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

REPLY BRIEF OF APPELLANT

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INTRODUCTION

The principal issue in this case is whether, and to what extent, the Director of Revenue may tax royalty income of Appellant Gore Enterprise Holdings, Inc. ("Holdings"), a company that has no connection with, or any activities of any kind in, Missouri. Despite Holdings' lack of any connection with this State, the Director argues that Holdings is required to pay Missouri income tax on its patent royalty income because W.L. Gore, Inc. ("Gore"), a licensee of Holdings' patents, is selling to Missouri customers goods that Gore entirely manufactured outside Missouri. Gore, and Holdings' other licensees, sell goods throughout the country, and Holdings has no right to control the sales activities. Consequently, those goods may be sold by Gore to customers located anywhere.

Contrary to the Director's Introduction (Dir. Br. 12), Gore's tax liability is not before this Court because the Director did not assess Gore or attempt to disallow Gore's expense deduction for royalty payments to Holdings. Also, it is incorrect to characterize Gore's claim to the royalty expense as "sudden" (Dir. Br. 12), given the undisputed record that Gore acquired the patent license and made royalty payments to Holdings starting in 1983 (L.F. 32). Likewise, we question the propriety of the Director's citation of a *Wall Street Journal* article (Dir. Br. 12). It is not part of the record in this case and is hardly the type of authoritative treatise that this Court would judicially notice. We would note, though, that it is in any event irrelevant since there is utterly no contention that Holdings is domiciled off shore like the entities referenced in that article.[1]

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[1] Exhibit 6 of the record is the report of Professor Richard Pomp, a well-respected academician and scholar, addressing one of the important legal issues in this case—nexus. Although the Director moved to exclude Professor Pomp's report from the trial in this case because it contained

Appellant also takes issue with many of the Director's statements of fact. Holdings' officers were not the same as Gore's officers for the Tax Periods (Dir. Br. 8). Specifically, for the Tax Periods starting in 1993 and 1994, Gore and Holdings had three common officers, but Holdings did not employ Learis Donovan (Gore's assistant secretary) (Ex. G, pp. 5-6). In 1995, Gore and Holdings shared ***no*** common officers. *Id*. Also, the Director's assertion that "[Holdings'] activities were carried out by Gore's employees at Gore's offices [for years ending in 1993 and 1994]"(Dir. Br. 8) is incorrect to the extent that it implies Gore's employees conducted all of Holdings' business. As the record shows, much of Holdings business was transacted by its "rented" employees—lawyers, accountants, and investment advisors—for which Holdings paid substantial sums (Tr. 56, 142-43, 164-65; Ex. G).

Similarly, the Director erroneously asserts (Dir. Br. 8) that Gore's royalty payment to Holdings "was calculated to move perhaps all of Gore's profits to Holdings[.]" To support that claim, the Director merely cites the provision of the license agreement that caps the total royalty due under the agreement (Dir. Br. 9). The record plainly reflects, though, that Gore actually had substantial profits; its Missouri taxable income from all sources (before apportionment) during the Tax Periods was between $44 million and $89 million (Ex. A, pp. 12, 40, 68).

ARGUMENT

I. Holdings' Patent License Royalties Are Not Missouri Source Income.

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legal opinions, she freely cites not only articles written by a Massachusetts Department of Revenue attorney (see App. Br. 58 n.9), but now also newspaper articles all of which were prepared by persons who have no expertise close to that of Pomp.

Holdings licenses patents employed by Gore (and now by other licensees as well) in manufacturing operations that the Director concedes are conducted solely outside of Missouri. Yet, without identifying anything that Holdings has done or is doing in Missouri, the Director argues that Holdings' royalty income "is derived from Missouri sources" (Dir. Br. 14). The focal point of the Director's argument is ***Gore's*** sales of products to Missouri customers. She reasons that because the amount of the royalty ***Gore paid to Holdings*** for the right to use the patents outside of Missouri was calculated as a percentage of ***Gore's*** sales of the manufactured products, the royalty income was derived ***by Holdings in Missouri*** (Dir. Br 13-15). But, Holdings' royalty income is not derived from anything it does in Missouri, ***because it does nothing in Missouri***.

As the Director concedes (Dir. Br. 24), Missouri law is clear that there must be some income-producing activity in Missouri to justify imposing the Missouri income tax upon a taxpayer's income. Sections 143.431 and 143.451 RSMo. This Court has just recently reaffirmed this fundamental proposition in *Medicine Shoppe Int'l, Inc. v. Director of Revenue*, 75 S.W.3d 731, 734 (Mo. banc 2002), where it said "[t]o be a [taxable] 'transaction,' there must be activity or effort in the taxing state that contributes to the production of income." Unlike the taxpayer in *Medicine Shoppe,* Holdings engages in no income-producing activity in Missouri. Here, the Director seeks to tax Holdings' royalty income without identifying anything ***that Holdings has done in Missouri*** that produced the income. She does not and cannot dispute Holdings' proof that unlike Medicine Shoppe, it does no business in Missouri, owns no real or personal property in Missouri, and has no agents or employees in Missouri. And neither the patents nor Holdings' "products" (the covenant not to sue for infringement embodied in the patent license) are located in Missouri. *Red Wing Shoe Co. v. Hockerson-Halberstadt, Inc.*, 148 F.3d 1355, 1359-62 (Fed. Cir. 1998). Faced with these

dispositive realities, the Director devotes substantial discussion to Gore's, rather than Holdings', activities (Gore's sales of products to Missouri customers), even though Gore is not a party to the Assessment at issue in this case.

The Director argues that Gore's "stream of revenue" was diverted from Missouri because Gore paid a royalty, and took a deduction for royalty expenses that lowered its Missouri tax liability. Accordingly, she reasons that Missouri is the "original source" of the royalty income, so Missouri has a right to tax it (Dir. Br. 15). Her actions in administering the tax laws are inconsistent with her arguments before this Court. If the Director believed that the royalty constituted a "diversion" of a "stream of revenue" that was already in Missouri, she should have challenged the royalty deduction taken by Gore on its returns, and assessed Gore based upon the effect of such a disallowance. Her failure to assess Gore, or even to question the propriety of the royalty rate, demonstrates that this was not her belief, and belies her arguments in this regard before this Court. Alternatively, the Director argues that because Holdings' activities in Delaware are insufficient to generate its income, she is entitled to tax that income. But, as explained in detail below, these arguments ignore the requirement under Missouri law that ***Holdings*** engage in some income-producing activity in Missouri. Because it does not, it is not subject to Missouri income tax.

A. Holdings Engages in No Missouri Income-Producing Activities.

Holdings' royalty income derives from its activities outside of Missouri, primarily in Delaware, where its affairs are centered. There, it entered into the contract for licensing the patents (Ex. 10), engaged in all conduct necessary to carry out the terms of that license, and otherwise carried on its business and affairs, including the licensing of patents to its licensees (Ex. E, App. Ans. to Int. 6). The one fact that the Director continually recites—that Gore sells products to Missouri customers—is no

basis for concluding that ***Holdings*** is doing anything in Missouri that is productive of the royalty income at issue.

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

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

The Director's position ignores the well-established rule of construction that tax statutes are to be strictly construed in favor of taxpayers, *United Air Lines, Inc. v. State Tax Comm'n*, 377 S.W.2d 444, 448 (Mo. banc 1964), and are to be given a reasonable construction, *Collins v.*

Director of Revenue, 691 S.W.2d 246 (Mo. banc 1985). The Director's attempt to impose Missouri income tax upon anyone who does business with someone who in turn does business in Missouri is overreaching, is beyond the reasonable expectations of the Missouri legislature, and violates federal law.

The Director's position in this regard is at odds with § 32.200, art. IV, §§ 15 and 17, and her regulation 12 CSR 10-2.075(55) incorporating that provision. Those provisions pertain to the calculation of the sales factor for income apportionment purposes of a taxpayer that, unlike Holdings, is in fact subject to Missouri income tax. Section 15 provides that the sales factor's numerator is the taxpayer's sales "in this state." Section 17 indicates how the numerator should be determined where sales are of other than tangible personal property, and provides:

> "Sales, other than sales of tangible personal property, are in this state if:
>
> (1) the income-producing activity is performed in this state; or
>
> (2) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance."

The Director's regulation 12 CSR 10-2.075(55) follows this provision.

Here, ***Holdings*** incurs no costs of performance in Missouri and engages in no income-producing activity in Missouri because it does nothing in Missouri. So none of its royalty receipts would be included in the numerator of the sales factor; the sales factor is zero. However, even if the Director were correct in focusing on ***Gore's*** activities for purposes of determining ***Holdings'*** liability for Missouri income tax, under the income-producing activity/cost of performance standard there would still be no sales in the numerator of the sales factor. The sales factor would still be zero. That is because by

far the greater proportion of Gore's income-producing activity and cost of performance is outside of Missouri, where Gore's factories and their employees are located. *See* Exhibit A showing Gore's Missouri apportionment factors at or well below one percent. Thus, § 32.200, art. IV, §§ 15 and 17, and the Director's regulation 12 CSR 10-2.075(55), are contrary to the Director's position in this regard.

Further highlighting the legislative intent not to tax this type of income is the action taken on proposed legislation in the last General Assembly session to disallow the royalty expense for any taxpayer that pays a royalty to a related company-legislation that no doubt was sponsored or supported by the Director. The Missouri Legislature, in tacit approval of Holdings' position herein, ***rejected*** this proffered legislation. *See* H.B. 1877, 91st Gen. Assem. (proposed § 143.435).[2]

[2] The Director's proposal to disallow the royalty expense only if paid to a related corporation contradicts the Director's claim and the Commission's Finding of Fact, in response to the uniformity and equal protection challenges, that she taxes all royalty income uniformly (Dir. Br. 37-39). Presumably, the Director would not be so arbitrary as to disallow the royalty expense deduction by the licensee, while also attempting to tax the royalties as income of the licensor.

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

The Director cites *A.P. Green Fire Brick Co. v. Missouri State Tax Comm'n*, 277 S.W.2d 544 (Mo. 1955), and *Brown Group, Inc. v. Admin. Hearing Comm'n*, 649 S.W.2d 874, 880 (Mo. banc 1983), as would-be authority for her position that she can tax the patent royalty income if the products produced with the patents are sold ***by the licensee*** to customers located in Missouri (Dir. Br. 15-21), ***even where the licensee's manufacturing operations are not in Missouri, and even where the taxpayer does nothing in Missouri to generate the royalty income***. But that is not the holding of those two cases. What this Court said in *A.P. Green* and *Brown Group*, consistent with the decisions in *Medicine Shoppe*, and *Maxland Development Corp. v. Director of Revenue*, 960 S.W.2d 503, 506 (Mo. banc 1998), is that the Director ***could not tax royalty income*** that was, in effect, passive investment income ***from the licensee's use of the taxpayers' intangible assets outside of Missouri***. Nowhere did the Court suggest that a licensor is subject to Missouri income tax if its only claimed contact with Missouri is its licensee's sales to Missouri customers. A.P. Green and Brown Group were Missouri-based taxpayers with royalty income, and the question was not whether those taxpayers were subject to tax in the jurisdictions where their licensees did business. Rather, the question was whether those royalties were subject to income tax in their home state of Missouri.

Furthermore, *A.P. Green* actually supports Holdings. As explained above, the Court was not concerned with whether Missouri could tax A.P. Green, as it clearly did business in Missouri. Thus, the Court never addressed the nexus issue. However, at 277 S.W.2d 547, this Court concluded that the "source" of patent royalty income was the "place in which the … manufacturing processes were

used[.]" Gore never used any manufacturing processes in Missouri. Thus, the Director's contention that Holdings' income was derived from Missouri sources is untenable.

C. Holdings' Licensee, Gore, Does Not Use Holdings' Patents in Missouri.

Even if the Director could tax Holdings solely on the basis of a licensee's use of patents in Missouri, she cannot win this case. The record is uncontroverted that the licensee, Gore, did not use Holdings' patents in Missouri. Gore used Holdings' patents, and became obligated to pay royalties to Holdings, when it manufactured products, and it has never engaged in any manufacturing in Missouri. In recognition of that hole in her case, the Director argues that Holdings ***could have*** supervised or "police[d]" Gore's "manufacture, use, and sale of goods made using [Holdings'] patents," even though she concedes that Holdings did not do so (Dir. Br. 21).[3] Here, the licensee's manufacture of products

[3] The Director cites 35 U.S.C. § 271 as her authority for Holdings' "legal right" to supervise sales of products produced with its patents (Dir. Br. 21). That section relates to and defines infringement of patents, a topic having no bearing on Holdings' relationship to Gore since, by granting Gore a license, Holdings provided a ***covenant not to sue Gore for infringement***. Furthermore, that section does not expressly grant any right to a licensor to supervise its licensees' sales and, in the absence of an infringement, the licensee has rights that the licensor cannot overcome. (footnote continued next page)

Those rights exist under 35 U.S.C. § 261. See, *e.g.*, *Becton Dickson & Co. v. R.P. Scherer Corp.*, 211 F.2d 835 (6th Cir. 1954). Under the Director's theory, every patent holder is subject to income tax in every state since that patent holder ***could*** make efforts there to determine if its patents are infringed. Such a scenario would be the very definition of chaos.

did not occur in Missouri. Since Gore does not use the manufactured products, it is difficult to understand how or why Holdings would perform any such supervision in Missouri.

Furthermore, the Director never explains how or why one would supervise sales, and why that supervision would be in Missouri, when the only connection to Missouri is that some of Gore's customers were located here. The record does not even show that Gore transferred title of the manufactured goods in Missouri, given that the plants where the products were made were outside of Missouri. The Director's brief is devoid of any authority for the novel proposition that she can tax persons that have engaged in no activity in Missouri simply because they had the ***right*** to engage in some activity in Missouri.

Finally, the Director argues (Dir. Br. 22) that Gore's activities that have utterly no connection to Holdings—Gore's use of Missouri highways and stores—may serve as a basis to tax Holdings. There is no authority, and the Director cites none, to support that claim, and in fact the Director's position in this case is inconsistent with her position in, and this Court's holding in, *Langley*, discussed above.

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

II. Holdings Is Not Subject to Missouri Income Tax Because It Has No Substantial Nexus With Missouri.

A. Holdings Has No Physical Presence in Missouri.

"It is fundamental that a State has no power to impose a tax on income that is earned outside of the State." *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 451 (1980) (Stevens, J., dissenting). The Director concedes that: (1) Holdings has no physical presence in Missouri; and (2) if a physical presence is required, §143.441.2 prohibits her from taxing Holdings (Dir. Br. 23, 34; Tr. 224-

25). To avoid the obvious conclusion that she is prohibited from taxing Holdings, the Director argues that no physical presence is required under the Commerce Clause (Dir. Br. 23-27).

The Director cites no case in which a patent licensor has been subjected to state taxation under the circumstances existing here; nor have we found any. The Director discusses some decisions of sister states that favor her position by analogy, most notably the controversial trademark-licensing case of *Geoffrey v. South Carolina*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993), while largely ignoring rulings from other states to the contrary. *See J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *Syl, Inc. v. Comptroller*, Case Number C-96-0154-01 at 6 (Md. Tax Ct. 1999); and *Cerro Copper Products, Inc. v. Alabama*, Docket Number F94-444 (Ala. Dept. Rev. 1995) (cited in App. Br. 59-60).[4] This case is distinguishable from *Geoffrey* in any event. Holdings does not have an "economic presence" in Missouri because Holdings' patents are not employed in Missouri.

The Director also cites *Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225, 1230 (Ohio 1996), which followed *Geoffrey* in *dicta*, but concluded that the physical presence standard was satisfied in any event by the out-of-state taxpayer lottery winner's purchase and redemption of the winning lottery ticket in Ohio. The Director's reliance on *American Dairy Queen Corp. v. Taxation and Revenue Dept.*, 605 P.2d 251 (N.M. Ct. App. 1979), is unavailing, as that case does not address the Commerce Clause issue, referring instead to earlier New Mexico decisions. As

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

noted in our opening brief, New Mexico's Supreme Court is currently considering the Commerce Clause nexus issue (App. Br. 57). The Director's citation of *In re A&F Trademark, Inc.*, Administrative Decision No. 381 (North Carolina Tax Review Bd. May 7, 2002), does not aid her cause because the administrative law judge refused to rule on the Commerce Clause issue since

"constitutional claims are not issues that the Tax Review Board is empowered to determine." *Id*. at 38.[5]

Notwithstanding her citations of selected authorities from other states, the Director judicially admits that Holdings' principal authority on this issue, *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), is "[t]he closest the U.S. Supreme Court has come to dealing with [this issue] in an analogous case" (Dir. Br. 24), and that *Quill* requires a physical presence under the Commerce Clause before a state can impose its sales and use taxes (Dir. Br. 24). The Director contends, however, that there is a constitutionally significant difference between the protections afforded income taxpayers and those afforded sales and use taxpayers, saying that the "physical-presence requirement makes little sense when a corporation's business is entirely the management of property that has no real physical existence" (Dir. Br. 24-25). But that lack of physical location of intangible property is exactly why "substantial nexus" under the Commerce Clause requires ***the taxpayer*** to be physically present.

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

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

> "Like other bright-line tests, the *Bellas Hess* rule appears artificial at its edges: Whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant or office. ***This artificiality, however, is more than offset by the benefits of a clear rule***." 504 U.S. at 315-16, emphasis added.

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

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

Third, physical presence is more consistent with business's settled expectations. This is reflected in the statement of interest of *amicus curiae* in the brief filed in this case by the Council on

State Taxation (Am. Cur. Br. 8-9). The United States Supreme Court has never held that nexus is satisfied by a metaphysical presence, and the Director has cited no authority so holding. Many corporations have been careful to steer clear of certain unfavorable jurisdictions and deliberately to concentrate their activities in business-friendly states. Such tax planning is perfectly legitimate; indeed, many of Missouri's tax statutes are designed to lure businesses to Missouri by providing favorable tax treatment. The Director's search for additional revenue has undermined confidence in the integrity of Missouri's taxing scheme and has caused businesses to rethink decisions previously made. Indeed, Holdings has conducted its activities under the license agreement with Gore since 1983, and a change in the rules at this stage of the game would be unseemly and inhospitable. If a metaphysical presence standard having such broad-reaching impact is to determine nexus under the Commerce Clause, only Congress has the power to impose it.

Fourth, the physical-presence nexus standard has the weight of history, tradition, and certainty behind it. It has been litigated, and its boundaries are well known and accepted. Metaphysical nexus, by its very nature, is amorphous and portends an abundance of litigation. Most businesses will not know exactly where their licensees have done or will do business. The uncertainty and unpredictability of a business's tax status would only serve to discourage interstate investments and thereby thwart the ultimate goal of the Commerce Clause.

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

Under any fair and reasonable reading of *Quill*, and the Supreme Court's Commerce Clause jurisprudence, a physical presence in Missouri is required for income

taxation. Because Holdings admittedly has no physical presence in Missouri, it is exempt from income tax. Section 143.441.2.[6]

B. The Nexus of Holdings' Licensee May Not Be Attributed to It.

In apparent recognition of her frail position on the basic nexus issue, the Director devotes a substantial portion of her brief to an attempt to disregard the separate corporate existences of Holdings and Gore so as to attribute Gore's minimal activities in Missouri to Holdings (Dir. Br. 27-36). The alter ego theory of attack was not raised in the Director's audit report, her final decision, or her answer (Exs. 1, 2, 3, and C).[7] And her "nexus by attribution" theory has been soundly rejected by numerous courts that have considered it in the personal jurisdiction setting. *See* Point IV, post.

First, as explained above, Holdings and Gore did not, as the Director asserts, share all officers for any year under examination, and for one of the tax years had no common officers at all (Ex. G, pp. 5-6). Second, as noted at the trial and in our opening brief (App. Br. 16), Holdings was formed for a variety of legitimate business reasons:

(1) central management of intellectual property; (2) prevention of turf wars over how to use inventions and sharing of credit for them; (3) administrative efficiencies and expertise; (4) encouragement of more

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[6] Even if something less than physical presence is sufficient to establish adequate nexus, it does not exist here. As discussed below in Point IV and footnote 9, minimum contacts for due process are not present, and "substantial nexus" under the Commerce Clause is an even more demanding test.

[7] Indeed, if Holdings really were Gore's alter ego, the posture of this case would have been much different. If the Director really believed the theory she is now advancing, she would have attempted to disallow Gore's royalty expense, thereby increasing Gore's tax liability.

use of inventions by the various divisions; and (5) tax savings (Tr. 59-62). The Director, while presenting no evidence to dispute the sworn testimony of Holdings' president on this subject (Tr. 59-62), pooh-poohs these corporate business objectives by characterizing them as "self-serving," by exaggerating the facts above, and by incorrectly claiming that Holdings could not "point to a single fact that suggests [Holdings] and Gore['s] separate minds, wills, or existence[s]" (Dir. Br. 28).[8]

The Director apparently concedes the governing axiomatic legal standards (Dir. Br. 27): (1) that even when the stock of one corporation is owned partly or wholly by another, the two separate corporations are to be regarded as distinct legal entities, *Central Cooling & Supply Co. v. Director of Revenue*, 648 S.W.2d 546, 547-48 (Mo. 1982);
(2) that corporations are not responsible for the acts of related entities, *Grease Monkey Int'l, Inc. v. Godat*, 916 S.W.2d 257, 262 (Mo. App. E.D. 1995); (3) that the existence of a partnership is never presumed, and the burden is on the party asserting a partnership to prove its existence by clear, cogent, and convincing evidence, *Morrison v. Labor and Industrial Relations Commission*, 23 S.W.3d 902 (Mo. App. W.D. 2000); (4) that a partnership consists of partners placing their money, efforts, labor, and skill in lawful commerce and dividing the resulting profits and losses; (5) that mere ownership of all the stock of one corporation by another, and the common identity of officers with another, are not alone sufficient to create an identity of corporate interests between two companies;

[8] Having made that assertion, however, the Director then attempts to address some of the "facts" Holdings identified in its opening brief, specifically, that it licensed its patents to one of Gore's competitors and to other unrelated companies, and abandoned, dedicated to the public, or did not pursue, other patents (Dir. Br. 29-30).

and, (6) that to pierce the corporate veil, there must be such dominion and control that the controlled corporation has, so to speak, no separate mind, will, or existence of its own, *Blackwell Printing Co. v. Blackwell-Wielandy Co.*, 440 S.W.2d 433, 437 (Mo. 1969); *Mid-Missouri Telephone Co. v. Alma Telephone Co.*, 18 S.W.3d 578, 582 (Mo. App. W.D. 2000).

The Director's invocation of *Osler v. Joplin Life Ins. Co.*, 164 S.W.2d 295 (Mo. 1942) (Dir. Br. 32), is way off the mark. There, individuals used shell corporations to defraud an investor. The Court found that "courts will ignore separate corporate entities in order to defeat a fraud, wrong, or injustice, at least where the rights of third persons are concerned." *Id.* at 298. *Osler* has no relevance here.

The Director attempts to avail herself of an unsupportably generous evidentiary standard. She affirmatively states that "[e]very fact in this case points to the conclusion that [Holdings] is an alter ego of Gore," but then identifies only two "facts," one of which is, as explained above, incorrect: (1) Holdings "immediately licensed" to Gore the patents Gore contributed for all of Holdings' stock; and (2) the alleged total commonality of officers (Dir. Br. 27). She then blithely labels as "self-serving" the sworn testimony and other evidence supporting the purposes for forming Holdings and the actions evidencing Holdings' independence. Missouri law will not disregard a corporation's separate existence on the basis of such a flimsy claim, particularly in the face of evidence to the contrary. The Director cites no case, from any jurisdiction, supporting her argument (even if all of the alleged facts supporting it were true) that common officers and an "immediate" license-back of patents justifies veil piercing, and her assertion is directly contrary to *Blackwell* and *Mid-Missouri*.

In *Collet v. American Nat'l 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

parent 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. As pointed out in our opening brief, Holdings not only licenses its patents to unrelated entities like The 3M Company, NTK, and Shinko, but also to the Donaldson Company, a Gore competitor (App. Br. 19, 63). The Director attempts to downplay this evidence since those entities were not licensees during the Tax Periods (Dir. Br. 29). But it cannot be denied that this conduct evidences independence of Holdings from Gore. The Director, paradoxically, then argues that the license to Gore was originally exclusive. Actually, the license was exclusive through 1989, and nonexclusive thereafter, including the Tax Periods (Tr. 110; Ex. 10). The Director never explains the basis for her premise that the grant of an exclusive license is a basis for piercing the corporate veil, particularly where, as here, she has never challenged the propriety of the royalty rate.

The Director urges, contrary to the sworn testimony of Holdings' president (Tr. 84-86), that Holdings' decision to dedicate a patent to the public did not demonstrate independence from Gore because prior patents, of other entities, already existed (Dir. Br. 29; Tr. 74). Obviously, however, dedicating a patent to the public deprives the licensees of the right to bring infringement actions against others who may claim patent rights or use the patented inventions, so the dedication is contrary to the interests of licensees, including Gore.

Lastly, the Director challenges Holdings' claim that its frequent abandonment of patents, or failure to apply for them, shows its independence from its licensees. She maintains that Holdings does so only because it is not in its best financial interest to incur the expense to maintain or apply for the patents (Tr. 86). We are bemused why the Director disagrees that this is not an act of independence

from Holdings' licensees, including Gore. If Holdings were truly just Gore's tool, Holdings' financial interests would not matter if Gore wanted to exclude others from practicing an invention.

The Director attacks one of the bases for forming Holdings—to prevent "turf wars" among divisions and to have a "common enemy"—as not supported by the evidence (Dir. Br. 31). She again simply dismisses the testimony of Holdings' president, an accomplished engineer and patent attorney (Ex. 11; Tr. 62), that the formation of Holdings "created administrative efficiency and cut down on complaining between divisions and avoid[ed] a lot of useless time and arguments" since Holdings was the "common enemy." The Director's professed disbelief of the sworn testimony of an expert in this highly technical field is too thin a reed to justify disregarding Holdings' 19 years of separate corporate existence.

The Director's rewriting of the record leads her to the self-serving conclusion that the only "purpose ***actually served*** by [the formation of Holdings was] tax avoidance" (Dir. Br. 32). This pronouncement is based upon nothing more than the Director's *ipse dixit*, and effectively assumes that all subsidiary corporations are alter egos. That is not the law in Missouri. *Blackwell,* 440 S.W.2d 433 (Mo. 1969)*; Mid-Missouri,* 18 S.W.3d 578 (Mo. App. W.D. 2000). There is no basis for disregarding the separate corporate status of Gore and Holdings.

III. Holdings Has No "Minimum Connection" with Missouri Sufficient To Subject It To Missouri Income Tax.

As explained in our opening brief (App. Br. 69), the Due Process Clause requires a "definite link" or "minimum connection" between Missouri and the person or transaction Missouri seeks to tax. *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 291-92 (1980). The Director has no quarrel with this legal proposition. She references her Commerce Clause nexus argument, however,

to support her claim of a minimum connection (Dir. Br. 34). She also cites her alter ego argument for the proposition that because Gore has the minimum connection to Missouri, so does Holdings. Both of these arguments have been refuted above.

The Director likewise claims that Holdings' intangible personal property, the patents, were in Missouri and that alone satisfies the definite link connection. That statement is factually inaccurate and legally flawed, as (a) as the patents clearly were not "in Missouri," and (b) the intangible property in question is not the patents but the licensing agreement, which entitles Holdings to the royalties. Moreover, the contention that a licensor has sufficient minimum contacts with any state where its licensees sell products has been decisively rejected by the most influential patent court in the country. In *Red Wing Shoe Co. v. Hockerson-Halberstat, Inc.*, 148 F.3d 1355, 1362 (Fed. Cir. 1998), the federal patent court ruled that a patent licensor's product is "a covenant not to sue, not a [product] incorporating the patented technology. As such, [the licensor's] product never enters the stream of commerce." Hence, the sale of the patented product in a state does not mean that the intangible property itself is in the state. The court held that a patent holder who had 34 licensees that sold the patented products in Minnesota did not have sufficient minimum contacts with that state to satisfy due process for purposes of personal jurisdiction. The court said:

> "HHI's licenses have extensive contacts with Minnesota, but this additional factor is also insufficient to submit HHI to personal jurisdiction in the state. In simple terms, doing business with a company that does business in Minnesota is not the same as doing business in Minnesota . . . . 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*. at 1361.

The *Red Wing* court also held that the defendant-licensor's receipt of royalty income for sales made in Minnesota was irrelevant to the due process analysis, in that it was a financial benefit that did not stem from a "constitutionally cognizable contact with that State." *Id*. at 1361-62, quoting *Worldwide Volkswagen*, 444 U.S. at 299. And, as noted, the Federal Circuit further expressly rejected the "stream of commerce" theory relied on below by the Commission. *Red Wing*, 148 F.3d at 1362. Obviously, if the actions of licensees in a state and the receipt of royalty payments from sales made in the state are insufficient to satisfy due process in the jurisdictional context, they are equally inadequate to justify taxation of that income under the Due Process Clause.[9]

[9] In *Quill*, the Supreme Court observed that the due process "minimum contacts" requirement is notably easier to satisfy than the "substantial nexus" test under the Commerce Clause. *Quill*, 504 U.S. at 312-13 ("a corporation may have the 'minimum contacts' with a taxing State required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause"). Thus, the insufficiency of a licensor's activities for purposes of due process, as decided in *Red Wing*, means *a fortiori* that the Commerce Clause nexus requirements — however defined — have not been met.

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

The Director does not challenge Holdings' authorities establishing that Missouri's Uniformity Clause requires that: (1) all taxes "shall be uniform upon the same class or subclass of subjects within the territorial limits of the authority levying the tax[,]" Mo. Const. art. X, § 3; and (2) the power of the State to classify for purposes of taxation must be reasonable, U.S. Const. amend. XIV, § 1; *Schnorbus v. Director of Revenue*, 790 S.W.2d 241, 242 (Mo. banc 1990); *Exxon Corp. v. Eagerton*, 462 U.S. 176, 195-96 (1983). Likewise, she apparently makes no attempt to defend the Commission's erroneous factual finding (L.F. 52) that there was no evidence to support the statement that the Director does not treat all taxpayers the same (Dir. Br. 36-39).

Rather, the Director argues that Holdings' claim is one of selective prosecution. This is a flawed characterization. Holdings' argument is that this Court should provide a fair and reasonable construction of §143.431, and construe it, like all other tax statutes, strictly in favor of the taxpayer. Further, any construction that allows one income tax standard to be imposed on a taxpayer doing business with a related entity, while imposing a different standard for taxpayers doing business with an unrelated entity, must be rationally based.

The Director argues that there is a rational basis for distinguishing between related and unrelated licensors because they are not similarly situated. She says that only related corporations "can remove income from the scope of state taxation" (Dir. Br. 38). But that is not really the case. The expense to Gore is income to Holdings. If the Director believes that certain related corporations are removing income otherwise earned in Missouri from the scope of taxation, she should disallow such deductions on the return of the entity subject to Missouri income tax while leaving the determination of Holdings'

taxable income to those states in which Holdings does business. There is no rational basis for the distinction the Director attempts to superimpose upon the law.[10]

V. The Commission Is Not Free to Exclude Apportionment Factors That the Commission Concludes are "Minimal."

In calculating Holdings' tax liability, the Commission simply chose to disregard, as "minimal," the property factor of the apportionment formula, §32.200, art. IV.[11] Because Holdings had no property in Missouri, and thus that factor was zero, this adjustment had the effect of overstating Holdings' tax liability by a third (dividing by 2 instead of 3). To do this, the Commission perverted §32.200, art. IV, §18, which allows a different apportionment formula when the three-factor formula of sales, property, and payroll, "do not fairly represent the extent of the taxpayer's business activity in [Missouri.]"

The Director states that the Commission's decision to exclude the property factor was a "fair apportionment," but provided no explanation or evidence to the Commission or this Court as to why (Dir. Br. 41-42). The Director also claims that "there is no reasonable argument … that $0 is a fair allocation" (Dir. Br. 41). As to the latter claim, however, Holdings understands that if this Court

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[10] If Donaldson, as Holdings' unrelated licensee, were selling exactly the same products to Missouri customers as Gore, manufactured out of state pursuant to the same patent, the royalty income received by Holdings from Donaldson would not be subject to Missouri tax, according to the Director's own theory. The irrationality of the Director's position is thus exposed.

[11] Contrary to the Director's brief (Dir. Br. 39), the Director and the Commission did not apply the single-factor apportionment formula of §143.451 (L.F. 52-3).

determines that it is subject to income tax in Missouri on the patent royalties, it will owe tax because the "sales" factor would not then be zero. *See* Holdings' Exhibit 15.[12]

If Holdings is subject to Missouri income tax on the royalty income, all factors should be considered, and Holdings' liability should be reduced by a third of that found due by the Commission. As explained in Holdings opening brief (App. Br. 81), intellectual property companies, by their very nature, may have limited payroll or property but, as in the case of an author, no one can reasonably deny the contribution of that one employee or his typewriter. The Commission's willingness to disregard apportionment factors when they are, in the Commission's opinion, "minimal" will make it practically impossible for corporations to predict with any kind of certainty their Missouri tax liability. The Commission's action in this regard opens the door for unending litigation.
For instance, the positions of the parties will undoubtedly change when the "minimal" payroll and property happen to be located within Missouri, as opposed to Delaware.

VI. The Commission's Decision Is an Unexpected Decision.

Sections 143.903 and 32.053 provide that when an assessment is based upon a change in policy of the Director, the assessment is valid only for tax years beginning after that change in policy. Holdings asserts a change of the Director's policy after the last tax period at issue, so §§ 143.903 and 32.053 are a complete defense to the assessment. In an effort to support her change in policy here, the Director seeks to characterize Holdings as a "newly invented type of corporation" and argues that the Director's policies did not change, "[i]t is ***corporations***, such as Gore that changed" (Dir. Br. 43-4;

[12] Unfortunately, Exhibit 15 contained a calculation error in the Director's favor. The Director was kind enough to correct that error in her brief to the Commission (L.F. 39).

emphasis original). Yet the record is clear that Holdings is nineteen years old and has operated under its license agreement with Gore for that period (L.F. 32).

The record also shows, rather clearly in Holdings' opinion, that the Director changed her policy in 1996 in response to an earlier court decision out of South Carolina (*Geoffrey*). At that time, the Director changed her instructions to her auditors (Ex. 9). Indeed, the auditor conceded that he did not make the assessment at issue during his audit of Gore for the immediately prior audit cycle (Tr. 221-23) (" Q Okay. So sometime

between roughly August of '95 and August of '98 you went from not taxing this type of income to taxing it? A Yes."). To counter this evidence, the Director claims that there is an "absence of evidence" in the record that she was even aware of intangible licensing transactions (Dir. Br. 43). Apparently, the Director would have this Court assume that she and her auditors never bothered to audit a taxpayer's claimed deductions, until after 1996, in contravention of her own constitutional duty set forth by article IV, §22 of the Missouri Constitution. That is an interesting claim given her litigation on the taxability of royalty receipts for trademarks and patents as early as 1955. *See A.P. Green, supra*. Such a dubious assumption should not serve as the basis to disregard evidence in the record. Sections 143.903 and 32.053 are intended to acknowledge that businesses make decisions based upon expectations that tax collectors will not change the rules in the middle of the game. That is precisely what the Director attempts to do here.

CONCLUSION

For the foregoing reasons, Holdings respectfully requests that the Court reverse the decision of the Commission and determine that the Assessment against Holdings is invalid because: (a) Holdings has no income derived from Missouri sources; (b) Holdings' royalty income cannot be constitutionally taxed by Missouri; (c) even if the royalty income were subject to tax by Missouri, it cannot be taxed retroactively; and (d) in any event the Commission incorrectly calculated the Missouri income tax by disregarding the property factor.

Respectfully Submitted,

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CERTIFICATE OF SERVICE

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

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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 7,627 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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