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A Washington National Tax Services (WNTS) Publication

April 27, 2012

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New Mexico Court of Appeals rules out-of-state internet retailer has nexus due to trademark goodwill generated by in-state retailer affiliate

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On April 18, 2012, the New Mexico Court of Appeals ruled that an out-of-state online retailer, Barnesandnoble.com LLC (BNC), had nexus for gross receipts tax (GRT) purposes because the goodwill generated by an in-state licensee of Barnes & Noble trademarks was imputed to BNC, another licensee of the same trademarks, who used the Barnes & Noble trademarks to make Internet sales to residents in New Mexico. [*BarnesandNoble.com LLC v. New Mexico Taxation and Revenue Department*; New Mexico Court of Appeals No. 31,231 (April 18, 2012)]. The imputed goodwill helped BNC "establish and maintain" a New Mexico market and therefore established substantial nexus between New Mexico and BNC.

Background

During the audit period January 31, 1998 through July 31, 2005, BNC was a wholly owned subsidiary of barnes&noble.com, inc., a subsidiary of B&N.com Holding Corp. The ownership of barnes&noble.com, inc. by B&N.com Holding Corp varied between 40% and 100% throughout the audit period. B&N.com Holding Corp. was a wholly owned subsidiary of Barnes & Noble, Inc. (Parent). Parent also owned several other companies including Barnes & Noble Booksellers Inc. (Booksellers) and Marketing

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Services (Minnesota) Corporation, Inc. (MSMC). Booksellers operates three brick and mortar stores in New Mexico, and MSMC provides gift card services to BNC and Booksellers. BNC is a Delaware limited liability company with all of its operations, facilities, and personnel located outside of New Mexico. BNC's offices are separate from those occupied by other Barnes & Noble entities. BNC did not own or lease property in New Mexico, had no retail stores within the state, and had no sales agents or employees in the state.

Following BNC's audit, the New Mexico Taxation and Revenue Department (Department) issued an assessment to BNC for GRT and interest for $534,536.11. BNC appealed the assessment and the hearing officer concluded that BNC did not have substantial nexus with New Mexico as the activities of Booksellers did not create, establish, and maintain a market for BNC. The Department appealed to the Court of Appeals. The appellate court can set aside a hearing officer's ruling if the ruling is found to be an abuse of discretion or if it is not in accordance with the law.

Appellate Court: Booksellers' New Mexico activities were not performed on behalf of BNC

The Department contended that BNC had substantial nexus with the state because BNC and Booksellers had close corporate connections, BNC and Booksellers used common trademarks and logos, and Booksellers' in-state activities helped BNC create and maintain a market in New Mexico. BNC argued that it did not have substantial nexus as it had no contact with New Mexico and that Booksellers' activities should not be considered as they were not undertaken on BNC's behalf. BNC further argued that the imposition of the GRT would violate the Due Process Clause of the US Constitution.

In opposing BNC's assertion, the Department identified the four activities that it alleged helped BNC create and maintain a market in New Mexico and thereby created substantial nexus: (1) BNC advertised Booksellers' locations and events on its website, (2) BNC outlined Booksellers return policy on its website, (3) both BNC and Booksellers sold gift cards that could be redeemed at either business, and (4) both BNC and Booksellers participated in a joint loyalty program. The appellate court addressed all four arguments, citing judicial precedence, and determined that the hearing officer did not err in ruling that the activities did not create substantial nexus for BNC.

First, in regard to BNC's website allowing customers to find Bookseller's stores and events, the appellate court ruled that since the transmission of the activity did not occur in New Mexico as the website had no physical connection to the state and the information was not provided on behalf of BNC, such activity did not contribute to the creation of a substantial nexus. Second, as Booksellers' return policy allowed customers to return all salable merchandise regardless of where the items were originally purchased for store credit, there was no preferable treatment for BNC purchases. Therefore, Booksellers accepted returns for its own benefit, not on behalf of BNC or any other third party. Third, since BNC and Booksellers both receive a fee from MSMC for selling gift cards and neither retailer could control where the gift cards are used, the appellate court could not say that the hearing officer abused her discretion in concluding that the gift cards did not create a substantial nexus. Fourth, the court's analysis of the joint loyalty program was similar to the gift card analysis and stated that the hearing officer could have reasonably viewed the loyalty program as either increasing BNC sales in New Mexico or not directly producing revenue. The appellate court found the hearing officer did not abuse her discretion in concluding that the loyalty programs did not directly produce BNC revenues. Thus, the appellate court ruled these four activities did not create substantial nexus between BNC and New Mexico.

Appellate Court: Booksellers' New Mexico activities may be imputed to BNC because booksellers enhanced the goodwill value of trademarks used by BNC

The court then turned to the Department's second argument that BNC's use of shared marketing, name recognition, and trademarks and logos created and established a market in New Mexico. BNC argued that the Department did not cite, nor was BNC aware of, any case that found that the use of a common or similar corporate logo created substantial nexus for an out-of-state retailer. BNC also argued that Bookseller's use of trademarks in-state was not done on behalf of BNC. However, the court disagreed. In support of its decision, the court looked to *Kmart Props. Inc.* (KPI), a case decided by the same appellate court. See, *Kmart Props. Inc. v. Revenue Dep't (KPI)*, 131 P.3d 22 (N.M. 2006). Though the New Mexico Supreme Court ultimately reversed the appellate court's decision on the issue of whether the GRT applied to certain royalty payments, the New Mexico Supreme Court did not address the constitutional question in *KPI*. However, the appellate court in this case determined that the constitutional analysis in *KPI* was persuasive in BNC's situation.

In *KPI*, the Kmart Corporation transferred its trademarks to a holding company in Michigan. The holding company then granted Kmart the exclusive rights to its US trademarks. In *KPI*, the court reasoned that the physical presence requirement could be satisfied if "the nature of trademarks and [the holding company's] relationship with Kmart Corporation within New Mexico . . . constitute[d] physical presence *or its functional equivalent*." The court observed that "a trademark, and its goodwill, are inseparable property rights that, as a practical matter, are bound to the business that generates the goodwill." Therefore, the court looked at the close relationship between goodwill and the physical business and concluded that Kmart and the holding company were "inextricably bound to each other." The court ruled that the combination of Kmart Corporation's New Mexico stores and the tangible presence in the state of the trademarks owned by the holding company was the '"functional equivalent of physical presence" for the holding company.

Using this analysis and taking it one step further, the appellate court considered Booksellers' operation of three stores in New Mexico and determined that Booksellers' in-state activities of running retail stores strengthened the goodwill behind the Barnes & Noble trademarks. Booksellers "personified the goodwill" owned by College Bookstores, the holder of Barnes & Noble trademarks, and facilitated sales in New Mexico. Under the reasoning of *KPI*, this activity cannot be separated from the ownership of the trademarks. The appellate court stated that because consumers expect to be able to find businesses on the Internet, some of this goodwill must accrue to BNC because Bookseller's customers would have no way of knowing that they were dealing with another licensee of Barnes & Noble trademarks and goodwill. Customers saw only one entity: Barnes & Noble. Therefore, since the goodwill generated by in-state business in *KPI* could not be separated from ownership of the trademarks, the appellate court ruled that it was not possible to separate the goodwill generated by Booksellers' in-state stores into physical and Internet components. This vicarious accrual of goodwill to BNC in conjunction with the gift card and loyalty program activities that explicitly mention the BNC website and are performed at in-state stores helped to establish and maintain a market in New Mexico for BNC, thereby creating substantial nexus in support of the imposition of the GRT.

Finally, BNC stated that even if the GRT was determined to be constitutional as applied, the tax imposition would violate its due process rights and would violate the state rules act. The appellate court ruled that the due process argument was without merit as both the Department and BNC had stipulated before the hearing officer that if substantial nexus were found, GRT would be due on BNC's New Mexico sales. The appellate court remarked that BNC can hardly stipulate that the GRT applies and then argue that it did not clearly apply. In regard to the state rules act, BNC provided no authority to support its argument.

Conclusion

The court ruled that the licensing of trademarks to both entities was in effect telling customers to consider BNC and Booksellers to be one and the same and that the goodwill developed by each entity benefited the other. The manner in which Booksellers used the trademarks in New Mexico helped BNC to establish and maintain a New Mexico market and therefore a substantial nexus existed between New Mexico and BNC.

PwC Observes

Joe Motola, SALT Director with PwC in Phoenix, provides the following observation.

The New Mexico courts have upheld the Department's position in several recent nexus related cases, including most recently in *Dell Catalog Sales LP*. Here, the court relied on an older case in *KMart Properties, Inc.* where the appellate court held that the licensing of trademarks in New Mexico by an out-of-state entity created nexus because the presence of intangibles was the "functional equivalent" of physical presence in New Mexico. While the New Mexico Supreme Court reversed the *KMart* appellate court, it did so on non-constitutional grounds.

The court relied on *KMart* to support the notion that a nexus would be created between Booksellers and its licensor, but then went one step further and found that Bookseller's New Mexico activities may be imputed to BNC who used the trademarks to make Internet sales to New Mexico residents.

It would not be surprising to see this case appealed to the New Mexico Supreme Court.

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