Appellants could not “point to a single fact that suggests [Appellants’] separate minds, wills, or existence[s]” (Dir. Br. 26).⁵

Indeed, the Director’s brief is essentially nothing more than a factual quarrel with the unrefuted testimony in this case (Dir. Br. 27). Because she is unhappy with the explanations of Ms. Hunter, a certified public accountant, the Director claims that this Court should disregard Appellants’ separate corporate existences. The Director apparently seeks this Court’s permission to disregard corporate form whenever she or her counsel are dissatisfied with the corporation’s business objectives.

Thankfully, that is not the law in Missouri.

The Director’s invocation of *Osler v. Joplin Life Ins. Co.*, 164 S.W.2d 295 (Mo. 1942) (Dir. Br. 29), is way off the mark. There, individuals used shell corporations to defraud an investor.

⁵ Having made that assertion, however, the Director then attempts to address (Dir. Br. 26-7) the “facts” Appellants identified in their opening brief (App. Br. 59-60).

The Court found that “courts will ignore separate corporate entities in order to defeat a fraud, wrong, or injustice, at least where the rights of third persons are concerned.” *Id.* at 298. *Osler* has no relevance here.

Furthermore, for some of the periods at issue in this case the licensor of the marks was neither of the Appellants, but rather ARCLP. Even if the Director could attribute ABC’s sales of products to its licensor, neither of the Appellants fell into that category during some of the relevant time frame. And the Director cites no facts or authority for the proposition that she can likewise disregard the existence of a Texas limited partnership.

At bottom, there is no basis in law or fact for disregarding the separate corporate status of ABC, Justin and Appellants, or the separate existence of ARCLP.

III. The Assessment Violates the Uniformity and Equal Protection Clauses.

The Director does not challenge Appellants’ authorities establishing that Missouri’s Uniformity Clause requires that: (1) all taxes “shall be uniform upon the same class or subclass of subjects within the territorial limits of the authority levying the tax[.]” Mo. Const. art X, § 3; and (2) the power of the State to classify for purposes of taxation must be reasonable, U.S. Const. amend. XIV, § 1; *Schnorbus v. Director of Revenue*, 790 S.W.2d 241, 242 (Mo. banc 1990); *Exxon Corp. v. Eagerton*, 462 U.S. 176, 195-96 (1983). Likewise, she apparently makes no attempt to defend the Commission’s erroneous factual finding (L.F. 60) that there was no evidence to support the statement that the Director does not treat all taxpayers the same (Dir. Br. 31-33).

Rather, the Director argues that Appellants’ claim is one of selective prosecution. This is a flawed characterization. Appellants’ argument is that this Court should provide a fair and reasonable construction of § 143.431, and construe it, like all other tax statutes, strictly in favor of the taxpayer.

Further, any construction that allows one income tax standard to be imposed on a taxpayer doing business with a related entity, while imposing a different standard for taxpayers doing business with unrelated entities, must be rationally based.

The Director argues that there is a rational basis for distinguishing between related and unrelated licensors because they are not similarly situated. She says that only related corporations “can remove income from the scope of state taxation” (Dir. Br. 32). But that is not really the case. The expense to ABC is income to the licensor, either ARC or ARCLP. If the Director believes that certain related corporations are removing income otherwise earned in Missouri from the scope of taxation, she should attempt to disallow such deductions on the return of the entity subject to Missouri income tax while leaving the determination of licensors’ taxable income to those states in which the licensors do business. There is no rational basis for the distinction the Director attempts to superimpose upon the law.

IV. The Commission Is Not Free to Exclude Apportionment Factors That the Commission Concludes Are “Minimal.”

Although the auditor and Director computed Appellants’ royalty income subject to Missouri income tax by use of the single-factor formula of § 143.451, Appellants did file returns after assessment employing the multi-state three-factor formula of § 32.200 (Exs. 9, 10). The Commission elected to apply a modified version of the three-factor formula (L.F. 61).⁶ It attributed ABC’s sales to Appellants and disregarded Appellants’ payroll and property factors in the calculation, because it thought them “minimal.” It was beyond dispute that Appellants had

⁶ The Director’s brief is not entirely clear on whether the Director agrees that the three-factor formula was the proper formula to use (Dir. Br. 34-5).

no payroll or property in Missouri (L.F. 42-43), and that those factors, if used, would be zero (Ex. 17). Thus, even if Appellants are subject to Missouri income tax on account of ABC's sales in Missouri, the Commission's calculation had the effect of tripling Appellants' tax liability since the denominator of the apportionment fraction was one rather than three (Ex. 17).

In disregarding two of the three apportionment factors, the Commission perverted § 32.200, art. IV, § 18, which allows a different apportionment formula when the three-factor formula of sales, property, and payroll, "do not fairly represent the extent of the taxpayer's business activity in [Missouri.]" The Director argues that the Commission's decision to exclude the payroll and property factors was a "fair apportionment," but the Director never explains why, other than the assertion that "there is no reasonable argument ... that \$0 is a fair allocation" (Dir. Br. 36). But Appellants understand that if this Court determines that they are subject to income tax in Missouri, they will pay some tax. That is why they submitted Exhibit 17 showing possible amounts due.

If Appellants are subject to Missouri income tax on the royalty income, all factors should be considered, and Appellants' liability should be reduced to a third of that found due by the Commission. As explained in Appellants opening brief (App. Br. 67), intellectual property companies, by their very nature, may have limited payroll or property but, as in the case of an author, no one can reasonably deny the contribution of that one employee (Stephen King) or his typewriter. The Commission's willingness to disregard apportionment factors when they are, in the Commission's opinion, "minimal" will make it practically impossible for corporations to predict with any kind of certainty their Missouri tax liability. The Commission's action in this regard opens the door for unending litigation. For instance, the positions of the parties will undoubtedly change when the "minimal" payroll and property happen to be located within Missouri, as opposed to Delaware or Texas.

V. The Commission's Decision Is An Unexpected Decision.

Sections 143.903 and 32.053 provide that when an assessment is based upon a change in policy of the Director, the assessment is valid only for tax years beginning after that change in policy. Appellants assert a change of the Director's policy after the last tax period at issue, so §§ 143.903 and 32.053 are a complete defense to the assessment. The Director argues that the Director's policies did not change, "[i]t is *corporations*, such as Justin Industries that changed" (Dir. Br. 40, emphasis original).

The record shows, rather clearly in Appellants' opinion, that the Director changed her policy in 1996 in response to a court decision out of South Carolina (*Geoffrey*). At that time, the Director changed her instructions to her auditors (Ex. 15). The auditor admitted that as a result of *Geoffrey*, "we decided that [assessing royalty companies] was an issue worth pursuing" (Ex. 22, p. 10). Also, the audit report provides that "[t]he audit was conducted based on the South Carolina Supreme Court case involving Geoffrey, Inc." (Ex. C). To counter this, the Director claims that there is "no evidence in the record" that "the Director was even aware of this type of transaction" (Dir. Br. 39). Apparently the Director would have this Court assume that she and her auditors were never aware of, much less bothered to audit, any claimed deductions for royalty payments until after 1996, in contravention of her own constitutional duty set forth by article IV, § 22 of the Missouri Constitution.

That is a curious claim given the Director's litigation on the taxability of royalty receipts for trademarks and patents as early as 1955. *See A.P. Green, supra*. Such a dubious assumption should not serve as the basis to disregard evidence in the record. Sections 143.903 and 32.053 are intended to acknowledge that businesses make decisions based upon expectations that tax collectors

will not change the rules in the middle of the game. That is precisely what the Director attempts to do here.

CONCLUSION

For the foregoing reasons, Appellants respectfully request that the Court reverse the decision of the Commission and determine that the Assessment against Appellants is invalid because: (a) Appellants have no income derived from Missouri sources;

(b) Appellants' royalty income cannot be constitutionally taxed by Missouri; (c) even if the royalty income were subject to tax by Missouri, it cannot be taxed retroactively; and (d) in any event the Commission incorrectly calculated the Missouri income tax by disregarding the payroll and property factors.

Respectfully Submitted,

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CERTIFICATE OF SERVICE

I hereby certify that two true and accurate copies of the foregoing, as well as a labeled disk containing the same, were mailed first class, postage prepaid or hand-delivered this ____ day of August, 2002, to State Solicitor Jim Layton, P.O. Box 899, Jefferson City, Missouri 65102.

CERTIFICATE REQUIRED BY SPECIAL RULE 1(C)

I hereby certify that the foregoing brief includes the information required by Supreme Court Rule 55.03 and complies with the limitations contained in Supreme Court Special Rule 1(b). The foregoing brief contains 6980 words.

The undersigned further certifies that the disk simultaneously filed with the briefs filed with this Court under Supreme Court Rule 84.05(a) has been scanned for viruses and is virus-free.
