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Subject: Recent Economic/Affiliate Nexus Decisions
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To Our Clients and Friends:

In recent years, the states have aggressively expanded the principle of nexus to include economic nexus and/or nexus via an affiliate operating in the state. Under these theories, a corporation with no physical presence in a taxing state can still be subject to tax if the corporation has purposefully directed its activity at the state's economic forum (generally through affiliated entities). Attached for your information are two recent decisions involving economic/affiliate nexus that demonstrate the current state tax environment.

In Kmart Corp. v. New Mexico Department of Taxation and Revenue, New Mexico Supreme Court, No. 27,269, December 29, 2005, the New Mexico Supreme Court let stand the ruling of the New Mexico Court of Appeals with respect to corporate income tax nexus. In that lower court ruling, Matter of Kmart Properties, Inc., New Mexico Court of Appeals, No. 21,140, November 27, 2001, an out-of-state subsidiary with no employees or property in New Mexico, that licensed trademarks to its parent corporation that operated stores in New Mexico, was subject to New Mexico corporate income tax. By allowing its intellectual property to be used in New Mexico, the subsidiary purposefully availed itself of New Mexico's consumer market. Moreover, the use of the subsidiary's intellectual property in New Mexico's economic market to generate revenue for the subsidiary established sufficient nexus between the income taxed and the legitimate interests of New Mexico to justify the tax imposition.

However, the New Mexico Supreme Court did reverse the lower court in holding that the royalties received by the out-of-state subsidiary attributable to the use of the licensed trademarks in New Mexico were not subject to New Mexico gross receipts tax. Using a statutory analysis, the court ruled that the granting of a license to use property was considered a sale rather than a lease. As such, the transaction was taxable where the property was sold (outside of New Mexico) rather than where it was used (in New Mexico). The court further noted that the property was exempt from New Mexico compensatory (use) tax due to its intangible nature.

In Geoffrey, Inc. v. Oklahoma Tax Commission, Oklahoma Court of Civil Appeals, December 29, 2005, a Delaware holding company with no physical presence in Oklahoma, that licensed the use of trademarks to stores that used such intangibles in Oklahoma, was subject to Oklahoma corporate income tax. The court held that the constitutional physical presence requirement applicable to sales and use taxes was not applicable to income tax. The court concluded that imposition of the Oklahoma corporate income tax did not violate either the substantial nexus requirement of the Commerce Clause or the minimum connection requirement of the Due Process Clause of the United States Constitution.

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If a company believes it has nonfiling exposure, voluntary disclosure can provide a significant tax benefit. Under this process, a taxpayer may approach a taxing state anonymously through a representative. An agreement is negotiated with the taxing state in which the taxpayer files returns (or provides return information) and pays back taxes for a limited number of years (typically the three or four most recent years), and timely pays taxes on a going forward basis.

In return, the taxing state agrees to waive unpaid taxes for years prior to those covered by the agreement, as well as all penalties that could be imposed. Interest on the taxes paid pursuant to the agreement is generally required, although in certain instances, interest can be waived by the taxing state. Confidentiality is preserved during the voluntary disclosure process by not revealing the name of the taxpayer or any information that could identify the taxpayer until the voluntary disclosure agreement is finalized. In certain instances, voluntary disclosure can be initiated on a multistate basis.

If you have any questions regarding the attached cases, the benefits of voluntary disclosure, or any other state and local tax matters, please do not hesitate to contact me.

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