

**IN THE SUPREME COURT OF MISSOURI**

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**No. 84226**

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**GORE ENTERPRISE HOLDINGS,**

**Appellant,**

**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

W.L. Gore (Gore) is a producer of expanded polytetrafluoroethylene (ePTFE). Legal File (L.F.) at 32. It is largely owned by the family of one of its founders, and by that family's trusts. *Id.* It has four divisions – medical, industrial, electronic, and fabrics, apparently none of which are separately incorporated. *Id.* Gore sells goods in Missouri and elsewhere, principally medical products, fabrics, and industrial products. L.F. at 34.

In 1983, Gore formed Gore Enterprise Holdings, Inc. (“Holdings”) as a Delaware corporation. L.F. at 32. During the tax periods at issue, Holdings’ officers were the same as Gore’s officers. L.F. at 34. For two of the years at issue, Holdings had no other officers and no employees or offices. *Id.* “Its activities were carried out by Gore’s employees at Gore’s offices.” *Id.* Only during the last year – 1995 – did Holdings have its own small office and a paralegal as its only employee. L.F. at 34-35.

When it formed Holdings, Gore transferred to Holdings all of its patents (but not trademarks), and in turn owns all of Holdings’ stock. L.F. 32, 34. Holdings quickly licensed those patents back to Gore. L.F. 32-33. During the tax periods at issue, that was an exclusive license. L.F. 33. Holdings licensed patents to only one other company during the tax periods here: a German subsidiary of Gore. L.F. 34. Holdings shared with Gore the right to sue for infringement – and gave to Gore the entire proceeds of any suit Gore undertook. L.F. 33. Gore agreed to pay a royalty to Holdings that was calculated to move perhaps all of Gore’s profits to Holdings:

[Gore] shall pay to [Holdings] a royalty at the rate of 7 ½ per centum of the sales prices of all products manufactured, by [Gore] in the United States and sold by [Gore] for use, disposition or consumption in the United States or any of its territories and possessions or in

any foreign country; provided, however, that [Gore's] obligations for royalty payments for any calendar year shall not exceed an amount equal to the Net Income from operations of [Gore] for that year.

L.F. 33. Though the agreement permitted the royalty to be renegotiated annually, L.F. 32, Gore and Holdings did not negotiate regarding royalty rates, L.F. 33.

Holdings, then, maintained the Gore patent portfolio, including paying the fees required to retain patent rights. L.F. 32-35. Gore continues to use those patents to create and sell products in Missouri and elsewhere. *Id.* Neither company has physical facilities in Missouri. *Id.* Holdings – unlike Gore – did not register to do business in Missouri, nor did it file Missouri income tax returns. L.F. at 35.

When the Director audited Gore, she discovered the existence of Holdings. L.F. 36. Her auditor concluded that Holdings was subject to Missouri income tax, and used a modified version of three-factor apportionment to determine the amount of Holdings' Missouri taxable income. L.F. 36. The Director issued notices of deficiency to Holdings, based on the auditor's findings. L.F. 37. Holdings protested, but on August 6, 1999, the Director issued final deficiency notices, assessing taxes and interest but not additions. L.F. 37.

On September 3, 1999, Holdings filed a timely complaint in the Administrative Hearing Commission (AHC). L.F. 36. The Commission upheld the Director's decision, rejecting Holdings' assertion that it "does not have a nexus with or do business in Missouri." L.F. 31. Holdings appealed.

## 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 appellant 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 do business in Missouri in precisely the same way, can suddenly exclude from taxation some or all of its profits from that business by designating them as “royalties” on patents, paid by the parent to a separately incorporated, but wholly owned and controlled subsidiary. 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 that the corporation uses to manufacture goods sold in Missouri. As discussed below, tribunals in other states have reached differing conclusions.

These decisions demonstrate that what Gore 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. In *Holdings*, Gore 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 *Holdings*’ 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 sale in Missouri of goods made using a company’s patent is income “derived from” Missouri, it is subject to**

**Missouri income tax under § 143.071 absent some exclusion or constitutional defense. (Responds to appellant's 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 Holdings has “Missouri taxable income,” it is 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.

Holdings argues, in its first point, that the royalties it collects from the use of the Gore patents 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 both the nature of patent rights and the manner in which the Gore patents are used and policed.

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

Holdings first quotes 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. It never returns to that language. Nor could it 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 Gore to Holdings. Gore made the payments pursuant to the license agreement (which, during the periods at issue, was an exclusive license) it entered into with Holdings. The payments were calculated as a percentage of Holding’s sales. Those sales occurred in places – including Missouri – that Gore had served since long before it created Holdings. If Gore had no sales in Missouri, Holdings 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 asserts 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 Holdings was diverted. *See* WEBSTER’S at 608.

The income at issue here was diverted from the stream of revenue obtained by Gore when it sold goods, made using the Gore patents that Gore transferred to its Holdings subsidiary, 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 the source of royalties paid on manufacturing processes and other types of intellectual property is not where the company owning the property is located, but where the income is produced.**

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) (emphasis added). Part of the income at issue in *A.P. Green* – the income from the licensing of intellectual property, including patents covering manufacturing processes – 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] . . . 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 Holdings wants to contest in its 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, Holdings must concede that the profit on the patents was the result of the sale in Missouri (and elsewhere) of goods made from materials manufactured using the patents. The income was not produced in Delaware, where Holdings purports to hold the patents, but here; but for the sale of goods, there would be no income, and hence no tax. Thus, under *A.P. Green*, or any other “realistic” approach, Holdings and Gore cannot remove income from Missouri taxation merely by ensuring that when they enter into a licensing agreement that provides for the royalty payments or when they hand over the royalty check, they stand outside the state.



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

The continued validity of *A.P. Green* was doubted, briefly, because of a decision on which Holdings relies, *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, now 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>1</sup>

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<sup>1</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 activities’ within that State,” *Truck Renting & Leasing Ass’n, Inc. v. Commissioner of*

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). Holdings makes the same error not just in its Point I, but also in its Point V. There it defined “derived from Missouri sources” by jumping to the apportionment or allocation portions of the Multistate Compact. App. Br. at 78-79. Even if its 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

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*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 Holdings did when it granted back to Gore a license that permitted Gore to continue doing business, using those patents, in Missouri.

actual statutory language, it is “derived from” Missouri. Again, but for sales, Holdings would have no income, and would owe no tax.

**D. That this case involves only patents and not trademarks does not mandate a different result.**

This case differs, of course, from *Acme Royalty Co. v. Director of Revenue*, No. 84225, in that the intellectual property Holdings owns consists of product and process patents, rather than trademarks. Thus the requirement under the Lanham Act, *see* 15 U.S.C. 1127, that the owner supervise use of the property does not apply. But that should not be dispositive. The question is not the legal *obligation* to supervise, it is the legal *right* to supervise. Under the patent laws, Holdings has the right to restrict and supervise the manufacture, use, and sale of goods made using its patents. 35 U.S.C.

§ 271. Of course, the record suggests that Holdings has not unilaterally exercised that right. But the reason for that would seem obvious from the manner in which Holdings was formed, the composition of its management, and the nature of the licensing agreement. Gore has the legal right to police the rights to the patents it gave to Holdings. And the common officers of Gore and Holdings can determine, based in part on where the greatest tax advantage lies, which entity will sue and collect damages. As discussed below, Holdings and Gore are effectively alter egos.

Moreover, Holdings, like Acme Royalty, obtains the benefit of Missouri law, law enforcement, and courts. There is one difference: patent infringement can be contested only in federal court. But Holdings’ economic benefit is nonetheless the result of a thriving Missouri market. If Missourians quit buying Gore products, Holdings would receive no royalties. Those products are delivered on Missouri

highways and sold in Missouri stores to Missouri customers using wages and other income earned in Missouri. The sales are thus dependent on the entire economic and regulatory structure of the state. And though Missouri courts would not hear infringement claims, they might well serve Holdings in its efforts to enforce contract rights or to collect judgments.

**II. No constitutional limitation prevents Missouri from taxing royalties based on sales paid between corporations with common ownership when one corporation uses patents licensed from the other. (Responds to appellant's Points II, III, and IV.)**

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

**1. Nexus requirement.**

In its effort to keep the royalty income out of the scope of Missouri's corporate income tax, Holdings cites 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 appellant points 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.

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 (Ohio 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 Holdings’ income is not a paper agreement, but Missouri’s Gore 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,” “Abercombie & 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 Holdings’ basic argument: that it 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 true when the companies licensing and selling cannot be effectively distinguished from their parent or from each other. Because of its close relationship with Gore, the “nexus” analysis cannot entirely ignore the combined efforts of Gore as Holdings demands. Every fact in this case points to the conclusion that Holdings is an alter ego of Gore: *e.g.*, the immediate grant of a license back to Gore; the complete identity of officers and the dearth of employees, particularly at the time the license was granted.

To argue to the contrary, Holdings first points 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 63. But then it fails to point to a single fact that suggests Holdings and Gore separate minds, wills, or existence.

Holdings does not – fortunately – merely rely on the self-serving claim that Gore organized Holdings because of the different skill levels are required to manage intellectual property. Such a claim would explain why Gore might want to create a group of intellectual property specialists and give them independence from the divisions of the company that were using the patents. But of course Gore never created such a group of specialists within Holdings, choosing instead to have it run by the same officers who run Gore. And unlike Acme Royalty, Holdings never suggests a reason that the requisite independence required a separate corporation – except, of course, for the tax advantages that Holdings claims here. *See* L.F. 32 (Gore formed Holdings “because it was administratively more efficient to centralize the patents developed in the various divisions. Tax savings were also a consideration.”)

Instead, Holdings asserts that Holdings is not Gore’s alter ego because “[i]n this case,” *i.e.*, in granting the license the income from which is at issue in this case, “Holdings acted in its own, not Gore’s interests.” App. Br. at 63. That is not a finding that was made by the AHC. Nor is it a finding that the AHC could have made based on the record. Holdings simply did not provide a basis for the Director or the AHC to reach such a conclusion.

To support its claim of independence, Holdings points first to its licenses “to other, unrelated entities including Donaldson, a direct competitor of Gore.” App. Br. at 63. Holdings there ignores the fact that the original license to Gore was exclusive, and that the licensing of patents to unrelated entities

occurred after the tax periods at issue. L.F. 33-34. And Gore merely assumes – it never proves – that granting a license to Donaldson or any other company was in the best interests of Holdings but not in the best interests of Gore. It may well be that the royalty agreement with Donaldson would result in more or better assured income to Gore, as a consolidated entity. We simply do not know. And given the identity of actors, it seems highly unlikely that Holdings entered into a licensing agreement that would result in an overall loss of income, *i.e.*, a decrease in Gore income that is not offset or exceeded by royalties received by Holdings from the other licensee.

Holdings also points to its decision to “dedicate a patent to the public.” App. Br. at 63. But Holdings ignores the reasons its witness gave for that decision: that the company found prior art that likely would have led to invalidation of the patent. Tr. at 74. Again, there is no basis in the record for concluding anything but that the common officers of Holdings and Gore concluded that further litigation was not cost-effective – regardless of whether the litigation was undertaken by Holdings or by Gore.

In attempting to define a rift between Holdings and Gore, Holdings asserts that “Holdings frequently decided to abandon patents, or to refrain from enforcing or renewing patents, even though that conduct was not in the best interests of its licensees (including Gore).” App. Br. at 63-64. But again, there is no AHC finding to that effect. And the evidence actually is that sometimes “the expense of maintaining” a patent “is just too great.” Tr. at 86. In other words, the royalties to be received from use of the patents no longer justify the costs of maintaining them. At that point, the source of the royalties is largely irrelevant.

And to the extent it is relevant, it would be the basis for renegotiation between Gore and Holdings. The license agreement with Gore permits Gore (the entity allegedly harmed by abandoning

the patent) to increase its royalty payment to Holdings (the entity allegedly harmed by maintaining it), if Gore's interest in maintaining the patent outweighs the benefit it receives through Holdings' profitability. Gore and Holdings simply do not engage in those negotiations. L.F. at 3. The necessary inference is that Holdings abandons patents when the profits to be made from them – profits that are largely or entirely moved from Gore to Holdings through royalties – do not justify further expense not just to Holdings, but through Holdings to Gore as a whole. At that point, abandoning the patent is in the best interest of the Gore group, though it may not be in the best interests of the managers of a division whose ability to contribute to corporate profits (by the manufacture and sale of goods using the patents) is, in essence, being shifted to Holdings (by the receipt of royalties from the manufacture and sale of goods by others).

Holdings' final claim, that it was formed "to prevent 'turf wars' between Gore divisions and for Holdings to become the 'common enemy' of those divisions" (App. Br. at 64), suffers from a similar dearth of support in evidence or logic. Gore's alleged need for "enemies" within its corporate family helps explain why Holdings would make decisions that were opposed by various divisions of Gore. But it does not explain why Holdings, led by Gore's officers and with all its shares in Gore's hands, would make decisions that were not in the interests of the corporate group. And of course, Holdings still offers no explanation why it would be necessary for Holdings to be separately incorporated in order to be the divisions' "common enemy."

Holding's subsequent reference to *Central Cooling and Supply Co. v. Director of Revenue*, 648 S.W. 2d 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 Holdings. “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, Holdings asserts a factual distinction: that it, unlike Geoffrey, Inc. in South Carolina, does not have “accounts receivable” in Missouri. App. Br. at 55. But that assertion is illogical. In fact, Holdings is in precisely the same position as Geoffrey, Inc. It has a right, under the licensing agreement, to a set portion of the proceeds of each sale of merchandise manufactured using its patents. Thus when Gore sells a Gore-Tex glove liner in Missouri (*see* L.F. at 32), 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.

Holdings also points 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, Holdings is indistinguishable from Geoffrey, Inc. It, too, has given such a license – and is now receiving income “derived from this state.”

**B. By taxing a corporation’s royalties derived from activities by its alter ego in Missouri, the state does not violate the Due Process Clause.**

**(Responds to appellant’s Point III.)**

Like Geoffrey, Inc., Holdings couples its Commerce Clause argument with a Due Process one. And as in *Geoffrey*, the Due Process claim should be rejected – for the reasons much the same as those explained in II.A. in response to Holdings’ Commerce Clause claim.

The issue in both is the relationship between the taxpayer and the taxing state. Both Holdings and Geoffrey point out that considered literally, they do not enter the taxing state. Neither has offices, employees, or other physical presence in the state. Neither sells goods in or into the state. But in both instances, the property that is the essence of the company's business – the intellectual property – *is* in the state. Like Geoffrey, Holdings “contemplated a purposely sought the benefit of economic contact with” Missouri. 437 S.E. 2d at 16.

Holdings suggests that it is different from Geoffrey, Inc. and Acme Royalty because its royalty payments are “triggered by the manufacture of products, an event that never occurs in Missouri.” App. Br. at 55. But that is contrary to the facts found by the AHC – specifically, contrary to the license agreement itself. The royalty is set at a particular portion of “the sales price.” L.F. at 33. That is not the list or some other hypothetical price; it is the price at which goods are actually sold. The only fair reading of the license is that if a licensee manufactures goods but never sells them, no payment is due under the licensing agreement. Certainly there is no suggestion in the record that Gore is paying Holdings at the moment of manufacture. Indeed, such payments would make it difficult if not impossible to determine when to cease royalty payments because the “exceed an amount equal to the Net Income from operations of [Gore] for [the] year.” L.F. at 33. Thus Holdings’ own witness described the royalties as “measured by sales into Missouri.” Tr. at 122. Holdings’ connection to Missouri through those sales is sufficient to establish a nexus for purposes of the Due Process Clause, just as it is for purposes of the Commerce Clause.

But the court need not merely follow *Geoffrey* and conclude that Holdings’ own contacts with Missouri were sufficient. The court can and should also “pierce the corporate veil” and rely on the

contacts by Gore – contacts which are evident from the AHC’s findings, and not contested by Holdings.

That the acts of an alter ego can form the nexus necessary under the Due Process clause is beyond dispute. A federal appellate court recently – and correctly – observed that federal courts have consistently acknowledged that it is compatible with due process for a court to exercise personal jurisdiction over an individual or a corporation that would not ordinarily be subject to personal jurisdiction in that court when the individual or corporation is an alter ego or successor of a corporation that would be subject to personal jurisdiction in that court. The theory underlying these cases is that, because the two corporations (or the corporation and its individual alter ego) are the same entity, the jurisdictional contacts of one are the jurisdictional contacts of the other for the purposes of the *International Shoe* due process analysis. *See, e.g., Lakota Girl Scout Council [Inc. v. Havey Fund-Raising Management, Inc.]*, 519 F.2d 634, 637 [(8<sup>th</sup> Cir. 1975)] (explaining that "if the corporation is [the individual defendant's] alter ego, its contacts are his and due process is satisfied"). *Patin v. Thoroughbred Power Boats Inc.*, 2002 U.S. App. LEXIS 11382, \*33 (5<sup>th</sup> Cir. 2002) (footnote omitted), citing *International Shoe Co. v. Washington*, 326 U.S. 310 (1945).

None of the precedents cited by Holdings (App. Br. at 72-74) are to the contrary. They deal with precisely what Holdings suggests: whether the activities of a mere licensee can be attributed to the licensor for due process purposes. *E.g., Aluminum Housewares Co., Inc. v. Chip Clip Corp.*, 609 F. Supp. 358, 361 (E.D. Mo. 1984) (defendant’s products were sold in Missouri “through an independent manufacturer’s representative”). Here, Gore is not a mere licensee. Rather, as discussed



above, Holdings and Gore are alter egos. Holdings thus cannot avoid Missouri tax liability by disavowing Gore's nexus with the state.

**C. Missouri law does not irrationally tax similar taxpayers differently in violation of the Equal Protection or Uniformity Clauses. (Responds to appellant's Point IV.)**

Holdings makes a third constitutional argument in Point IV: that the Director imposes different taxes on two taxpayers who are in the same position. But its hypothetical taxpayers are not in the same position.

Its argument is phrased as an attack on the "Director's" actions. *See* App. Br. at 75-76. But the only authority it cites 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). Holdings does not identify any statutory distinction here; its argument, as phrased, is a claim of selective prosecution. But it never attempts 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 Holdings must do, then, is challenge the statute itself. And again, neither at the AHC nor in its brief on appeal did Holdings identify a statutory distinction of the sort that it says 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 Holdings proposes, 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 here, corporations) that are “similarly situated.” *See Missourians for Tax Justice Education Project v. Holden*, 959 S.W.2d 249, 257 (Mo. banc 1997). Appellant argues that the distinction being made by the state here is between the use of “patents by a *related* licensee” and the same kind of transactions if they involve “an *unrelated* licensee.” App. Br. at 75-76 (emphasis added). But its 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 a 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). Holdings provides no basis for supposing that the distinction it says 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 Holding's income – unlike the method that appellant demands, which would ignore the reality of what it is doing. (Responds to appellant's Points V and VI.)**

In Points V and VI, Holdings makes arguments that go directly to apportionment. But it seeks 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 appellant's Point VI.)**

Given that it has some income “derived from Missouri,” but that the royalty payments it receives also include income derived from other states, Holdings must choose a method to allocate income among the various states. Of course, it did not do so in a timely fashion, instead failing to file income tax returns on the premise that it had no Missouri income that required it 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. Thus, for example, § 143.451.2(1) speaks of “income and deductions [that] cannot be segregated.”

The principal error in Holdings’ apportionment analysis is in its 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;
- (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.

**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 appellant’s Point V.)**

In Holdings’ final apportionment argument, which appears as its Point V, Holdings bootstraps its opening argument, *i.e.*, that it had no income “derived from” Missouri. That argument would, of course, be dispositive of its appeal without reference to apportionment. But again, it is without merit. Holdings’ 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 Holdings, the Compact, § 32.300, art. IV, §§ 9 and 17, precludes the state from considering the sales by Gore 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 Gore sales. It is relying solely on the royalties paid to Holdings – 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(4). Notably, Holdings does 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 it cites no authority for the proposition that under Section 18 the state cannot do what it did.

In lieu of pertinent authority, Holdings points to the definition in Art. IV § 17 of the denominator in three-factor apportionment. But in doing so, it again ignores 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 Holdings argues, in essence, is that because it is a round peg and because the Compact version of apportionment is a square hole, its 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 devised.

**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 appellant’s Point VII.)**

When invoking the “unexpected decision” rule of § 143.903, Holdings does not point to any audit, adjudication, assessment, or decision by or involving the Director that was contrary to the position she takes now. *See* App. Br. at 83-84. Thus Holdings’ last point raises what is apparently a novel question: whether, when the Director for the first time identifies, 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, Holdings lacks two essential elements. First, it cites no authority for the proposition it asserts, other than the statute

itself. And turning to the statute's language, it provides no evidence of "prior law, policy or regulation of the Director" on the point at issue here.

Again, the "evidence" to which Holdings points is merely the absence of evidence, *i.e.*, that the witnesses knew of no instance, until after *Geoffrey*, where the Director pursued royalty income being paid between related corporations. *See* App. Br. at 84; L.F. 55. 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. Gore, for example, would deduct from its income royalties paid to Holdings, but it would not announce that the payee was a corporation that it created, owned, controlled, and operated, or that what it now called deductible royalties was what it had previously called taxable income.

It took the Director 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 instruct 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 Gore, 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 22<sup>nd</sup> day of July, 2002, to:

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The undersigned hereby certifies that the foregoing brief complies with the limitations contained in Local Rule 360, and that the brief contains 9,995 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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