

JURISDICTION: OKLAHOMA TAX COMMISSION
CITE: 2003-09-23-08 / PRECEDENTIAL
ID: P-98-071
DATE: SEPTEMBER 23, 2003
DISPOSITION: DENIED
TAX TYPE: INCOME
APPEAL: AFFIRMED
CITE: 2006 OK CIV APP 27, 132 P.3d 632

FINDINGS OF FACT AND CONCLUSIONS OF LAW

A hearing was held in this matter, and upon submission of additional documents and proposed findings of fact and conclusions of law, the case was submitted for decision.

FINDINGS OF FACT

The parties stipulate to the following facts:

Procedural Facts

1. PROTESTANT COMPANY, ("PROTESTANT"), did not file Oklahoma corporate income tax returns for the tax years at issue.

2. By letter dated January 21, 1998, Deputy Director of the Audit Division, the Commission proposed to assess income tax and interest against PROTESTANT for the tax years 1992, 1993 and 1994, under the Commission's audit number 9801264 in the amount of One Hundred Sixty-Three Thousand One Hundred Eighty-Nine Dollars and No Cents (\$163,189.00) tax, and interest in the amount of Ninety Thousand One Hundred Fifty-Four Dollars and No Cents (\$90,154.00), for a total of Two Hundred Fifty-Three Thousand Three Hundred Forty-Three Dollars and No Cents (\$253,343.00). Exhibit 1 [to the *Partial Stipulation of Facts*].

3. PROTESTANT timely filed a formal Protest objecting to the proposed assessment by letter dated February 19, 1998. Exhibit 2 [to the *Partial Stipulation of Facts*].

4. A Pre-Hearing Conference was held on September 24, 1998. The Administrative Law Judge issued a Scheduling Order on April 5, 1999. The Scheduling Order was amended several times, with the hearing finally being set to commence on May 23, 2000. Exhibit 3 [to the *Partial Stipulation of Facts*] is the Order setting the hearing for May 23, 24, 25 and 26, 2000.

5. The Protest of PROTESTANT is properly before the Commission.

General Facts

6. In 1984, RETAIL COMPANY substantially reorganized its corporate structure. Several new corporations were formed. Following the reorganization, RETAIL COMPANY remained the parent corporation holding the stock of various retail operating subsidiaries ("other retail companies"), as well as the stock of SUBSIDIARY 1, also a subsidiary of RETAIL COMPANY. In 1985, RETAIL COMPANY transferred the stock of PROTESTANT, a newly formed corporation, to SUBSIDIARY 1. RETAIL COMPANY continued to own and operate its retail stores in Oklahoma and other states after the formation of PROTESTANT.

7. PROTESTANT was formed on January 24, 1984, has its commercial domicile in the state of Delaware, and is the legal owner of the XYZ STORE NAME and ABC STORE NAME trademarks, service marks and trade names (the "Marks"). Exhibit 4 [to the *Partial Stipulation of Facts*] is a copy of PROTESTANT'S Certificate of Incorporation and by-laws in effect during the tax years 1992, 1993 and 1994.

8. Effective August 1, 1984, RETAIL COMPANY assigned to PROTESTANT certain of the Marks in exchange for the stock of PROTESTANT. Exhibit 5 [to the *Partial Stipulation of Facts*] is a true and correct copy of the Assignment recorded in the United States Patent and Trademark Office. Thereafter, PROTESTANT became the sole legal owner of the assigned Marks.

9. During the tax years in issue, Protestant licensed the Marks to RETAIL COMPANY, as well as to the other retail companies and to third party licensees.

10. PROTESTANT licensed the Marks, including XYZ STORE NAME and ABC STORE NAME, to others in exchange for payment of a royalty fee.

11. For the period at issue, PROTESTANT received a three percent (3%) royalty for the use of the XYZ STORE NAME marks and a two percent (2%) royalty for the use of the ABC STORE NAME marks.

12. RETAIL COMPANY, one of PROTESTANT'S licensees, operates retail toy and children's clothing stores in Oklahoma and in other states.

13. PROTESTANT paid no income tax to the State of Oklahoma during the tax years 1992, 1993 and 1994.

14. If it is ultimately determined that: (a) PROTESTANT has nexus with Oklahoma for income tax purposes; and (b) a one factor apportionment formula based on the sales factor of RETAIL COMPANY is appropriate, then the numeric calculations included in the January 21, 1998, assessment (see Exhibit 1) are numerically accurate computations.

15. Exhibit 6 [to the *Partial Stipulation of Facts*] is a true and correct copy of a License Agreement between PROTESTANT and RETAIL COMPANY, dated May 3, 1992, in accordance with which the Marks were licensed to RETAIL COMPANY.

16. Exhibit 7 [to the *Partial Stipulation of Facts*] is a true and correct copy of an amended License Agreement between PROTESTANT and RETAIL COMPANY dated January 30, 1994, that was in effect for the latter portion of the years in issue.

17. The royalties paid by RETAIL COMPANY to PROTESTANT were paid at arm's length rates consistent with the requirements under Internal Revenue Code § 482.

18. Under an agreement between PROTESTANT and the firm of ACCOUNTING FIRM in effect during the years in issue, the ACCOUNTING FIRM performed various accounting and other services for PROTESTANT in exchange for a fee and leased office space to PROTESTANT in exchange for a monthly rental payment. Exhibit 8 [to the *Partial Stipulation of Facts*] is a true and correct copy of an Accounting and Management Service Agreement between PROTESTANT and the ACCOUNTING FIRM, dated January 8, 1993, in effect during the years in issue.

19. PROTESTANT takes the following positions: (1) PROTESTANT cannot be subject to Oklahoma corporate income tax because it has no physical presence, and is not otherwise doing business in Oklahoma; (2) even if PROTESTANT were taxable, the tax has not been properly apportioned or allocated by the Commission

20. The Commission takes the following positions: (1) PROTESTANT has established nexus in Oklahoma by virtue of its economic presence and therefore has Oklahoma taxable income; (2) said income is taxable to Oklahoma on a one factor modified apportionment formula or, in the alternative, by a direct allocation methodology.

Facts Relating to Nexus

21. RETAIL COMPANY, a licensee of certain of PROTESTANT'S Marks, used said Marks in the State of Oklahoma during the audit period for various purposes, including but not limited to, advertising and "corporate citizen activities" in Oklahoma. Exhibit 9 [to the *Partial Stipulation of Facts*] consists of samples of the stipulated uses: i) Complaint filed in the United States District Court for the Northern District of Oklahoma styled *PROTESTANT v. DEFENDANT, et al.*, Civil Action No. 99 X 999 X, together with attached exhibits; ii) Article from The Daily Oklahoman / Oklahoma City Times, dated November 27, 1992; iii) Announcement from The Daily Oklahoman / Oklahoma City Times, dated November 25, 1994; and iv) Article from TV News dated March 6, 1994.

22. PROTESTANT did not provide documents containing "market or other analyses of any Oklahoma marketplaces" in response to the Division's Second Request for Production of Documents, stating that PROTESTANT did not conduct market studies of any Oklahoma marketplaces and that any such documents, if they existed, were "not within its possession, custody or control." Exhibit 10 [to the *Partial Stipulation of Facts*] is Protestant's Response to Division's Second Request for Production.

23. At his deposition on March 3, 2000, CHAIRMAN – Chairman of the Board and former CEO of RETAIL COMPANY and an incorporator of PROTESTANT per its Articles of Incorporation–indicated that he did not recall RETAIL COMPANY conducting any market studies

comparing RETAIL COMPANY to others engaged in the sale of toys regarding consumer perception or customer service. Exhibit 11 [to the *Partial Stipulation of Facts*] is a copy of the pages 18-22 of said deposition transcript.

24. For the period at issue, PROTESTANT received a three percent (3%) royalty for use of the XYZ STORE NAME mark and a two percent (2%) royalty for the use of the ABC STORE NAME mark.

25. For the tax years 1992 through 1994, PROTESTANT licensed its Marks to RETAIL COMPANY. RETAIL COMPANY used the Marks in Oklahoma and other states.

26. For the tax years 1992 through 1994, but for its license agreements with PROTESTANT, RETAIL COMPANY would not have been allowed to identify in any way its stores in Oklahoma, or any other state, and its products for sale in Oklahoma with names such as XYZ STORE NAME, ABC STORE NAME", or any other such mark owned by PROTESTANT or to use the name in any advertising.

27. For the tax years 1992 through 1994, PROTESTANT was legally a separate and independent business from RETAIL COMPANY.

28. PROTESTANT has economic substance.

29. PROTESTANT did not own or lease real or tangible personal property, maintain an office, or have employees or officers in the state of Oklahoma during the years in issue.

Additional Stipulated Facts

30. The gross royalties paid by RETAIL COMPANY and its affiliates and third parties to Protestant were: \$161,353,253.00 for the tax year ending January 30, 1993 (of which \$103,029,518.00 was paid by RETAIL COMPANY); \$210,680,075.00 for the tax year ending January 30, 1994 (of which \$124,702,241.00 was paid by RETAIL COMPANY); and \$211,254,574.00 for the tax year ending January 30, 1995 (of which \$138,039,428.00 was paid by RETAIL COMPANY). Exhibit 1 [to the *Second Partial Stipulation*] consists of the support schedules from the Federal Form 1120 filed on behalf of RETAIL COMPANY and affiliates for the years ending January 30, 1993, January 29, 1994, and January 28, 1995, showing royalties paid to the Protestant by RETAIL COMPANY and by other affiliates.

31. Exhibit 2 [to the *Second Partial Stipulation*] consists of true and correct copies of the Oklahoma corporate income tax returns filed by RETAIL COMPANY for the years at issue.

32. Exhibit 3 [to the *Second Partial Stipulation*] consists of true and correct copies of the Federal pro forma Forms 1120 filed on behalf of Protestant, and included in the consolidated Federal Form 1120 for the RETAIL COMPANY'S group of companies, for the years at issue.

33. The Commission stipulates to the admissibility at the hearing of the expert report prepared by LAW PROFESSOR entitled, "In the Matter of the Income Tax Protest of

PROTESTANT. Before the Administrative Law Judge," dated February 2000, and his curriculum vitae. Exhibit 4 [to the *Second Partial Stipulation*].

34. Protestant agrees and stipulates to the admissibility at the hearing of the expert report prepared by EXPERT X entitled, "Opinion in the Oklahoma Tax Commission Protest Case No. P 98-071," dated May 9, 2000. Exhibit 5 [to the *Second Partial Stipulation*].

ADDITIONAL FINDINGS OF FACT

35. During the years at issue, RETAIL COMPANY, ABC SUBSIDIARY) and Protestant engaged in activities and operations as follows:

- a) RETAIL COMPANY was involved in the operation of toy stores in numerous U.S. states, including Oklahoma.
- b) ABC SUBSIDIARY, a wholly owned subsidiary of RETAIL COMPANY, provided treasury, tax, accounting and management services to Protestant and RETAIL COMPANY and operated stores in New Jersey.
- c) Protestant owned and licensed to operating companies the use of intellectual property throughout the world.

36. DIRECTOR/SECRETARY, Director and Secretary, PROTESTANT, and Vice President/Taxes, RETAIL COMPANY, testified regarding Protestant, which owns the licenses that are used within the RETAIL COMPANY'S umbrella of operating companies and franchises.

- a) Protestant is incorporated and headquartered in Wilmington, Delaware, and the Board of Directors holds its meetings there. DIRECTOR/SECRETARY explained that at these meetings the board reviews financial statements, any pending litigation, any needed license agreements and investment policy regarding excess money.
- b) Protestant, during the years at issue, rented an office in Wilmington, Delaware. Protestant had a telephone listing, paid bills from its office, had its own bank account and maintained books and records at its Wilmington office.
- c) Protestant did not have any full-time employees, but it did have part-time employees. For a fee of \$300,000.00 per year, Protestant could utilize a number of ABC SUBSIDIARY employees. Additionally, Protestant engaged outside lawyers and accountants. The attorneys' fees of Protestant were approximated at \$1,000,000.00 a year.
- d) The services performed by ABC SUBSIDIARY for Protestant were done either in New Jersey or New York City. ABC SUBSIDIARY did not perform any services for Protestant in Oklahoma.
- e) DIRECTOR/SECRETARY testified that Protestant owned the XYZ STORE NAME name, the ABC STORE NAME name, the MASCOT logo and many other names that were used under the license agreement. He further testified that Protestant had possession and control of those trademarks which it licensed to RETAIL COMPANY; SUBSIDIARY 1; SUBSIDIARY 2; and other operating companies in the United States as well as foreign companies. Protestant licensed the trademarks to companies that were entirely or partially owned by RETAIL COMPANY and its franchisees.

f) Protestant had the ability to review the advertising of its licensees, including that of RETAIL COMPANY.

37. Licensing agreements entered into between PROTESTANT, as Licensor, and RETAIL COMPANY, as Licensee, in effect during the years at issue included the following requirements of RETAIL COMPANY.

- a) Pay Licensor a royalty based upon a percentage of sales in return for use of the Marks.
- b) Provide Licensor with a quarterly royalty statement, the first of which was to include "all such Products sold and Services rendered between the effective date of th[e] Agreement and the date of the . . . period for which such statement [was] prepared."
- c) Covenant and agree that licensed products and services would be of high standard and of quality, workmanship, style and appearance as "shall, in the sole judgment of Licensor, be reasonably adequate and suited to their exploitation to the best advantage and to the protection and enhancement of the Licensed Mark and Licensed trade name, and the goodwill pertaining thereto."
- d) Conduct its business in such a way as to comply with all applicable law and in a manner that does not reflect adversely on Licensor.
- e) Submit to Licensor, upon Licensor's request, at least 15 days prior to use thereof, for Licensor's approval, samples and specifications of Licensed Products and Services, together with samples of signs, labels, tags, packaging materials, advertising and promotion materials, bills, catalogs, etc. on which appear the Licensed Mark.
- f) Follow Licensor's instructions and exercise its own care to prevent the trademark from becoming a generic term.
- g) Indemnify Licensor against losses, including legal fees and expenses, relating to claims of third persons against Licensor.
- h) Cooperate fully with Licensor in any action in which Licensor sought to undertake to protect the Marks against infringement, counterfeiting or passing off.
- i) Immediately notify Licensor of complaints or legal actions asserted against Licensee due to use of the Marks.

38. PROFESSOR, a Professor of Economics, Vanderbilt University, testified at the hearing on Protestant's behalf as an expert in state and local fiscal policy and public finance regarding a report he prepared at the request of PROTESTANT'S counsel entitled *Nexus and State Corporation—State Corporate Income Taxation*. In this report, PROFESSOR considered from a public finance perspective whether it is desirable for states to tax corporations which are not present physically within their jurisdiction and concluded that it is undesirable for states to do so. He based his opinion on the fact that these businesses do not impose fiscal burdens on the state in that they do not utilize or benefit from the services i.e., fire and police protection, transportation, libraries, education, etc., provided by state and local government. Further, he described various harmful effects would ensue if states were to impose taxes on businesses that were not physically present within the state.

39. PROFESSOR agreed that an out-of-state company whose only contact with a state was to license intangible property to a separate entity doing business in the state, is not physically present in that state.

40. ECONOMIST, economist with the firm of XYZ ACCOUNTING FIRM, testified as an expert in microeconomics in regard to the business purpose for the creation of Protestant stating that it is prudent to create such an organization for the protection and negotiation of royalties with non-related third parties. Without such a program to protect the trademark, the legal right to the trademark can be lost.

41. From an economist's viewpoint, ECONOMIST testified that possession and control, as well as the obligation to protect and defend, reside solely with Protestant.

42. LAW PROFESSOR, Professor of Law, University of Connecticut Law School and Visiting Professor, Harvard Law School, testified on Protestant's behalf as an expert in state tax policy, state tax distortion, factor analysis and state tax accounting. He prepared a report regarding his opinion concerning policies that distinguish Due Process nexus from Commerce Clause nexus, specifically which nexus standard—physical presence, based on the in-state presence of employees, tangible personal property or real property, or nonphysical presence, based on the in-state use of intangible personal property—is more compatible with the values embodied in the Commerce Clause and which nexus standard is more consistent with sound tax policy. LAW PROFESSOR concluded that physical presence was far superior to nonphysical presence as a nexus standard, discussing in some detail certain criteria which he stated are commonly used by tax policy analysts in evaluating interstate tax systems.

43. CHAIRMAN explained that before the creation of Protestant in 1984, although RETAIL CHAIN was doing work in trademark protection and had assistance of counsel, it was not of a high priority because of the lack of sophistication of RETAIL CHAIN at the time. Once Protestant was formed, CHAIRMAN continued, it became very aggressive in building the brand and expanding throughout the world, and Protestant was utilized as the licensing company to accomplish these objectives. Other corporate restructuring was undertaken to enable RETAIL CHAIN to expand worldwide. A number of store operating companies, investment companies and other companies were created to aid the expansion.

44. CHAIRMAN testified that the most significant reason for the creation of Protestant and the other corporate restructuring was for trademark and brand protection. An additional reason was to enable effective negotiations with non RETAIL CHAIN entities.

45. CHAIRMAN related that RETAIL CHAIN is located in 25 or more countries and that in addition to a toy business with over 700 stores, RETAIL CHAIN has a CLOTHING STORE business with over 100 stores, ABC CLOTHING STORE with over 200 stores, CHILDREN'S STORE with approximately 40 stores, and non-store retailing through catalogs and the internet.

46. Testimony of MARKETING OFFICER, Senior Vice President of Marketing and Advertising for RETAIL COMPANY, was received into the record through deposition upon oral examination. He stated that the XYZ STORE NAME and ABC STORE NAME marks are used on signage inside the stores and outside the stores, on such things as trucks, billboards, advertising, newspapers, magazines, television advertisements, radio and direct mail. Basically, any form of communication bears their logo.

47. OTC AUDITOR, auditor for the Division, testified that he performed the audit of Protestant under the authority of Section 2355(C) of Title 68 of the Oklahoma Statutes, wherein Oklahoma income tax is due on corporations doing business in Oklahoma or deriving income from sources within Oklahoma. It was his determination that Protestant derived income from sources within Oklahoma.

48. To ascertain the income Protestant derived from sources within Oklahoma, the auditor made a series of calculations to determine the amount of royalty income attributable to Oklahoma from sales by RETAIL COMPANY, as licensee of Protestant's Marks, and the related sales factor percentage, as well as Oklahoma apportionable income for Protestant, Oklahoma taxable income and tax amount due. He described the methodology as follows:

- a) First, the sales factor was computed for the tax years at issue, 1992, 1993 and 1994. For tax year 1992, the Oklahoma sales figure stated on the state tax return of RETAIL COMPANY was divided by 360 days to arrive at an average daily sales amount. The royalty income of Protestant as a result of Oklahoma sales figures reported by RETAIL COMPANY was prorated between the two different royalty rates applied in 1992.
- b) Next, Protestant's foreign royalty income was subtracted from its total royalty income to arrive at a figure for net royalty income nationally. The Oklahoma royalty income was then divided by the national royalty income, resulting in a sales factor percentage for 1992.
- c) The auditor explained that the audit methodology utilized to determine Protestant's royalty income attributable to Oklahoma for the 1993 and 1994 tax years was basically the same, although proration of the different royalty rates was unnecessary.
- d) Explaining the procedure to arrive at the additional tax figure for tax year 1992 for Protestant, the auditor stated he began with Protestant's federal return, line 28-taxable income, deducting foreign royalties and certain interest income to arrive at a net apportionable income figure. The sales factor percentage previously calculated was then applied to arrive at an Oklahoma apportionable income figure.
- e) The accrued Oklahoma income tax deduction was subtracted from the apportionable income to arrive at Oklahoma taxable income, which was then multiplied by the six percent (6%) tax rate in effect, to arrive at the tax amount due for 1992.
- f) The same procedure was employed by the auditor to determine Protestant's additional tax for 1993 and 1994.

49. Upon cross-examination, the auditor testified that use of one percent (1%) or three percent (3%) of total sales to arrive at royalty income was based on the license agreements in effect during the audit periods. He saw no reference in the agreements to a two percent (2%) rate for ABC STORE NAME, and thus did not use it in computing the assessment.

50. Addressing the three-factor apportionment formula as applied to Protestant for tax year 1992, the auditor testified that Protestant's property factor consisted of zero property in Oklahoma and \$1,200.00 everywhere; Protestant's payroll factor consisted of zero payroll in Oklahoma and \$1,800.00 of payroll everywhere; and Protestant's sales factor consisted of gross revenue or sales in Oklahoma of \$808,344.00 and gross revenue or sales everywhere of \$150,487,856.00.

The auditor added that the numbers in the property and payroll factors were the same for 1993 and 1994; only the numbers in the sales factor varied for each year.

51. The auditor testified that based upon legislative authority to adjust an apportionment formula if the portion of income attributed to Oklahoma is out of all proportion to the property owned and/or business transacted within the State, he determined that property Protestant owned and its payroll outside of Oklahoma were *de minimis* and therefore he did not use them in the formula.

52. During the years at issue, TRADEMARK ATTORNEY of the firm XYZ LAW FIRM, who specializes in intellectual property, was trademark counsel for Protestant, the legal owner of the Marks. Protestant licensed Marks, governed by licensing agreements, to various domestic operating companies and foreign entities. TRADEMARK ATTORNEY'S responsibilities included arranging for the registration, renewal and enforcement of the various Marks, both in the United States and abroad. In his view, the trademarks are one of the most valuable assets of the corporation.

53. TRADEMARK ATTORNEY testified that a trademark is an intangible asset and identifies the source of the product it represents, although the source is usually anonymous and consumers would not know the source. He also testified of several things a trademark does not do: (1) it generally does not identify the attributes and benefits of a product; (2) it does not identify the consumer; and (3) it does not attach itself to a licensee's physical location.

54. In his testimony regarding the location of trademarks, TRADEMARK ATTORNEY differentiated between the trademarks themselves, which are intangible and therefore not located anywhere, and trademark registrations, which are located with whomever has possession of the registration. To his knowledge, no trademarks had ever been registered in Oklahoma.

55. Further testimony of TRADEMARK ATTORNEY concerned the protection of Protestant's Marks from infringement once they have been registered. A computerized service is subscribed to for monitoring and notification concerning the Marks that are printed for opposition purposes in every trademark office around the world. Additionally, individual associates throughout the world, who monitor the Marks, or third party individuals, who become aware of infringements, send notification. In the United States, licensees also keep them advised. Additionally, on an ongoing basis, TRADEMARK ATTORNEY checks advertisements or promotions to verify the Marks are being used correctly.

Protestant authorized and bore the expense of various responses in protection of the Marks, including opposition proceedings or cancellation proceedings before a trademark office, cease and desist letters or filing of lawsuits. TRADEMARK ATTORNEY testified that Protestant's rights, in all of its trademarks cases over the 16 years it had owned the Marks, have been sustained in every court action or administrative court proceeding around the world.

56. In an effort to maintain "their high quality reputation and distinctiveness," a brochure was prepared by TRADEMARK ATTORNEY and distributed to RETAIL CHAIN employees, soliciting their help in protecting the trademarks and service marks. The brochure instructs

employees in the proper use and form of the Marks, giving examples, as well as requesting employees to watch for infringing uses of the DISTINCTIVE LETTERING designation.

57. GENERAL COUNSEL, General Attorney for RETAIL COMPANY, testified through deposition that to protect the RETAIL CHAIN marks employees are urged to report any infringer who comes to their attention to a store manager, who in turn transmits the information to corporate headquarters for a determination of any action to be taken.

ISSUES

Whether the federal constitution prohibits the State of Oklahoma from imposing an income tax on royalties received by Protestant, a non-domiciliary corporation, from the licensing of its trademark to a related company licensee for use in that licensee's retail operations in Oklahoma.

Whether the royalty income of Protestant is allocable in its entirety to either Delaware or Oklahoma or is apportionable to Oklahoma for purposes of taxation under 68 O.S. § 2358.

Whether Protestant has shown that the Division improperly applied Section 2358(A)(5) of Title 68 of the Oklahoma Statutes when it modified the standard apportionment formula.

CONTENTIONS OF PROTESTANT

Protestant contends it did not "purposefully direct" its activities at residents of Oklahoma, but directed licensing activities to RETAIL COMPANY. Therefore, Protestant's activities are protected under the Due Process Clause of the United States Constitution.

In addition, Protestant contends that the Division is prohibited from assessing Oklahoma corporate income tax under the Commerce Clause of the United States Constitution, because physical presence is necessary to establish nexus. Protestant contends it cannot be subject to Oklahoma corporate income tax because it has no physical presence in Oklahoma nor is it otherwise doing business in Oklahoma. It is the contention of Protestant that the royalties paid by its Oklahoma licensee with respect to the use and promotion of its trademarks does not create nexus.

Protestant argues that there are no in-state activities performed on its behalf by anyone, and that the protection of the trademarks and the amount of quality control are not "activities" sufficient to establish a basis for finding that a licensor is physically present. Protestant asserts that *Oklahoma Administrative Code 710:50-17-03(a)(9)* is inapplicable to the facts in this case since Protestant did not lease tangible property in the state.

Protestant contends alternatively that if it is subject to Oklahoma tax, under the language of Section 2358(A)(5) and 2358(A)(4)(b) of Title 68 of the Oklahoma Statutes and *Oklahoma Administrative Code 710:50-17-51*, then the income from intangible property must be allocated to a non-domiciliary taxpayer's commercial domicile, whether or not it arises from a unitary business, and is therefore not available for apportionment, in whole or in part, to Oklahoma.

Lastly, Protestant contends that if nexus is found, then any apportionment formula should include the amounts that Protestant paid its contract service providers in the payroll factor and the value of Protestant's Marks in the property factor.

CONTENTIONS OF THE DIVISION

It is the contention of the Division that the minimum contact requirements of the Due Process Clause of the United States Constitution are met by Protestant's activities and those of the related retail companies acting on Protestant's behalf pursuant to the licensing agreements.

Additionally, the Division contends that the requirement under the Commerce Clause is substantial nexus, not physical presence, and thus the assessments do not violate the Commerce Clause.

It is the further contention of the Division that the principal and only income-producing activity of Protestant is the licensing of the trademarks and the resulting royalty income from use of the trademarks in Oklahoma and in other states, which results in economic presence, and thereby creates nexus. Additionally, the Division asserts that Protestant has established nexus in Oklahoma by virtue of its economic presence and physical presence through its related entity licensee. The Division concludes that Protestant is doing business in and deriving income from Oklahoma as defined in 68 O.S. § 2355(C) and that Protestant has nexus with Oklahoma pursuant to 710:50-17-3 of the *Oklahoma Administrative Code*.

The Division further maintains that since Protestant is doing business in Oklahoma as well as in other states, it is a unitary enterprise for purposes of Oklahoma income taxation, and therefore is subject to apportionment. In addition, the use of a one-factor modified apportionment formula is asserted by the Division, or in the alternative, a direct allocation methodology.

CONCLUSIONS OF LAW

1. Jurisdiction over the parties and subject matter of this proceeding is vested in the Tax Commission. 68 O.S. 1991, § 207.

2. A proposed assessment is presumed correct and the taxpayer bears the burden of showing that it is incorrect, and in what respect. *Enterprise Management Consultants, Inc. v. Oklahoma Tax Commission*, 768 P.2d 359 (Okl. 1988). Failure to provide evidence which is sufficient to show an adjustment to the proposed assessment is warranted will result in the denial of the protest. *Continental Oil Company v. Oklahoma Tax Commission*, 570 P.2d 315 (Okl. 1977).

3. An income tax is “imposed upon the Oklahoma taxable income of every corporation doing business within this state or deriving income from sources within this state . . .” 68 O.S. 1991, § 2355(C).

4. The Oklahoma Income Tax Code does not, nor does the *Oklahoma Administrative Code*, define the phrase “doing business”. In the absence of a statutory definition, the meaning of words used in a statute are to be understood in their ordinary sense. 25 O.S. 1991, § 1. “Doing business”

has been defined by the Supreme Court in *Flint v. Stone Tracy Co.*, 31 S.Ct. 342, 357 (1911), as follows:

"Business" is a very comprehensive term and embraces everything about which a person can be employed. Black's Law Dict. 158, citing *People ex rel. Hoyt v. Tax Comrs.*, 23 N.Y. 242, 244. "That which occupies the time, attention, and labor of men for the purpose of a livelihood or profit." 1 Bouvier's Law Dict. P. 273.

"Doing business" is a very broad concept and generally encompasses all the activities in which a business engages that contribute to the profit or loss of the business.

I. NEXUS

5. Section 710:50-17-1(b) of the *Oklahoma Administrative Code* provides that "any corporation is subject to Oklahoma income taxes if it has 'nexus' with Oklahoma." Activities that create nexus for income tax purposes are described by 710:50-17-3 of the *Oklahoma Administrative Code*, which provides in pertinent part, as follows:

(a) If a corporation has one or more of the following activities in Oklahoma, it is considered to have "**nexus**" and shall be subject to Oklahoma income taxes:

* * *

(8) Other miscellaneous activities by employees or representatives in Oklahoma such as credit investigations, collection of delinquent accounts, conducting training classes or seminars for customer personnel in the operation, repair and maintenance of its products.

(9) Leasing of tangible property and licensing of intangible rights for use in Oklahoma.

(10) The sale of other than tangible personal property such as real estate, services and intangibles in Oklahoma.

(11) The performance of construction contracts or service contracts in Oklahoma.

(12) The delivery of merchandise in a company owned or leased vehicle to a destination within the state from a source outside the state, in connection with the solicitation of sales.

(b) The guidelines expressed in (a) of this Section as to what activities constitute "nexus" should not be considered all-inclusive.

6. Protestant maintains that because the conjunctive term, "and", was used in subsection (a)(9) rather than the disjunctive, "or", that both the leasing of tangible personal property and the licensing of intangible rights must exist to give rise to nexus for income tax purposes.

However, such a construction would result in conflict when the Section is considered as a whole in light of its stated purpose¹—to describe the parameters of nexus. The phrasing at issue can be interpreted as a grouping of similar activities, rather than a linking of the two. This interpretation is supported by a reading of the Section in its entirety, since the intangibles are implicated and listed in other subsections.² Moreover, *Oklahoma Administrative Code 710:50-17-4*, which deals with the scope of federal limitations on the state's ability to tax, specifically states that "immunity from income taxation . . . does not extend to those businesses which sell . . . intangibles in more than one state."³

7. The Commission has previously interpreted 710:50-17-3(a)(9) of the *Oklahoma Administrative Code*, stating that the "licensing of intangible rights for use in Oklahoma is sufficient to create nexus with the State of Oklahoma. [Once] nexus has been established, Oklahoma source income is subject to Oklahoma income tax."⁴

8. To meet the requirements of the Due Process Clause there must be "some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax." *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992) (quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-345 (1954)). Additionally, the "income attributed to the state for tax purposes must be rationally related to values connected with the taxing state." *Id.* at 306 (quoting *Moorman Mfg. Co. v. Blair*, 437 U.S. 267, 273 (1978)) (citation omitted). If a foreign corporation purposefully avails itself of the benefits of an economic market of a state, then it may be subjected to the jurisdiction of that state without having a physical presence there. *Quill*, 504 U.S. at 307.

¹*Bishop v. Takata Corp.*, 12 P.3d 459 (Okla. 2000).

²See subsection (a)(10). The sale of other than tangible personal property such as . . . intangibles in Oklahoma. Also see subsection (a)(8). Other miscellaneous activities by . . . representatives in Oklahoma such as . . . maintenance of its products.

³ 710:50-17-4. Federal limitations on taxation of foreign corporations

(a) Under Federal law a state may not impose its income tax on a business selling tangible personal property, if the only activity of that business is the solicitation of orders by its salesman or representative which orders are sent outside the state for approval or rejection, and are filled by delivery from a point outside the state. The activity must be limited to solicitation. If there is any activity which exceeds solicitation, the immunity from taxation is lost.

(b) Immunity from income taxation by states under Federal law does not extend to:

- (1) Those businesses which sell services, real estate or intangibles in more than one state;
- (2) Domestic Corporations;
- (3) Foreign nation corporations, i.e., those not incorporated in the United States.

(c) If the only activities in Oklahoma of a corporation selling tangible personal property are those described below, the corporation is not subject to Oklahoma Income Taxes.

- (1) Usual or frequent activity in Oklahoma by employees or representatives soliciting orders for tangible personal property, which orders are sent outside this state for approval or rejection.
- (2) Solicitation activity by non-employee independent contractors, conducted through their own office or business location in Oklahoma. [See: 15 U.S.C.A. § 381]

⁴Advisory Opinion dated September 23, 2002, issued by the Tax Policy Division of the Oklahoma Tax Commission.

9. In *Quill*, an out-of-state mail-order company sold office equipment and supplies to North Dakota customers through catalogs, advertisement in national periodicals and telephone calls from outside North Dakota. The goods were delivered to its North Dakota customers from out-of-state locations by mail or common carrier. Quill did not have sales outlets or representatives in North Dakota, but did have a minimal amount of tangible property in that state.⁵ The State of North Dakota sought to compel Quill to collect use tax from its North Dakota customers and this action by the State was challenged by Quill. The *Quill* Court held that a taxpayer has sufficient nexus with a taxing state for due process purposes if the taxpayer purposely directs its activities towards residents of the state and avails itself of the economic benefit of the state. *Quill*, 504 U.S. at 308. The Court found that there was a sufficient connection between Quill and North Dakota to satisfy due process requirements stating that “there is no question that Quill has purposely directed its activities at North Dakota residents, that the magnitude of these contacts are more than sufficient for due process purposes, and that the use tax is related to the benefits Quill receives from access to the State.” *Id.*

10. Protestant herein has purposely directed its activities toward residents of this State and availed itself of the benefits of Oklahoma’s economic market. As owner of the Marks, Protestant controlled the license agreements i.e., to whom the trademarks and trade names would be licensed and where the trademarks and trade names would be used. Protestant could have taken steps to prevent its licensee from using the Marks in Oklahoma, but did not do so. Protestant chooses to license its trademarks to RETAIL COMPANY, who operates retail toy and children’s clothing stores in Oklahoma, as well as other states. The royalty income that Protestant earns is directly related to the sales made by the Oklahoma stores, the licensing fee being a percentage of the sales revenue earned by the Oklahoma licensee. By allowing the use of the Marks in Oklahoma and receiving income in exchange for their use, Protestant has purposefully derived an economic benefit through the use of its property, the Marks and related goodwill in Oklahoma. Therefore, Protestant possesses the minimum connection with this State required by due process. See *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993) *cert. denied*, 510 U.S. 992 (1993); and *Kmart Properties, Inc. v. Taxation and Revenue Dept. of N.M.*, No. 21,140 Ria Checkpoint (N.M. Ct. App. Nov. 27, 2001) (unpublished opinion), *cert. granted*, No. 27,269, 2002 N.M. Lexis 26 (N.M. Jan. 9, 2002).

11. The State of Oklahoma and its local governmental units provide the basic infrastructure i.e., public transportation, construction and roadway maintenance, police and fire protection, utility and state banking services, in which Protestant’s licensee operates. By providing an organized social and economic context in which RETAIL COMPANY conducts business, the State of Oklahoma has made it possible for Protestant to earn income from its licensing agreement. *Geoffrey* at 18. Absent this context, the value of Protestant’s trademarks would be diminished. The conclusion that Protestant has been a recipient of the protections, benefits and opportunities from the State is demonstrated by the fact that it earns income here. *Id.* Protestant’s expert witness acknowledged that Protestant received “indirect benefits” from the State of Oklahoma. Since the State of Oklahoma only seeks to tax that portion of Protestant’s income earned in Oklahoma, the income tax at issue herein is rationally related to the State and local protections and benefits

⁵Quill's North Dakota customers possessed software licensed by Quill, which enabled these customers to peruse Quill's current inventories and prices and to place direct orders.

received by Protestant. Therefore the State of Oklahoma is not prohibited by the Due Process Clause from taxing Protestant's royalty income.

12. In its Commerce Clause analysis, the Court in *Quill* reiterated the test set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977),⁶ considered whether physical presence in the taxing state was necessary to establish substantial nexus for Commerce Clause purposes, and held that the substantial nexus requirement, unlike the Due Process nexus requirement, is not a proxy for notice. The Court concluded that the physical presence was required for the assessment of sales and use tax. *Quill*, 504 U.S. at 314.

13. The *Quill* Court did not establish a bright-line “physical presence” requirement for other taxes⁷ and the Court specifically noted pronouncing that “concerning other types of taxes we have not adopted a similar bright-line physical-presence requirement.” *Id.* at 318. Since *Quill*, the extant case law remains undecided as to whether *Quill*'s “physical presence” requirement is limited to sales and use tax cases, or is to be applied to income tax issues; nor has the United States Supreme Court considered whether a physical presence is necessary to meet a Commerce Clause nexus challenge to an assessment of income tax. In fact, the U.S. Supreme Court has twice refused to hear conflicting cases that raised the issue.⁸

14. Protestant argues that there is no basis to have one standard governing sales and use tax and another for all other type of taxes. Current jurisprudence does not support this argument. The rationale for a bright-line physical presence rule in the income tax context is less persuasive than in the sales and use tax setting. Unlike an income tax, a sales and use tax can impose a special burden on interstate commerce beyond the payment of money since it makes the taxpayer an agent of the state, obligated to collect the tax from the consumer at the point of sale and pay it over to the taxing entity. *Kmart Properties* at ¶ 23. While “a state income tax is usually paid only once a year, to one taxing jurisdiction, and at one rate; a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates.” *Id.*, citing *Quill*, 504 U.S. at 313 n.6. Furthermore, requiring physical presence for the imposition of a state income tax would be a divergence from established precedent; see, e.g., *New York ex rel. Whitney v. Graves*, 299 U.S. 366, 372 (1937); *International Harvester Co. v. Wisconsin Department of Taxation*, 322 U.S. 435, 441-42, and the prevailing authority in the area of state and local taxation; Jerome R. Hellerstein and Walter Hellerstein, *State Taxation: Constitutional Limitations and Corporate Income and*

⁶ For Commerce Clause purposes a tax is valid if it: (1) is applied to an activity with a substantial nexus to the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the taxing state. *Quill* at 279.

⁷ The Court specifically states that in their review of other types of taxes there had not been articulated “the same physical presence requirement that *Bellas Hess* established for sales and use taxes.” *Quill*, 504 U.S. 314.

⁸ *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993) (wherein the physical presence requirement was limited to sales and use taxes for Commerce Clause purposes) and *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 839 (Tenn.Ct.App. 1999) (wherein a physical presence was required to satisfy Commerce Clause for the imposition of income tax). However, the Tennessee Court of Appeals in a more recent case, *American Online Inc. v. Johnson*, 2002 WL 1751434 (Tenn.Ct.App.), indicated that no bright-line test (of requiring an out-of-state company to have physical presence in the state in order to have substantial nexus with it) has been adopted.

Franchise Taxes, ¶ 6.08 (3d ed. 1907-2000) (stating a corporation that regularly exploits state markets should be subject to its state income tax whether or not it is physically present). *Kmart Properties* at ¶ 24.

15. Based on the above, it is evident that the Commerce Clause analysis for Oklahoma income tax must be controlled not by physical presence but by the substantial nexus announced in *Complete Auto Transit*. The licensing of Protestant's Marks for use within Oklahoma's economic market for the purpose of generating substantial income for Protestant, establishes sufficient nexus between the royalty income and the legitimate interests of the State of Oklahoma and justifies the imposition of the state income tax. See *Geoffrey, Inc.*, 437 S.E.2d at 18; *Kmart Properties* at ¶ 25.

II. TRADEMARKS

16. In analyzing whether a taxpayer had nexus for Commerce Clause purposes, in situations similar to the instant case, state courts and administrative tribunals have also reviewed the special nature of trademark law.

17. Trademarks are not separate property rights. "There is no such thing as property in a trademark except as a right appurtenant to an established business or trade in connection with which the mark is employed." *United States Drug Co. v. Theodore Rectanus Co.*, 248 U.S. 90, 97 (1918).

A trademark or trade name "is merely a symbol of goodwill; it has no independent significance apart from the goodwill it symbolizes," *Marshak v. Green*, 746 F.2d 927, 929 (2nd Cir. 1984); and cannot exist apart from the going business in which it is used, Jerome Gilson, *Trademark Protection and Practice*, Vol. 1, § 1.031[7][b]. Consequently the trademark and the goodwill it represents are inseparable. *Id.*

18. To retain their status as a protected property right, trademarks must continue to be used in association with the business with which they are associated; otherwise they may be considered to be abandoned. *Hanover Star Milling Co. v. Metcalf*, 240 U.S. 403 (1916).

19. The term used to refer to the transfer of a trademark is *assignment*. Because trademarks are inseparable from the goodwill they symbolize, they are required by law to both be transferred by the assignment. A naked transfer of the mark alone, known as a *transfer in gross*, is invalid. *Visa, U.S.A. Inc. v. Birmingham Trust National Bank*, 696 F.2d 1371 (C.A. Fed. 1982), *cert. denied*, 464 U.S. 826 (1983).

20. The owner of a trademark may allow others use of the trademark, through a contractual agreement called a license, but is required to control or police the nature and quality of the goods and services sold under the mark by the licensee and must avoid deceiving the public. Gilson, § 6.01[4]. This quality control requirement was incorporated into the Lanham Act, 15 U.S.C. §§ 1051-1127, through the related company doctrine. Gilson, § 6.01[4]. Under the Act, a related company is defined as "any person whose use of the mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services on or in connection with which the mark is used." 15 U.S.C. § 1127. When the trademark owner controls the use of the mark by the

licensee, the owner obtains the benefits of Section 5 of the Lanham Act.⁹ The licensee's use of the mark can only inure to the benefit of the licensor if the licensee is a "related company" under the Lanham Act. In the event an owner of a trademark does not exercise sufficient actual control over the use of the mark by the licensee, the owner loses its rights in the mark through abandonment. Gilson, § 6.01[4]. Mere paper control i.e., a quality control provision in a licensing agreement, is insufficient. Also, the mere legal right to control is insufficient, Gilson § 6.01[5], as is the voluntary exchange of information, *Phillip Morris, Inc. v. Imperial Tobacco Co.*, 282 F. Supp. 931 (E.D. Va. 1967), *aff'd*, 401 F.2d 179 (4th Cir. 1968), *cert. denied*, 393 U.S. 1094 (1969).

21. The Division contends that activities of Protestant's related entity licensee, RETAIL COMPANY and its employees, performed on Protestant's behalf, confers "physical presence" in Oklahoma pursuant to *Tyler Pipe Industries v. Washington Department of Revenue*, 483 U.S. 232 (1987), and *Scripto v. Carson*, 362 U.S. 207 (1960). In *Scripto*, a Georgia corporation did not have an office or employees in Florida but it did have wholesalers, jobbers or salesmen conducting continuous solicitation in Florida. Any resulting orders from that solicitation in Florida were forwarded to Atlanta for acceptance and shipment of the goods ordered. *Scripto*, 362 U.S. at 209. The activities of these independent contractors performed on taxpayer's behalf in the State of Florida were found to be sufficient for Commerce Clause purposes to enable the State to impose use tax obligations on taxpayer. *Id.* at 213. Similarly in *Tyler Pipe*, taxpayer had no office, property or employees in the State of Washington but it did have independent contractors in the State of Washington acting on its behalf performing various functions, which included sales solicitation and the maintenance and improvement of taxpayer's name recognition, goodwill and individual customer relations. *Tyler Pipe*, 483 U.S. at 249. The Court found that the "activities of Tyler's sales representatives adequately support the State's jurisdiction to impose its wholesale tax on Tyler." *Tyler Pipe*, 483 U.S. at 250. Although the representatives were not employees of the company, the Court found that "such a fine distinction is without constitutional significance." *Id.* at 250 (quoting *Scripto v. Carson*, 362 U.S. 207 (1960)).

22. In a case similar to the one herein, the New Mexico Court of Appeals, in *Kmart Properties*, ruled that the imposition of income and gross receipts tax against a Michigan corporation did not violate the United States Constitution. In 1991, Kmart transferred ownership of trademarks, trade names, and service marks to KPI and the two corporations entered into a licensing agreement whereby KPI granted to Kmart the exclusive right to use the marks in the United States and its territories, in exchange for royalty payments. The court, found that both the special nature of trademarks and KPI's relationship with Kmart Corporation within New Mexico, justified the conclusion that KPI had physical presence or its functional equivalent in New Mexico, noting that the two corporations were "inextricably bound" to each other through the trademark relationship they had formed. *Kmart Properties* at ¶ 29.

⁹Section 5 of the Lanham Act Provides:

Where a registered mark or a mark sought to be registered is or may be used legitimately by related companies, such use shall inure to the benefit of the registrant or the applicant for registration, and such use shall not affect the validity of such mark or of its registration, provided such mark is not used to such a manner as to deceive the public. 15 U.S.C. § 1055.

23. Likewise, in 1984 when PROTESTANT was formed and RETAIL COMPANY transferred its trademarks, trade names and service marks to Protestant, it separated the trademarks and the associated goodwill from the actual retail business upon which the goodwill depends. At that point, as in *Kmart*, Protestant and RETAIL COMPANY were similarly bound to each other.

24. In this case the licensee, RETAIL COMPANY, is a related company in corporate structure and as contemplated by the Lanham Act, since Protestant exercised an active and ongoing, even pervasive, control over the Marks through the licensing agreements between Protestant and the related retail company, RETAIL COMPANY. This control was evidenced by the statements of policy in the brochure prepared by trademark counsel for Protestant and distributed to RETAIL CHAIN employees.

25. The licensing agreements required the licensee to maintain and protect the standard of quality, to enhance the goodwill associated with the Marks, and to ensure proper use of the Marks. See, Secretary of Revenue, N.C. Dept. of Revenue Decision No. 97-990 Ria Checkpoint (Sept. 19, 2000), *Aff'd* 381 N.C. Tax Rev. Bd., Ria Checkpoint (May 7, 2002). *Aff'd mem.* Wake County Super. Ct. No. 02-CV-007467, (May 22, 2003). Because Protestant had no employees in the State, Protestant relied on its related company to provide the required control as to the quality and nature of goods and services sold under its Marks and to aid in the protection of the Marks from unauthorized use by others. *Id.* During the years at issue, contrary to its argument, Protestant's representatives in Oklahoma, its licensee, RETAIL COMPANY, and licensee's employees, performed various quality control and trademark protection services in relation to Protestant's Marks, used the Marks, and enhanced the goodwill associated with the Marks, preserving Protestant's property rights in the intangibles and the royalty income related to the use of the Marks in Oklahoma. The Oklahoma retail stores operated by retail company affixed the Marks to the stores, ensured that the licensed products and services were of high quality, workmanship, style and appearance, conducted business in compliance with applicable law and in a manner to not reflect adversely on licensor. RETAIL COMPANY submitted samples and specification of licensed products and services, together with samples of signs, labels, tags, packaging materials, advertising materials, bills and catalogs on which the licensed Marks appeared, to Protestant for its approval. RETAIL COMPANY exercised care to prevent the trademark from becoming a generic term and reported trademark violations to Protestant. Should it be found that the physical presence requirement of Quill is applicable to income tax, the above-described activities performed on behalf of Protestant by its representative licensee and licensee's employees in Oklahoma are more than sufficient to establish Protestant's physical presence for Commerce Clause purposes in this State.

III. ASSESSMENT

26. The remaining issues center on whether the income received by Protestant is allocated under Section 2358(A)(4)¹⁰ or is apportioned under 2358(A)(5)¹¹ of Title 68.

¹⁰ A. The taxable income of any taxpayer shall be adjusted to arrive at Oklahoma taxable income for corporations and Oklahoma adjusted gross income for individuals, as follows:

* * *

4. Items of the following nature shall be allocated as indicated. Allowable deductions attributable to items separately allocable in subparagraphs a, b and c of this paragraph, whether or not such items of income were actually received, shall be allocated on the same basis as those items:

27. Codified in Oklahoma at Section 2358(A)(4)(b) of Title 68, the general rule for taxation of income generated from intangible personal property is that it is allocated to the domiciliary situs of the taxpayer. See *Grieves v. State ex rel. Co. Atty.*, 168 Okl. 642, 35 P.2d 454 (1934). Exceptions to the general rule, however, arise in two instances: (1) where the property has acquired a nonunitary business or commercial situs apart from the domicile of the taxpayer,¹² and (2) where the income from the intangible personal property is required to be allocated pursuant to paragraph 5 of Section 2358(A).¹³

28. The Division offers the direct allocation method as an alternative basis for its assessment pursuant to the first exception under Section 2358(A)(4)(b)(1). To make such a determination, the facts of the individual case must be considered. See *Thompson v. Bankers Investment Co.*, 288 P.2d 364 (Okl. 1955).

29. In *Davis v. Oklahoma Tax Commission*, 488 P.2d 1261 (Okl. 1971), the Court delineated the facts that must be shown for establishing a business situs for intangibles, stating:

We have used the rule that in order to constitute a business situs where intangible property is taxable, other than the owner's domicile, it must be shown that possession and

a. Income from real and tangible personal property, such as rents, oil and mining production or royalties, and gains or losses from sales of such property, shall be allocated in accordance with the situs of such property;

b. Income from intangible personal property, such as interest, dividends, patent or copyright royalties, and gains or losses from sales of such property, shall be allocated in accordance with the domiciliary situs of the taxpayer, except that:

(1) where such property has acquired a nonunitary business or commercial situs apart from the domicile of the taxpayer such income shall be allocated in accordance with such business or commercial situs; a resident trust or resident estate shall be treated as having a separate commercial or business situs insofar as undistributed income is concerned, but shall not be treated as having a separate commercial or business situs insofar as distributed income is concerned,

(2) income from such property which is required to be allocated pursuant to the provisions of paragraph 5 of this subsection shall be allocated as herein provided;

c. Net income or loss from a business activity which is not a part of business carried on within or without the state of a unitary character shall be separately allocated to the state in which such activity is conducted;

* * *

¹¹ 5. The net income or loss remaining after the separate allocation in paragraph 4 of this subsection, being that which is derived from a unitary business enterprise, shall be apportioned to this state on the basis of the arithmetical average of three factors consisting of property, payroll and sales or gross revenue enumerated as subparagraphs a, b and c of this paragraph. Net income or loss as used in this paragraph includes that derived from patent or copyright royalties, purchase discounts, and interest on accounts receivable relating to or arising from a business activity, the income from which is apportioned pursuant to this subsection, including the sale or other disposition of such property and any other property used in the unitary enterprise. Deductions used in computing such net income or loss shall not include taxes based on or measured by income.

* * *

¹² See 68 O.S. § 2358(A)(4)(b)(1).

¹³ See 68 O. S. § 2358(A)(4)(b)(2).

control of the property has been localized in some independent business or investment away from the owner's domicile so that its substantial use and value attaches to and becomes an asset of the outside business, and that in order to establish a "commercial domicile" and to give a business situs, for purposes of taxation, to intangibles which are used in the business or are incidental to it, they must become integral parts of some local business. In re Harris, Upham & Co., 194 Okl. 155, 148 P.2d 191. See too Groseclose v. Sutherland, 194 Okl. 479, 153 P.2d 479, and Glen v. Buck, Okl., 272 P.2d 573.

Id. at 1264. In accordance with this rule, it must be shown that possession and control of the intangible personal property is localized in an independent business or investment in Oklahoma and has become an integral part of the business. The evidence in this case is insufficient to meet this test.

30. The second exception to domiciliary allocation leads to an examination of paragraph 5 of Section 2358(A), which provides that the net income or loss remaining after separate allocation shall be apportioned to the State of Oklahoma based on the arithmetical average of three factors consisting of property, payroll and sales or gross receipts. Paragraph 5 defines the net income or loss to be apportioned as "that which is derived from a unitary business enterprise." Therefore, Protestant's royalty income is subject to apportionment if derived from a unitary business enterprise.

31. The United States Supreme Court has defined a "unitary business" as a corporate taxpayer and any other subsidiaries or affiliates that, when grouped together, possess the following traits: functional integration, centralization of management and economies of scale. *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 435 (1980). The unitary business concept serves to prevent a corporation from inaccurately reflecting its in-state value or net income and, as a matter of due process, is a limit on the state's authority to tax income or value that cannot in fairness be attributed to the taxpayer's activities within the state. *Allied-Signal, Inc. v. Director, Division of Taxation*, 112 S.Ct. 2251, 2255 (1992).

32. The Oklahoma Supreme Court defines a unitary business as a business which operates in more than one state and whose operations conducted in one state benefit and are benefitted by the operations in one or more other states where the various activities are so interdependent and of such mutual benefit that they, in effect, comprise one integral business. *Flint Resources Company v. Oklahoma Tax Commission*, 780 P.2d 665, 670 (Okl. 1989).

33. Based on the evidence presented, Protestant operated a unitary business enterprise within and without the state during the years at issue and therefore, the net income from Protestant's licensing of intangibles is properly apportionable to the State of Oklahoma under Section 2358(A)(5).

34. States have wide latitude in the selection of a formula used to apportion the income of an interstate business. *Moorman Mfg. Co. v. Blair*, 437 U.S. 267, 274 (1978). The Court in *Moorman*

reiterated the basic principal that a formula-produced assessment will not be disturbed unless the taxpayer has proved by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportion to the business transacted in that State, or has led to a grossly distorted result. *Id.* at 274.

35. The three-factor Oklahoma apportionment formula provides:

a) The property factor is a fraction, the numerator of which is the average value of taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all taxpayer's real and tangible personal property everywhere owned or rented and used during the tax period. 68 O.S. Supp. 1997, § 2358 (A)(5)(a).

* * *

b) The payroll factor is a fraction, the numerator of which is the total compensation for services rendered in the state during the tax period and the denominator is the total compensation for services rendered everywhere during the tax period. "Compensation" as used in this subsection, means those paid-for services to the extent related to the unitary business but does not include officers' salaries, wages and other compensation. 68 O.S. Supp. 1997, § 2358 (A)(5)(b).

* * *

c) The sales factor is a fraction, the numerator of which is the total sales or gross revenue of the taxpayer in this state during the tax period and the denominator of which is the total sales or gross revenue of the taxpayer everywhere during the tax period. 68 O.S. Supp. 1997, § 2358 (A)(5)(c).

* * *

36. Many states, including Oklahoma, have enacted alternative apportionment relief provisions. In Oklahoma, the Tax Commission is empowered by statute to modify the standard apportionment factors. Section 2358(A)(5) is the provision permitting such modification, and it reads as follows:

In any case where the apportionment of the three factors prescribed in this paragraph attributes to Oklahoma a portion of net income of the enterprise out of all appropriate proportion to the property owned and/or business transacted within this state, because of the fact that one or more of the factors so prescribed are not employed to any appreciable extent in furtherance of the enterprise; or because one or more factors not so prescribed are employed to a considerable extent in furtherance of the enterprise; or because of other reasons, the Tax Commission is empowered to permit, after a

showing by taxpayer that an excessive portion of net income has been attributed to Oklahoma, or require, when in its judgment an insufficient portion of net income has been attributed to Oklahoma, the elimination, substitution, or use of additional factors, or reduction or increase in the weight of such prescribed factors. Provided, however, that any such variance from such prescribed factors which has the effect of increasing the portion of net income attributable to Oklahoma must not be inherently arbitrary, and application of the recomputed final apportionment to the net income of the enterprise must attribute to Oklahoma only a reasonable portion thereof.

68 O.S.Supp. 1997, § 2358(A)(5).

37. Modification of the three-factor formula is permissible only if its use would result in net income being attributed to Oklahoma "out of all appropriate proportion to the property owned and/or business transacted within this state." 68 O.S. Supp. 1997, § 2358(A)(5). No elimination, substitution or use of additional factors is justified unless this condition is met.

38. After examination of Protestant's three factors, the Division determined that Protestant had no property or payroll in Oklahoma; that Protestant's payroll and property factors everywhere were *de minimis* especially when compared with Protestant's sales factor (royalty income) everywhere and that inclusion of the *de minimis* payroll and property factors would skew the Oklahoma apportionable income of Protestant. Therefore, based on that determination, the Division applied a modified one-factor apportionment formula, utilizing only the sales factor to determine Protestant's apportionable income. Neither the stipulated facts nor the exhibits admitted into evidence demonstrate that Oklahoma will receive an excessive portion of the net income by utilizing only the sales factor. In fact, the Division calculated the amount owed based on direct allocation and the amount arrived at is only negligibly different from that computed through apportionment utilizing the single sales factor. This not only supports the Division's argument that the one-factor apportionment assessment is not arbitrary, it also supports the proposition that had the three-factor formula been utilized, the amount attributed to Oklahoma would have been "out of all appropriate proportion to the business done and/or property owned in the State." The modified one-factor apportionment is an accurate reflection of the business done in Oklahoma by Protestant.

39. To determine if a tax is fairly apportioned under the second prong of the *Complete Auto* test, the question to be answered is whether the tax is internally consistent and if so, whether it is externally consistent. *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983). The internal consistency test looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate. *Oklahoma Tax Commission v. Jefferson Lines*, 514 U.S. 175, 184 (1995). The Division's modified apportionment formula meets the internal consistency test. If every state in which Protestant licenses its trademarks applied the single sales factor utilized by Oklahoma to apportion Protestant's income, no more than 100% of Protestant's income would be subject to tax,

since the formula is based upon Protestant's royalties received for licensing its trademarks in the taxing state divided by its royalty income everywhere.

40. External consistency looks to the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing state. *Jefferson Lines*, 514 U.S. at 185. This test is also met since the sales factor utilized in the apportionment formula closely reflects how Protestant's income is generated, being tied directly to the activity which generated most of Protestant's income, the licensing of its trademarks. The formula is designed to source income to Oklahoma in proportion to the royalty income Protestant earns from licensing its trademarks in Oklahoma, compared to its total licensing royalties everywhere. Therefore, the formula reflects the economic reality of how Protestant earns its income in Oklahoma.

41. As to the third prong of the *Complete Auto* test, a State may not impose a tax which discriminates against interstate commerce by providing a direct commercial advantage to local business. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458 (1959). Protestant has not made an argument that the imposition of this tax discriminates against interstate commerce.

42. *Complete Auto's* fourth prong requires only that the tax be fairly related to the services provided by the state. The tax is rationally related to the benefits, protections and opportunities received by Protestant since the state seeks only to impose tax on the income earned by Protestant from licensing its Marks in Oklahoma, measured by the amount of retail sales made in this State.

43. Protestant contends that the value of the intangible assets should have been included in the denominator of the property factor, as nearly all Protestant's income was derived from those valuable assets. Pursuant to Section 2358(A)(5)(a), the property factor includes only a taxpayer's real and tangible personal property owned or rented during the period at issue. Further, Protestant has been unpersuasive in the attempt to include amounts paid to service providers for business services in the denominator of the payroll factor, since even this yields a *de minimis* result. Thus the payroll and property factors were properly eliminated from the computation of income apportioned to Oklahoma.

44. Even if the value of the intangible assets and the amounts paid service providers could be included under the equitable provision, taxpayer has only made general allegations regarding the inappropriateness of the use of the single-factor sales formula without submitting evidence to substantiate these claims, and thus has failed to meet its burden of proof.¹⁴ *Oklahoma Administrative Code 710:1-5-47*.

45. Based on the foregoing analysis of the facts and applicable case law, Protestant was properly assessed income tax for tax years 1992, 1993 and 1994.

¹⁴Additionally, Protestant raises a constitutional argument regarding factor representation. Likewise, Protestant failed to present sufficient evidence to support this argument.

DISPOSITION

It is the ORDER of the OKLAHOMA TAX COMMISSION, based upon the specific facts and circumstances of this case that the income tax protest of RETAIL COMPANY be denied.

OKLAHOMA TAX COMMISSION