IN THE
SUPREME COURT OF MISSOURI

No. 84226

GORE ENTERPRISE HOLDINGS, INC.,

APPELLANT,

v.

DIRECTOR OF REVENUE, STATE OF MISSOURI,

RESPONDENT.

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

BRIEF OF APPELLANT

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JURISDICTIONAL STATEMENT

The principal issues before the Court involve the construction of sections 143.431.1; 32.200, art. IV, § 18; 143.903; and 32.053;[1] and, if such statutes are construed against this taxpayer, the application and construction of the Commerce Clause of the United States Constitution (U.S. Const. art. I, § 8), the Equal Protection Clause and the Due Process Clauses of the United States Constitution (U.S. Const. amend. XIV), the Due Process Clause of the Missouri Constitution (Mo. Const. art. I, § 10), the Equal Protection Clause of the Missouri Constitution (Mo. Const. art. I, § 2) and the Uniformity Clause of the Missouri Constitution (Mo. Const. art. X, § 3). In particular, the questions presented are:

(1) whether under section 143.431, Appellant's patent royalty income is Missouri source income based solely on the fact that Appellant's licensee sells to Missouri customers some of the products the licensee manufactures outside of Missouri using Appellant's patents;

(2) whether the assessment against Appellant may be sustained under the Commerce Clause since Appellant has no presence, physical or otherwise, in Missouri;

(3) whether the assessment against Appellant may be sustained under the Due Process Clause since Missouri provides no benefit of any kind to Appellant;

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[1] All statutory citations are to the Revised Statutes of Missouri of 2000, as amended, unless otherwise noted.

(4) whether the Equal Protection Clause, Due Process Clause and Uniformity Clause prohibit the Director from imposing tax on royalty income received by a taxpayer having no presence, physical or otherwise, in Missouri from a licensee related to the taxpayer, when the Director imposes no such liability on royalty income received by a like taxpayer from unrelated licensees;

(5) whether under section 32.200, art. IV, § 17, the Commission may attribute a licensee's sales to its licensor in computing the licensor's sales factor;

(6) whether under section 32.200, art. IV, § 18, the Commission is free to exclude the property factor in apportioning income for taxpayers having no or small property ownership; and

(7) whether the term "previous policy" as used in section 143.903 includes a position of not taxing certain transactions, and whether the phrase "change in policy or interpretation" as used in section 32.053 includes, in reaction to judicial precedent from another state, the imposition of tax on transactions that the Director earlier did not tax.

Thus, the Court's review of this case will necessarily involve the construction of sections 143.431.1; 32.200, art. IV, § 18; 143.903; and 32.053—all of which are revenue laws of the State of Missouri and, alternatively, the constitutional issues noted above. This Court has exclusive jurisdiction over these issues pursuant to article V, section 3 of the Missouri Constitution.

STATEMENT OF FACTS

Introduction

Appellant Gore Enterprise Holdings, Inc. ("Holdings") appeals from the Administrative Hearing Commission's ("Commission") decision upholding an assessment of Missouri income tax on royalty income received from the licensing of patents and from passive investments. The Director assessed Holdings for annual tax periods ending March 31, 1994 ("1993"); March 31, 1995 ("1994") and March 31, 1996 ("1995") (each a "Tax Period" and, collectively, the "Tax Periods").

The facts and issues before this Court in this case are similar to, but not the same as, those presented in *Acme Royalty Co. v. Director of Revenue*, Case Number SC 84225. This case addresses whether Missouri may subject a foreign corporation's ***patent*** royalty income on patents licensed by a foreign manufacturer to produce products outside of Missouri merely because the manufacturer is related to the patent licensor and because the manufacturer sells some of its products to Missouri customers. In *Acme*, the issue is whether Missouri may subject a foreign corporation's ***trademark and trade name*** royalty income on trademarks used by a licensee that uses the trademarks to sell the licensee's products to customers located in Missouri. Consequently, several of the issues overlap between the two cases while others do not.

In both cases, this Court is asked to determine: (a) whether the taxpayers' royalty income is Missouri source income; (b) whether a taxpayer must have physical presence in Missouri to be subject to the Missouri income tax; (c) whether the Director may subject the royalty income of a licensor of intellectual property to Missouri income tax when the intellectual property is licensed to a related corporation while not taxing similar income when the intellectual property is licensed to an unrelated corporation; (d) whether the Director can ignore statutory factors in the three-factor apportionment

method when the numerators of some or all of the factors are small or zero; and (e) whether the Director's determination to tax the royalty income of such a licensor may be applied on a retroactive basis against Holdings.

Because this case addresses patents, rather than trademarks and trade names, this Court is also called upon to determine: (a) whether the sales by Holdings' licensee may be attributed to Holdings for purposes of determining if Holdings has any Missouri source income; and (b) whether such potential imposition of Missouri income tax is consistent with the Due Process Clause.

Consequently, Holdings respectfully requests that this case be heard in tandem with *Acme Royalty Company*, although not consolidated for decision therewith.

Formation of Holdings

Holdings is a Delaware corporation formed in 1983 (L.F. 32). Holdings is a wholly-owned subsidiary of W.L. Gore & Associates, Inc. ("Gore") (L.F. 32). Gore produces expanded polytetrafluoroethylene ("ePTFE"), a unique polymer used for purposes such as synthetic arteries, breathable fabric and glove liners (such as "Goretex"), industrial applications, and electronic applications such as coaxial cables for computers. Holdings' domicile during the Tax Periods was 555 Paper Mill Road, Newark, Delaware 19714 (Ex. G).

Holdings was formed when Gore contributed all of its patents, including its patent for ePTFE, to Holdings in exchange for all of Holdings' stock (Tr. 62-63). Holdings was formed because:

(a) Gore was becoming a diversified company with four divisions and in need of central management of its patents because each division was making inventions, but showing no interest in them unless they were of benefit to the particular division;

(b) The various divisions were involved in "turf wars" over how to use inventions and which division should obtain credit for them;

(c) Having a separate company with expertise in patent management would create administrative efficiencies and expertise; and

(d) Having a separate patent company would encourage the flow of information to Gore's divisions about the inventions of other divisions and thus encourage additional use of inventions (Tr. 59-62).

Holdings owns only product and process patents, as discussed below; it does not own any trademarks or trade names (L.F. 34). Holdings originally owned 24 patents as listed in an attached schedule to the License Agreement at issue in this case (L.F. 33). The schedule was amended as new patents were developed, and Holdings owned more than 300 patents during the Tax Periods (L.F. 33).

Holdings' patent management decisions sometimes conflicted with the best interests of its licensees, including Gore. For instance, Holdings licensed its patents to The Donaldson Company ("Donaldson") even though Donaldson was a direct competitor of Gore (Tr. 84). Holdings also dedicated one or more patents to the public, thereby preventing its licensees from exclusively operating under such patents (Tr. 83). Additionally, Holdings frequently decided not to enforce, apply for, or renew patents even though it was in its licensees' best interests for it to do so (Tr. 85-86).

Patents

A patent is a grant from the Federal or a foreign government covering an invention (Tr. 27). Patentable inventions can include an article, machine, process, or composition of matter (Tr. 27). These can broadly be described as two different categories: "a new thing or a new way of doing something, [in other words,] product or process" (Tr. 28). A product patent gives the patent holder the right to

exclude others from engaging in certain activities, including making, using, or selling a product falling within the claims of the patent (Tr. 28-29). A process patent gives the patent holder the right to exclude others from using the patented process, for example, making product (Tr. 28).

The patent allows its owner to exclude others from practicing the invention during the term of the patent (Tr. 27). A patent expires either 17 years from its issuance or 20 years from the filing of the application for the patent, depending upon when the patent was obtained (Tr. 27). The patent owner enforces the right of exclusivity by bringing a patent infringement action in federal court (Tr. 29). Federal courts have exclusive jurisdiction of such actions, and state courts have no such jurisdiction (Tr. 29).

Applying for and maintaining patents is an expensive proposition. For instance, in the United States, the cost to obtain a patent ranges from $10,000 to more than $50,000 per patent (Tr. 43). In the European Patent Office, that cost can be as great as $250,000 if the patent grant is opposed (Tr. 46). In addition, a patent holder may have to pay annual fees of up to $5,000 per country to keep the patent in force in that country (Tr. 46-47).

Patent Licensing and Royalties

When a patent owner licenses a patent, the licensor, in essence, covenants not to sue the licensee for patent infringement (Tr. 49). In exchange for the grant of a license, the licensee typically pays a royalty to the licensor (Tr. 49). With respect to a process patent, the obligation to pay a royalty typically arises when the patented process is used, for example, to manufacture a product (Tr. 51). With respect to a product patent, the obligation to pay a royalty typically arises upon the earliest of the patented product's manufacture, use, or sale (Tr. 51-52). The licensee typically makes only one payment even if more than one activity (manufacture, use, or sale) occurs (Tr. 51-52). Thus, if a

licensee makes and sells a patented product, the obligation to pay the royalty is typically triggered when the patented product is made (Tr. 52).

The License Agreement

In 1983, Holdings entered into a License Agreement ("License Agreement") with Gore (Ex. 10). The License Agreement granted to Gore an exclusive license through March 31, 1989, and a nonexclusive license thereafter, to make, use, and sell patented inventions (Tr. 109-11).

The License Agreement provides that Gore must pay Holdings a royalty equal to 7.5% of the sales price of all products manufactured with Holdings' product and process patents (Ex. 10, ¶¶ 1-2; Tr. 51-52, 77-79). Every such product that was sold by Gore during the Tax Periods was manufactured by Gore (Tr. 78-79). Thus, the obligation to pay the royalty was always triggered by the manufacture of products by Gore (Tr. 52, 78-79).

During the Tax Periods, Gore never operated any manufacturing facility in Missouri (L.F. 34). All of its manufacturing facilities were located in Delaware, Maryland, Arizona, Wisconsin, and Texas (L.F. 34).

During the Tax Periods, Holdings licensed its patents to two companies: Gore and W.L. Gore & Associates GmbH, a German subsidiary of Gore (L.F. 34). After the Tax Periods, Holdings also licensed its patents to The 3M Company, to Donaldson, and to two Japanese companies, NTK and Shinko (Tr. 72). NTK, Shinko, The 3M Company, and Donaldson are unrelated to Holdings (Tr. 72), and as stated above, Donaldson was a direct competitor of Gore (Tr. 84).

Operations of Holdings

In 1993 and 1994, Holdings conducted its business through third parties who acted as "rented employees" (*i.e.*, law firms specializing in patent law, accounting firms specializing in accounting procedures, and patent lawyers of Gore) (Tr. 56, 164-65;
Ex. G). Holdings paid outside law and accounting firms directly for their patent services (L.F. 35). During 1995, Holdings conducted business through the same law firms and through its employee, a paralegal housed in its offices (L.F. 35).

Holdings incurred substantial expenses to obtain and maintain its patents. For 1993, Holdings incurred patent and legal fees of $537,273; for 1994, $955,496; and for 1995, $1,347,101 (Tr. 142-43). Additionally, Holdings incurred outside accounting expenses and investment portfolio management expenses (Ex. G).

Lack of Missouri Contacts by Holdings

Holdings has never, in Missouri, owned property, had agents, had an office or mailing address, had a phone number, had a bank account, or had any payroll (L.F. 35). Except for this tax controversy, Holdings has never, in Missouri, brought suit, been sued, or entered into a contract, and has never been party to a contract that was to be interpreted under Missouri law (L.F. 35; Tr. 68-71). Holdings has never applied for, or obtained, a Missouri patent, because there are no "Missouri" patents (since patents are created only under Federal law).

Holdings has never registered to do business in Missouri, has never filed tax returns in Missouri (L.F. 35), and has never conducted any business or held a directors' meeting in Missouri (Tr. 64). Holdings' lawyers, accountants, and investment bankers have never performed services in Missouri on behalf of Holdings, except to the extent involved in this appeal (L.F. 35). Outside brokers have

managed Holdings' investment portfolio, and none of those brokers performed services in Missouri (L.F. 35).

Director's Audit

The Director audited Holdings, and assessed Missouri income tax against Holdings, using a modified version of the multistate three-factor apportionment formula under section 32.200 (L.F. 36). Specifically, the auditor computed Holdings' sales for purposes of the sales factor by dividing Gore's sales to Missouri customers by Gore's sales everywhere and multiplying that by Holdings' royalty income (L.F. 36).[2] Thus, the Director assessed Missouri income tax against Holdings based solely on the fact that one of its licensees (Gore) sold to Missouri purchasers some of the products that it manufactured outside of Missouri. Gore files Missouri income tax returns and pays Missouri income tax and did so for the Tax Periods (Exhibit A).

Director's Policies

In October 1996, the Director published the Nexus portion of her Corporate Income Tax Manual for her Field Audit Bureau ("Nexus Position") (L.F. 38; Ex. 15; Ex. 18, pp. 60-67; Ex. 20, pp. 25-30). Prior to the publication of the Nexus Position, the Director did not tax the royalty income of out-of-state patent licensors based upon the use of patents by a related licensee to manufacture products outside Missouri that were eventually sold to Missouri customers (Ex. 18, pp. 60-67; Ex. 20, pp. 25-30).

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[2] In subsequent calculations the Director submitted to the Commission, she corrected these calculations by, among other things, excluding from the multiplicand royalties received from the German licensee that made no sales to customers located in Missouri.

After the publication of the Nexus Position, the Director asserted the power to tax the royalty income of out-of-state patent licensors based upon the use of patents by a related licensee to manufacture products outside of Missouri that are eventually sold to Missouri customers. *Id*. However, even after the publication of the Nexus Position, the Director has not taxed similar income when the licensee is unrelated to the licensor (Ex. 18, pp. 29-32, 41-42; Ex. 20, pp. 19-20, 31-34).

Commission's Decision

In its Findings of Fact and Conclusions of Law dated January 3, 2002, the Commission concluded that Holdings had sufficient nexus under both the Commerce Clause and the Due Process Clause to permit Missouri taxation. Specifically, the Commission found that Holdings had nexus with Missouri under the Due Process Clause because Holdings "purposefully availed itself of the benefits of Missouri's economic market" based solely upon the fact that Holdings licensed its patents to Gore, and Gore utilized the patents to manufacture products outside of Missouri that were eventually sold by the licensee to Missouri customers (L.F. 44).

The Commission found that Holdings had nexus with Missouri under the Commerce Clause even though Holdings had no physical presence in Missouri because the Commerce Clause's physical presence requirement, in the Commission's opinion, applies only to sales and use taxes (L.F. 45). The Commission stated:

> "Income tax is different because intangibles, such as those at issue here, may earn income in the taxing state, even though their owner has no physical presence in that state. As noted in Michael T. Fatale, *State Jurisdiction and the Mythical 'Physical Presence' Constitutional Standard*, 54 Tax Lawyer 105, 107 (Fall 2000), 'a corporation though designated as a

> "person" for purposes of various legal requirements including tax filings, is a mere legal construct that is not in fact present anywhere.'" (L.F. 45).[3]

The Commission further concluded that the deficiency assessed against Holdings did not violate the Equal Protection Clause or the Uniformity Clause (L.F. 52). Despite the admission in the Director's deposition that the Director has not taxed similar income when the licensee is unrelated to the licensor (Ex. 18, pp. 29-32, 41-42), the Commission concluded that:

> "Holdings argues that the Director attempts to tax out-of-state corporations that transfer the right to use trademarks and patents to related corporations in Missouri while not taxing out-of-state corporations that transfer the right to use trademarks and patents to unrelated corporations. However, there is no evidence that this is the Director's position. On the contrary, the evidence establishes that the Director would treat royalty income the same way regardless of whether the patents were transferred to a related corporation" (L.F. 52).

With respect to apportionment, the Commission stated that the property factor should be eliminated in apportioning Holdings' income because it "was minimal in relation to [Holdings'] huge royalty income" (L.F. 53).

As for the sales factor, the Commission noted Holdings' argument that "the manufacture of the products triggered the obligations to pay patent royalties under the licensing agreement, even though the royalties are measured by sales" (L.F. 54). Nonetheless, the Commission held that "attributing the

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[3] Michael T. Fatale is a tax attorney employed by the Massachusetts Department of Revenue.

income to the state where the products were sold, thus generating royalty income, is an equitable method of apportionment" (L.F. 54).

The Commission concluded that its decision would apply retrospectively because the deficiency the Director assessed against Holdings was not contrary to the Director's prior policy even though the Director's current policy was precipitated by the South

Carolina Supreme Court's decision in *Geoffrey v. South Carolina*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993):

> "Before the Director began taxing royalty holding companies after *Geoffrey*, the Director did not have a policy regarding such because it was a non-issue. The Director's decision to pursue collections under the reasoning of *Geoffrey* was not a change in the Director's policy, but simply an awareness, that was not there before, that there was a new issue possibly resulting in tax liability." (L.F. 55).

STATEMENT OF THE ISSUES

Section 143.431 imposes the Missouri income tax upon Missouri source income. Income is from Missouri sources only "if the Missouri effort is among the efficient causes which contribute directly to the production of income." *Wohl Shoe Co. v. Director of Revenue*, 771 S.W.2d 339, 342 (Mo. banc 1989). Gore became obligated to pay royalties upon the manufacture of products. None of Gore's products, some of which were eventually sold to Missouri customers, were manufactured within Missouri. Does Holdings' receipt of royalty income from the manufacture of products by Gore outside of Missouri constitute Missouri source income?

The Commerce Clause authorizes Congress "to regulate Commerce with foreign Nations, and among the several States." In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the United States Supreme Court held that a taxpayer must have physical presence within a State to be subject to sales and use taxes. Holdings does not have a physical presence in Missouri. Can Missouri subject Holdings to Missouri income tax consistent with the Commerce Clause?

The Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-45 (1954). In *Asahi Metal Industry Co., Ltd. v. Superior Court of California, Solano County*, 480 U.S. 102, 112 (1987), the United States Supreme Court held that:

> "[A] defendant's awareness that the stream of commerce may or will sweep the product into the forum state does not convert the mere act of placing the product into the stream into an act purposefully directed toward the forum state."

The Commission concluded that the assessment of Missouri income tax upon Holdings is consistent with the Due Process Clause because Holdings, even though it had no presence, physical or otherwise, in Missouri, licensed its patents to manufacturers outside Missouri, and those manufacturers produced products, some of which were ultimately sold by the manufacturer to Missouri customers. Is the imposition of Missouri income tax upon Holdings consistent with the Due Process Clause?

The Uniformity Clause requires that all taxes "shall be uniform upon the same class or subclass of subjects within the territorial limits of the authority levying the tax." The Director imposed Missouri income tax upon Holdings based upon the licensing of Holdings' patents to a licensee that manufactures products outside Missouri that are eventually sold to Missouri customers. The Director's designee acknowledged that he was unaware of any instance where the Director taxed similar income when the licensee was unrelated to the licensor. Does the imposition of Missouri income tax upon Holdings violate the Uniformity Clause?

Assuming, *arguendo*, that the Director may constitutionally subject Holdings to Missouri income tax, its income is to be apportioned using the three-factor method of apportionment. Section 32.200, art. IV, § 17, states that in determining the sales factor for sales other than of personal property, sales are within Missouri only if the greater proportion of the income-producing activities is performed in Missouri. Gore became obligated to pay royalties to Holdings upon the manufacture of Gore's products. None of Gore's products that were eventually sold to Missouri customers were manufactured in Missouri. Does Holdings' receipt of royalty income constitute income from Missouri sales within the meaning of section 32.200, art. IV, § 9?

Section 32.200, art. IV, § 9, requires the use of all three statutory factors in apportioning income. The Commission excluded the property factor in apportioning Holdings' income because its

property was "minimal" in comparison to Holdings' royalty income. May the Commission exclude statutory factors of the three-factor method of apportionment consistent with section 32.200, art. IV, § 9?

Section 143.903 prohibits the Director from assessing tax if a decision upholding such assessment would not have been expected by a reasonable person based on prior law or prior policy of the Director. Likewise, section 32.053 states that any final decision of the Director that is a result of a change in policy or interpretation by the Director effecting a particular class of person subject to such decision may be applied prospectively only. Prior to the publication of the Director's Nexus Position, the Director did not attempt to tax the royalty income of out-of-state licensors based upon the license of patents by a licensee to manufacture products outside Missouri that are eventually sold in Missouri. The Nexus Position reversed that policy. With publication of the Nexus Position, the Director asserted the power to assess Missouri income tax upon the royalty income of Holdings, an out-of-state licensor, based upon its receipt of royalty income from Gore for its license of Holdings' patents to manufacture products outside of Missouri, some of which were eventually sold to Missouri customers for periods prior to her publication of the Nexus Position. Is the Director's assessment permissible under sections 143.903 and 32.053?

STANDARD OF REVIEW

The decision of the Commission is to be upheld: (1) if it is authorized by law; (2) if it is supported by competent and substantial evidence upon the whole record; (3) if no mandatory procedural safeguards are violated; and (4) where the Commission has discretion, if it exercises that discretion in a way that is not clearly contrary to the Legislature's reasonable expectations. Section 621.193; *Concord Publishing House, Inc. v. Director of Revenue*, 916 S.W.2d 186 (Mo. banc 1996). The first two standards are at issue before this Court.

Furthermore, sections 143.431.1; 32.200, art. IV, § 18; 143.903; and 32.053 are all taxing statutes. Taxing statutes are construed against the Director, and if the right to tax is not plainly conferred by statute, it will not be extended by implication. *United Air Lines, Inc. v. State Tax Comm'n*, 377 S.W.2d 444, 448 (Mo. banc 1964), *quoting Leavell v. Blades*, 141 S.W. 893, 894 (Mo. 1911) ("When the tax gatherer puts his finger on the citizen, he must also put his finger on the law permitting it.").

Finally, this Court's interpretation of Missouri's revenue laws is *de novo*. *Zip Mail Services, Inc. v. Director of Revenue*, 16 S.W.3d 588, 590 (Mo. banc 2000).

POINTS RELIED ON

I. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT HOLDINGS DOES NOT HAVE MISSOURI SOURCE INCOME UNDER SECTION 143.431 BECAUSE HOLDINGS' ROYALTY INCOME WAS NOT DERIVED FROM THE USE OF ITS, OR ANYONE ELSE'S, EFFORTS IN MISSOURI.

Dow Chemical Company, Inc. v. Director of Revenue, 834 S.W.2d 742 (Mo. banc 1992);

Dow Chemical Co. v. Director of Revenue, 787 S.W.2d 276 (Mo. banc 1990);

Goldberg v. State Tax Commission, 639 S.W.2d 796 (Mo. banc 1982);

Medicine Shoppe International, Inc. v. Director of Revenue, Case Number 83888 (Mo. banc 2002);

Section 32.200 art. III, RSMo;

Section 32.200 art. III, § 1, RSMo;

Section 32.200 art. IV, RSMo;

Section 32.200 art. IV, § 2, RSMo;

Section 143.431, RSMo;

Section 143.431.1, RSMo;

Section 143.451, RSMo;

Section 143.451.1, RSMo;

Section 621.189, RSMo;

Section 621.193, RSMo;

Interstate Income Law, 15 U.S.C. § 381.

II. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT THE IMPOSITION OF MISSOURI INCOME TAX UPON APPELLANT IS NOT PERMITTED BY SECTION 143.441.2(5) BECAUSE HOLDINGS DOES NOT HAVE A SUFFICIENT NEXUS WITH MISSOURI, CONSISTENT WITH THE COMMERCE CLAUSE, THAT WOULD PERMIT MISSOURI TO IMPOSE INCOME TAXES UPON APPELLANT BECAUSE HOLDINGS HAS NO PHYSICAL PRESENCE IN MISSOURI.

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977);

Quill Corp. v. North Dakota, 504 U.S. 298 (1992);

Red Wing Shoe Co. v. Hockerson-Halberstadt, Inc., 148 F.3d 1355 (Fed. Cir. 1998);

J.C. Penney National Bank v. Johnson, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied,* 531 U.S. 927 (2000);

Section 143.071, RSMo;

Section 143.431, RSMo;

Section 143.441.2, RSMo;

Section 143.441.2(5), RSMo;

Section 621.189, RSMo;

Section 621.193, RSMo;

N.M.R. App. P. 12-502;

RESTATEMENT (SECOND) OF AGENCY § 12;

U.S. Const. art. I, § 8.

III. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT THE IMPOSITION OF MISSOURI INCOME TAX UPON APPELLANT IS NOT PERMITTED BY SECTION 143.441.2(5) AND THE DUE PROCESS CLAUSE SINCE APPELLANT HAS NOT AVAILED ITSELF OF THE PROTECTIONS OF MISSOURI LAW AND MISSOURI PROVIDES NO BENEFITS TO APPELLANT.

Asahi Metal Industry Co., Ltd. v. Superior Court of California, Solano County, 480 U.S. 102 (1987);

World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286 (1980);

Red Wing Shoe Co. v. Hockerson-Haberstadt, Inc., 148 F.3d 1355 (Fed. Cir. 1998);

Quill v. North Dakota, 504 U.S. 298 (1992);

Section 143.071, RSMo;

Section 143.431, RSMo;

Section 143.431.1, RSMo;

Section 143.441.2, RSMo;

Section 143.441.2(5), RSMo;

Section 621.189, RSMo;

Section 621.193, RSMo.

IV. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT THE EQUAL PROTECTION CLAUSE AND UNIFORMITY CLAUSE PROHIBIT THE IMPOSITION OF MISSOURI INCOME TAX ON ROYALTY INCOME RECEIVED BY A TAXPAYER HAVING NO PHYSICAL PRESENCE IN MISSOURI FROM A LICENSEE RELATED TO THE TAXPAYER WHEN NO SUCH IMPOSITION IS MADE UPON A LIKE TAXPAYER ON ROYALTY INCOME RECEIVED FROM UNRELATED LICENSEES.

Exxon Corp. v. Eagerton, 462 U.S. 176 (1983);

Schnorbus v. Director of Revenue, 790 S.W.2d 241 (Mo. banc 1990);

U.S. Const. amend. XIV, § 1;

Mo. Const. art. X, § 3;

Section 621.189, RSMo;

Section 621.193, RSMo;

Mo. R. Civ. P. 57.03(b)(4).

V. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT THE SALES OF ANOTHER TAXPAYER MAY NOT BE TREATED AS APPELLANT'S SALES UNDER SECTION 32.200, ART. IV, § 17.

Section 32.200;

Section 32.200 art. IV, § 9;

Section 32.200 art. IV, § 17;

Section 621.189, RSMo;

Section 621.193, RSMo;

12 CSR 10-2.075(56).

VI. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT UNDER SECTION 32.200, ART. IV, § 18, NEITHER THE DIRECTOR NOR THE COMMISSION IS FREE TO EXCLUDE THE PROPERTY FACTOR IN APPORTIONING THE INCOME OF TAXPAYERS HAVING NO OR SMALL AMOUNTS OF PROPERTY OWNERSHIP.

Rentco Trailer Corporation v. Director of Revenue, Case Number 97-1373RI (Mo. Admin. Hrg. Comm. 1998);

Section 32.200 art. IV § 18, RSMo;

Section 621.189, RSMo;

Section 621.193, RSMo.

VII. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT THE IMPOSITION OF MISSOURI INCOME TAX UPON APPELLANT CONSTITUTES A CHANGE FROM "PREVIOUS POLICY" AS THAT PHRASE IS USED IN SECTION 143.903 AND CONSTITUTES A "CHANGE IN POLICY OR INTERPRETATION" WITHIN THE MEANING OF SECTION 32.053 AND, ACCORDINGLY, THAT POLICY SHOULD NOT APPLY RETROACTIVELY.

Laciny Brothers, Inc. v. Director of Revenue, 869 S.W.2d 761 (Mo. banc 1994);

Lloyd v. Director of Revenue, 851 S.W.2d 519 (Mo. banc 1993);

Section 32.053, RSMo;

Section 32.200, RSMo;

Section 143.903, RSMo;

Section 621.189, RSMo;

Section 621.193, RSMo.

ARGUMENT

I. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT HOLDINGS DOES NOT HAVE MISSOURI SOURCE INCOME UNDER SECTION 143.431 BECAUSE HOLDINGS' ROYALTY INCOME WAS NOT DERIVED FROM THE USE OF ITS, OR ANYONE ELSE'S, EFFORTS IN MISSOURI.

The Missouri income tax is imposed upon so much of a corporation's federal taxable income "as is derived from Missouri sources." Section 143.431. Here, the Director seeks to tax certain of Holdings' royalty income and thus the focus in this case is entirely upon that stream of income. Because Holdings' royalty income is not from Missouri sources, it is not subject to Missouri income tax.

This Court has been called upon several times to determine whether income is "Missouri source income." In *J.C. Nichols Company v. Director of Revenue*, 796 S.W.2d 16, 17-18 (Mo. banc 1990), this Court stated the general proposition that "[t]he source of income 'is the place where it was produced.'" (citing *In re Kansas City Star Company*, 142 S.W.2d 1029, 1037 (Mo. banc 1940)). In *Wohl Shoe Co. v. Director of Revenue*, 771 S.W.2d 339, 342 (Mo. banc 1989), this Court determined that income was subject to Missouri tax "if the Missouri effort is among the efficient causes which contribute directly to the production of income." Recently, in *Medicine Shoppe International, Inc. v. Director of Revenue*, Case Number 83888 (Mo. banc 2002), this Court

succinctly stated the Missouri source income standard: "[t]he basic requirement is that there be some activity in [Missouri] that justifies imposing the tax."

Missouri's source of income requirement is consistent with the constitutional requirements for taxation of income. This Court explained that principle in *Dow Chemical Company, Inc. v. Director of Revenue*, 834 S.W.2d 742, 747 (Mo. banc 1992) ("*Dow II*"): "[the Court's decision in *Dow Chemical Co. v. Director of Revenue*, 787 S.W.2d 276 (Mo. banc 1990) ("*Dow I*")] infuses [section] 143.431 with the grounding of principle that validates the compact apportionment formula as a device of constitutional state taxation of interstate activity."

Regardless of how Missouri source income from interstate transactions is calculated (using the single-factor apportionment formula of section 143.451 or the three-factor formula of the Multistate Tax Compact ("Compact"), section 32.200, arts. III and IV), a corporation must have some income derived from Missouri sources (i.e. activity in Missouri that is productive of its income) or it is not subject to Missouri income tax. Section 143.431.1; section 143.451.1; section 32.200, art. III, § 1 and art. IV, § 2; *Goldberg v. State Tax Commission*, 639 S.W.2d 796, 802-03 (Mo. banc 1982); *Dow II*, 834 S.W.2d at 745-46.

Under the Multistate Tax Compact, section 32.200, art. III, § 1, income tax is due "pursuant to the laws of [Missouri,]" thus incorporating section 143.431.1's requirement that income be "sourced" to Missouri. Also, art. IV, § 2, provides that "[a]ny taxpayer having income from business activity which is taxable both within and without [Missouri] . . . shall allocate and apportion his net income as provided in this article." Although a unitary business is not required under Missouri's source of income requirement, that source of income requirement is entirely consistent with the unitary business concept that is the "linchpin" of apportionability of multistate income under the Compact. *Dow II*, 834 S.W.2d

at 746. There, this Court stated that "in the context of an apportionment under [the C]ompact . . . *in pari materia* with [section] 143.431, ***so much of the federal taxable income as is derived from sources in Missouri*** means 'so much of the value of the business income of the unitary business activity of the multistate enterprise as can fairly be attributed to the taxpayer's activities in Missouri.'"[4]

Holdings' royalty income derives from the License Agreement between Holdings and Gore that was negotiated and executed entirely outside of Missouri. Under the License Agreement, Gore became obligated to pay the royalties by its manufacture of products using Holdings' patents. The amount of the royalty under the License Agreement was based upon a percentage of Gore's sales price of the manufactured products (although it could have been determined any number of ways unrelated to any sales price). It is an undisputed fact that Gore did not engage in any of that manufacturing in Missouri. All of the products that Gore sold to customers located in Missouri were manufactured ***outside of Missouri with Gore's*** license of Holdings' patents.

Holdings' royalty income is not Missouri source income because Holdings engaged in no activity nor used any effort in Missouri to produce it. The royalty income was derived by Holdings from its licensing transaction with Gore, a transaction consummated entirely outside of Missouri by people having no connection to Missouri.

The Director attempts to impose Missouri income tax on Holdings based not upon any activity of Holdings, but, rather, on activity of Holdings' licensee, Gore, who sold to Gore's Missouri customers some of the products manufactured by Gore under Holdings' patents. The Director reasons that

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[4] Emphasis added here and throughout, unless otherwise noted.

Gore's sales to Missouri customers are sufficient, unto themselves, to allow the Director to characterize Holdings' royalty receipts as Missouri source income. But for the fact that Holdings' royalties were computed using Gore's sales, some of which were to Missouri customers, nothing remotely related to the licensing even took place in Missouri. Absolutely nothing that Holdings did to produce its royalty income was done in Missouri.

The weakness of the Director's attribution theory rests upon her failure to focus on Holdings' activity to determine Holdings' liability for tax. Under the source of income rules, the potential taxpayer, and not some other party, must be engaging in activity to produce income in Missouri. The Director disregards the undisputed fact that Holdings engaged in no activity in Missouri.[5]

Further, as explained above, the conduct the Director focuses on is ***Gore's sales of products to Missouri customers***. Thus, the Director attempts to tax Holdings solely on the fact that Gore sells to Missouri customers some of the products Gore manufactured with Holdings' patents. Yet, ***even if Holdings had directly engaged in the sale of those products***, the Director would be precluded as a matter of federal law from taxing Holdings. The federal Interstate Income Law, 15 U.S.C. § 381, prohibits a state from taxing a foreign corporation solely on the basis of sales it makes to customers within that state.[6] In effect, the Director seeks to attribute the activities of Gore to Holdings

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[5] As discussed in detail below under Point II, there is no legal basis to disregard Holding's separate corporate existence, nor is there any partnership or agency relationship between Holding and Gore.

[6] Title 15, section 381 provides that "[n]o State . . . shall have power to impose . . . a net income tax on the income derived within such State by any person from interstate commerce if the only business

in an attempt to subject Holdings to Missouri income tax, ***when those particular activities if engaged in directly by Holdings*** are an insufficient basis to subject Holdings to tax.

Missouri's tax statutes are to be given reasonable constructions, *Collins v. Director of Revenue*, 691 S.W.2d 246 (Mo. banc 1985), and strictly in favor of taxpayers. *United Air Lines, Inc. v. State Tax Comm'n*, 377 S.W.2d 444, 448 (Mo. banc 1964). Under the facts of this case, section 143.431.1 has been construed in a manner never intended by the legislature, a manner that is in fact absurd! The Director attempts to apply section 143.431.1 in a way that has staggering implications for all taxpayers doing business across state lines, particularly those taxpayers who deal in intangible property. Consider the author who is paid royalties by a publisher from the sale of a book, or a software writer paid royalties for the sale of its software, or an athlete receiving royalties from his endorsement of a product, or a television producer paid royalties by a network for the use of a program. The Director would subject all of those entities to Missouri income tax, ***even though they did nothing in Missouri***, simply because they did business with persons or entities that did business in Missouri. The legislature never could have reasonably expected such a result. Indeed, as this record clearly shows and the Commission acknowledged, these types of transactions had never been subjected to Missouri income tax before, and the Missouri legislature apparently never saw fit to tax these types of transactions (the Director has certainly referenced no legislative change as a basis for this profound

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activities within such State by or on behalf of such person during such taxable year are . . . the solicitation of orders by such person . . . in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State[.]"

change in Missouri taxation). It is within the sole province of the legislature to effect such a staggering change in Missouri income tax law and not within the province of ingenious tax collectors.

In short, none of Holdings' patent royalty income was Missouri source income. It is, therefore, not subject to Missouri income tax under section 143.431.1.

II. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT THE IMPOSITION OF MISSOURI INCOME TAX UPON APPELLANT IS NOT PERMITTED BY SECTION 143.441.2(5) BECAUSE HOLDINGS DOES NOT HAVE A SUFFICIENT NEXUS WITH MISSOURI, CONSISTENT WITH THE COMMERCE CLAUSE, THAT WOULD PERMIT MISSOURI TO IMPOSE INCOME TAXES UPON APPELLANT BECAUSE HOLDINGS HAS NO PHYSICAL PRESENCE IN MISSOURI.

A. Introduction

Section 143.431 imposes the Missouri income tax on corporations upon so much of their federal taxable income as is derived from Missouri sources. As explained above, the royalty income at issue is not Missouri source income and is, therefore, not subject to Missouri income tax. However, even if it were Missouri source income, it would be exempt from Missouri income tax anyway. Section 143.441.2 states:

> "The tax on corporations provided in subsection 1 of section 143.431 and section 143.071 shall not apply to:
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> * * *
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> (5) Any other corporation that is exempt from Missouri income taxation under the laws of Missouri or the laws of the United States.

In other words, Missouri statutes expressly prohibit the Director from taxing any corporation, including those doing business in Missouri, if that corporation is exempt from Missouri income taxation under United States law. Appellant does no business in Missouri, but even if it did, the Director's Assessment is invalid because the Director is precluded from imposing the tax by United States law.[7]

The Commerce Clause, Article I, Section 8 of the United States Constitution, authorizes Congress to "regulate Commerce with foreign Nations, and among the several States." Although the Commerce Clause does not expressly provide for the protection of interstate commerce in the absence of action by Congress, the United States Supreme Court has consistently stated that the "dormant" aspect of the Commerce Clause "by its own force" prohibits certain State actions that interfere with interstate commerce. *See, e.g., South Carolina State Highway Department v. Barnwell Brothers, Inc.*, 303 U.S. 177 (1938).

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), the United States Supreme Court evaluated a Commerce Clause challenge to a Mississippi sales tax directed against automobiles manufactured out-of-state. The Court developed a four-part test to examine the Commerce Clause dispute that assesses:

(i) whether the tax is applied to an interstate activity with a ***substantial nexus*** with the taxing state;

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[7] The Court, of course, should avoid constitutional adjudications when the case may be decided on statutory grounds. *See, e.g., State ex rel. Union Elec. v. Public Serv. Comm'n*, 687 S.W.2d 162, 165 (Mo. banc 1985). This maxim compels that section 143.431 should be construed as argued in Point I, *ante* to avoid a constitutional confrontation.

(ii) whether the tax is fairly apportioned;

(iii) whether it discriminates against interstate commerce; and

(iv) whether it is fairly related to the services provided by the state. *Id*. at 279.

This Court has held that the *Brady* factors are equally applied to a determination of the taxability of the income from the interstate operations of a foreign corporation. *Amway Corp. v. Director of Revenue*, 794 S.W.2d 666, 671 (Mo. banc 1990). The issue in this case is whether Holdings has a ***substantial nexus*** with Missouri satisfying the Commerce Clause.

The United States Supreme Court's most recent discussion of the requirements of the Commerce Clause regarding the taxation of out-of-state vendors is *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). In *Quill*, the Court prohibited North Dakota from imposing a use tax collection duty on out-of-state mail order businesses. The North Dakota Supreme Court, which had permitted the imposition of use tax collection duties upon the taxpayer, based its decision on a determination that the evolution of Commerce Clause jurisprudence signaled a "retreat from the formalistic constrictions of a stringent physical presence test in favor of a more flexible substantive approach." *Id*. at 314, *citing* 470 N.W.2d 203, 214 (N.D. 1991). Specifically, the North Dakota court stated that the precedents of the United States Supreme Court had signaled a retreat from *National Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753 (1967). In *Bellas Hess*, the Court held that a State could not constitutionally impose a sales tax upon out-of-state vendors having no physical presence in the State, even though the vendor used the United States Postal System to deliver catalogs into the State and used the Postal System or a common carrier to deliver their products.

In *Quill*, the Supreme Court flatly rejected the reasoning of the North Dakota Supreme Court. The United States Supreme Court stated that it had never intimated a desire to reject "bright-line" tests in all instances, and reinforced the bright-line rule of *Bellas Hess*:

> "Like other bright-line tests, the *Bellas Hess* rule appears artificial at its edges: Whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant or office. ***This artificiality, however, is more than offset by the benefits of a clear rule***. Such a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes. This benefit is important, for as we have so frequently noted, our law in this area is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation.'" *Id*. at 315-16 (citations omitted).

The Court continued:

> "In sum, although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes. To the contrary, the continuing value of a bright-line rule in this area and the doctrine

> and principles of *stare decisis* indicate that the *Bellas Hess* rule remains good law.
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> "This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions." *Id*. at 317-18.

In short, the Court, while noting that Congress has the power to modify the standard, stated in *Quill* that ***in the absence of physical presence of a taxpayer in the State, the taxpayer does not have substantial nexus*** for purposes of the Commerce Clause. Significantly, Congress has not modified this standard in the decade since the Court's decision in *Quill*.

B. The Commission's Attempts to Avoid the Commerce Clause are Unavailing.

The Director conceded at trial that Holdings had no physical presence in Missouri (Tr. 224-25).[8] That should be the end of the matter, compelling a conclusion that the Director may not constitutionally tax Holdings. But the Commission held that notwithstanding the lack of physical

[8] This concession is consistent with the Court's decision in *Quill*, in which the Court noted that the existence of floppy diskettes owned by Quill in North Dakota did not constitute its physical presence in North Dakota. Holdings does not have even minimal amounts of property in Missouri since its patents have no connection with Missouri.

presence, the Director could impose taxes upon Holdings. Because none of the reasons advanced by the Commission passes constitutional muster, each should be rejected by this Court.

1. The Commerce Clause Requires Physical Presence for the Imposition of Income Tax.

The Commission concluded that, while the Commerce Clause requires physical presence for the imposition of sales and use taxes, no physical presence was required for the imposition of income taxes. This position cannot be reconciled with the Supreme Court's language in *Quill* interpreting the Commerce Clause.

In *Quill*, the Court stated:

> "First, as the state court itself noted, 470 N.W.2d at 214, all of these cases involved taxpayers who had a physical presence in the taxing State and therefore do not directly conflict with the rule of *Bellas Hess* or compel that it be overruled. Second, and more importantly, although our Commerce Clause jurisprudence now favors more flexible balancing analyses, we have never intimated a desire to reject all 'bright-line' tests. Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule." *Id.* at 314.

The Director's primary authority (and the one that precipitated her change in policy) is *Geoffrey v. South Carolina*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993). The Director's reliance on Geoffrey is misplaced. There, the South Carolina Supreme Court held that physical presence is not required to establish nexus in an income tax case. Geoffrey received royalties from Toys R Us, Inc., for the use of various trademarks and trade names owned by Geoffrey. In upholding the assessment on Geoffrey's trademark and trade name royalty income, the court

erroneously paraphrased the language of *Quill*, above, as stating that "the physical presence requirement has not been extended to other types of taxes." *Id*. at 23, n.4. The *Geoffrey* court continued, "The presence of intangible property alone is sufficient to establish nexus." *Id.* at 23. The Court emphasized that the presence of accounts receivable, as well as Geoffrey's trademarks, were sufficient to satisfy the nexus requirements of the Commerce Clause. Thus, *Geoffrey* is not only inconsistent with *Quill*, and therefore wrong, but is distinguishable on its facts.

In contrast to Geoffrey, Holdings licenses patents; it does not own, much less license, trademarks and trade names, which are significantly different intangible property. Holdings has no accounts receivable in Missouri. Its licensees' obligation to pay royalties, as described below, is always triggered by the manufacture of products, an event that never occurs in Missouri. Thus, Holdings does not even have the "intangible presence" relied upon in *Geoffrey* to support the assessment of taxes.

Furthermore, Holdings is not a franchiser; it merely licenses its patents. In *Geoffrey*, the Toys 'R' Us giraffe (which was licensed for use in South Carolina) provided a clear visual presence in South Carolina. In this case, Holdings patents had absolutely no presence in Missouri—physical or visual—because the patents were not used in Missouri. In fact, only some of the products manufactured with Holdings' patents eventually found their way into Missouri. Even assuming, *arguendo*, the validity of the constitutional analysis in *Geoffrey*, the Commission's reliance on it is misplaced because of the significant factual distinction between the two cases.

Under a misreading of *Geoffrey* and in spite of facts entirely distinguishable from those of this case, the Commission has taken an already controversial decision in *Geoffrey* and expanded it. The Commission would tax all corporations whose customers' customers do business in Missouri and derive any benefit from Missouri. Under the Commission's analysis, a French winery would be subject to

Missouri income tax because its wholesale customer imports the French winery's wine and sells the same to Missouri customers. Such an expansive interpretation of constitutional nexus is contrary to the very purpose of the commerce clause.

The other authorities cited by the Commission likewise provide no support for its decision. First, its citation of *Borden Chemicals and Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (Ill. App. 2000), for the proposition that physical presence is not required for income tax cases is unavailing because the Illinois Court of Appeals' statement was mere *dictum* inasmuch as the court concluded that the plaintiff was physically present in Illinois.

Second, the Commission cited the slip opinion of the New Mexico Court of Appeals in *Kmart Properties, Inc. v. Taxation and Revenue Department*, Number 21,140 (November 27, 2001). In *Kmart*, the intermediate appellate court concluded that an out-of-state corporation owning trademarks and trade names that were licensed to another corporation for use in New Mexico was subject to New Mexico income tax. This decision is of no avail to the Director for at least two reasons. First, like *Geoffrey*, the *Kmart* decision is factually distinguishable. Holdings does not own, much less license, trademarks and trade names, and its royalty income is triggered by the manufacture of goods wholly outside the subject state. Also, the New Mexico Supreme Court, pursuant to New Mexico Rule of Appellate Procedure 12-502, granted Kmart's petition for writ of certiorari, and has ordered the Court of Appeals to refrain from taking any action to publish its decision. The *Kmart* opinion is, therefore, currently in legal limbo and is not authority for anything. A copy of the Writ of Certiorari is attached as Appendix A.

As evidenced by the dearth of authority cited in *Geoffrey*, *Borden*, and *Kmart*, the Commerce Clause itself does not articulate differing standards for different types of taxes. Instead, it

states that Congress has the power to "regulate Commerce with foreign Nations, and among the several States." Neither the Director nor the Commission offered any logical reason to extrapolate from the Commerce Clause a distinction between different types of taxes on interstate commerce.

The Commission, in attempting to distinguish sales/use taxes from income taxes, stated:

> "Income tax is different because intangibles, such as those at issue here, may earn income in the taxing state, even though their owner has no physical presence in that state. As noted in Michael T. Fatale, *State Tax Jurisdiction and the Mythical "Physical Presence" Constitutional Standard*, 54 Tax Lawyer 105, 107 (Fall 2000), 'a corporation though designated as a "person" for purposes of various legal requirements including tax filings, is a mere legal construct that is not in fact present anywhere.' We do not countenance the use of a mere legal construct to shelter income from taxation in the state from whose revenue stream the income was derived, as the Supreme Court has plainly ruled that physical presence is not required." (L.F. 45-46).[9]

Neither the Commission nor Fatale, the Massachusetts revenue attorney the Commission cited for authority, attempted to explain any policy rationale for distinguishing income taxes from sales and use

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[9] The Commission's citation of the arguments of Massachusetts Revenue Department attorney Fatale is indeed ironic in light of its exclusion at the hearing of the testimony (Ex. 6) of Holdings' witness on this issue, Professor Pomp of the University of Connecticut. Unlike the biased opinions of the Director's lawyer's counterpart in Massachusetts, Professor Pomp's opinions are that of an academician and tax scholar.

taxes for purposes of the Commerce Clause. Contrary to their insinuations, the United States Supreme Court has stated that direct taxes impose greater burdens on interstate commerce than sales and use taxes. *National Geographic Society v. California Board of Equalization*, 430 U.S. 551, 560 (1977). Therefore, to the extent the two types of taxes are properly distinguishable, the Commerce Clause should impose ***greater*** barriers for the imposition of direct income taxes than for the imposition of sales and use taxes.

The Commission also failed to square Fatale's statement that a corporation may not be present anywhere with the numerous decisions of the United States Supreme Court determining the presence of corporate entities for purposes of personal jurisdiction and Commerce Clause litigation.

The Commission did not consider or discuss decisions of various state tribunals that have rejected the Commission's rationale. For example, in *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000), a Tennessee appeals court rejected the revenue authority's attempt to apply its net income tax upon a corporation managing thousands of credit card accounts and deriving fees from Tennessee residents. The Tennessee revenue authority maintained that the Commerce clause required no physical presence for imposing franchise and excise taxes and, alternatively, that the presence of the corporation's credit cards and affiliated companies in Tennessee constituted the corporation's physical presence there. The Tennessee court disagreed. First, it concluded that a physical presence was required. *Id*. at 839. Second, it concluded that the presence of the credit cards, which represented the corporation's intangible credit accounts (and a level of economic presence much greater than anything Holdings' has in Missouri), did not constitute physical presence. *Id*. at 840. Last, it concluded that the presence of retail J.C. Penney stores of a related company was insufficient to establish physical presence. *Id*. at 842-43. Therefore,

consistent with *Quill*, the court ruled that the imposition of Tennessee income tax was unconstitutional. *Id.*

The Tennessee court's decision is not unique in its rejection of the Director's argument for dismissal of a physical presence requirement under the Commerce Clause. *See, e.g., Syl, Inc. v. Comptroller*, Case Number C-96-0154-01 at 6 (Md. Tax Ct. 1999) ("*Geoffrey* focused on the use of the marks by the in-state affiliate of the unitary group in order to determine the nexus of the foreign corporation. We disagree that that activity constitutes substantial nexus."); *Cerro Copper Products, Inc. v. Alabama*, Docket Number F94-444 (Ala. Dept. Rev. 1995) ("I disagree with *Geoffrey's* Commerce Clause analysis concerning intangibles. Specifically, I disagree that receivables generated by a non-resident taxpayer's activities in a state are necessarily 'located' in that state. I also disagree that the 'use' or 'presence' of intangibles in a state is, by itself and without some physical presence, sufficient to establish 'substantial nexus' for Commerce Clause purposes.").

The Commission also ignored the conclusions of the hearing officer in the unpublished *Kmart* decision:

> "I concur with KPI's arguments that I can find ***no principled basis to distinguish between sales and use taxes, and income taxes under the Commerce Clause***…. On this basis, I disagree with the portion of the South Carolina Supreme Court's decision in *Geoffrey*, which upheld the imposition of an income tax, under facts nearly identical to this case … on the basis that the Commerce Clause physical presence requirement announced in

Quill, was limited to sales and use taxes." Number 01-287446-00-6 at 23, n. 10 (N.M. Tax Dept. 2000).

In summary, there is no principled distinction between income taxes and sales/use taxes for purposes of the Commerce Clause. Therefore, the Commission's attempt to create such a distinction to avoid the physical presence requirement of the Commerce Clause must be rejected by this Court.

2. The Nexus of Holdings' Licensees May Not be Attributed to Holdings.

The Director argued below that the nexus of Gore, one of Holdings' licensees, could be attributed to Holdings. Although the Commission declined to reach this issue based upon its determination that the Commerce Clause's physical presence requirement does not apply to income taxes, the Commission made several findings of fact regarding the control of Gore and Holdings and stated, "[b]ecause Gore and Holdings were a unitary business and were functionally integrated, we could easily rule that Gore's business activity in Missouri may be attributed to Holdings and that physical presence is established" (L.F. 51). As discussed below, this line of reasoning is patently inconsistent with Missouri law.

Under Missouri law, even when the stock of one corporation is owned partly or wholly by another, the two separate corporations are to be regarded as distinct legal entities. *Central Cooling & Supply Co. v. Director of Revenue*, 648 S.W.2d 546, 547-48 (Mo. 1982). Corporations are not responsible for the acts of related entities. *See, e.g., Grease Monkey Int'l, Inc. v. Godat*, 916 S.W.2d 257, 262 (Mo. App. E.D. 1995); *Mitchell v. K.C. Stadium Concessions, Inc.*, 865 S.W.2d 779, 784 (Mo. App. W.D. 1993).

Although the Director's arguments before the Commission were somewhat opaque, she apparently urged that the above cited general rule did not apply to Holdings for three reasons: (1) Holdings and Gore were partners; (2) Holdings and Gore were alter egos; and/or (3) the License Agreement created some sort of joint venture. None of these theories is consistent with the facts in this case.

(a) Holdings and Gore were not partners.

The existence of a partnership is never presumed, and the burden is on the party asserting a partnership to prove by clear, cogent and convincing evidence that a partnership exists. *Morrison v. Labor and Industrial Relations Commission*, 23 S.W.3d 902 (Mo. App. W.D. 2000). A partnership consists of partners placing their money, efforts, labor and skill in lawful commerce and dividing the resulting profits and losses. *Id*. In this case, the record is clear that Holdings and Gore shared neither profits nor losses. Therefore, Holdings was not, and is not, Gore's partner.

(b) Gore was not Holdings' alter ego.

The Commission emphasized that Gore and Holdings had a commonality of officers and directors and constituted a functionally integrated unitary business in stating that it could "easily rule that Gore's business activity in Missouri may be attributed to Holdings to establish physical presence" (L.F. 51). The Commission did not cite any authority to justify using these facts to disregard Holdings' separate corporate status. Missouri law is clear that a corporation is an entity that is separate and apart from its stockholders. Mere ownership of all the stock of one corporation by another, and the common identity of officers with another, are not alone sufficient to create an identity of corporate interests between two companies. Rather, there must be such dominion and control that the controlled corporation has, so to speak, no separate mind, will or existence of its own. *Blackwell Printing Co.*

v. Blackwell-Wielandy Co., 440 S.W.2d 433, 437 (Mo. 1969); *Mid-Missouri Telephone Co. v. Alma Telephone Co.*, 18 S.W.3d 578, 582 (Mo. App. W.D. 2000). The evidence does not support any contention that Holdings was Gore's alter ego.

In *Collet v. American National Stores, Inc.*, 708 S.W.2d 273, 284 (Mo. App. E.D. 1986), the court noted that among the factors used to determine whether a subsidiary is the alter ego of its parents is whether the parent uses the subsidiary's property as its own and whether the directors of the subsidiary act independently in the interest of the subsidiary or take their orders from the parent corporation in the latter's interest. In this case, Holdings acted in its own, not Gore's, interests. Holdings licensed its patents to other, unrelated entities including Donaldson, a direct competitor of Gore (Tr. 72, 84). Holdings also dedicated a patent to the public, thereby allowing everyone to practice the patent and eliminating the monopoly that it and its licensees (including Gore) had enjoyed (Tr. 83). Additionally, Holdings frequently decided to abandon patents, or to refrain from enforcing or renewing patents, even though that conduct was not in the best interest of its licensees (including Gore) (Tr. 85-86). One of the business reasons for forming Holdings was to have an independent company to prevent "turf wars" between Gore divisions and for Holdings to become the "common enemy" of those divisions (Tr. 60-62). Under these circumstances, it is clear that Holdings is not the alter ego of Gore.

In an interesting twist, in *Central Cooling & Supply Co. v. Director of Revenue*, 648 S.W.2d 546 (Mo. 1982), the Director successfully argued for the separate corporate existence of two related corporations which were exchanging tangible personal property. This Court refused to disregard the separate corporate existence in upholding the assessment of sales and use tax on transactions between two related corporations. *Id.* at 547. This Court relied on *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438-39 (1943), which held:

> "The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal and undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."

This conclusion was followed in this Court's recent decision in *State ex rel., Ford Motor Company v. Bacon*, 63 S.W.3d 641 (Mo. banc 2002). In *Bacon*, a plaintiff attempted to maintain an action against Ford based upon the location of offices of Ford's subsidiary. In rejecting that theory, this Court concluded that there must an agency relationship before the Court will attribute the subsidiary's office to the parent, citing *State ex rel. Elson v. Koehr*, 856 S.W.2d 57, 60 (Mo. banc 1993) (applying the Restatement (Second) of Agency, section 12, to conclude that, among other things, the agent must hold the power to alter legal relationships between the principal and a third party). Gore did not have the authority to alter the legal relations between Holdings and any third parties, as demonstrated by the Holdings' licensing of its patents to Gore's competitor Donaldson.

The Director's arguments that the commonality between Gore and Holdings permit this Court to disregard their respective corporate statuses is inconsistent with Missouri law.

(c) The License Agreement Does Not Permit "Attributional Nexus."

The Commission disregarded the significant and undisputed testimony at trial that Gore's obligation to pay the royalties to Holdings was triggered by Gore's manufacture of products using Holdings' patents (Tr. 52, 78-79). Gore sold only products that it had previously manufactured using

Holdings' patents (Tr. 79). In every case, Gore's manufacture occurred outside of Missouri (Tr. 79). Therefore, the action that triggered the obligation to pay the royalty—the manufacture of products using Holdings' patents—occurred beyond Missouri borders.

Nonetheless, the Commission held that "Holdings does business in Missouri by licensing its intangible assets to generate royalty income from Missouri sales" (L.F. 41). In the first instance, the record does not support any conclusion that Gore's products "were sold in Missouri," although it is clear that Gore sold some products to Missouri customers (Tr. 91, 121). In any event, the Commission confused the ***obligation to pay a royalty*** with the ***method of computing the royalty***. The event obligating Gore to pay royalties to Holdings was the manufacture of products, and that occurred wholly outside of Missouri. The Commission's position, however, is that the Director may make assessments based upon the manner in which the parties calculated the royalty payment. Taking that position to its logical end, the Director would have no power to tax Holdings if its royalties were, as is frequently the case, paid in one fixed lump sum each year because the amount of the royalty would be totally unrelated to the amount of any sales made to customers in Missouri. Under that analysis, the license of patents to manufacture products outside of Missouri is not taxable in Missouri if the royalties are a set amount, but is taxable if the royalties are computed in reference to sales.

The Commission's treatment of licensing income is inconsistent with the law. "In simple terms, doing business with a company that does business in [Missouri] is not the same as doing business in [Missouri]." *Red Wing Shoe Co., Inc. v. Hockerson-Halberstadt, Inc.*, 148 F.3d 1355, 1361 (Fed. Cir. 1998). To hold otherwise would subject an entity to taxation in every state solely because it

decides to do business with a company that does business nationwide. *Id*. Because this basis for taxation does not satisfy the Commerce Clause, it must be rejected by this Court.

III. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT THE IMPOSITION OF MISSOURI INCOME TAX UPON APPELLANT IS NOT PERMITTED BY SECTION 143.441.2(5) AND THE DUE PROCESS CLAUSE SINCE APPELLANT HAS NOT AVAILED ITSELF OF THE PROTECTIONS OF MISSOURI LAW AND MISSOURI PROVIDES NO BENEFITS TO APPELLANT.

As stated above, section 143.431 imposes the Missouri income tax on corporations to the extent that their federal taxable income is derived from Missouri sources. However, even if Holdings had Missouri source income under section 143.431.1, which it does not, Missouri is still precluded from taxing Holdings' royalty income by virtue of section 143.441.2. It provides:

> "The tax on corporations provided in subsection 1 of section 143.431 and section 143.071 shall not apply to:
>
> * * *
>
> (5) Any other corporation that is exempt from Missouri income taxation under the laws of Missouri or the laws of the United States."

The Due Process Clause prohibits Missouri from taxing Holdings' royalty income. Therefore, Holdings is exempt from tax by section 143.441.2(5).

The Due Process Clause of the Fourteenth Amendment to the United States Constitution serves two related, but distinguishable, functions. It ensures fundamental fairness in governmental activity and

guarantees that the States do not reach out beyond the limits imposed upon them by their status as coequal sovereigns in a federal system. *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 291-92 (1980). The Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax," *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-45 (1954), and demands that the "income attributed to the State for tax purposes must be rationally related to values connected with the taxing State." *Moorman Manufacturing Co. v. Blair*, 437 U.S. 267, 273 (1978). In order to be subject to taxation under the Due Process Clause, therefore, a foreign corporation must purposefully avail itself of the benefits of an economic market in the forum State. *Burger King Corporation v. Rudzewicz*, 471 U.S. 462, 476 (1985).

The Commission afforded little deference to the Due Process Clause. The Commission stated:

> "We find taxation of Holdings wholly consistent with Due Process, as it has purposefully availed itself of the benefits of Missouri's economic market. Holdings licensed its patents to generate royalty income from Missouri and other states. Holdings then earned income from the sale of patented products in Missouri. We see nothing fundamentally unfair or that would offend notions of substantial justice in subjecting Holdings to Missouri income tax based on these contacts with Missouri" (L.F. 44).

The Commission said nothing else on the subject. The Commission cited no authority in support of its conclusion. The Commission ignored numerous United States Supreme Court rulings, as well as lower court decisions, dealing expressly with the licensing of patents.

In *Asahi Metal Industry Co., Ltd. v. Superior Court of California, Solano County*, 480 U.S. 102, 112 (1987), a plurality of the United States Supreme Court held that "[t]he placement of a product into the stream of commerce, without more, is not an act of the defendant purposefully directed toward the forum State." In *Asahi*, a California court asserted jurisdiction over Asahi, a Japanese manufacturer of tire valve stems, in a products liability suit after a motorcycle accident in California. Asahi sold the tire valve stems to a tire manufacturer in Taiwan who sold tires throughout the world. Even though Asahi was aware that some of its valves would be incorporated into tires eventually sold in California, the Supreme Court held that Asahi was not subject to personal jurisdiction in California courts because:

> "[A] defendant's awareness that the stream of commerce may or will sweep the product into the forum state does not convert the mere act of placing the product into the stream into an act purposefully directed toward the forum State." *Id*. at 112.

The conclusion in *Asahi* that foreseeability is insufficient to subject a corporation to personal jurisdiction under the Due Process Clause is consistent with the Court's prior rulings. *See, e.g., World-Wide Volkswagen*, 444 U.S. at 291-92 (seller of automobile in New York not subject to personal jurisdiction in Oklahoma after accident involving the automobile even though it was foreseeable that the car could be moved to Oklahoma); *American Oil Co. v. Neill*, 380 U.S. 451 (1965) (seller's knowledge that goods sold in Utah were destined for use in Idaho insufficient to permit Idaho to exercise personal jurisdiction).

Under Due Process clause analysis, there are parallels between the authority to subject a corporation to personal jurisdiction and the authority to impose a tax upon it. In *Quill Corp. v. North*

Dakota, 504 U.S. 298, 308 (1992), the United States Supreme Court stated that, even in the absence of physical presence, the taxpayer could be taxed under the Due Process Clause when it had engaged in continuous and widespread solicitation of business within the State by the use of catalogs such that the State provided benefits and protections to the taxpayer. This Court's tax decisions are in accord. *See Swift v. Director of Revenue*, 727 S.W.2d 880, 882 (Mo. banc 1987) (under the Due Process Clause, "[a]n income tax is justified only when contemporary benefits and protections are provided the subject property or entity during the relevant taxing period.").

In the present case, Missouri has provided no contemporary benefits or protections to Holdings. Because patents are exclusively within the domain of the United States Government, Missouri has provided no registration or regulation of Holdings' patents. Furthermore, Gore's manufacture of products with Holdings' patents occurs entirely outside of Missouri. The products were not Holdings'; they were Gore's. Holdings never solicited any business from Missouri customers by any means. Missouri has provided no benefits or protections to Holdings to entitle it to subject Holdings to tax. *See also James v. International Telephone & Telegraph Corp.*, 654 S.W.2d 865, 868 (Mo. banc 1983) (to satisfy the Due Process Clause, there must be a connection between the taxpayer and Missouri such that the taxpayer "avails itself of the substantial privilege of carrying on business" within Missouri).

The Commission's conclusion that the Due Process clause requirements are satisfied is not only contrary to numerous United States Supreme Court rulings, but also conflicts with two cases decided in the United States District Court of the Eastern District of Missouri: *BIB Manufacturing v. Dover Manufacturing Co.*, 804 F. Supp. 1129 (E.D. Mo. 1992), and *Aluminum Housewares Co., Inc. v. Chip Clip Corp.*, 609 F. Supp. 358 (E.D. Mo. 1984).

In *BIB*, the plaintiff argued that an out-of-state licensor was subject to Missouri jurisdiction consistent with the Due Process Clause based upon sales of products by its exclusive licensee in Missouri. The court rejected this argument and held it did not have jurisdiction over the out-of state licensor:

> "Lastly, BIB seeks to impute [licensee's] sales activities in Missouri to [licensor]. BIB cites no apposite authority for its argument that a ***licensing agreement between two non-resident defendants establishes the basis for long-arm jurisdiction over a defendant with only de minimis contacts with the jurisdiction***." 804 F. Supp. at 1133.

In *Aluminum Housewares*, 609 F. Supp. at 362, the court reached the same result: "Plaintiff cites no authority for its argument that a licensing agreement between two non-resident defendants establishes the basis for long-arm jurisdiction when one of the non-resident defendants has had no contact with the forum state."

In *Red Wing Shoe Co. v. Hockerson-Haberstadt, Inc.*, 148 F.3d 1355 (Fed. Cir. 1998), the court concluded that numerous licensees' activities afforded no basis upon which to rest personal jurisdiction over the licensor. Red Wing filed an action in United States District Court in Minnesota against Hockerson, a Louisiana corporation, seeking a declaration that Red Wing's production of sneakers did not infringe Hockerson's patents. Red Wing alleged that personal jurisdiction existed, because, among other things, Hockerson licensed its patents to thirty-four licensees who made sales in Minnesota:

> "Red Wing characterizes this as a '34-licensee distribution channel,' whereby [Hockerson] has 'deliberately created a system under which [it] reaps the benefits of foreseeable sales of patented products in Minnesota.' Under these circumstances, Red Wing argues, [Hockerson] has effectively 'deliver[ed] its products into the stream of commerce with the expectation that they will be purchased by consumers in the forum State.'" *Id*. at 1359.

The Court of Appeals for the Federal Circuit rejected this argument:

> "[Hockerson's] licensees have extensive contacts with Minnesota, but this additional factor is also insufficient to submit [Hockerson] to personal jurisdiction in this state. ***In simple terms, doing business with a company that does business in Minnesota is not the same as doing business in Minnesota.*** Indeed, as stated above, the Supreme Court has made clear that contacts resulting from 'the unilateral activity of another party or third person' are not attributable to a defendant. Red Wing's flawed theory would subject a defendant to nationwide personal jurisdiction if it decides to do business with a company that does business nationwide." *Id*. (citations omitted).

The Commission paid only lip service to the due process requirement. Under the Commission's reasoning, almost anybody would be subject to tax in Missouri under the due process clause because almost everybody and every entity does business with a person or entity that does business in Missouri and receives some benefit from Missouri. In conclusion, the Commission's unsupported *ipse dixit* that

the taxation of Holdings by the Director is consistent with due process and section 143.441.2(5) is incorrect.

IV. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT THE EQUAL PROTECTION CLAUSE AND UNIFORMITY CLAUSE PROHIBIT THE IMPOSITION OF MISSOURI INCOME TAX ON ROYALTY INCOME RECEIVED BY A TAXPAYER HAVING NO PHYSICAL PRESENCE IN MISSOURI FROM A LICENSEE RELATED TO THE TAXPAYER WHEN NO SUCH IMPOSITION IS MADE UPON A LIKE TAXPAYER ON ROYALTY INCOME RECEIVED FROM UNRELATED LICENSEES.

The Uniformity Clause of the Missouri Constitution requires that all taxes "shall be uniform upon the same class or subclass of subjects within the territorial limits of the authority levying the tax." Mo. Const. art X, § 3. While the power of the State to classify for purposes of taxation is broad, taxpayers must be classified on a reasonable basis. *Schnorbus v. Director of Revenue*, 790 S.W.2d 241, 242 (Mo. banc 1990). The validity of a state tax statute under the Equal Protection Clause (U.S. Const. amend. XIV, § 1) is determined under the rational basis standard. *Exxon Corp. v. Eagerton*, 462 U.S. 176, 195-96 (1983).

The taxation of an out-of-state patent licensor based upon the license of patents by a related licensee to manufacture products outside of Missouri that are eventually sold to Missouri customers violates the Uniformity and Equal Protection Clauses when the Director does not seek to tax the license income of an out-of-state patent licensor based upon the license of patents by an unrelated licensee under otherwise like circumstances. There is utterly no rational basis for such discrimination under the

law. The Commission did not dispute this legal conclusion. Instead, it said that "there is no evidence that this is the Director's position" (L.F. 52), a statement that is patently incorrect.

The Commission's factual finding is unsupported by competent and substantial evidence in the record. The Director, through her designee pursuant to Missouri Rule of Civil Procedure 57.03(b)(4), testified that, although there were numerous situations in which out-of-state licensors derive license income from products sold by its unrelated licensees in Missouri, she was unaware of any instance in which an assessment was made in that situation (Ex. 18, pp. 29-32, 41-42). This conclusion was amplified by the deposition of one of the Director's auditors, another designee of the Director, and who sits on the Director's Tax Policy Committee. He likewise stated that he was unaware of any situation in which the Director taxed income similar to Holdings' when the licensee was unrelated to the licensor (Ex. 20, p. 19-20, 31-34).

Accordingly, the Commission's statement that "the evidence establishes that the Director would treat royalty income the same way regardless of whether the patents were transferred to a related corporation" (L.F. 52) is contradicted by the Director's failure to assess similarly situated taxpayers. The Director's assessment against Holdings is, therefore, invalid because it is contrary to the Uniformity Clause and denies Holdings equal protection of the laws.

V. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT THE SALES OF ANOTHER TAXPAYER MAY NOT BE TREATED AS APPELLANT'S SALES UNDER SECTION 32.200, ART. IV, § 17.

The parties agreed that, to the extent the Director may constitutionally subject Holdings to Missouri income tax, Holdings tax liability was to be determined under the Multistate Tax Compact ("Compact") three-factor method of apportionment in determining Missouri source income (L.F. 52). Missouri adopted the Compact as codified by section 32.200. Article IV, section 9 of section 32.200 provides that "all business income shall be apportioned to this state multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three." Because Holdings' has no sales in Missouri, and because its property and payroll factors are likewise zero, Holdings has no Missouri source income.

In computing Holdings' Missouri taxable income, the Commission included ***Gore's*** sales of products in Missouri within the sales factor of ***Holdings***. This is inconsistent with section 32.200, art. IV, § 17, which provides that sales other than sales of tangible personal property are included in the numerator of the sales factor only if the majority of the income producing activity takes place in Missouri. The Director's Regulation 12 CSR 10-2.075(56) states that income-producing activities include the sale, licensing or other use of intangible personal property.

As stated above, the amount of the royalty received by Holdings' from Gore was ***calculated*** by using Gore's sales. It could have just as easily been ***calculated*** as a set dollar amount per year, totally unrelated to the licensee's sales. The obligation to pay the royalty in either case is triggered by the manufacture of products. Here, in every case, the licensees' manufacture of products under Holdings' patents took place outside of Missouri. Holdings did nothing in Missouri to produce its royalty income. Indeed, its licensees' activities related to the patents took place entirely outside of Missouri.[10] Because all of Holdings' income-producing activities took place outside of Missouri, the Commission's aggregation of Gore's sales into Holdings' sales factor was inappropriate.

[10] But for the fact that Gore and Holdings were related, Holdings would not likely even have access to the locations of Gore's customers and, therefore, would not even know where to file income tax returns, or how much to pay, under the Director's theory.

VI. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT UNDER SECTION 32.200, ART. IV, § 18, NEITHER THE DIRECTOR NOR THE COMMISSION IS FREE TO EXCLUDE THE PROPERTY FACTOR IN APPORTIONING THE INCOME OF TAXPAYERS HAVING NO OR SMALL AMOUNTS OF PROPERTY OWNERSHIP.

The Commission apportioned Holdings' income by using the sales factor and the payroll factor with a denominator of two, thereby excluding the property factor. The Commission stated that it excluded the property factor in apportioning Holdings' income because its property holdings were minimal in relation to its royalty income (L.F. 53). The Commission justified this departure from the statutorily required three-factor method under the authority of section 32.200, art. IV, § 18, which provides that the Director may exclude one or more factors "[i]f the allocation and apportionment provisions of this article do not fairly represent the extent of the taxpayer's business activities in this state."

The Commission's determination that the three-factor method does not fairly represent Holdings' business is erroneous and is contrary to its own decision in *Rentco Trailer Corporation v. Director of Revenue*, Case Number 97-1373RI (Mo. Admin. Hrg. Comm. 1998). In *Rentco*, the Commission addressed a situation in which the Director attempted to apportion a taxpayer's income using fewer than all of the three factors. Specifically, the Director excluded the payroll factor because the taxpayer did not have payroll in any state. In *Rentco*, the Commission held that the Director's

calculation was impermissible because the statute requires the use of all three factors. While the Commission recognized that section 32.200, art. IV, § 18 permits deviation from the statutory formula, such a deviation requires a determination that the three-factor method does not fairly represent the extent of the taxpayer's business. Because the Commission determined that the taxpayer's lack of payroll was due to its organization, rather than the nature of its business, the Commission determined that the use of an alternative method of apportionment was inappropriate.

Assuming *arguendo* that Holdings is subject to Missouri income tax, under *Rentco* the Commission's exclusion of the property factor was improper and must be rejected by this Court. Holdings' small amounts of property were based upon the nature of Holdings' organization. A simple example demonstrates the fallacy of the Commission's reasoning, particularly for income generated from intellectual property. Suppose Stephen King, Inc., writes books that it copyrights and then licenses the copyrights. Stephen King, Inc. pays its one employee, Stephen King, $20,000 per year in salary. Stephen King, Inc. has only a small office and a word processor that its one employee uses, and the value of that property is $2,000. Yet, Stephen King, Inc. generates millions of dollars each year in copyright royalties. The Commission would disregard the payroll and property factors because they were minimal in relation to the royalties, yet no one could reasonably deny that the one employee and the small amount of property were primarily responsible for the production of that royalty income.

Indeed, the Commission's willingness to disregard factors that, in the Commission's opinion, are "minimal" will make it practically impossible for corporations that actually are subject to Missouri income tax to predict with any kind of certainty their Missouri income tax liability. Depending upon the Commission's whim, Missouri may be a one, two, or three factor apportionment state for a particular

taxpayer. One can only wonder whether the Director would agree with the Commission if Holdings' "minimal" property were in Missouri.

In short, Holdings' property, payroll and sales factors are zero, and Holdings has no Missouri source income. Because section 143.431 permits the Director to assess Missouri income tax only upon Missouri source income, the Director's assessment against Holdings is invalid.

VII. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE NOTICES OF DEFICIENCY BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT THE IMPOSITION OF MISSOURI INCOME TAX UPON APPELLANT CONSTITUTES A CHANGE FROM "PREVIOUS POLICY" AS THAT PHRASE IS USED IN SECTION 143.903 AND CONSTITUTES A "CHANGE IN POLICY OR INTERPRETATION" WITHIN THE MEANING OF SECTION 32.053 AND, ACCORDINGLY, THAT POLICY SHOULD NOT APPLY RETROACTIVELY.

Section 143.903 provides that an "unexpected" decision is applied only after the most recently ended tax period for purposes of additional assessment. A decision is unexpected if "a reasonable person would not have expected the decision or order based on prior law, policy or regulation of the Director." *Id. See also Lloyd v. Director of Revenue,* 851 S.W.2d 519, 522-23 (Mo. banc 1993); *Laciny Brothers, Inc. v. Director of Revenue,* 869 S.W.2d 761 (Mo. banc 1994).

The Director's designee stated that her Audit Manual sets forth the policy and guidelines for what the Director holds taxable (Ex. 18, p. 63-64). Prior to the publication of the Nexus Position in the Audit Manual in October 1996, the Director did not assert the power to tax the royalty income of out-of-state licensors based upon the use of patents by a licensee to manufacture products outside of Missouri that are eventually sold to Missouri customers. After the publication of the Nexus Position, the Director did assert this power and began making retroactive assessments, including the one against Holdings.

Nonetheless, the Commission determined that the Director's change of position did not constitute a change of policy because prior to the Nexus Position, "the Director did not have a policy" (L.F. 55). The Commission stated, "The Director's decision to pursue collections under the reasoning of *Geoffrey* was not a change in the Director's policy, but simply an awareness, that was not there before, that there was a new issue possibly resulting in tax liability" (L.F. 55).

It should go without saying that the Director's constitutional duty, as provided by article IV, section 22 of the Missouri Constitution is to "collect all taxes and fees payable to the state as provided by law." Thus, the Director's overriding policy is to collect all taxes imposed by statute. The Commission's statement that the Director was "unaware" of whether a certain type of income is subject to Missouri tax suggests a dereliction of the Director's constitutional duty. Instead, the Director's decision to pursue collections under the reasoning of *Geoffrey* was a change in the Director's interpretation of the law, and therefore a change in policy that should be applied on a prospective only basis under section 143.903.

Likewise, section 32.053 provides that any final decision of the Director that is the result of a change in policy or interpretation by the Director may be applied on a prospective basis only. Even assuming *arguendo* that the Director did not have a "policy" with respect to the taxation of the patent royalty income of out-of-state licensors based upon the license of patents by a licensee to manufacture products outside of Missouri that are eventually sold to Missouri customers, it is clear that the Director's assertion of the power to tax such income was based upon a new interpretation of the law as a result of *Geoffrey*. As a consequence, this determination must be applied only on a prospective basis. Because the Assessment against Holdings was made on a retroactive basis, the Assessment is invalid.

CONCLUSION

For the foregoing reasons, Holdings respectfully requests that the Court reverse the decision of the Commission and determine that the Assessment against Holdings is invalid because: (a) section 143.431 permits the assessment of Missouri income tax upon Missouri source income only; (b) it violates the United States and Missouri Constitutions; (c) Holdings has no property, payroll or sales in Missouri; (d) Holdings has no income derived from Missouri sources; and (e) Holdings owes no Missouri income tax for any of the Tax Periods.

Respectfully Submitted,

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CERTIFICATE OF SERVICE

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

_____

CERTIFICATE REQUIRED BY SPECIAL RULE 1(C)

I hereby certify that the foregoing brief includes the information required by Supreme Court Rule 55.03 and complies with the limitations contained in Supreme Court Special Rule 1(b). The foregoing brief contains 15,869 words.

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

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