

**IN THE SUPREME COURT OF MISSOURI**

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**No. 84225**

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**ACME ROYALTY CO., INC., et al.**

**Appellants,**

**v.**

**DIRECTOR OF REVENUE,**

**Respondent.**

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**Appeal from the Administrative Hearing Commission,  
Honorable Sharon M. Busch, Commissioner**

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**RESPONDENT'S BRIEF**

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## STATEMENT OF FACTS

Acme Brick Company has long “filed Missouri income tax returns and paid Missouri income tax on its Missouri sales.” Legal File (L.F.) at 46. This case arises from a corporate reorganization under which a substantial portion of the profits from those sales are diverted to a separate corporate entity, and, in Acme’s view, thus removed from the scope of Missouri’s ability to tax.

Until 1991, Acme Brick was a division of Justin Industries, Inc. In December 1991, Justin Industries reorganized, creating three subsidiary corporations that play a role here. L.F. 37. Acme Brick Company held all the property and personnel of the former Acme Brick Division. *Id.* It continued to manufacture and sell bricks in a seven-state area that included Missouri. L.F. 37-38. Justin Management Company performed management functions for all of the Justin Industries subsidiaries. L.F. 38. And Acme Royalty Company was assigned all Justin Industries’ “building related trademarks and trade names,” and was given responsibility “to hold, manage, protect, and market the trademarks and trade names.” *Id.* Acme Royalty was organized as a Delaware corporation. L.F. 39. In December 1993, Justin Industries created a fourth relevant subsidiary, Brick Investment Company (BIC). L.F. 40.

Although Acme Royalty was to “market” the Acme trademarks, its “marketing” consisted of a single grant of an exclusive license to Acme Brick, a license it granted just two weeks after the 1991 reorganization. *Id.* In return, Acme Brick paid Acme Royalty a royalty based on sales. *Id.* Acme Royalty’s own activities consisted of the bare requisites of corporate existence: it used a Delaware agency to provide space, equipment, and personnel necessary to hold annual board meetings and other tasks. L.F. 43-44. Acme Royalty’s Delaware officers and their “assistants maintained the checkbook,

paid bills, produced transaction reports for the operating account, produced bank reconciliation reports, and made monetary transfers.” L.F. 44. Those officers were employed in a similar fashion by many other corporations. *Id.*

When BIC was organized, Justin Industries formed a limited partnership, Acme Royalty Company LP. L.F. 40. Acme Royalty contributed all of the Acme trademarks and trade names; BIC contributed cash. *Id.* BIC was the general partner, and was responsible for the trademark- and royalty-related tasks previously undertaken by Acme Royalty. *Id.* BIC had the same officers as Justin Management, *id.*, and entered into an agreement under which Justin Management would perform BIC’s accounting and administrative functions, L.F. 41.

Acme Royalty filed “holding company information returns with Delaware ..., but did not pay tax to Delaware.” L.F. 45. BIC did not file any income returns with any state, and did not pay income tax to any state, though it did pay franchise tax to Texas. *Id.* Neither Acme Royalty nor BIC filed income tax returns in or paid income tax to Missouri. L.F. 46-47. Acme Brick filed Missouri returns and paid Missouri taxes – but took a deduction for royalties paid to Acme Royalty Company LP. L.F. 46.

In July 1998, the Director began an audit of Acme Brick. The Director’s auditor there learned of Acme Royalty and BIC, and audited those companies as well. *Id.* He treated “the royalty income attributable to Missouri sales as income from wholly within Missouri.” L.F. 47. The Director issued notices of deficiency to Acme Royalty and BIC, based on the auditor’s findings. *Id.* Acme Royalty and BIX protested, but on August 5, 1999, the Director issued final deficiency notices, assessing taxes and interest but not additions. *Id.*

On September 3, 1999, Acme Royalty and BIC filed timely complaints in the Administrative Hearing Commission (AHC). L.F. 36. The Commission upheld the Director's decision, rejecting Acme Royalty and BIC's assertion that "as partnership owners of trademarks and trade names used in Missouri, ... they are free from taxation on the royalty income by any state." L.F. 37.

## ARGUMENT

### *Standard of Review*

This is an appeal from a decision by the Missouri Administrative Hearing Commission (AHC). The AHC's decisions are upheld when authorized by law and supported by competent and substantial evidence upon the record as a whole, and when they are not clearly contrary to the reasonable expectations of the General Assembly. *See Becker Elec. Co. v. Director of Revenue*, 749 S.W.2d 403, 405 (Mo. banc 1988); § 621.193, RSMo. 2000. This court, in essence, adopts the AHC's factual findings. *See Concord Publ'g House v. Director of Revenue*, 916 S.W.2d 186, 189 (Mo. banc 1996).

The AHC's decisions on questions of law are matters for this Court's independent judgment. *La-Z-Boy Chair Co. v. Director of Economic Development*, 983 S.W.2d 523, 524-25 (Mo. banc 1999); *Hewitt Well Drilling & Pump Service, Inc. v. Director of Revenue*, 847 S.W.2d 797, 797 (Mo. banc 1993).

The appellants had the burden of proof before the AHC. *See* § 621.050.2, RSMo 2000.

## ***Introduction***

This appeal presents the question whether a corporation, while continuing to use trademarks and sell goods in Missouri in precisely the same way, can suddenly exempt a substantial portion of its profits from those sales by designating them as “royalties,” paid by one subsidiary to another. Although the appeal presents a question of first impression in Missouri, it is not the first to address the ability of a corporation to avoid state taxes merely by creating and then transferring to a Delaware subsidiary rights to intellectual property (here, trademarks) that the corporation uses in Missouri. As discussed below, tribunals in other states have reached differing conclusions.

These decisions demonstrate that what Acme did here was not unusual. The practice is becoming a popular method not just to avoid state taxes, but to avoid federal tax as well. *See* Glenn R. Simpson, “A New Twist in Tax Avoidance Firms Send Best Ideas Abroad,” Wall Street Journal (June 24, 2002) at A1. Acme invoked a tax evasion device that did not require any change in how or where it sold its goods – only a change in where the profits moved. In Acme’s view, a bare corporate change can make income that is taxable today not taxable tomorrow. The court, like the AHC, should reject that perversion of statutory and constitutional tax law.

**I. Because royalty income from the use of licensed trademarks in Missouri is income “derived from” Missouri, it is subject to Missouri income tax under § 143.071 absent some exclusion or constitutional defense. (Responds to appellants’ Point I.)**

Missouri imposes an income tax on corporations “in an amount equal to five percent of Missouri taxable income.” § 143.071, RSMo. 2000. If Acme Royalty and BIC have “Missouri taxable income,” they are subject to tax (barring, of course, a constitutional defense, discussed in part II below).

“Missouri taxable income,” for purposes of the corporate income tax, is “so much of” the corporation’s “federal taxable income . . . as is derived from sources within Missouri as provided in section 143.451.” § 143.431. The cross referenced section begins by restating the same rule: “Missouri taxable income of a corporation shall include all income derived from sources within this state.” § 143.451.1.

Acme Royalty and BIC argue, in their first point, that the royalties they collect from the use of their trademarks in Missouri are not “income derived from sources within this state.” That is wrong. It makes no sense when compared to the language of the statute. It contradicts this court’s prior holdings. And it ignores the nature of trademark rights.

#### **A. Income “derived from” Missouri is taxed.**

Acme Royalty and BIC first quote the language of the statute, noting that a corporation’s Missouri taxable income is “so much of the corporation’s income ‘as is derived from Missouri sources.’” Appellant’s Brief (App. Br.) at 35, quoting § 143.431. They never return to that language. Nor could they reasonably do so. There is no reasonable argument to be made that the income at issue here was not “derived from Missouri sources.”

As noted above, the income at issue is royalty payments from Acme Brick to Acme Royalty and BIC.<sup>1</sup> Acme Brick made the payments pursuant to the exclusive license agreement it entered into with Acme Royalty. The payments were calculated as a percentage of Acme Brick's sales. Those sales occurred in the seven-state area – which includes Missouri – that Acme Brick had served since long before Justin Industries reorganized. If Acme Brick had no sales in Missouri, Acme Royalty would receive no royalties from Missouri sales.

“Derived” is not an ambiguous term. It means “to have or take origin,” to “originate.” WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY (Merriam-Webster 1993) at 608. When referring to funds, Missouri statutes use “derived” to refer not just to funds that come directly from a particular source, but also to funds that are connected with, or whose receipt is triggered by a particular source or act. *E.g.*, § 474.163.1 (value of property “derived” by survivor includes assets received from third parties, but triggered by spouse’s death). Its use in § 143.431 requires the Director of Revenue and the taxpayer to look to the source of funds from which the part ultimately paid to Acme Royalty was diverted. *See* WEBSTER’S at 608.

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<sup>1</sup> For some of the years at issue, the royalties passed through the limited partnership. Acme Royalty and BIC do not suggest that inserting the intervening step changed their liability for Missouri taxes.

The income at issue here was diverted from the stream of revenue obtained by Acme Brick when it sold goods, using the Acme trademarks, in Missouri. Missouri is thus the original source of the income. The statutory language precludes any logical argument that the royalty income is not within the scope of Missouri's corporate income tax (barring, of course, some constitutional or other statutory exception).

**B. This court held in *A.P. Green* that trademark royalty income is derived from where the trademarked goods are sold.**

Although the statutes speak of income “derived from” Missouri, caselaw often speaks instead of “Missouri source income” – thus hearkening back to the former language of the statute, which imposed a tax on a corporation’s “net income from all sources in this state during the preceding year.” § 143.040, RSMo. 1949. The “derived from” language was adopted in 1972. Mo. L. 1972, S.B. 549. The change to “derived from” does not suggest a stricter standard. In fact, it suggests a broader reach. Certainly the change does not suggest that something taxable under the “source” language is not taxable under the “derived from” language.

Thus this court can refer back to “source” cases, and again say, “Felicitous to the circumstances of these proceedings is *A.P. Green Fire Brick Co. v. Missouri State Tax Commission*, 277 S.W. 2d 544 (Mo. 1955), for it finds that ‘source of income’ is the place where trademarks, trade names and manufacturing processes are used and the income produced.” *Brown Group, Inc. v. AHC*, 649 S.W. 2d 874, 880 (Mo. banc 1983). The income at issue in *A.P. Green* was the precise corollary of the income at issue here: “royalties to [A.P. Green] as the consideration for the use of certain of [A.P. Green’s] trade-marks, trade names and manufacturing processes in



connection with the manufacture and sale of firebrick and other clay products.” 277 S.W.2d at 545.

The “sole question” before the court in *A.P. Green* was the same one Acme Royalty and BIC want to contest in their Point I: “whether the royalties . . . were income from ‘sources in this state’ . . . and taxable as income under the Income Tax Act, Chapter 143, RSMo.” *Id.* at 545.

This court held that they were not – even in part – and in doing so established a rule for the determining the source of income that applies to those with royalty income from Missouri (this case) as it does to those with royalty income from elsewhere (*A.P. Green*). The court recognized that “technically, the income in royalties paid . . . for the use of respondent’s property might be said to have had its genesis in the property interest of’ A.P. Green, a Missouri resident corporation. *Id.* at 547. But the court refused to accept that “technical” point as dispositive. Instead, it concluded that “realistically, the ‘source’ of the income was the place where the trade-marks, trade names and manufacturing processes were used and the income produced.” *Id.*

The court relied on *In re Kansas City Star Co.*, 142 S.W. 2d 1029 (Mo banc 1989), where the court had previously “employed what it termed a realistic approach to these questions.” 277 S.W. 2d at 547. It determined that the “source” of income is the place where the property or capital was “actually use[d].” *Id.* at 547-48.

Here, of course, Acme Royalty and BIC must concede that the “actual use” of the trademarks was in Missouri. Thus, under *A.P. Green*, or any other “realistic” approach, they cannot avoid Missouri taxation merely by walking across the state line when they enter into a licensing agreement that provides for the royalty payments or to hand over the royalty check.

### **C. The *A.P. Green* holding stands today.**

The continued validity of *A.P. Green* was doubted, briefly, because of a decision on which Acme Royalty and BIC rely, *M.V. Marine Co. v. State Tax Commission*, 606 S.W. 2d 644 (Mo. banc 1980). There, the court observed that “the legislative taxing scheme in this state ha[d] been broadened since the days of *Green*.” *Id.* at 648. The court cited just one statutory change for its conclusion that the legislature had “broadened” the tax scheme: the adoption of the Multistate Tax Compact, set out at § 32.200, RSMo. 2000. 606 S.W. 2d at 648. Adding the Compact to the language of §§ 143.451 and .461, the court moved directly to the question of how the combination of statutes authorizes a taxpayer to “allocate its income” (606 S.W. 2d at 648) or to “apportion” it among the various states that might wish to impose a tax (*id.* at 649). The court then asked whether the taxpayer could use the three-factor apportionment method provided in the Compact, § 32.200, art. IV, cl. 9. *Id.* The court remanded the case to the State Tax Commission to determine whether apportionment under the Compact was available. *Id.* at 650. Notably, the court observed that “[w]hile duplicative taxation is to be spurned, so is” an interpretation of law “that would permit an avoidance of tax by any state.” *Id.*

In *M.V. Marine*, the court did not distinguish between the question of whether the corporation had Missouri income, making it subject to tax, and the question of how to allocate income among states. The court purported to abandon its earlier practice of determining “whether a particular taxpayer was entitled to apportion” income among states, which “involved a tortured process of discerning the ‘source’ of the taxpayer’s income.” *Id.* at 649. The court reached that conclusion by drawing on the language of the Multistate Compact. The court concluded that after adoption of the Compact,

“although taxpayers are still given an option on the *method* of allocation they may use, all other questions reference apportionment of income are to be resolved by reference to the Compact.” *Id.* (emphasis in original).

In *Goldberg v. State Tax Commission*, 639 S.W. 2d 796, 798-99 (Mo. banc 1982), this court expressly rejected the conclusion in *M.V. Marine* that the adoption of the Multistate Tax Compact had eliminated the “source of income” test used in *A.P. Green*. The court recognized that the Compact “was never intended by anyone to be a substantive taxation statute,” *id.* at 799, *i.e.*, to replace or modify the Missouri law that now imposes a tax on income “derived from” the state. Rather, the Compact was “merely a procedural vehicle by which the states could resolve conflicts among themselves and aggrieved taxpayers concerning the proper scope of taxation authority that affected states could exercise with regard to a taxpayer subject to taxation in more than one state.” *Id.* It was designed to “forestall the threat that Congress might take away from them the authority to tax any part of income earned from business conducted in interstate commerce.” *Id.* at 800. Thus the court concluded that “[a]ny reasonable reading” of the Chapter 143 and the Compact “compels the conclusion that neither the Multistate Tax Commission . . . nor the Missouri legislature ever intended that the Compact have the effect *M.V. Marine* would give it.” *Id.*<sup>2</sup>

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<sup>2</sup> *M.V. Marine* involved the lease of personal property. If it retained any viability in a manner that would affect this case, it should be overruled as inconsistent with *A.P. Green* and other cases discussed in the text. It ignores the fact that “a lessor” of such equipment “that allows and facilitates its lessees to use its property within the taxing State purposefully avails itself of the ‘privilege of conducting

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activities' within that State," *Truck Renting & Leasing Ass'n, Inc. v. Commissioner of Revenue*, 746 N.E. 2d 143, 148 (Mass. Sup. Jud. Ct. 2001), citing *Hanson v. Denckla*, 357 U.S. 235, 253 (1958). That is what Acme Royalty did here when it granted a license to Acme Brick to continue its longstanding use of the Acme name in the sale of brick in Missouri.

What the court did wrong in *M.V. Marine* was to use the second question (apportionment or allocation) to answer the first (whether the corporation has income “derived from” Missouri). Acme Royalty and BIC make the same error not just in their Point I, but also in their Point IV. There they defined “derived from Missouri sources” by jumping to the apportionment or allocation portions of the Multistate Compact. App. Br. at 64-65. Even if their analysis of the allocation formula and its application here were correct (and it is not, as discussed in part III below), it would not matter at the first stage of the analysis. For again, this court recognized in *Goldberg* that merging the “source” and “allocation” questions is impermissible. The Director (and thus the court) must answer the independent “source” question first, and only then determine how to allocate income among states that might assert a claim of ability to tax it.

As this court indicated in *Goldberg*, then, it must consider first “the existence and application of state laws independent of the Compact.” 639 S.W. 2d at 801. That included, in *Goldberg*, and includes, here, “the ‘source of income’ test embodied in the present § 143.451.” *Id.* Contrary to the conclusion in *M.V. Marine*, that test still governed – and today, still governs – the question of “how a taxpayer is to make the threshold determination whether his income is ‘subject to apportionment and allocation for tax purposes.’” *Id.* *Goldberg* thus reinstates the rationale behind, and the holding in *A.P. Green*. Royalty income of the sort at issue here still has a Missouri source – or, to return to the actual statutory language, it is “derived from” Missouri.

**D. A trademark owner cannot disassociate itself from use of the mark.**

Under the Lanham Act, *See* 15 U.S.C. 1127, trademarks differ from some other types of intellectual property in a significant respect: those licensing trademarks *must*, if they are to retain rights

to the marks, supervise their use. They cannot disassociate the marks they own from the use of those marks. *See United Drug Co. v. Theodore Rectanus Co.*, 248 U.S. 90, 987 (1918) (“There is no such thing as property in a trade-mark except as a right appurtenant to an established business or trade in connection with which the mark is employed.”). In other words, Acme Royalty could not legally just sell a license to Acme Brick and then be done with it; Acme Royalty was required to maintain some level of involvement in supervising use of the marks. Thus Acme Royalty and BIC are careful not to argue that they did nothing at all in Missouri; they simply argue that their supervision of the trademarks is not enough.

But that kind of involvement means more than appellants suggest. Acme Royalty obtained the benefit of Missouri law, law enforcement, and courts in protecting its marks. It could have availed itself of such tools to attack infringement. Moreover, its economic benefit was purely the result of a thriving Missouri market. If Missourians quit buying Acme-labeled products, Acme Royalty would receive no royalties. Those products are delivered on Missouri highways. They are used to build structures under Missouri permits. They are dependent on the entire economic and regulatory structure of the state. But again, a

**II. No constitutional limitation prevents Missouri from taxing royalties based on sales paid between corporations with common ownership when one corporation uses on sales in Missouri a trademark licensed from the other.**

**(Responds to appellants’ Points II and III.)**

**A. Missouri’s income tax on the royalty income does not violate the Commerce Clause. (Responds to appellants’ Point II.)**

## 1. Nexus requirement.

In their effort to keep the royalty income out of the scope of Missouri's corporate income tax, Acme Royalty and BIC cite decisions such as *Medicine Shoppe International v. Director of Revenue*, 2002 Mo. LEXIS 45 (Mo. banc 2002). But those decisions do not suggest that the law has been changed, or even been reinterpreted, since *Goldberg* so as to modify the holding in *A.P. Green*. Instead, they dwell on a different question: how far Missouri may go, under the U.S. Constitution, in imposing a tax on income involving interstate transactions. As appellants point out, Missouri law contains an exception that excuses tax payments when the imposition of taxes would violate federal law – including constitutional law. Ap. Br. at 45, citing § 145.441.2. But the constitutional limits on state taxation do not prevent Missouri from taxing the royalties at issue here.

Acme Royalty and BIC correctly describe the issue as whether they “have a substantial nexus with Missouri satisfying the Commerce Clause” of the U.S. Constitution. App. Br. at 47 (emphasis omitted). In *Medicine Shoppe*, this court recognized that the Commerce Clause limits the scope of Missouri taxation, reiterating that the “constitution prohibits a state from imposing an income-based tax on income earned outside its borders.” 2002 Mo. LEXIS 45 at \*6, citing *Luhr Bros. Inc. v. Director of Revenue*, 780 S.W.2d 55, 57 (Mo. banc 1989). But the Commerce Clause does not shield all interstate transactions from tax. “The state may, of course, tax the income from interstate operations, which include operations within the taxing state, if the state provides a fair apportionment formula.” 2002 Mo. LEXIS at \*6, citing *Luhr Bros. and Maxland Development Corp. v. Director of Revenue*, 960 S.W.2d 503, 505 (Mo. banc 1998). The court correctly stated that the “basic requirement is that there be some activity in the taxing state that justifies imposing the tax.” 2002

Mo. LEXIS at \*6. Where royalties are being paid between two corporations with common ownership, based on the sales in a state, the recipient corporation has sufficient nexus with the state to permit the state, without violating the Commerce Clause, to impose an income tax.

The closest the U.S. Supreme Court has come to dealing with that question in an analogous case was in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). There the Court demanded a physical presence, but it also took great pains to emphasize that it was considering only sales and use taxes. As other courts have observed, “[t]here is no indication in *Quill* that the Supreme Court will extend the physical-presence requirement” cited by appellants here “to cases involving taxation measured by income derived from the state.” *Couchot v. State Lottery Comm’n*, 659 N.E. 2d 1225, 1230 (1996). And indeed, the “physical-presence requirement” makes little sense when a corporation’s business is entirely the management of property that has no real physical existence.

The issue of *Quill*’s application to such intangible property was quickly taken up in the states. The first court to rule was in South Carolina. *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C.), *cert. denied* 510 U.S. 992 (1993). The fact situation in *Geoffrey* was strikingly similar to the one here – it was merely an earlier use of the same tax avoidance tool. While the Supreme Court in *Quill* demanded the physical presence of a taxpayer in a state in order to impose sales or use taxes, the South Carolina Supreme Court held in *Geoffrey* that there was no such requirement where the business at issue is dealing only with intangible personal property – property that could not logically have a “physical presence” in any specific location.

Addressing *Geoffrey*’s Commerce Clause challenge, the South Carolina court observed that it is “well settled that the taxpayer need not have a tangible, physical presence in a state for income to be



taxable there.” *Id.* at 18. That permits the taxation of a corporation based on the “presence,” or use, of intangible personal property in the state. “The presence of intangible property alone is sufficient to establish nexus.” *Id.*, citing *American Dairy Queen Corp. v. Taxation and Revenue Dept.*, 605 P.2d 251, 255 (N.M. 1979). The court rejected Geoffrey’s claim that “the situs of its intangibles is its corporate headquarters in Delaware.” 437 S.E. 2d at 17. The court pointed out that in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 445 (1980), the Supreme Court had rejected the view that intangibles have only one taxable situs.

The South Carolina court concluded that the nexus was sufficient when the “real source of Geoffrey’s income is not a paper agreement,” *i.e.*, a license, “but South Carolina’s Toys R Us customers.” 437 S.E.2d at 18. The same is true, of course, here: the real source of Acme Royalty and BIC’s income is not a paper agreement, but Missouri’s Acme customers.

More recently, the question came before the New Mexico courts. The court of appeals affirmed the decision of the Revenue and Taxation Department’s hearing officer (decision available July 18, 2002 at [http://www.state.nm.us/tax/d&o/dno2000\\_04.htm](http://www.state.nm.us/tax/d&o/dno2000_04.htm)), and followed *Geoffrey, Ennis v. Kmart Corp.*, No. 20,977 (N.M. Ct. App. June 21, 2001). The New Mexico Supreme Court granted certiorari and is now considering the case, *see* Appendix A to App. Br.

The issue has been raised, with opposing results, before the Maryland Tax Court, in *Syl, Inc. v. Comptroller*, 1999 Md. Tax LEXIS 3 (Md. Tax Ct. 1999), and in *Crown Cork & Seal (Delaware) Inc. v. Comptroller*, 1999 Md. Tax LEXIS 4 (Md. Tax Ct. 1999). And it has been most recently decided by the North Carolina Tax Board, which followed *Geoffrey* and affirmed the imposition of taxes on the intellectual properties subsidiaries of Limited Stores, Inc., that hold the rights

to trademarks such as “The Limited,” “Abercombe & Fitch,” “Victoria’s Secret,” and “Lane Bryant.” *In re A&F Trademark, Inc.*, Administrative Decision No. 381 (North Carolina Tax Review Board May 7, 2002), available on July 18, 2002 at [http://www.dor.state.nc.us/practitioner/hearing/A&F\\_TrademarkDecision2002.pdf](http://www.dor.state.nc.us/practitioner/hearing/A&F_TrademarkDecision2002.pdf).

The tribunals that have followed *Geoffrey* have rejected Acme Royalty and BIC’s basic argument: that they cannot be taxed because another, albeit affiliated, corporation is the entity actually making the sales in Missouri. They recognize that “substantial nexus has never turned on this distinction.” *General Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1027 (Wash. App. 2001). This court should not give that paper distinction dispositive force.

## **2. Alter egos.**

That is particularly appropriate when the companies licensing and selling in Missouri cannot be effectively distinguished from their parent or from each other. Because of their close relationship with Justin Industries, the “nexus” analysis cannot entirely ignore the combined efforts of Justin Industries and its other subsidiaries as Acme Royalty and BIC demand. Every fact in this case points to the conclusion that Acme Royalty and BIC are alter egos of Justin Industries: *e.g.*, their original creation solely by Justin Industries the sale of a single, exclusive license to another newly-created subsidiary of Justin Industries; the subsequent corporate reorganization that moved all of the management functions of both companies to the same subsidiary – Justin Management – that manages the other Justin subsidiaries.

To argue to the contrary, Acme Royalty and BIC first point to the correct legal standard: that there is “such dominion and control that the controlled corporation has, so to speak, no separate mind, will or existence of its own.” App. Br. at 59. But then they fail to point to a single fact that suggests Acme Royalty, BIC, the later limited partnership, Justin Management, or any other corporate creations have a “separate mind, will, or existence.” Instead, they point to two self-serving claims, neither of which logically leads to the corporate restructuring that created Acme Royalty.

They say, first, that the corporations (and the LLP) “were formed for the specific purpose of separating the Trademarks from the operating divisions of Justin because, different skill levels are required to manage intellectual property than to produce and sell footwear.” *Id.* It may well be that “different skill levels are required to manage intellectual property.” But that statement is inadequate to explain the corporate reorganization for at least three reasons.

First, though it may explain why a group of specialists should be assigned responsibility for managing intellectual property, it does not explain why those specialists need to have their own corporate entity in which to operate.

Second, it implies that Acme Royalty or BIC or both in fact created staffs of specialists, when there is no evidence in the record to support such a claim. Indeed, the evidence is precisely to the contrary. The management of Acme Royalty was left, first, to a person who specialized not in trademarks, but in the corporate formalities of Delaware corporations, working for dozens of such companies (L.F. 43-44), and later to the same Justin Management personnel who worked for the other Justin subsidiaries ( L.F. 45).

And third, it implies that someone at or on behalf of Acme Royalty or BIC actually engaged in sophisticated intellectual property management, when the only intellectual property transaction entered into by either appellant was the sale of an exclusive license to Acme Brick – a sale that occurred just two weeks after Acme Royalty was formed. *See* L.F. at 38. There is not even a hint, much less proof, in the record that Acme Royalty during those two weeks or at any time needed or used additional skills to manage intellectual property.

The second reason given by Acme Royalty and BIC for “separating the Trademarks from the operating divisions of Justin” is that “people specializing in intellectual property would be better able to market the same to unrelated entities.” App. Br. at 59. But the possibility of marketing the Acme Brick trademarks to “unrelated entities” disappeared two weeks after Acme Royalty was formed, when Acme Royalty gave an exclusive license to its sister company. That event – and, again, the speed with which it occurred – simply cannot be reconciled with the assertion that Justin Industries was setting up a new corporation in Delaware, without expert employees or independent ownership or supervision, to actually market the trademarks whose use in Missouri led to the Director’s assessment.

Appellants’ reference to *Central Cooling and Supply Co. v. Director of Revenue*, 648 S.W. 2d at 546 (Mo. 1982), is curious. There, the court distinguished cases in which it had previously “ignored separate corporate entities” when seeking to “pierce the corporate veil” to impose liability on the corporation, not to bestow an advantage” of the sort Central Cooling sought. *Id.* at 547. The court recognized that Missouri law will refuse to recognize corporate distinctions that appear on paper “where one corporation is so controlled and its affairs so conducted as to transform it into the adjunct or alter ego of another corporation.” *Id.* at 548. The distinct “legal forms and relationships” are

observed “[i]f the purpose served by the arrangement is fair and lawful.” *Id.* That analysis requires, again, that the court consider the “purpose served by the arrangement.” And here, there is only one purpose *actually served* by the arrangement: tax avoidance. That purpose is not “fair.”

This case is, in fact, more like one that the court distinguished in *Central Cooling: Osler v. Joplin Life Insurance Co.*, 164 S.W.2d 295 (Mo. 1942). The description of the formation of the corporations involved in *Osler* sounds much like the creation of Acme Royalty, BIC, and Justin Management: “The men in control of the corporation heretofore mentioned formed four separate subsidiary corporations . . . . The principal business of these corporations was dealing in the stock and securities of’ the parent company. 164 S.W. 2d at 297. “The affairs of the corporations named were completely managed and controlled” by the same group of people and companies. *Id.* at 298. The court thus “pierced the corporate veil” despite the fact that “all the corporations may have been formed for a legitimate purpose,” *id.* at 297.

Again, the court in *Central Cooling* merely held that when a corporation subdivides for business advantage, it cannot then avoid the consequences of that subdivision. Nothing in *Central Cooling* suggests that a corporation can subdivide, maintaining all its business in the state as before, save for the redirection of profits to a new, out-of-state subsidiary, and then demand that Missouri affirm that the redirection of profits prevents Missouri from taxing them.

This case is, of course, even more like *Geoffrey* than it is like *Osler*. Arguing against the *Geoffrey* parallel, Acme Royalty and BIC assert a factual distinction: that they, unlike Geoffrey, Inc. in South Carolina, do not have “accounts receivable” in Missouri. App. Br. at 52. But that assertion is illogical. In fact, these appellants are in precisely the same position as Geoffrey, Inc. They have a right,

under the licensing agreement, to a set portion of the proceeds of each sale of trademarked merchandise. Thus when Acme Brick sells a brick in Missouri, it creates an account receivable – the same kind of receivable that was a factor in *Geoffrey*. That receivable is, of course, intangible personal property. Its location at any given moment is difficult to define. But at least at the moment of sale, it must be in the location where the proceeds of the sale are located, *i.e.*, Missouri.

Acme Royalty and BIC also point out that the court in *Geoffrey* referred to Geoffrey, Inc. as a “franchiser.” App. Br. at 52. But that was not intended to refer to a formal franchise arrangement, of the sort found in the fast-food industry. The court referred to the rights granted by Geoffrey’s license to Toys R Us as a “franchise.” 437 S.E.2d at 17 & n.2. In that respect, again, Acme Royalty and BIC are indistinguishable from Geoffrey, Inc. They, too, have given such a license – and are now receiving income “derived from this state.”

**B. Missouri law does not irrationally tax similar taxpayers differently in violation of the Equal Protection or Uniformity Clauses. (Responds to appellants’ Point III.)**

Acme Royalty and BIC make a second constitutional argument in Point III: that the Director imposes different taxes on two taxpayers who are in the same position. But their hypothetical taxpayers are not in the same position.

Their argument is phrased as an attack on the “Director’s” actions. *See* App. Br. at 62-64. But the only authority they cite is to a case involving not a decision by the Director to assess taxes against one person and not another, but a challenge to the constitutionality of a statutory distinction, *Schnorbus v. Director of Revenue*, 790 S.W. 2d 241 (Mo. banc 1990). Acme Royalty and BIC do not identify any statutory distinction here; their argument, as phrased, is a claim of selective prosecution. But they never attempt to fulfill the elements of such a claim – and never tried to assert it at the AHC. That is, perhaps, because the requirements for such a claim are stringent. “To establish the defense of selective prosecution movant must show he was prosecuted while others similarly situated were not and the state's election to prosecute him was based upon such impermissible considerations as race, religion, or the state's desire to prevent movant's exercise of constitutional rights.” *Chamberlain v. State*, 721 S.W. 2d 139, 140 (Mo. Ct. App. E.D. 1986). What appellants must do, then, is challenge the statute itself. And again, neither at the AHC nor in their brief on appeal do they identify a statutory distinction of the sort that they say is constitutionally barred.

But even if the Director’s decision to assess taxes first against those in a position analogous to Geoffrey, Inc., could be tested as Acme Royalty and BIC propose, it would pass the test – under both the equal protection and uniformity rules.

The first critical question in equal protection analysis is, of course, whether the state is treating differently two persons (or her, corporations) that are “similarly situated.” *See Missourians for Tax Justice Education Project v. Holden*, 959 S.W.2d 249, 257 (Mo. banc 1997). Appellants argue that the distinction being made by the state here is between the use of “trademarks and trade names by a *related* licensee” and the same kind of transactions “if they involve *unrelated* licensees.” App. Br.

at 62-63 (emphasis added). But their very statement of the “problem” reveals the element that dooms their claim. Related and unrelated companies are not similarly situated.

And if they were deemed “similar,” the Director’s alleged distinction would merely recognize the obvious. Only the related company could attempt, by unilateral decisions of corporate organization, to remove income from the scope of state taxation without changing their business risks or practices. Only a related company would have the same people managing the owner of the intellectual property and other subsidiaries. A “related/unrelated” distinction would have the “rational basis” required by equal protection jurisprudence.

When faced with a uniformity clause challenge, this court has used parallel criteria. *E.g.* *Associated Industries v. Director of Revenue*, 857 S.W. 2d 182, 192 (Mo. 1993). It has sustained distinctions among taxpayers unless they are “palpably arbitrary.” *Id.*, quoting *State v. Bates*, 224 S.W. 2d 996, 1000 (Mo. 1949). Appellants provide no basis for supposing that the distinction they say the Director made was “palpably arbitrary.” Indeed, the Director could rationally conclude, in the wake of *Geoffrey*, that by far the best place to begin her efforts to eliminate this newly developed tool to avoid state taxation was companies whose activities paralleled those of Geoffrey, Inc. Surely if she is successful in her initial effort, she will expand her enforcement.

**III. The AHC chose a statutorily permissible apportionment method that fairly represents the source of appellant’s income – unlike the method that appellants demand, which would ignore the reality of what they are doing. (Responds to appellants’ points IV and V.)**



In Points IV and V, Acme Royalty and BIC make arguments that go directly to apportionment. But they seek to apportion in a way that creates an exception to Missouri taxation that Missouri's own statute does not countenance, and that the Multistate Tax Compact specifically permits Missouri to avoid.

**A. A company that has minimal payroll and tangible property cannot use three-factor apportionment to avoid taxation. (Responds to appellants' Point V.)**

Given that they have some income "derived from Missouri," but that the royalty payments they receive also include income derived from other states, Acme Royalty and BIC must choose a method to allocate income among the various states. Of course, they did not do so in a timely fashion, instead failing to file income tax returns on the premise that they had no Missouri income that required them to file. Thus the Director applied single factor apportionment, under § 143.451.

Any apportionment discussion must emphasize the purpose of apportionment: to calculate the portion of income that should, in fairness, be taxed in one state rather than another. The various formulas – including both the single-factor formula in § 143.451 and the three-factor formula in the Multistate Compact, § 32.200 – are merely methods of allocating income whose proper classification is uncertain.<sup>3</sup> Thus, for example, § 143.451.2(1) speaks of "income and deductions [that] cannot be segregated."

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<sup>3</sup> Here it seems odd to even be speaking of apportionment by formula. There does not appear to be any problem with allocating the royalty income among the states. It is, after all, based

The principal error in appellants' apportionment analysis is in their determination to belittle a critical part of the Compact's apportionment scheme. Though the Compact provides for a three-factor formula, it also recognizes that the formula does not always represent a fair or accurate division of income, and thus contains a relief mechanism. That mechanism is found in Article IV § 18. It permits the Director to require any one of several alternatives to the standard three-factor formula:

If the allocation and apportionment provisions of this article do not fairly represent the extent of the taxpayer's business activity in this state, . . . The tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of any one or more factors;

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purely on sales. Though Acme Royalty and BIC have some deductions, they are minimal compared to the amount of royalties received. In fact, appellants do not contest any of the figures that the Director used. They merely contest which formula to use and how to use it – asserting that the proper choice was “three-factor” apportionment (a position that the AHC assumed), then applying it in a way that results in no income to be taxed in Missouri.

- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Under this provision, the goal of “fair apportionment” is paramount. No taxpayer can demand a right to use the standard three-factor formula if the result does not fairly represent the various states' share of the taxpayer's income. And there is no reasonable argument (given the conclusion reached in part I above) that \$0 is a fair allocation of royalty income to Missouri.

Acme Royalty and BIC did not seek to use single-factor apportionment – and with good reason, for the results would be the same, as shown in *Brown Group* and *A.P. Green*, as the result reached by the AHC. In those cases, the question was tax treatment of royalties by a Missouri company, when the royalties were paid for the use of intellectual property outside the state. In each instance this court confirmed that the “source of income” for use of trademarks and similar intellectual property “is the place where [they] are used and the income produced.” *Brown Group*, 649 S.W. 2d at 880; *A.P. Green*, 277 S.W. 2d at 547. Here, the trademarks were used on sales made in Missouri. Thus the royalties on Missouri sales are income from “wholly within” the state. Incorporating that into the single-factor formula would give the same result as the analysis of the AHC using the three-factor formula, modified to match the economic reality of what Justin Industries and its subsidiaries are doing.

**B. The Multistate Compact does not bar using a formula that looks at the location from which the income is derived regardless of whose hands it**

**first passes through, when, as here, such a formula is required to “fairly represent the extent of the taxpayer’s business activity in this state.”**

**(Responds to appellants’ Point IV.)**

In appellants’ final apportionment argument, which appears as their Point IV, Acme Royalty and BIC bootstrap their opening argument, *i.e.*, that they have no income “derived from” Missouri. That argument would, of course, be dispositive of their appeal without reference to apportionment. But again, it is without merit. Their argument must really be that the Multistate Compact prohibits modification of three-factor apportionment in the manner chosen by the AHC. It does not.

According to Acme Royalty and BIC, the Compact, § 32.300, art. IV, §§ 9 and 17, preclude the state from considering the sales by Acme Brick in calculating Missouri’s fair share of the royalty income that is derived in whole or in part from Missouri. So stated, the argument misses the mark. Missouri is not basing its calculation on Acme Brick sales. It is relying solely on the royalties paid to appellants – dividing them according to their original source. The distinction is subtle. But Missouri is merely using the sales location as a substitute for the sales and other elements normally used in three-factor apportionment – a step that is permissible under art. IV § 18. Notably, Acme Royalty and BIC do not argue that the use of the source of the royalties is unfair or that it does not represent the economic reality of the source of their income. And they cite no authority for the proposition that under section 18 the state cannot do what it did.

In lieu of pertinent authority, they point the definition in Art. IV § 17 of the denominator in three-factor apportionment. But in doing so, they again ignore the impact of § 18. That section permits

the numerator, and not just the denominator, to be changed when necessary to “fairly represent” the portion of income that comes from Missouri.

What Acme Royalty and BIC argue, in essence, is that because they are a round peg and because the Compact version of apportionment is a square hole, their apportionment factor is zero. But again, section 18 permits the Director to modify the shape of the hole to accommodate the configuration of an invention, such as intellectual property subsidiaries, that was not specifically contemplated when three-factor apportionment was derived.

**IV. The imposition of existing taxes on a newly invented type of corporation does not constitute a change in policy or interpretation under § 143.903.**

**(Responds to appellants’ Point VI.)**

Appellant’s last point raises what is apparently a novel question: whether, when the Director for the first time observes and concludes that there is a method to defeat a particular tax avoidance structure, her effort to do so is necessarily a “change” from prior law or policy of the sort contemplated under § 143.903. In making that argument, appellants lack two essential elements. First, they cite no authority for the proposition they assert, other than the statute itself. And turning to the statute’s language, they provide no evidence of “prior law, policy or regulation of the Director” on the point at issue here.

The evidence to which they point is merely negative, *i.e.*, that until after *Geoffrey*, the Director made no effort to pursue royalty income being paid between related corporations. *See* App. Br. at 70. There is no evidence in the record that, until *Geoffrey*, the Director was even aware of this sort of transaction. It would not be apparent on the face of returns filed with the Director. Acme Brick, for example, would deduct from its income royalties paid to Acme Royalty, but it would not announce that the payee was a corporation owned, controlled, and operated by the same parent, or that what it now called deductible royalties was what it (or Justin Industries) had previously called profits. The Director took some time in which to learn that tax lawyers and accountants were spreading the word on a new tax avoidance tool, to analyze whether the tool was legal, to train auditors, and to identify taxpayers whose returns present a reasonable basis for testing the validity of the position that the tool was illegal. That delay does not mean that the *Director* changed any “law, policy or regulation.” It is *corporations*, such as Justin Industries that changed. The Director’s response to such a change cannot be what the legislature contemplated in § 143.903.

## **CONCLUSION**

For the reasons stated above, the decision of the AHC should be affirmed.

Respectfully submitted,

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## **Certificate of Service**

The undersigned hereby certifies that a copy of the foregoing was mailed, postage prepaid, via United States mail, on this 19<sup>th</sup> day of July, 2002, to:

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## **Certification of Compliance**

The undersigned hereby certifies that the foregoing brief complies with the limitations contained in Local Rule 360, and that the brief contains 8,913 words.

The undersigned further certifies that the disk simultaneously filed with the hard copies of the brief has been scanned for viruses and is virus-free.

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