BEFORE THE HEARING OFFICER
OF THE TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO

IN THE MATTER OF THE PROTEST OF
LONG JOHN SILVER'S, INC. **NO. 98-16**
ID. NO. 01-824513-00 7, PROTEST TO
ASSESSMENT NO. 1880539

DECISION AND ORDER

This matter came on for formal hearing before Gerald B. Richardson, Hearing Officer, on May 20-22, 1997. Long John Silver's, Inc., hereinafter, "Long John Silvers" or "Taxpayer", was represented by Curtis W. Schwartz, Esq. and Timothy C. Holm, Esq. of Modrall, Sperling, Roehl, Harris & Sisk, P.A. The Taxation and Revenue Department, hereinafter, "Department", was represented by Bridget A Jacober, Esq. At the close of the hearing, the parties were requested to file briefs and proposed findings of fact and conclusions of law. The last pleading was filed on February 2, 1998 and the matter was submitted for decision at that time. The parties have granted the Hearing Officer an additional thirty days beyond the thirty days specified by Section 7-1-24(H) NMSA 1978. Based upon the evidence and the arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. Long John Silver's Restaurants, Inc., hereinafter, "Restaurants, Inc." is a privately owned Kentucky corporation and holding company which holds or owns 100%

of the stock of six subsidiary corporations, including that of the Taxpayer, Long John Silvers.

2. Prior to being taken private in late 1989 through a highly leveraged buyout, the entity that became Restaurants, Inc. was known as Jerrico, Inc.

3. QSC, Inc. is a Delaware corporation, which is a wholly-owned subsidiary of Restaurants, Inc., which holds the Long John Silver's trademarks and tradename and licenses them to Long John Silver's.

4. Long John Silver's, is a Delaware corporation which is a wholly owned subsidiary of QSC, Inc.

5. Abbott Advertising Agency, Inc., hereinafter, "Abbott Advertising" is a Kentucky corporation which is a wholly owned subsidiary of Restaurants, Inc.

6. Kentucky is the principal place of business and commercial domicile of Restaurants, Inc., Long John Silver's, and Abbott Advertising.

7. Lexington, Kentucky is the principal place from which the businesses of both Long John Silver's and Abbott Advertising are operated.

8. In 1969, Jerrico, Inc. formed Long John Silver's as a wholly-owned subsidiary, to own and operate its new quick service seafood concept. Long John Silver's does so by owning and operating its own Long John Silver's Seafood Shoppes and by franchising that concept to franchisees.

9. After the leveraged buyout of Jerrico, Inc. and because of the large amount of debt now being carried by Restaurants, Inc., there was not capital available to open or acquire more company owned stores. Thus, the only available way to expand the Long John Silver's restaurant chain was to expand through franchising, which uses other

people's capital, and this became the business strategy of Restaurants, Inc. and Long John Silver's.

10. During the audit period, January 1, 1988 through June 30, 1994, there were approximately 1500 Long John Silver's restaurants, of which approximately 1000 were company owned and operated stores and approximately 500 were owned and operated by franchisees.

11. The concept of franchising has evolved over time. Initially, most franchising was of a type called product and trade name franchising. This type of franchise agreement involved licensing of trade names and trademarks, granting exclusive rights to use those trade names and trademarks in a designated area and granting rights to sell the products associated with those trade names and trademarks. Examples of this type of franchising were gasoline service stations and soft drink bottlers.

12. After the second world war, a new type of franchising concept evolved, with McDonald's hamburger franchises representing a prime example of this type of franchise agreement. The new concept is called business format franchising, which involves a complete package of resources, including trademarks and trade names, company products and systems, as well as services that a franchisee would need to succeed in business.

13. The business format type of franchising agreement is premised upon the mutual interests of both the franchisor and the franchisees in the overall success of the particular business being franchised. This concept is called "business partnering". In the context of Long John Silver's franchising business, it means that the success of Long John Silver's franchisees enhances the success of Long John Silver's and the success of Long John Silver's enhances the success of Long John Silver's franchisees.

14. Long John Silver's is a business format franchisor in the quick service seafood restaurant segment of the fast food franchise industry, and, in fact, is the leader of that segment of the industry.

15. Long John Silver's Franchise Agreement with its franchisees provides that it "is the developer of and sole and exclusive owner of a distinctive food service system (hereinafter, "the System" under which food is sold to the public from restaurants operated under the name "Long John Silver's Seafood Shoppes" (hereinafter, "LJS Restaurants")." The agreement lists the elements of "the System" to include:

a) methods and procedures for the preparation and serving of food and beverage products;

b) special ingredients, confidential recipes, a secret batter mix and distinctive service accessories such as uniforms, menus, packages, containers and paper and plastic items;

c) methods of achieving quality control, quantity control and procedures designed to be advantageous to LJS Restaurant operators and consumers;

d) plans and specifications for distinctive standardized premises, addressing both interior and exterior design and decor, equipment layout and signage;

e) a uniform method of operating as described in the Long John Silver's confidential operating manual;

f) distinctive and characteristic trademarks and service marks, signs, designs and emblems (called "Proprietary Marks");

g) a public image that each restaurant is a unit in an established franchise system and that all restaurants are operated with uniform standards of service and product quality and portions; and

h) exclusive copyrights and trade secrets as are owned or may be developed by Long John Silver's.

16. Long John Silver's franchisees entering into the Franchise Agreement acknowledge that they wish to obtain a franchise to operate a Long John Silver's restaurant pursuant to "the System" described above and to be afforded the training and other assistance provided by Long John Silver's in connection with operating such a restaurant. The franchisee further acknowledges and accepts the terms and conditions as set forth in the Franchise Agreement as being reasonably necessary to maintain Long John Silver's high and uniform standards of quality, service and portions designed to protect the good will and enhance the public image of the "Proprietary Marks" and "the System", and the franchisee agrees to open and operate the franchised restaurant in faithful compliance with the uniform standards and specifications of Long John Silver's and to diligently promote the interests of "the System" during the term of the agreement.

17. The Franchise Agreement describes the franchise granted the franchisee as the right to build and operate a Long John Silver's restaurant and to use "the System" for a specified period and at a specified location, to use Long John Silver's "Proprietary Marks", and to represent to the public that the franchisee's restaurant is part of the Long John Silver's "System".

18. The specific requirements the Franchise Agreement require that the franchisee:

a) sell and serve only food and beverage products listed as standard menu items in the confidential manual and which meet Long John Silver's uniform standards of quality and portions and which are prepared in accordance with the recipes and food handling and preparation methods found in the confidential manual;

b) purchase secret recipe items only from Long John Silver's or an approved source;

c) purchase food products, paper, plastic goods and service items which conform to the specifications and standards of Long John Silver's and are included in approved lists of brands, unless prior written approval from Long John Silver's has been obtained;

d) purchase for its employees' use uniforms and costumes which conform to Long John Silver's specifications;

e) operate the restaurant in strict accordance with the confidential manual;

f) pay the designated royalty fee and advertising fee called for in the agreement in a timely manner;

g) follow Long John Silver's cost control procedures, use its format for charts of accounts and for reporting receipts.

h) construct its restaurant in strict compliance with plans either prepared or approved by Long John Silver's;

i) maintain the franchised restaurant premises and all equipment in conformity with the high standards and public image of Long John Silver's and the System, including keeping the restaurant in the highest degree of sanitation, and to make no additions or alterations to the restaurant without prior written consent from Long John Silver's;

j) operate the restaurant for at least the minimum hours and days prescribed in the confidential manual; and

k) comply with the training specified by Long John Silver's for the franchisees' managers and employees.

19. The Franchise Agreement also specifies a number of services, benefits and materials which the franchisor agrees to provide the franchisee, including:

a) written guidelines for site selection and lease evaluation;

b) standard plans, drawings and specifications for the franchised restaurant;

c) standard layouts and specifications for fixtures, furnishings, interior design and decor, signs and equipment pursuant to the System;

d) such pre-opening assistance as Long John Silver's deems necessary for the franchisee to meet system standards;

e) pre-opening management training and other training for such periods as may be designated by Long John Silver's;

f) on-site opening assistance;

g) one copy of the confidential manual, with periodic updates

h) a sample of Long John Silver's standardized chart of accounts, statement of earnings and balance sheet;

i) regular and continuing supervisory services and periodic inspections and evaluations of the franchisee's operation;

j) Long John Silver's marketing and advertising programs; and

k) reasonable efforts by Long John Silver's to disseminate to suppliers designated by the franchisee, the System standards and specifications for non-secret food products and equipment.

20. In addition to the services outlined in the Franchise Agreement, in the course of dealing between Long John Silver's and its franchisees, other services are provided as well. Many of these same services are also provided to Long John Silver's company owned restaurants. Those services include:

a) strategic planning to ensure that Long John Silver's restaurants keep up with changing consumer demands and tastes, changing consumer demographics, new food technologies, new information technologies, etc. to better market and sell Long John Silver's product;

b) consultation and advice, primarily given by regional directors of franchise operations, can also come from Long John Silver's legal department, public relations department, etc.;

c) quality assurance, through inspections of all Long John Silver's restaurants, inspection of Long John Silver's seafood, etc., to assure the quality and consistency of the Long John Silver's meal experience;

d) post opening design services to update restaurant decor, layout, and incorporate new concept changes, such as adding drive-up windows, etc.;

e) governmental relation services, such as lobbying congress on issues affecting Long John Silver's operations and providing restaurants with legislative updates;

f) training;

g) organizational buying power and procurement services for the food, paper products and restaurant equipment.

21. Long John Silver's maintained a training center in Lexington, Kentucky, known as the Jerrico Center, until October, 1992. The Jerrico center was used to train company and franchisee employees including executive, managerial and supervisory employees. After the closing of the Jerrico Center, managerial training has been performed at Long John Silver's company owned restaurants. Because there are no Long John Silver's company owned restaurants located in New Mexico, the managerial training for Long John Silver's New Mexico franchisees took place out of state.

22. Franchisees' opening managers and all successor managers and assistant managers must successfully complete a training program prior to assuming the position of manager or assistant manager of a franchised restaurant.

23. Franchisees are responsible for all expenses of travel, employee salaries and room and board for their employees receiving training. Additionally, franchisees are charged a fee to cover the operational costs of the training program in accordance with the Franchise Development Guide provided to franchisees. Because of this, the cost of this service is paid for by the franchisees independently of the royalty fee they pay to Long John Silver's.

24. Organizational buying power and procurement services involve the processes and people at Long John Silver's who develop supplier relationships and sources for the food products and supplies needed in the Long John Silver's restaurants and which ensures a stable and predictable supply of these products, and the uniformity and quality

of the products. The maintenance of a distribution network and relationships with suppliers also affords the benefits of low prices to those who purchase through the network because of volume discounts which are negotiated by Long John Silver's. The availability of a stable and predictable supply is especially important with regard to the fish products sold by Long John Silver's and its franchisees because of global shortages, seafood diseases, and other factors which affect the source and supply of this product. Long John Silver's purchases these products, and sells them to an independent distributor, Martin-Brower, or ProSource, which then distributes and sells these products to both Long John Silver's company owned stores and to franchisees.

25. Participation in the Long John Silver's purchasing system is voluntary. Long John Silver's company owned restaurants purchase more than 95% of their food products, restaurant supplies and related goods from Martin-Brower. Franchisee owned restaurants purchase in the aggregate 80% of their food products, restaurant supplies and related goods from Martin-Brower.

26. Long John Silver's applies a mark up to the price it sells products to Martin-Brower or ProSource to cover its costs of managing and running its procurement system. Thus, the cost of this service is paid for by the franchisees independently of the royalty fee they pay to Long John Silver's.

27. The vast majority of the services provided by Long John Silver's to its franchisees are performed at Long John Silver's Lexington, Kentucky headquarters or other out-of state locations. Essentially, the only services performed in New Mexico are those services, such as on site opening assistance and on site consultation, inspection and the limited training provided by the regional Director of Franchise Operations and Long

John Silver's quality assurance personnel, which are performed in New Mexico with respect to Long John Silver's New Mexico franchisees.

28. During the early 1990's Long John Silver's developed a state of the art point of sale software information system. It is a restaurant operating system which can be used, among other things, for forecasting, for controlling both food and labor costs and for quality control. Long John Silver's licenses the point of sale software to franchisees for $1. Franchisees are under no obligation to use the point of sale software.

29. Long John Silver's receives thousands of inquiries annually from persons interested in becoming Long John Silver's franchisees. In selecting franchisees, Long John Silver's requires potential franchisees to have both business acumen and financial resources. The financial resources required are a minimum net worth of $350,000 and liquid assets of $150,000. Long John Silver's looks more to whether a potential franchisee has demonstrated good business expertise over time, rather than whether the person has prior restaurant experience because Long John Silver's business format franchise concept provides detailed guidance on all of the basics of running a Long John Silver's restaurant.

30. All Long John Silver's franchise agreements relating to franchises in New Mexico were executed by Long John Silver's in Kentucky.

31. All Long John Silver's franchise agreements provide for an initial franchise fee, a grand opening fee, an advertising fee and a royalty fee.

32. In 1988, the beginning of the audit period, the initial franchise fee for a standard restaurant was $12,500. By the end of the audit period, 1994, the fee had been raised to $20,000.

33. All new franchisees are obligated to pay a grand opening fee of $2,000. The grand opening fee is used for advertising and promotional materials benefiting the new restaurant which is opening. The franchisee agreement requires that this payment be made to Long John Silver's or its designee. The franchisee pays this fee directly to Abbott Advertising, as the designee of Long John Silver's.

34. The Franchise Agreement requires that franchisees pay Long John Silvers a royalty fee equal to 4% of the franchisees' gross receipts from the operation of the franchised restaurant, payable monthly. The Franchise Agreement does not specify, designate, break down or tie in the royalty fee to any particular services, benefits or trademarks and trade names provided under "the System" which is being franchised.

35. Occasionally, Long John Silver's has had a program under which between 1% and 2% of the 4% royalty fee (one-quarter to one-half of the royalty fee) is diverted into the Abbott Advertising client account for the individual Long John Silver's owned or franchisee-owned store for the first twelve months of the new store's operation to promote that new restaurant in its local area.

36. The Franchise Agreement requires franchisees to pay an advertising fee equal to 5% of gross receipts from the operation of a franchised restaurant, payable monthly. The fee is for advertising and marketing programs. The Franchise Agreement requires franchisees to pay the advertising fee to Long John Silver's or its designee. Franchisees pay this fee directly to Abbott Advertising, as designee of Long John Silver's.

37. The Franchise Agreement requires that Long John Silver's make an equal contribution for advertising for each of its company owned stores as the franchisees are

required to make under the Franchise Agreement, and Long John Silver's made those contributions during the audit period.

38. Under the terms of the Franchise Agreement, the franchisee recognizes the value of advertising and the importance of advertising to further the goodwill and public image of the long John Silver's System. The franchisee further agrees that Long John Silver's or its designee conducts, determines, maintains and administers all national, regional, local and other advertising and marketing and has sole discretion over the concepts, materials, media, nature, type, scope, frequency, place, form, copy layout and context of such advertising and marketing. The franchisee also acknowledges that advertising expenditures are intended to maximize general public recognition and acceptance of all Long John Silver's restaurants which are part of the Long John Silver's system and that Long John Silver's does not warrant or represent that any particular restaurant, including the franchisee's restaurant will benefit directly or pro-rata from the advertising.

39. The purpose of the advertising fee is to promote the products sold by Long John Silver's and its franchisees, to increase the sales of both Long John Silver's and the franchisees, to enhance Long John Silver's reputation and to maximize general public recognition of Long John Silver's restaurants, its trademarks, trade names and products, wherever they are displayed and sold.

40. Each franchisee and Long John Silver's can contract with Abbott Advertising for its services separate and apart from the 5% advertising fee paid by both franchisees and Long John Silver's on behalf of its company owned stores. This additional advertising spending is called "investment spending".

41. Investment spending is totally optional. Many franchisees investment spend and many don't. Long John Silver's generally investment spends on advertising in a majority of its markets.

42. Although franchisees have no right under the franchise agreement to direct or control the advertising done with the 5% advertising fee, Long John Silver's from time to time consults with its Franchisee Advisory Board concerning its advertising and marketing strategies. Individual franchisees are also sometimes consulted and listened to by Long John Silver's with respect to its advertising and marketing campaigns and strategies.

43. Abbott Advertising maintains separate client account records for franchisees and Long John Silver's, to account for the monthly 5% advertising fees and investment spending .

44. Long John Silver's and its franchisees are Abbott Advertising's only clients.

45. Abbott Advertising does not itself develop advertising campaigns. It contracts with outside advertising agencies and develops advertising campaigns and places media advertising through those outside advertising agencies. During the audit period Abbott Advertising contracted with Timerlin McClain of Dallas, Texas and Mark Advertising of Pittsburgh, Pennsylvania.

46. The 5% advertising fees received by Abbott Advertising from franchisees and Long John Silver's company owned stores are expended by Abbott Advertising as follows: 12% is allocated to the "Agency Fund", 13% is allocated to the "Production Fund" and 75% is allocated to the "Media Fund".

47. The Agency Fund is used to pay for creative consultants, consumer research, field marketing, media commissions, salaries of Abbott Advertising employees and general and administrative expenses of Abbott Advertising.

48. The Production Fund is used to pay for the production of radio and television commercials, the design of print media advertisements and related expenditures.

49. The Media Fund is used for the purchase of local and national advertising. Forty-four percent (44%) of the Media Fund, which represents 33% of the 5% advertising fee, is used to purchase national cable network television advertising. The remaining 56% of the Media Fund is used to purchase local television, radio and print advertising.

50. Abbott Advertising did not directly place advertisements in the media. The purchasing of media advertising was handled through the advertising agencies with which Abbott Advertising contracted.

51. During the audit period the advertising done with the 5% advertising fee emphasized Long John Silver's products and prices, as opposed to strictly promoting Long John Silver's trademarks and trade names. Of course, all advertising was identified with Long John Silver's by including its trademarks and trade names.

52. The work and services performed by Abbott Advertising with respect to the 5% advertising fee were performed outside of New Mexico during the audit period.

53. The Franchise Agreement is a complete and non-negotiable package. A person wishing to become a Long John Silver's franchisee may not pick and choose the terms of the agreement they wish to be bound to, but must agree to all of the terms of the Franchise Agreement in order to become a franchisee.

54. Franchisees pay the full amount of royalty fee and advertising fee called for in the Franchise Agreement regardless of whether they use or utilize all of the services embedded in the Franchise Agreement.

55. Long John Silver's employs several individuals who hold the title of Director of Franchise Operations. There is one Director for every 40 to 60 Long John Silver's restaurants. They operate as a key communication link between Long John Silver's and its franchisees. They deliver training in the restaurants, they consult with franchisees to identify problems, communicate changes in the Long John Silver's system, observe and ensure compliance with the Long John Silver's operational manual and procedures, etc.

56. The Long John Silver's Director of Franchise Operations assigned to its New Mexico franchises during the audit period was Mr. Carlos Barrera. Mr. Barrera is based in Dallas, Texas. During the audit period, he was in New Mexico visiting New Mexico franchise operations approximately 30 days each year.

57. From time to time, other Long John Silver's employees visit Long John Silver's franchised restaurants. For example, Long John Silver's has "quality assurance" personnel who visit every franchise restaurant approximately every 18 months. These personnel go through a checklist of procedures to assure that the restaurant is in compliance with the procedures and requirements of the operations manual.

58. Long John Silver's maintains no offices in New Mexico and has no employees based in or residing in New Mexico.

59. Long John Silver's does not have any company operated stores in New Mexico.

60. During the audit period Long John Silver's had 21 franchisee owned and operated restaurants in New Mexico. Those restaurants display and utilize the Long John Silver's trademarks and trade names in their operations in New Mexico.

61. Long John Silver's does not own or lease equipment in New Mexico nor does it directly sell goods or products to its franchisees in New Mexico.

62. Long John Silver's has tangible personal property in New Mexico in the form of its operating manuals, which are owned by Long John Silver's and are located in each of its franchisee owned and operated restaurants in New Mexico, and in the form of manuals and videotapes related to Long John Silver's point of sale system, which is used by most of Long John Silver's franchisee operated stores in New Mexico.

63. Long John Silver's secret recipes are kept in Lexington, Kentucky.

64. Long John Silver's franchise system is employed in New Mexico. During the audit period, there were 21 Long John Silver's restaurants in New Mexico, each of which was franchisee owned and operated.

65. Twenty of the twenty-one Long John Silver's restaurants in New Mexico are owned and operated by American Seafood Partners, which is a general partnership organized in the state of Kansas which is controlled by Mr. Hal McCoy. American Seafood Partners has a separate franchise agreement with Long John Silver's for every franchised location it owns in New Mexico.

66. Long John Silver's franchisees in New Mexico pay gross receipts tax on their gross receipts from operating restaurants in New Mexico.

67. In 1988 Long John Silvers obtained an evaluation of the components of its royalty stream for the sole purpose of determining a fair market royalty rate of its

trademarks and trade names. As noted earlier, QSC, Inc. owns the Long John Silver's trademarks and trade names and licenses them to Long John Silver's. Thus, the evaluation was to determine the percentage of the 4% royalty fee which could be attributed to the use of Long John Silver's trademarks and trade names, as opposed to the portion relating to the use of other intangibles, such as trade secrets and recipes and know how, and as opposed to the portion of the royalty fee representing services provided as part of the franchise system.

68. The 1988 appraisal report concluded that 30% of the 4% royalty stream (the equivalent of 1.2% of gross sales) represented a fair market royalty rate for the use of Long John Silver's trademarks and trade names. The other intangibles, namely trade secrets, recipes and know how represented 20% of the royalty stream. The remaining 50% of the royalty stream was attributed to the costs or value of services covered by the 4% royalty fee. The appraisal attributed percentages to the various services as 20% for franchise services, consisting of policing of franchises and inspection visits conducted to ensure that standards are being maintained throughout the system; 10% for the purchasing network and services to assist franchisees develop new restaurants; 15% for training and 5% for general and administrative services. The report goes on to state with reference to the purchasing, development and training services, however, that since the costs associated with those services are charged back to the franchisees, it would not be appropriate to charge a royalty fee for the benefit of those services.

69. In 1997, Long John Silver's had the same appraisal firm perform a similar appraisal for use in connection with this litigation. Although the purposes stated in the appraisal was the same as for the 1988 appraisal, namely to determine an arms length

royalty rate associated with the trademarks and trade names held by QSC, Inc., in fact, the purpose was broader, and it was to provide an opinion of the component fair market royalty rates underlying all of the intangible assets and services that form the overall 4% royalty rate charged franchisees. The 1997 appraisal covered the 1989-1994 time period.

70. The 1997 appraisal concluded that the value of the Long John Silver's trademark had declined from 30% of the royalty fee to 20% due to such factors as the increasingly competitive environment for quick service restaurants during this period of time, the fact that fried foods became less popular for health reasons and the depressing effect that the 1989 buyout had on corporate earnings since Long John Silver's carried so much additional debt load and costs associated with that debt load. The appraisal retained the same values as the 1988 appraisal for the other intangibles, such as trade names, trade secrets and recipes and know how, representing 20% of the royalty fee. Thus, the 1997 appraisal concluded that the value of intangible assets represented by the royalty fee had declined from 50% of the royalty fee to 40% of the royalty fee.

71. The 1997 appraisal determined that the value of franchise services (policing and inspection services) remained at 20% of the royalty fee and general and administrative services remained at 5% of the royalty fee. The value of procurement and development services were increased by 15% to 25% of the royalty fee based upon what the appraiser learned about the importance of Long John Silver's purchasing program in ensuring a reliable supply of fish. The value of training services was decreased by 5% based upon the closing of the training center and on the appraiser's new understanding that most Long John Silver's franchisees are already experienced operators. As a result

of these changes, the value of services was increased by 10% from representing 50% of the royalty fee to 60%.

72. Because there is no market for Long John Silver's trademarks and trade names separate and apart from the services embedded in the Long John Silver's franchise agreement, any appraisal which purports to arrive at an arm's length market value for the separate components represented by the franchise royalty fee is highly subjective and arbitrary.

73. The 1997 appraisal concluded that the value of Long John Silver's trademark had declined by 10% between 1988 and 1994 even though Long John Silver's income from franchise royalties increased from $10,544,000 in 1988 to $11,576,000 in 1994.

74. The 1988 and 1997 appraisals are not a reliable gauge of the value of the services embedded in the franchise agreement and relationship between Long John Silver's and its franchisees because it attributes a portion of the franchise royalty fee to services, such as procurement, restaurant development and training, even though the costs of those services are paid for separately by the franchisees in addition to the royalty fee.

75. Business format franchising is essentially a business arrangement whereby a franchisee agrees to sell goods or services in conformity with an entire business operating system and procedures prescribed by the franchisor and pays a fee, usually in the form of a percentage of sales, for the use of the business operating system and the trademarks, trade names and other proprietary marks of the franchisor. In addition to providing the franchisee a business operating system and the use of its proprietary marks, the franchisor markets and promotes the franchise business, the trademarks, trade names and other

proprietary marks and polices the entire system to ensure the quality and consistency of businesses operating under the franchise system.

76. Long John Silver's franchisees do not obtain services under the Franchise Agreement, but rather, they acquire the right to use a trademark with systems and procedures which inherently protect and promote the Long John Silver's trademark.

77. The essence of a franchise is that the franchisor and the franchisee share a common goal of maximizing the value of the trademark, which represents the franchise system. The franchisor and franchisee maximize the value of the trademark by selling more product.

78. The franchisor's and franchisees' common goal of selling more product is achieved by promotion and marketing and by policing, which ensures the quality and consistency of the product sold.

79. Each of the services performed by Long John Silver's under the franchise agreement is essentially an effort to either promote or police the Long John Silver's franchise system.

80. Commencing in late 1993, the Department conducted a desk audit of Long John Silver's. A desk audit is one conducted by correspondence and exchange of information between a taxpayer and the Department, without an actual site visit to the taxpayer to examine a taxpayer's books and records.

81. As a result of its audit, on December 28, 1994, the Department issued Assessment No. 1880539 to Long John Silver's. The assessment assessed $367,108.07 in gross receipts tax, $36,710.67 in penalty and $189,076.45 in interest for the period of January, 1988 through June, 1994.

82. On February 1, 1995 the Department granted Long John Silver's an extension of time, until March 28, 1995, to file a protest to Assessment No. 1880539.

83. On March 27, 1995 Long John Silver's filed a timely, written protest to Assessment No. 1880539.

84. The gross receipts tax portion of the assessment was assessed upon the total amount of the 4% royalty fees Long John Silver's received from its New Mexico franchisees during the audit period, the 5% advertising fee paid to Long John Silver's designee, Abbott Advertising, by Long John Silver's New Mexico franchisees, and the initial fees and grand opening fees paid by New Mexico franchisees. Gross receipts tax was not assessed on any amounts paid by New Mexico franchisees for investment spending advertising.

DISCUSSION

The issue to be determined herein is whether, and to what extent, Long John Silver's is subject to gross receipts tax on the revenues it receives from its New Mexico franchisees pursuant to its franchise agreements. Conceptually, this case turns on one basic issue. Are the revenues Long John Silver's receives pursuant to the franchise agreement to be treated as receipts from leasing property in New Mexico, that property being a franchise, which consists of a bundle of intangible property rights combined with various services which promote and protect the value of that franchise, or are the revenues to separately analyzed with respect to the imposition of tax according to each of the separate services and activities incorporated in the franchise agreement between Long John Silver's and its New Mexico franchisees?

<u>LONG JOHN SILVER'S HAS GROSS RECEIPTS FROM LEASING PROPERTY IN NEW MEXICO</u>

Although this case presents some nuances which have not been specifically addressed, the basic issue of how New Mexico's gross receipts tax applies to the franchise fees paid to out-of-state franchisors by New Mexico franchisees has been addressed and well established in New Mexico caselaw for nearly 20 years. In 1979, the New Mexico Court of Appeals issued three decisions which govern the determination of most of the issues raised in the instant matter, ***AAMCO Transmissions, Inc. v. Taxation and Revenue Department,*** 93 N.M. 389, 600 P.2d 841 (Ct. App., 1979), *cert. denied,* 93. N.M. 205, 598 P.2d 1165 (1979), ***American Dairy Queen Corp. v. Taxation and Revenue Department,*** 93 N.M. 743, 605 P.2d 252 (Ct. App. 1979) and ***Baskin-Robbins Ice Cream Co. v. Revenue Division, Taxation & Revenue Department,*** 93 N.M. 301, 599 P.2d 1098 (Ct. App. 1979).

In each of those cases, the taxpayers argued against the imposition of gross receipts tax upon the revenues they received from their New Mexico franchisees, alleging that they were not engaging in business in New Mexico and there existed insufficient nexus to impose tax under the Due Process and Commerce Clauses of the Constitution on the grounds that they were located out of state, that the franchise agreements were executed out of state, that they had no employees residing in New Mexico and that they had no property in New Mexico. The taxpayers in the ***AAMCO Transmissions*** and ***Baskin-Robbins*** case also argued that the Department was imposing gross receipts taxes upon services performed out of state in violation of the Due Process and Commerce Clauses.

The Court of Appeals determined that each of the taxpayers were subject to gross receipts tax for engaging in business in New Mexico. In arriving at this conclusion, the court relied upon the definitions of "gross receipts", "property" and "leasing" as found in §§ 7-9-3(F)(I)and(J) respectively of the Gross Receipts and Compensating Tax Act. Specifically, it relied upon the broad definition of "leasing", which is defined as, "any arrangement, whereby, for a consideration, *property is employed for or by any person* other than the owner of the property". § 7-9-3(J). It found that franchises were specifically defined to be property, § 7-9-3(I), and it found that gross receipts included money or consideration received from leasing property in New Mexico. The court also found that the franchisors had property located in New Mexico in the form of intangible property such as a significant financial interest in the goodwill and economic health of its franchisees. Finally, the court was not persuaded that the Department was imposing a tax on services performed out of state. Rather, what was being taxed were lease payments completely tied to receipts earned from business conducted in New Mexico done under the aegis of the franchisor's trademarks.

Long John Silver's argues that the ***AAMCO Transmissions, American Dairy Queen,*** and ***Baskin-Robbins*** decisions no longer apply because in 1991, subsequent to the Court of Appeals decisions, the legislature amended the definition of "leasing", which the Court of Appeals had relied upon in those decisions. Specifically, the definition of leasing was amended to define leasing to mean, "any arrangement whereby, for a consideration, property is employed for or by any person other than the owner of the property, *except that the granting of a license to use property is the sale of a license and not a lease."* (emphasis supplied to language added by amendment). Further, Long John

Silver's relies upon Department regulation 3 NMAC 2.1.7.5 (formerly GR 3(I):2) which, in describing a franchise, states that, "The franchise usually conveys to the franchisee a license to use the franchisor's trademark or trade name in the operation of the franchisee's business." Long John Silver's then goes on to argue, based upon the amended statute and regulation, that its franchise agreement amounted to a sale of a license to use its intangibles, and since the agreement was executed outside of New Mexico, that there was no taxable sale of property in New Mexico.

This argument overlooks the fact that the definition of "property", as contained in § 7-9-3(I) remains unchanged from how it was written when the three franchising cases were decided by the Court of Appeals. Section 7-9-3(I) defines property to mean, "real property, tangible personal property, licenses, *franchises*, patents, trademarks and copyrights. Tangible personal property includes electricity and manufactured homes;...." (emphasis added). Franchises are specifically defined to be property and are listed separately from licenses in the definition of property. Since the legislature is presumed not to use surplus or unnecessary language in writing statutes, franchises are presumptively different than mere licenses. That fact is born out if the full language of regulation 3 NMAC 2.1.7.5 defining franchises is consulted. Long John Silver's failed to take note of the first sentence of the regulation which provides:

> A 'franchise' is an agreement in which the franchisee agrees to undertake certain business activities or to sell a particular type of product or service in accordance with methods and procedures prescribed by the franchisor, and the franchisor agrees to assist the franchisee through advertising, promotion and other advisory services.

The regulation then mentions that franchises usually convey a license to use the franchisor's trademarks and trade names. Thus, franchises may involve the licensing of trademarks and trade names, making licensing an aspect of franchising, but there are many licenses which have no relationship to franchising. As the full context of the regulation makes clear, franchises are more than a mere license to use the franchisor's trademarks and trade names. Franchises involve a whole bundle of rights and obligations which the parties to a franchise agreement agree to. That is apparent from a reading of Long John Silver's franchise agreement. The franchisee agrees to comply with an extensive list of requirements which essentially ensure the quality and consistency of the product being sold and Long John Silver's agrees to assist the franchisee by providing various business systems, its confidential operations manual, menu management, procurement services, training, monitoring of quality, and promotion of the Long John Silver's system and products. A franchisee also knows that other franchisees are also required to conform to the same system and standards of the Long John Silver's franchise system. All of this is in addition to and in association with the use of Long John Silver's proprietary marks, which are licensed to the franchisee as a part of the entire franchise agreement for use in New Mexico. The Long John Silver's franchise is property. It is "leased" in New Mexico because Long John Silver's allows its franchise to be employed by its New Mexico franchisees in New Mexico in consideration for the payment of the specified franchise fees. Thus, the franchise fees are gross receipts from the leasing of property in New Mexico, and are subject to gross receipts tax.

THE DEPARTMENT IS NOT ESTOPPED BY REGULATION 3 NMAC 2.1.7.5

Long John Silver's objects to this characterization, pointing out that regulation 3 NMAC 2.1.7.5 refers to a franchise as an "agreement", and argues that agreements cannot be leased. Further, in reliance on Section 7-1-60, which estops the Department from withholding relief requested by a taxpayer if the taxpayer can show that their position is in accordance with a Department regulation, Long John Silver's argues that the Department is estopped from taking the position that a franchise is property when the regulation defines it as an agreement. This argument ignores the full context of the regulation. Although it does refer to a franchise as an agreement, the full wording of the regulation references the activities and obligations undertaken as part of the relationship created between the parties to a franchise agreement. The wording of the regulation is really just a reflection of the conceptual difficulty inherent in the concept of intangible property. As noted in 63C ***Am Jur.2d Property*** §9, "Intangibles consist of rights not related to physical things, *but are merely relationships between persons, natural or corporate,* which the law recognizes by attaching to them certain sanctions enforceable in the courts." (emphasis added). Thus, the franchise agreement is the physical embodiment of the legal relationship between the parties, but the rights created by that relationship remain and can still be properly characterized as intangible property. Because § 7-9-3(I) specifically defines a franchise to be property and the regulation is merely interpreting that statutory section, and reading the regulation in its full context and in light of the nature of intangible property itself, the Department's position is not in conflict with the regulation and the Department is not estopped from characterizing Long John Silver's franchise fee receipts as receipts from leasing intangible property in New Mexico.

<u>THE LEGAL SITUS OF LONG JOHN SILVER'S INTANGIBLES IS IRRELEVANT TO THE INQUIRY</u>

In another argument related to this one, Long John Silver's argues that because the legal situs of its intangible property is the situs of the owner of that property, and since Long John Silver's situs is its corporate domicile, which is located out of state, that Long John Silver's does not have intangible property in New Mexico which may be leased. The legal situs of Long John Silver's intangibles is irrelevant to the inquiry herein. Under the definition of leasing, the issue is not where the property is legally situated, but rather, where the property is "employed". ***See,*** Section 7-9-3(J) NMSA 1978. There can be no doubt that Long John Silver's intangible property is "employed" in New Mexico when its trademarks, trade names, know-how and, in fact, its entire restaurant operating system is used by its franchisees to sell food at its 21 franchise restaurant locations in New Mexico.

<u>SUFFICIENT NEXUS TO TAX EXISTS UNDER BOTH THE COMMERCE CLAUSE AND THE DUE PROCESS CLAUSES OF THE U.S. CONSTITUTION</u>

Related to its arguments that Long John Silver's is not leasing property in New Mexico is its argument that it lacks sufficient nexus with New Mexico for the Department to subject it to gross receipts tax based upon its franchising activity in New Mexico. The issue of whether sufficient nexus exists for a state to impose a tax on activities implicates both the Due Process Clause and the Commerce Clause of the United States Constitution. The recent Supreme Court case, ***Quill Corp. v. North Dakota***, 504 U.S. 298 (1992) drew a distinction between the "minimum contacts" requirement of the Due Process Clause and the "substantial nexus" requirement of the Commerce Clause, finding that a taxpayer may have the "minimum contacts" with a taxing state as required by the Due Process Clause, yet lack the "substantial nexus" with that state as required by the Commerce Clause. 504 U.S. at 313. Under the "minimum contacts" requirement of the Due Process Clause, the Court ruled that a state can tax an out of state corporation, even if the corporation has no physical presence in the state, as long as the corporation has purposefully availed itself of the benefits of an economic market in the forum state by directing its activities at residents of the taxing state. ***Id.*** at 307. There can be no doubt that Long John Silver's meets the "minimum contacts" requirement of the Due Process Clause for New Mexico tax purposes. Long John Silver's has purposefully availed itself of New Mexico's economic markets by franchising the operation of 21 Long John Silver's restaurants in New Mexico which provide a stream of revenue to Long John Silver's in the form of franchise fees.

The "substantial nexus" requirement of the Commerce Clause requires at least some physical presence in the taxing state. In ***Quill, supra,*** the Court prohibited North Dakota from requiring an out of state retailer with no physical presence in the state from imposing a requirement to collect the state's use tax on sales to in state customers.

Long John Silver's argues that although it has some physical presence in New Mexico through the visits to franchisees by Long John Silver's representatives to provide training and ensure that Long John Silver's system standards are being maintained, that these visits are too inconsequential to meet the requirements of "substantial nexus." Long John Silver's has substantial nexus with New Mexico. Long John Silver's regional Director of Franchise Operations visits Long John Silver's franchised restaurants in New Mexico approximately 30 days each year. In addition, Long John Silver's quality assurance personnel visit its New Mexico franchisee owned shops approximately every

18 months. This regular and continuing presence of Long John Silver's employees, alone, is sufficient to amount to "substantial nexus." This is because their presence is associated with Long John Silver's ability to establish and maintain a market in New Mexico for the products sold under its trademark and trade names. ***Scripto, Inc. v. Carson***, 302 U.S. 207 (1960), ***Tyler Pipe Industries v. Washington State Dept. of Revenue,*** 483 U.S. 232 (1987). Additionally, however, Long John Silver's has both tangible and intangible property in New Mexico. The tangible property consists of its confidential operating manuals, which it provides to each of its franchise locations. Long John Silver's also owns videotapes which it makes available to its New Mexico franchisees. More significantly, however, Long John Silver's has substantial intangible property in New Mexico consisting of its franchise system and its trademarks and trade names which it permits its franchisees to use to promote the sale of Long John Silver's products. Although the legal situs of these intangibles is Long John Silver's corporate domicile, the nature of intangibles allows them to be used in more than one place at the same time. Thus, it has long been recognized that although a taxpayer may be domiciled in one state, if he carries on business in another, he is subject to tax in the other state which can be measured by the value of the intangibles used in the other state. ***Wheeling Steel Corp. v. Fox,*** 298 U.S. 193 (1936), ***Curry v. McCanless,*** 307 U.S. 357 (1939). In this case, Long John Silver's continuously avails itself of New Mexico's markets by extending franchises and licensing its trademarks and trade names to its New Mexico franchisees. There can be no doubt that there exists substantial nexus for New Mexico to impose a tax on Long John Silver's franchising activities in New Mexico as measured by its franchise fees which are directly tied to sales conducted under Long John Silver's

trademark in New Mexico. The Court of Appeals arrived at the same result when it rejected the claim of insufficient nexus raised in ***AAMCO Transmissions, supra.*** The court recognized that although the situs of AAMCO''s trademarks was in Pennsylvania, it also had substantial other intangible property in New Mexico in the form of AAMCO's substantial monetary interest in the good will and economic health of its New Mexico franchisees' businesses, which it noted were protected and benefited by the laws of New Mexico. ***Id.*** 93 N.M. at 392. Additionally, it quoted with approval the following excerpt from ***Curry v. McCanless, supra,*** at 307 U.S. 367-368:

> when the taxpayer extends his activities with respect to his intangibles, so as to avail himself of the protection and benefit of the laws of another state, in such a way as to bring his person or property within the reach of the tax gatherer there, the reason for a single place of taxation no longer obtains....[I]ncome may be taxed both by the state where it is earned and by the state of the recipient's domicile. Protection, benefit and power over the subject matter are not confined to either state. The taxpayer who is domiciled in one state but carries on business in another is subject to a tax there measured by the value of the intangibles used in his business.

AAMCO Transmissions, 93 N.M. at 393. Because of Long John Silver's substantial and continuous presence in New Mexico through its franchisees' use of Long John Silver's proprietary marks and its entire franchise system for selling fish and other food products, substantial nexus exists for purposes of the Commerce Clause.

LONG JOHN SILVER'S FRANCHISE FEES ARE NOT GROSS RECEIPTS FROM PERFORMING SERVICES OUT OF STATE

Long John Silver's has argued that the franchise fees it receives from its New Mexico franchisees must be examined and broken down into fees for the various services and activities embedded in the franchise agreement with its franchisees and that since the vast majority of those services are performed out of state, that the Department may not impose gross receipts tax upon those fees. An additional part of its argument relies upon the allegation that the preponderance of the fees relate to services. Thus, the entire franchise agreement must be characterized as a contract to perform services, and since those services are performed out of state, none of the franchise fees may be taxed. With the exception of the argument concerning the portion of the franchise fees relating to advertising, which will be discussed separately, these issues have already been determined adversely to Long John Silver's by the Court of Appeals in its ***AAMCO Transmissions*** and ***Baskin-Robbins*** decisions.

In both the ***AAMCO Transmissions*** and ***Baskin-Robbins*** cases, the taxpayers argued that New Mexico was imposing its gross receipts tax upon services performed out of state in violation of the Commerce Clause. The ***Baskin-Robbins*** decision contains the most extensive discussion of this issue. Baskin-Robbins Ice Cream Company ("Baskin-Robbins") was a Delaware corporation headquartered in California which had no employees or offices in New Mexico, nor did it directly manufacture or sell any products in New Mexico. It owned distinctive trademarks, trade names, emblems, merchandizing designs and services, recipes and formulas. It entered into a franchise agreement with Creamland Dairies, Inc. ("Creamland"), where Creamland used Baskin-Robbins recipes and other products in the manufacture and sale of Baskin-Robbins ice cream through stores established by Creamland through a "Baskin-Robbins Retailers Franchise Agreement." The court noted that Baskin-Robbins' most valuable assets were its trade name, trademark and related intangibles, which properties, secret formulas and techniques were utilized in New Mexico. Creamland paid Baskin-Robbins a royalty based upon the Baskin-Robbins ice cream products sold by Creamland to its New Mexico retail stores and New Mexico assessed gross receipts tax on those royalties. The court couched its inquiry as follows:

> What are Taxpayer's 'activities' or 'services' that place it in the stream of [interststate] commerce? (1) New flavors are developed in California; (2) forms for leases and agreements supplied by Taxpayer are developed in California; (3) trademarks are the symbol of the good will of Taxpayer's business and its continued value depends upon the continuing use of the trademarks in its business with its continuing effort to regulate the use of the trademarks. When we bundle up these 'activities' or 'services,' we find no relationship to the concept of interstate commerce. The only contact Taxpayer has with New Mexico is its Area Franchise Agreement.
>
> When Taxpayer's recipes, recipe book and trademarks come to rest in New Mexico, their use becomes localized and have left the stream of interstate commerce.

Baskin-Robbins, 93 N.M. at 304. The court went on to conclude:

> Taxpayer is not engaged in interstate commerce. *The tax here imposed is conditioned on Creamland's local business of manufacturing and selling ice cream products in New Mexico. It is not a tax imposed on the importation of property or the rendering of services outside the state;* neither is it a tax measured by income derived from manufacturing and selling ice cream products in any other state; nor is the tax different from that assessed and paid by local taxpayers in manufacturing and selling ice cream products for others. (emphasis added).

Id., 93 N.M. at 306. The court in its ***AAMCO Transmissions*** decision took a similar approach to the issue, although the Department assessed tax only upon the 9% "franchise fee" which did not include "license fees", "service fees" or "advertising assessments" and receipts from inventory and specialty sales paid to AAMCO by its franchisees. It is impossible to tell from the court decision how these license fees, service fees or advertising assessments operated and upon what activities they were imposed. Nonetheless, the court applied the same reasoning which it applied in ***Baskin-Robbins***, where it found that New Mexico's tax was conditioned upon activities occurring in New Mexico, concluding:

> None of the fees upon which the tax is assessed relate to any of the alleged interstate services available from AAMCO to the franchisee but, rather, *are tied directly and completely to the monthly lease payments computed on receipts earned from the day-to-day operation of the businesses under AAMCO's trademark and trade name in New Mexico.* (emphasis added.)

AAMCO Transmissions, 93 N.M. at 392.

The same can be said about the Department's assessment of gross receipts taxes in this case. The assessment is tied directly and completely to the 9% lease payments called for by Long John Silver's franchise agreement, computed on receipts earned from the day to day operation of Long John Silver's New Mexico franchisees doing business under Long John Silver's trademark and trade name in New Mexico.

Conceptually, this issue turns upon the nature or character of the activity upon which the tax is imposed. Is the tax imposed upon Long John Silver's receipts from leasing intangible property consisting of its trademarks, trade names and, ultimately its entire franchise system, which admittedly includes promotional services as well as other activities which ensure the consistency and quality of the Long John Silver's experience? Or, as Long John Silver's argues, do we analyze separately the components of the franchise system and determine how much of the franchise fee is attributable to each component and where that component is being leased to determine taxability?

In concluding that the former approach is the correct approach, I am guided by the language of the Long John Silver's franchise agreement, which describes the franchise as an entire system, together with the fact that franchisees cannot pick and choose which elements of the system they want or are willing to pay franchise fees for. This concept of what is being leased in New Mexico is also consistent with the concept of business format franchising, as it was explained by the Department's expert witness.

Exhibits S-4, S-5 and S-6 are representative franchise agreements during the audit period for three different New Mexico restaurant locations. The recitals at the beginning of the agreement set out the parties' general understanding of the franchise business arrangement the parties are entering into, providing, "The Company is the developer of and sole and exclusive owner of a *distinctive food service system, (hereinafter, the "System")* under which food is sold to the public from restaurants operated under the name "Long John Silver's Seafood Shoppes" (hereinafter, "LJS Restaurants)" (emphasis added). The recitals then go on to list the elements of the system, such as the secret ingredients and food preparation and serving methodologies, quality and quantity control methods, restaurant design and decor, uniform restaurant operating methodologies, distinctive trademarks, service marks, designs and emblems, and a public image that each restaurant is a unit of an established franchise system operated with uniform standards of service and product quality. In the recitals, the franchisee expresses a desire to operate a Long John Silver's restaurant pursuant to "the System", to receive the training and assistance provided by Long John Silver's in connection with operating a restaurant, and the franchisee affirms an understanding and acceptance of the terms of the agreement as being necessary to maintain the high uniform standards of quality, service and portions designed to protect the good will and enhance the public image of the proprietary marks and the system. The franchisee agrees with the necessity of operating its Long John Silver's restaurant in faithful compliance with the terms of the agreement and with Long John Silver's standards and specifications. Paragraph 1.01 then describes what Long John Silver's is granting the franchisee, stating, "the Company grants to Franchisee, for and during the term hereof, the right to build and operate an LJS Restaurant (the "Franchised Restaurant") *and to use the System* at the location described..., to use such Proprietary Marks of the Company as are now or may hereafter be specifically designated by the Company in writing for use with the System..., and to indicate to the public that the Franchised Restaurant is operated as a part of, or unit in, the System...." (emphasis added.)

As a reading of the Franchise Agreement makes clear, what the franchisee is getting is the right to operate a Long John Silver's Restaurant and to use the Long John Silver's trademark and other proprietary marks as a part of the Long John Silver's restaurant system. "The System", as described in the Franchise Agreement is a complete and integrated system designed to efficiently and cost-effectively deliver a consistent and quality restaurant and dining experience to Long John Silver's customers, no matter which Long John Silver's restaurant the consumer chooses to patronize. It is also significant, when considering Long John Silver's argument that each component of the system must be analyzed separately for tax purposes, that none of the so-called components of the system are negotiable by franchisees who wish to become a part of Long John Silver's franchised restaurant system. It is a package. You can take it or leave it, but the package and the franchise fees are non-negotiable. Thus, it is the Long John

Silver's franchise system itself which the parties to the Franchise Agreement have bargained for and agreed to. Conceptually, it is analogous to buying a new television with digital technology. Undoubtedly, the research and development services, as well as the promotional activities that made me want to buy a Sony, all probably occurred outside of New Mexico, and in a sense, I am buying those, as well, when I buy a Sony television. Nonetheless, what the Sony dealer is selling me and what I am purchasing is a television set. Not the pieces of the set, the services to assemble it, the services to develop its technology, the services to ship it and stock it and the services involved in selling it to me in a retail establishment.

It is also significant that the system which Long John Silver's grants its franchisees the right to operate under is entirely consistent with the concept of a franchise system as described by the Department's expert witness, Dr. Paul Rubin. As noted above, in the recitals of the Franchise Agreement, the franchisee accepts the terms, conditions and covenants of the Franchise Agreement, "as those reasonably necessary to maintain the Company's high and uniform standards of quality, service and portions *designed to protect the good will and enhance the public image of the Proprietary Marks and the System,...*" (emphasis added). Dr. Rubin testified as follows with respect to the significance of the Long John Silver's trademark:

> I think the significance of the trademark is in a way the most important aspect of the case, and I think it's been misinterpreted by many of the other witnesses. The trademark as such is not the key, but the key thing is in selling a product like Long John Silver's, people have to know what it is and where to buy it. The only way they know where it is and where to buy it is by seeing that Long John Silver's name and symbol and so forth in a store, in an ad, somewhere so they can know what they're doing. *So,*

> *the value of the franchise is essentially that people know what they're getting when they walk into a Long John Silver's, and the trademark conveys that information. So the goal--in the real sense, the goal of Long John Silver's, the franchisor, and of each of [the] franchisee[s] is to maximize the value of that trademark, not because the trademark itself is important, but because by maximizing the value of the trademark, they're really maximizing the value of the business.* (emphasis added).

TR 595-596. When asked how they maximize the value of the trademark, Mr. Rubin testified that is accomplished through two activities, promotion and advertising, and through policing. Mr. Rubin testified that the services Long John Silver's provides as part of its obligations under the Franchise Agreement are essentially policing. Policing assures the consistency and quality of the Long John Silver's experience and is very important to the value of the trademark, because if a customer has one bad fish experience at a Long John Silver's, he won't patronize any Long John Silver's restaurant again. Thus, a bad meal at one Long John Silver's restaurant damages the business of all Long John Silver's restaurants.

It is also interesting to note that because of the mutually beneficial structure created by the Long John Silver's franchise, the services that Long John Silver's provides its franchisees not only benefit the franchisees, but also Long John Silver's. Thus, the procurement services which assure a steady, reliable supply of quality fish and other products benefit the franchisees, but they also benefit Long John Silver's. Not only because Long John Silver's benefits through its company owned stores, but because it ensures the quality and consistency of the Long John Silver's dining experience anywhere, enhancing the value of the Long John Silver's trademark everywhere.

In summary, Mr. Rubin testified:

> So that the value of the trademark--and that's in the interest of both the franchisor, because he wants to sell more franchises and wants to sell more fish, and the franchisee, because they have the same goals. So the whole structure of the arrangement is aimed at maximizing that value, both through promotion, through advertising and equally important through policing, to making sure that people get high quality fish and the same quality fish wherever they may go into a Long John Silver's.

TR 597. Thus, the Long John Silver's trademark represents the entire Long John Silver's restaurant system. That is where the value of the system resides. And that system is what is employed in New Mexico by Long John Silver's New Mexico franchisees. Even though the promotion and policing services may largely be performed out of state, their value ultimately resides in the Long John Silver's trademark, representing the Long John Silver's system. Long John Silver's New Mexico franchisees derive a benefit from being part of the Long John Silver's system. It is the Long John Silver's system and trademarks that the franchisees are paying for. It is intangible property which Long John Silver's is leasing in New Mexico. The Department is not taxing the rendition of services out of state. It is taxing Long John Silver's lease receipts from leasing intangible property in New Mexico. These receipts are not conditioned upon or measured by services performed out of state. They are completely tied to the revenues generated by the New Mexico franchisees operating under the Long John Silver's trademarks and system in New Mexico. As such, they are subject to New Mexico gross receipts tax. ***AAMCO Transmissions, Baskin-Robbins, supra.***

In spite of the fact that New Mexico's courts have examined franchises and treated franchise fees as gross receipts from leasing property employed in New Mexico, Long John Silver's argues that New Mexico should follow the treatment given franchise fees by the states of South Dakota and Michigan. ***See,*** Long John Silver's Post-Hearing Reply Brief, p.8. Apparently, because of how the South Dakota tax code is written, South Dakota does not subject to either sales or use tax the fees (characterized as "royalty fees") paid by a franchisee which are strictly for the privilege of engaging in business using the franchisor's name. It does, however, impose tax on royalty fees to the extent that they are for services or tangibles provided by the franchisor. Clearly, New Mexico does impose its gross receipts tax upon royalty fees paid by franchisees for the lease of intangible property employed in New Mexico. ***AAMCO Transmissions, Baskin-Robbins*** and ***American Dairy Queen, supra.*** Given our own court's examination of this issue, and the different statutory provisions being applied, South Dakota's treatment is not persuasive. The Michigan case cited by Long John Silver's is similarly inapposite and unpersuasive. ***Mourad Brothers, Inc. v. Dept. of Treasury***, 171 Mich. App. 792, 431 N.W. 2d 98 (1988) involved the application of Michigan's single business tax. That tax required that "royalties" be added to business income to arrive at the taxable base. Michigan's single business tax did not apply to services or advertising. The fee at issue was a 5% fee designated as a 1% royalty fee and 4% for advertising and other services. The case simply applied the statutes to include the 1% royalty fee in business income. Given New Mexico's different tax statutes and our own court's examination of this issue, ***Mourad Brothers*** is unpersuasive.

Long John Silver's presented appraisals by American Appraisal Associates, (exhibits S-47 and S-47) in support of its argument that its Franchise Agreement represents a contract for the performance of services, almost all of which are performed out of state. Long John Silver's relies upon the 1997 appraisal, which concluded that

60% of the royalty fee represented the value of services performed for franchisees and that only 40% of the royalty fee was attributable to the value of intangibles. Long John Silver's relies upon the definition of "service", found at § 7-9-3(K) NMSA 1978, which provides in pertinent part:

> 'service' means all activities engaged in for other persons for a consideration *which activities involve predominantly the performance of a service as distinguished from selling or leasing property.* (emphasis added).

Long John Silver's argues that since the appraisals establish that the majority of the value of the 4% royalty fee relates to services provided franchisees, the entire fee must be characterized as a receipt for performing services. Since the vast majority of those services are performed out of state, the Department may not impose tax upon any of the 4% royalty fee Long John Silver's received from its New Mexico franchisees. As discussed above, I believe that Long John Silver's argument mischaracterizes the nature of its franchise agreement with its franchisees, which is properly characterized as a lease of intangible property, as established not only by the terms of the franchise agreement itself, but also the decisions of the Court of Appeals in the ***AAMCO Transmissions*** and ***Baskin-Robbins*** decisions. I also found the appraisals not to be reliable evidence that the services made up the predominant part of the royalty fees paid to Long John Silver's. In the first place, even Long John Silver's appraiser admitted that he was not aware of any franchise without a trademark, nor was he aware of any market for a franchise trademark separate and apart from the franchise that it is associated with. TR 532. Simply stated, there is no market for the items he was attempting to segregate out of the 4% royalty fee against which his purported values can ever be referenced to verify their accuracy. The nature of the appraisal performed may suffice for accounting conventions which insist on arriving at some sort of value for various things on a company's books of account, even though the value is highly speculative, but it is not sufficiently reliable for purposes of convincing this fact finder that the majority of the royalty fee represents the value of services. The arbitrariness of the appraisals is manifest when we look more carefully at them. The 1988 appraisal had concluded that 50% of the royalty was attributable to the intangibles and 50% to the services. That appraisal was done independently of this litigation and would not establish that the preponderance of the fee was for services. The 1997 appraisal, done for the purposes of this litigation, managed to shift 10% to the service end of things based upon some questionable assumptions. The most notable conclusion was that the value of Long John Silver's trademark had declined during the audit years by 10%, because of the increasingly competitive fast food environment and the rising popularity of ethnic foods and the declining popularity of fried foods. Mr. Travis also cited the 1989 leveraged buyout of Long John Silver's, which, because of the significant debt incurred, had less capital available to invest in its trademark. Mr. Travis gave no explanation of how exactly the 10% was arrived at as opposed to 7%, 9% or even 12%. The percentages changed by increments of 5% to 10% for all categories which changed between the two appraisals, which is of itself, a confirmation of the somewhat arbitrary and speculative nature of such an appraisal. Most troubling, however, was that while Mr. Travis made some rather general assumptions about the franchise food industry and fried foods in particular, he did not take into account that Long John Silver's own revenues from franchise royalties actually increased over the same corresponding period. Those revenues are directly linked to the sales volume of Long John Silver's franchised restaurants, which indicates that the value of at least Long John Silver's own trademark was not declining in that same period, because as we know from Dr. Rubin's testimony, the value of the franchise business resides in the trademark and in its ability to generate business for the franchisor and the franchisees.

I also found that the appraisals themselves were faulty in their analysis. The appraisals purport to determine an arm's length royalty rate for the rights to Long John Silver's trademarks and trade names. It did this by analyzing the various components of the 4% royalty fee paid by franchisees, and valuing each of those components, breaking them down into the fees for the intangibles (trademark and trade name) and the portion representing the various services provided to franchisees. The testimony revealed that Long John Silver's puts a mark-up on the products it sells to the distributors, Martin-Brower and ProSource, who in turn sell those products to Long John Silver's franchisees. The mark up is intended to cover Long John Silver's costs of running its procurement program. Long John Silver's Development Guide, exhibit S-32, which is provided to new franchisees to assist them in learning about the Long John Silver's franchise system, explains that in addition to being responsible for their own management trainee employee's expenses while attending mandatory management training, that Long John Silver's imposes a "nominal charge" for field training taken in company shops. This charge covers the operational costs of the field training program. Thus, the costs of these "services" for franchisees are paid for separate and apart from any portion of the 4% royalty fee. This fact was actually recognized and acknowledged in each appraisal by the following language found on page 9 of each appraisal:

> Since the purpose of this investigation is to determine an arm's length royalty rate for the rights to certain intangible assets as previously defined, we shall exclude from consideration all benefits and services that are primarily a function of the company and would be necessary for operations regardless of ownership. For instance, the inspection and accounting functions are to ensure that standards are being maintained and that all royalty income due is accounted for. *Other services, such as development, purchasing and training would all be required for any type of ownership structure. Generally, costs associated with these services are charged back to the franchisees. Therefore, it would not be appropriate to charge a royalty fee for the benefit of these services.* (emphasis added).

In spite of this statement, purchasing and development services were valued at 25% of the royalty fee, or 1% of the 4% fee, and training services were valued at 10% of the royalty fee, or .4%. It thus appears that the appraisal methodology itself was fatally flawed, at least with respect to any probative value the appraisals would have for purposes of determining the relative portion of the 4% royalty fee attributable to services which are provided to franchisees as part of the Long John Silver's franchise system.

<u>ADVERTISING SERVICES ARE AN INTEGRAL PART OF THE FRANCHISE SYSTEM BEING LEASED IN NEW MEXICO</u>

Although the analysis in the preceding section is applicable to the issue of whether the portion of Long John Silver's franchise fees represented by the 5% advertising fee is subject to gross receipts tax, the advertising fee itself warrants further discussion. Long John Silver's has correctly pointed out that the Court of Appeals' previous decisions did not specifically address advertising fees. Neither of the ***American Dairy Queen*** or ***Baskin-Robbins*** decisions make any mention of advertising fees, and in ***AAMCO Transmissions***, the court noted that the Department had not included AAMCO's receipts from “advertising assessments” in its assessment of tax. ***Id.,*** 93 N.M. at 390. This is indicative, that at least at the time that the earlier franchise cases were being litigated, the Department chose not to include advertising fees in the franchise fees which were being subjected to tax. Long John Silver’s also relies upon two Department rulings, exhibits S-55 and S-56, issued in 1996, which ruled that advertising fees collected by franchisors from New Mexico franchisees were not receipts from selling property in New Mexico, performing services in New Mexico, leasing property in New Mexico or from the sale of research and development services performed out of state and initially used in New Mexico so as to be subject to gross receipts tax. Although there are some differences in how the advertising funds are administered, the rulings are really quite close to the facts of the instant matter. Long John Silver’s also correctly points out that advertising is characterized as a service under numerous Department regulations as well as New Mexico appellate decisions. ***See, e.g. Markham Advertising Co. v. Bureau of Revenue,*** 88 N.M. 176,177, 538 P.2d 1198 (Ct. App.), ***cert. denied,*** 88 N.M. 318, 540 P.2d 248 (1975); ***Mountain States Advertising Inc. v. Bureau of Revenue,*** 89 N.M. 331, 332, 552 P.2d 233, 234 (Ct. App.) ***cert. denied,*** 90 N.M. 8, 558 P.2d 620 (1976); regulations 3 NMAC 2.1.18.4; 3 NMAC 2.1.18.15; 3 NMAC 2.10.10; 3 NMAC 2.48.13.1; 3 NMAC 2.48.13.2 and 3 NMAC 2.55.7.2. Finally, Long John Silver’s argues that the advertising fees cannot be considered to be gross receipts of Long John Silver’s because they are paid directly by the franchisees to Abbott Advertising.

The latter issue will be addressed first, because there is no point in even determining the applicability of the gross receipts tax to advertising revenues if Long John Silver’s cannot be considered the proper taxpayer to raise this issue. Abbott

Advertising is a wholly owned subsidiary of Long John Silver's Restaurants, Inc., which is a holding company which owns QSC, Inc., which owns the Taxpayer in this case, Long John Silver's. Thus, Long John Silver's and Abbott Advertising are closely related corporations which are part of the same family of Long John Silver's related corporations. Paragraph 7.01 of the Franchise Agreement provides as follows:

> Recognizing the value of advertising, and the importance of the standardization of advertising to the furtherance of the goodwill and public image of the System, Franchisee agrees that *the Company* [Long John Silver's] *or its designee* shall conduct, determine, maintain and administer all national, regional, local and other advertising and marketing as may be instituted from time to time, and shall direct all such advertising and marketing with sole discretion over the concepts, materials, media, nature, type, scope, frequency, place, form, copy, layout and context used therein. (emphasis added).

Paragraph 7.02 of the Franchise Agreement specifically lists Abbott Advertising as its designee, providing in pertinent part:

> The Company shall have the right to delegate and redelegate its responsibilities and duties hereunder to any designee(s) of its choosing, including to its affiliate, Abbott Advertising Agency, Inc., or any successor or other agency; however, the right of final approval of all advertising programs shall be retained at all times by the Company.

The advertising fee paid by franchisees is provided for in paragraph 6.02(a), which provides in pertinent part:

> Franchisee shall pay to the Company or its designee for advertising and marketing programs, a sum equal to five percent (5%) of Franchisee's Gross Receipts from the operation of the Franchised Restaurant.

These paragraphs make clear that not only is Abbott Advertising Long John Silver's designee under the Franchise Agreement, but that ultimately, Long John Silver's retains complete and total control over the Long John Silver's advertising program, regardless of who its designee is. As such, it is clear that the advertising fees are receipts of Long John Silver's under the terms of the Franchise Agreement. Long John Silver's simply chooses to direct its franchisees to make payment to its designee, rather than itself. This does not change the fact that the ultimate recipient is Long John Silver's, the franchisor under the agreement. Even if one is persuaded by the form of the payment transaction, the advertising fee still meets the applicable part of the definition of "gross receipts" being considered for purposes of this discussion. This is because gross receipts is defined to be, "the total amount of money or the value of other consideration received" from selling or leasing property in New Mexico, or from performing services in New Mexico, etc. ***See,*** § 7-9-3(F) NMSA 1978. Thus, even if Long John Silver's did not receive the money, it received "other consideration" in the form of the activities engaged in by Abbott Advertising in fulfillment of Long John Silver's obligations to administer the advertising and marketing program for Long John Silver's and its franchisees.

Admittedly, the treatment of the 5% advertising fee is a far more difficult issue than the 4% royalty fee. For one thing, the fee is specifically earmarked for advertising and promotion, as opposed to the difficulty presented with determining the relative portions of the royalty fee attributable to various activities undertaken as part of the franchising agreement. There can also be no dispute that advertising is a service, and that the advertising services performed by Long John Silver's through its designee were performed out of state. The Department's own rulings are also indicative of the strength of Long John Silver's argument on this issue[1]. Nonetheless, the Department has apparently taken a new look at this issue and, while reasonable minds may differ, I am persuaded that the advertising fee is integral to the concept of franchising, as explained by the Department's expert witness, and it cannot be segregated from the entire franchise system which Long John Silver's New Mexico franchisees employ in New Mexico.

In arriving at this conclusion, I am persuaded by several factors. Foremost among them is the fact that it is clear, both from the unambiguous language of the Franchise Agreement, as excerpted above, as well as the testimony of Long John Silver's own witness, Mark Sievers, that Long John Silver's, and not the franchisees, controls and directs Long John Silver's advertising and marketing program. This is distinct from the situation described in Ruling 401-96-05, where a franchisee advisory group actually administers the advertising fund and from the situation described in Ruling 401-96-6, where the franchisee advisory group actually approves or disapproves of advertising programs and estimated costs. Because the franchisees do not have the power to control the advertising and marketing which is paid for as part of the franchise fees, it is far less convincing that the advertising fee is actually a service they are purchasing directly with their advertising fee.

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[1] Rulings were defined during the audit period herein at § 7-1-5(B)(2) NMSA 1978 (1993 Repl. Pamp.) as, "written statements of the secretary, *of limited application to one or a small number of taxpayers,* interpreting the statutes to which they relate, ordinarily issued in response to a request for clarification of the tax consequences of a specified set of circumstances" (emphasis added). Although the Department is estopped from taking action not in accordance with a ruling with respect to taxpayers to whom a written ruling was personally addressed, § 7-1-60 NMSA 1978, there is no allegation that Long John Silver's was the addressee of either of the two rulings at issue herein. While rulings are persuasive evidence of the Department's view of the tax consequences of a given situation, they are limited to the facts stated and the taxpayer to whom they are issued. Additionally, the fact that rulings have been issued on a subject does not prohibit the Department from taking a new look at the issue, in light of more developed facts, new law, or a more thorough analysis of any given issue, except with respect to the taxpayers to whom the rulings were specifically addressed.

I also was persuaded by the testimony of the Department's expert witness, Dr. Rubin, who testified quite convincingly about how marketing and promotion is a consistent element of modern franchising and how integral it is to the concept of franchising. The promotion and marketing serve to enhance the value of the trademarks and, indeed, the entire franchise system which the franchisees pay a fee to participate in. As noted in the previous section of this decision, it is apparent from the wording of the franchise agreements themselves, that what the franchisees are contracting for is the entire Long John Silver's franchise system. Advertising and promotion are an important part of the system, without a doubt. There are many services and business systems which are an important part of the Long John Silver's system. Ultimately, however, it is the franchise system which the franchisees are paying the franchise fees for. They may not pick and choose which services or activities they wish to participate in and adjust the franchise fees accordingly. They cannot opt out of management training. They cannot choose their own restaurant designs and get a fee discount. They can't design their own menu and offer products not approved by Long John Silver's. Nor can they design their own advertising program and opt out of paying the advertising fee. It is a complete and integrated restaurant management and promotion package that they sign up for, and that is embodied in the concept of a franchise, which is intangible property employed by Long John Silver's franchisees in New Mexico.

THE GROSS RECEIPTS TAX PAID BY LONG JOHN SILVER'S NEW MEXICO FRANCHISEES IS IMPOSED UPON A SEPARATE TRANSACTION

The last argument raised by Long John Silver's with respect to the tax assessed is that because Long John Silver's franchisees already pay tax upon their sales in New Mexico and because the franchise fees are calculated as a percentage of those sales, that tax has already been paid to New Mexico and Long John Silver's does not owe additional tax upon its franchise fees. This argument is totally with out merit. We have two separate taxpayers and two separate taxable transactions. We have the franchisees, who have gross receipts from selling food and beverages in New Mexico, and we have Long John Silver's, which has gross receipts from leasing intangible property in New Mexico.

PENALTY IS PROPERLY IMPOSED

The final issue to be determined is whether the assessment of penalty was proper in this case. The imposition of penalty is governed by the provisions of NMSA 1978, Section 7-1-69(A)(1995 Repl. Pamp.), which imposes a penalty of two percent per month, up to a maximum of ten percent:

> In the case of failure, due to negligence or disregard of rules and regulations, but without intent to defraud, to pay when due any amount of tax required to be paid or to file by the date required a return regardless of whether any tax is due,....

This statute imposes penalty based upon negligence (as opposed to a willful or fraudulent intent) for failure to timely pay tax. Thus, there is no contention that Long John Silver's failure to report and pay taxes upon its New Mexico franchise fees was based upon any willful attempt by the Taxpayer to underreport taxes. What remains to be determined is whether the Taxpayer was negligent in failing to report its taxes properly. Taxpayer "negligence" for purposes of assessing penalty is defined in Regulation 3 NMAC 1.11.10 as:

1) failure to exercise that degree of ordinary business care and prudence which reasonable taxpayers would exercise under like circumstances;
2) inaction by taxpayers where action is required;
3) inadvertence, indifference, thoughtlessness, carelessness, erroneous belief or inattention.

Long John Silver's offered no factual testimony whatsoever to explain why it had failed to report taxes on any of its franchise fees during the audit period. Section 7-1-17(C) NMSA 1978 provides that there is a presumption of correctness which attaches to any assessment of tax by the Department. The presumption of correctness also applies to the assessment of penalty. ***Tiffany Construction Co. v. Bureau of Revenue,*** 90 N.M. 16, 558 P.2d 1155 (Ct. App. 1976), ***cert. denied,*** 90 N.M. 255, 561 P.2d 1348 (1977). As noted earlier, it has been established law in New Mexico since the ***AAMCO Transmissions, Baskin-Robbins*** and ***American Dairy Queen*** cases were decided in 1979, that gross receipts tax was applicable to the fees paid by New Mexico franchisees to their franchisors. Long John Silver's offered evidence as to why they did not report and pay any tax on any portion of the franchise fees they received[2]. Perhaps they were not aware of the law in New Mexico. Even so, New Mexico has a self-reporting tax system which requires that taxpayers voluntarily report and pay their tax liabilities to the state. Because of this, the case law is well settled that every person is charged with the reasonable duty to ascertain the possible tax consequences of his actions, and the failure to

[2] In its Post-Hearing Brief, Long John Silver's did argue that many other out-of-state franchisors treat advertising and royalty fees paid by New Mexico franchisees as nontaxable for New Mexico gross receipts tax purposes. This argument assumes facts not in evidence and will not be considered.

do so has been held to amount to negligence for purposes of the imposition of penalty pursuant to Section 7-1-69 NMSA 1978. ***Tiffany Construction Co., supra.***

Long John Silver's also argued that because it was cooperative with the Department's auditor and furnished the Department with all information requested in a timely manner during the audit that this demonstrates that they were not negligent. I am not aware of any law which provides that it is a defense to the imposition of a negligence penalty to have cooperated during audit. Indeed, taxpayers are required to make their records available to the Department, and the secretary is given enforcement powers when they fail to do so. Section 7-1-4 NMSA 1978. Long John Silver's has failed to present any evidence or arguments which rebut the presumption of correctness of the penalty assessment and the imposition of penalty is proper.

CONCLUSIONS OF LAW

1. Long John Silver's filed a timely, written protest to Assessment No. 1880539 pursuant to § 7-1-24 NMSA 1978 and jurisdiction lies over both the parties and the subject matter of this protest.

2. Long John Silver's has substantial nexus with New Mexico for purposes of the Commerce Clause.

3. Long John Silver's leases intangible property in New Mexico in the form of its franchise system and its trademarks and trade names to its New Mexico franchisees who employ such property in New Mexico.

4. Pursuant to Long John Silver's Franchise Agreement, Long John Silver's Franchisees acquire the right to use and become a part of the Long John Silver's franchise

system, which includes the right to use the Long John Silver's trademark and other proprietary marks in conjunction with the franchise system.

5. Long John Silver's franchise system is an integrated whole which cannot be considered separately, by its various components of intangible property, tangible property and services.

6. Because Abbott Advertising is Long John Silver's designee to receive payment of the 5% advertising fee portion of Long John Silver's franchise fees and to act on behalf of Long John Silver's in fulfilling its obligation to do marketing and advertising for the Long John Silver's franchise system and its franchisees, Long John Silver's has received other consideration for purposes of the imposition of gross receipts tax in the amount of the 5% advertising fee.

7. The initial fees and opening fees Long John Silver's received from its New Mexico franchisees constitute gross receipts to Long John Silver's from leasing property employed in New Mexico.

8. While both licenses and franchises are intangible property, the terms are not synonymous.

9. The 1991 amendments to § 7-9-3(J) NMSA 1978 do not alter the fact that Long John Silver's has gross receipts from leasing property in New Mexico to its New Mexico franchisees.

10. Under New Mexico tax law, advertising is characterized and treated as a service.

11. The 5% advertising fee is not a fee for services performed outside of New Mexico but is part of the franchise fees paid to in order to use and be part of the Long John Silver's franchise system.

12. The Department is not estopped by regulation 3 NMAC 2.1.7.5 from treating the franchise fees received by Long John Silver's from its New Mexico franchisees as gross receipts from the leasing of property in New Mexico.

13. The predominant ingredient test found in § 7-9-3(K) has no applicability to this case because New Mexico law has established that franchise fees are gross receipts from the lease of property employed in New Mexico.

14. The payment of gross receipts tax on the gross receipts of Long John Silver's New Mexico franchisees from their sale of food and beverage does not relieve Long John Silver's from payment of gross receipts tax upon its receipts from leasing property in New Mexico. There are two separate taxpayers and two separate taxable transactions.

15. Long John Silver's has failed to overcome the presumption of correctness of the penalty assessment and the imposition of penalty is proper.

For the foregoing reasons, Long John Silver's protest IS HEREBY DENIED.

DONE, this 2nd day of April, 1998.