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# State Tax Return

## Half The Loaf Is Better Than None: *Kmart* Wins On Statutory Grounds In New Mexico

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After nearly a decade of litigation, the New Mexico Supreme Court reversed the Court of Appeals and found that Kmart's intangible holding company ("KPI") was not subject to the state's gross receipts tax because it was not selling property *in* New Mexico as required by the statute. See, *Kmart Corp. v. New Mexico Taxation and Rev. Dept.*, No.27,269, slip op., CCH NM-TAXRPTR ¶401-115 (N.M. Dec. 29, 2005). Notably, however, the New Mexico Supreme Court declined to consider whether New Mexico's assessment of income tax against KPI violated the Commerce Clause or Due Process Clause of the United States Constitution. By declining to revisit the issue of nexus, the Court left the Court of Appeals' constitutional nexus analysis intact -- an analysis that emphasizes economic considerations and limits *Quill's* physical presence nexus rule to sales and use tax only.

### Facts

In 1991, Kmart Corporation created a wholly-owned intangible holding company, Kmart Properties, Inc. ("KPI"), for the purpose of owning and managing the various Kmart trademarks, tradenames and service marks. KPI granted Kmart the exclusive right to use the marks pursuant to licensing agreements between the parties. In exchange, Kmart paid KPI a royalty based on a percentage of sales. Since Kmart was able to deduct the royalties it paid to KPI from its own income tax liability, the creation of KPI dramatically reduced Kmart's tax liability in New Mexico. Likewise, KPI had physical presence nexus only in Michigan, which did not tax income from royalty payments.

On audit, the New Mexico Taxation and Revenue Department (the "Department") assessed state income tax and gross receipts tax on the royalties Kmart paid to KPI. KPI challenged the assessments on both statutory and constitutional grounds. With respect to the constitutional issues, KPI maintained that it lacked nexus with New Mexico for both corporate income and gross receipts tax purposes because it had no physical presence within the state. From a statutory standpoint, KPI argued that it was not "selling property in New Mexico" within the meaning of the state's gross receipts tax statute.

## Review Of Court Of Appeals' Decision

The Court of Appeals upheld the imposition of gross receipts tax and corporate income tax on KPI, primarily focusing on the constitutional issues. See *Kmart Props., Inc. v. New Mexico Taxation & Revenue Dep't*, No. 21,140, St. Tax Rep. (CCH) ¶ 401-004 at 21,174 (N.M. Ct. App. Nov. 27, 2001)(hereafter cited as "CCH Op"), *rev'd*, No. 27,269, slip. op. (N.M. Dec. 29, 2005). Specifically, the Court of Appeals held that the assessments were authorized by the state's taxing statutes and that neither the Commerce Clause nor the Due Process Clause prohibited the state from imposing tax.

### **Quill Applies To Sales and Use Taxes Only**

First, the Court of Appeals held that physical presence was not necessary to create nexus for corporate income taxation. The court specifically found that "*Quill's* physical presence requirement was intended to apply to sales and use taxes only; it was not intended to apply to other taxes such as a state income tax." (CCH Op. at 21,180). According to the court, "the Commerce Clause analysis of New Mexico income tax is controlled, not by *Quill's* physical presence, but by the overarching substantial nexus test announced in *Complete Auto Transit.*" *Id.* at 21,181.

The court applied an economic standard and held that the "use of KPI's marks within New Mexico's economic market, for the purpose of generating substantial income for KPI, establishes a sufficient nexus between that income and the legitimate interests of the state and justifies the imposition of a state income tax." (CCH Op. at 21,181). Thus, the court upheld the income tax assessment, finding nexus based on economic rather than physical ties.

### **Physical Presence Or Its Functional Equivalent Creates Nexus For Gross Receipts Tax Purposes**

By contrast, New Mexico was not free to disregard *Quill's* physical presence test for purposes of the gross receipts tax. The court found that the "New Mexico gross receipts tax is similar in structure to the sales and use tax at issue in *Quill*" and thus acknowledged that *Quill's* bright-line physical presence test was controlling for purposes of gross receipts taxation. (CCH Op. at 21,180). The court found that KPI was subject to gross receipts tax in New Mexico because it had established a physical presence in the state.

The court found that nexus existed because the trademarks themselves were physically present in New Mexico and "[a]n extensive apparatus of Kmart stores, signs, and employees are also physically present in New Mexico to work on behalf of KPI's goodwill and associated interests." (CCH Op. at 21,183). As a result, the court concluded that "the combination of Kmart Corporation's activities in New Mexico, together with the tangible presence of KPI's [intangible] marks, constitutes the functional equivalent of physical presence. . . ." *Id.* Although the Court did work within the framework of *Quill*, its finding of a physical presence based on the facts of this case looks more like an attempt to fit a square peg in a round hole.

## Statutory Analysis

The Court of Appeals also rejected KPI's statutory claims. KPI argued that its royalties were not "gross receipts" subject to tax because the taxable event – the sale of a license – took place in Michigan rather than in New Mexico. Although previous authorities had held that the granting of a license to use property constituted "selling" for purposes of the tax, KPI argued that it was not "selling property *in* New Mexico" because the sale (the license) occurred outside the state.

The court rejected what it called a "place of contracting" argument. (CCH Op. at 21,184). Instead, the court found that the act of licensing intangible trademarks to a New Mexico franchisee, for use in the state, constituted "selling property in New Mexico."

## The New Mexico Supreme Court's Decision

### Reverses On Statutory Grounds

The Court of Appeals issued its decision back in November of 2001. Although the New Mexico Supreme Court granted a writ of certiorari on January 9, 2002, the action was stayed during Kmart's bankruptcy proceedings. Subsequently, the stay was lifted and Kmart was substituted for KPI.<sup>1</sup>

In a decision dated December 29, 2005, a unanimous New Mexico Supreme Court reversed the Court of Appeals' holding on the gross receipts tax issue and disposed of the case on statutory grounds. The Supreme Court resolved the issue in favor of Kmart and held that the imposition of gross receipts tax on KPI was not authorized by statute.

The Supreme Court first stated that the statute had been amended to make it clear that the licensing activities at issue were to be analyzed as a sale of property rather than as a lease. When considered in this way, it is clear that "licensed property can only be subject to [gross receipts tax] in New Mexico if the license was in essence *sold in New Mexico*."

Because all activity relating to the license agreement took place outside New Mexico, there was no "sale" in New Mexico and the royalties resulting from the license agreement were not subject to tax. In reaching this result, the court reaffirmed the proposition that "[g]ross receipts tax is due from the seller on its receipts from the sales only if the sales occurred inside New Mexico." *Kmart Corp.* No. 27,269, slip. op. at ¶ 19 (quoting *Siemens Energy & Automation, Inc. v. New Mexico Taxation & Revenue Dep't*, 119 N.M. 316, 322, 889 P.2d 1238, 1244 (N.M. Ct. App. 1994).

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<sup>1</sup> The substitution occurred after the two companies were merged and Kmart assumed KPI's state tax rights and obligations.

Importantly, the Supreme Court rejected the Department's argument that the location of the trademark, rather than where the agreement was made, was determinative. The Court focused on the plain language of the statute and concluded that it is irrelevant that the property may ultimately be **used** in New Mexico: "The language 'selling property in New Mexico' means that the property as defined in the tax code **must be sold in New Mexico** for it to be taxed, otherwise the statute would read 'selling property **used** in New Mexico' is taxable." Slip op. at ¶ 18. (Emphasis added). Thus, the fact that the trademarks were used in New Mexico and may have acquired a business situs there was irrelevant.

### **Declines To Consider Constitutional Nexus Issues**

The Court's ruling on statutory grounds eliminated any need to consider whether KPI had sufficient physical presence nexus for gross receipts tax purposes. But the Court of Appeals had found that KPI had sufficient nexus for *corporate income tax* purposes as well. Although the New Mexico Supreme Court originally agreed to review the issue by granting certiorari, the court never reviewed the Court of Appeals' income tax nexus analysis. Instead, the Supreme Court quashed certiorari and ordered that the Court of Appeals decision be filed concurrently with its own decision. As a result, the Court of Appeals' decision upholding the income tax assessment in this case was left intact.

### **Conclusion**

The Supreme Court's decision in *Kmart* is a mixed bag. On the positive side, its gross receipts tax analysis is not limited to intangible holding companies or other companies that engage in licensing activities. The court's decision is important because it holds that merely selling property for use in New Mexico is not enough to subject a company to gross receipts tax obligations. *Kmart* instructs that the sale itself must take place in the state in order to create such obligations. For this reason, the *Kmart* decision is instructive for any company that sells property for use in New Mexico.

On the down side, the court did not review the Court of Appeals' decision on income tax nexus. This decision held that *Quill's* physical presence standard did not apply to state income tax and that the use of KPI's trademarks within New Mexico's economic market established a sufficient nexus under *Complete Auto's* general Commerce Clause test. Thus, the Court of Appeals' ruling on this point remains the law of the land of enchantment. ■



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