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

IN THE MATTER OF THE PROTEST OF
BURLINGTON NORTHERN
SANTA FE CORPORATION **No. 03-04**
ID NO. 02-347761-00-0
TO ASSESSMENT NO. 2589486

DECISION AND ORDER

A formal hearing on the above-referenced protest was held November 7, 2002, before Margaret B. Alcock, Hearing Officer. Burlington Northern Santa Fe Corporation ("BNSFC") was represented by its attorneys, Curtis W. Schwartz and Timothy R. Van Valen, Modrall Sperling Roehl Harris & Sisk P.A. The Taxation and Revenue Department ("Department") was represented by Bruce J. Fort, Special Assistant Attorney General. At the close of the hearing, a briefing schedule was established and the final brief of the parties was filed on January 31, 2003, at which time the matter was submitted for decision. Based on the evidence and arguments presented,

IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

The Agreement

1. In 1974, The Atchison, Topeka and Santa Fe Railway Company ("AT&SF") and the New Mexico Bureau of Revenue, the predecessor in interest to the Department, entered into an agreement ("the Agreement") pursuant to NMSA 1953, § 72-15A-35, which is currently codified as NMSA 1978, § 7-4-20 of New Mexico's version of the Uniform Division of Income for Tax Purposes Act ("UDITPA").

2. The Agreement set out the method to be used by AT&SF in allocating and apportioning certain items of income on its New Mexico corporate income tax returns.

3. The Agreement states in its entirety, except for the signature lines:

CORPORATION INCOME TAX AGREEMENT
PURSUANT TO SECTION 72-15A-35

An agreement is hereby entered into between the New Mexico Bureau of Revenue and The Atchison, Topeka and Santa Fe Railway Company to settle certain issues concerning the Corporation Income Tax as follows:

1. Interest Income, excluding interest income earned on obligations of the United States or instrumentalities, taxable for federal income tax purposes will be reported as follows:

    a. Business Income subject to apportionment on the basis of the three-factor formula to the extent earned on investments from less than one year's duration or which are directly related to the operation of the business.

    b. Nonbusiness income, allocable to New Mexico only if commercial domicile is in the State, to the extent earned on Investments held for one year or more and which are only Indirectly related to the operation of the business.

2. Fifty percent of rents and royalties taxable for federal Income tax purposes will be deemed to be business income subject to apportionment. The remaining fifty percent will be allocated according to Section 72-15A-21 N.M.S.A. 1953 (Supp. 1973).

3. Twenty-five percent of the gain taxable for federal Income tax purposes from sales and exchanges of real or tangible or intangible personal property will be deemed to be business Income subject to apportionment. The remaining seventy-five percent will be allocated pursuant to Section 72-15A-22 N.M.S.A. 1953 (Supp. 1973).

4. Miscellaneous income will be classified as business or nonbusiness income based on the relevant facts of each item, and apportioned or allocated accordingly.

5. The above proposals will be effective for calendar year 1971 and subsequent years subject to periodic review by either party. Amended returns will not be required for years prior to 1971.

This agreement is entered into between the New Mexico Bureau of Revenue and The Atchison, Topeka and Santa Fe Railway Company pursuant to Section 72-15A-35. This agreement may be terminated by either party by a written notice thereof to the other party at least (90 days) before the beginning of the taxable year to which the termination shall apply.

4. There is no evidence that either party ever conducted a review of the terms of the Agreement after it was signed in 1974.

5. In the course of an audit initiated in 1998, the Department concluded that the Agreement was no longer effective as a result of AT&SF's 1996 merger with another corporation.

6. On July 3, 2002, the Department's Cabinet Secretary sent a letter to the surviving corporation of the merger. The letter stated, in part:

> Without prejudice to the Department's position that the agreement is already termin-ated, which it believes is correct, and solely to avoid any dispute as to the validity of the agreement for any future reporting periods which could be subject to the agreement, I hereby inform you that the agreement attached as Exhibit A is terminated effective 90 days after the date of this letter, pursuant to NMSA 1978, Section 7-4-20 (1986).

The Corporate Entities

7. BNSFC was incorporated in the State of Delaware in December 1994.

8. On September 22, 1995, the stockholders of Santa Fe Pacific Corporation and Burlington Northern Inc. became the stockholders of BNSFC pursuant to a business combination of the two companies. In order to effect the combination, BNSFC was formed to act as the parent holding company of Santa Fe Pacific Corporation and Burlington Northern, Inc.

9. AT&SF was a subsidiary of Santa Fe Pacific Corporation.

10. Burlington Northern Railroad Company ("BN") was a subsidiary of Burlington Northern Inc.

11. On December 30, 1996, Santa Fe Pacific Corporation and Burlington Northern Inc. merged, with Santa Fe Pacific Corporation as the surviving corporation.

12. On December 31, 1996, AT&SF and BN merged, with BN as the surviving corporation. BN subsequently changed its name to Burlington Northern and Santa Fe Railway Company ("BNSF Rwy") (see chart below).

Chart of Corporate Acquisitions and Mergers

Prior to 9/22/95

Burlington Northern, Inc.	Santa Fe Pacific Corporation
(BNI)	(SFPC)
/	/
Burlington Northern Railroad	Atchison, Topeka & Santa Fe Rwy
(BN)	(AT&SF)

9/22/95

Burlington Northern Santa Fe Corporation
(BNSFC)

/	/
Burlington Northern Inc.	Santa Fe Pacific Corporation
(BNI)	(SFPC)
/	/
Burlington Northern Railroad	Atchison, Topeka & Santa Fe Rwy
(BN)	(AT&SF)

12/30/96

Burlington Northern Santa Fe Corporation
(BNSFC)
/
Santa Fe Pacific Corporation
(BNI merges into SFPC)

/	/
Burlington Northern Railroad	Atchison, Topeka & Santa Fe Rwy
(BN)	(AT&SF)

12/31/96

Burlington Northern Santa Fe Corporation
(BNSFC)
/
Santa Fe Pacific Corporation
(SFPC)
/
Burlington Northern Railroad
(AT&SF merges into BN)
Renamed
Burlington Northern Santa Fe Railway
(BNSF Rwy)

13. All of the corporate entities involved in this protest, *i.e.*, BNSFC, Burlington Northern Inc., Santa Fe Pacific Corporation, AT&SF, and BN, were incorporated under the laws of the State of Delaware.

14. The merger of AT&SF and BN was governed by Delaware law.

15. The Agreement and Plan of Merger stated the effect of the merger in Article 1, Section 1:3:

> 1.3 *Effect of the Merger*. From and after the Effective Time, the Surviving Corporation shall possess all the rights, privileges, powers and franchises, as well of a public as of a private nature and will be subject to all the restrictions, disabilities and duties of each of [AT&SF] and [BN] and all property, real, personal and mixed, and all debts due to [AT&SF] or [BN] on whatever account, as well as for stock subscriptions as all other things in action or belonging to [AT&SF] or [BN] shall be vested in the Surviving Corporation; and all property rights, privileges, powers and franchises, and all and every other interest shall be thereafter as effectually the property of the Surviving Corporation as they were of [AT&SF] and [BN] and title to any real estate vested by deed or otherwise, under Delaware Law, in [AT&SF] or [BN], shall not revert or be in any way impaired by reason of the [General Corporation Law of the State of Delaware]; but all rights of creditors and liens upon any property of [AT&SF] or [BN] shall be preserved unimpaired, and all debts, liabilities and duties of [AT&SF] or [BN] shall thenceforth attach to the Surviving Corporation and may be enforced against it to the same extent as if said debts, liabilities and duties had been incurred or contracted by it.

16. Prior to the 1996 merger, AT&SF and BN were both operating railroad companies.

17. Following the merger, AT&SF ceased to exist as a separate entity, and BN (renamed BNSF Rwy), the surviving corporation, continued the railroad operations of the two merged corporations.

18. A majority of the directors and senior officers of BNSF Rwy were former officers of AT&SF who assumed the same or similar positions with BNSF Rwy.

19. Following the merger of AT&SF and BN, a substantial number of pre-merger BN employees were let go by BNSF Rwy.

20. Prior to the merger, AT&SF and BN both operated in New Mexico, although AT&SF was the dominant company in the state.

21. The merger of AT&SF and BN resulted in a corporation of significantly increased size, both in terms of track mileage and in terms of revenues.

BNSFC'S Corporate Income Tax Returns

22. BNSFC filed its 1996 and 1997 corporate income tax returns using the combined method of reporting.

23. BNSFC used the same filing and accounting methods on its 1996 and 1997 corporate income tax returns.

24. BNSFC used the same taxpayer identification number on its 1996 and 1997 corporate income tax returns.

25. The combined group for BNSFC's 1996 return included Santa Fe Pacific Corporation and Burlington Northern Inc., as well as their respective subsidiaries, AT&SF and BN.

26. The combined group for BNSFC's 1997 return included only Santa Fe Pacific Corporation and BNSF Rwy, reflecting the changes resulting from the December 30, 1996 merger of Santa Fe Pacific Corporation and Burlington Northern Inc. and the December 31, 1996 merger of AT&SF and BN.

27. For the 1996 tax year, BNSFC applied the 1974 Agreement between AT&SF and the Department to apportion and allocate the income of AT&SF, which was reporting as a separate, identifiable entity on BNSFC's combined return.

28. For 1996, BNSFC reported $7,520,176 of allocated non-business income for AT&SF, most of it related to the gain on a reported non-business asset sale. During its audit, the Department found additional gains of $557,476 that should have been reported as well.

29. For the 1997 tax year, AT&SF had ceased to exist as a separate, identifiable entity, and BNSFC applied the 1974 Agreement between AT&SF and the Department to apportion and allocate the income of BNSF Rwy, the survivor of the merger between AT&SF and BN.

30. For 1997, BNSFC reported $56,686,158 of allocated non-business income for BNSF Rwy, including $20,532,541 in interest income, $3,629 in royalties, and $36,149,988 in gains from the sale of non-business assets.

31. The 1997 return did not indicate whether BNSF Rwy's reported non-business interest, royalties, and gains were attributable to investments previously owned by AT&SF or to investments previously owned by BN, although it is reasonable to assume that some of that income was attributable to assets originally held by BN.

32. BNSFC has not applied the 1974 Agreement to allocate BNSF Rwy's income for tax years 1998 through 2000.

The Audit

33. In 1998, the Department initiated a corporate income tax audit of BNSFC for tax year 1996, which was later extended to tax year 1997.

34. The auditor permitted BNSFC's application of the 1974 Agreement to allocate and apportion AT&SF's income for 1996.

35. The auditor corrected various errors that BNSFC had made in applying the terms of the Agreement, resulting in an assessment of additional corporate income tax for tax year 1996. BNSFC does not contest this portion of the assessment.

36. When reviewing BNSFC's 1997 return, the auditor asked the taxpayer's accounting staff to explain the source of the income allocated on the return. The auditor did not receive a

response and noted in his audit report that: "The exact method used to estimate former ATSF's allocable income for 1997 under the terms of the Agreement was not established."

37. The auditor also asked the taxpayer's accounting staff for an explanation as to why the 1974 Agreement was applied to BNSF Rwy's 1997 income and was told that it was likely a mistake since AT&SF did not exist in 1997.

38. The auditor subsequently determined that the 1974 Agreement could not be applied to BNSFC's 1997 return because AT&SF, the original party to the Agreement, had ceased to exist as a separate entity.

39. The auditor recalculated BNSFC's 1997 corporate income tax liability without regard to the allocation and apportionment terms of the 1974 Agreement

40. The auditor did not attempt to determine whether the 1974 Agreement represented an equitable method of allocating and apportioning the income of BNSF Rwy.

The Assessment and Protest

41. On October 20, 2000, Department issued Assessment No. 2589486 to BNSFC in the total amount of $316,771.20, representing $223,608.00 corporate income tax, $22,360.80 penalty, and $70,802.40 interest due for the period January 1996 through December 1997.

42. On January 19, 2001, pursuant to an extension of time granted by the Department, BNSFC filed a written protest to the Department's assessment.

43. The parties subsequently reached a settlement on one of the issues raised in the protest. The only issue remaining in dispute concerns the application of the 1974 Agreement to BNSFC's 1997 corporate income tax return.

ISSUE TO BE DECIDED

The issue to be decided is whether BNSFC was entitled to apply the 1974 Agreement between the Department and AT&SF, which sets out the method of allocating and apportioning certain items of AT&SF's income for purposes of reporting New Mexico corporate income tax, to the 1997 income of BNSF Rwy, the surviving corporation of the 1996 merger between AT&SF and BN.

POSITIONS OF THE PARTIES

BNSFC argues that it was entitled to apply the terms of the 1974 Agreement to BNSF Rwy's 1997 income because the 1996 Plan of Merger provided that BNSF Rwy would succeed to "all the rights, privileges, powers and franchises" of AT&SF, which included the 1974 Agreement. The Department maintains that the Agreement was based on equitable principles as they applied to the income and unique circumstances of AT&SF, and argues that the merger cannot expand the scope of the Agreement to include the combined income of AT&SF and BN.

BURDEN OF PROOF

There is a statutory presumption that any assessment of tax made by the Department is correct. NMSA 1978, § 7-1-17(C). *See also, Archuleta v. O'Cheskey*, 84 N.M. 428, 431, 504 P.2d 638, 641 (Ct. App. 1972). Accordingly, it is BNSFC's burden to establish that the Department's decision not to apply the 1974 Agreement to BNSF Rwy's 1997 income was incorrect and that the assessment of tax resulting from that decision should be abated.

DISCUSSION

The 1974 Agreement between the Department and AT&SF was entered into pursuant to NMSA 1953, §§ 72-15A-34 and 72-15A-35, which are currently codified, without material change, as NMSA 1978 §§ 7-4-19 and 7-4-20 of New Mexico's version of the Uniform Division of Income for Tax Purposes Act ("UDITPA"). These sections read as follows:

> **7-4-19. Equitable adjustment of standard allocation or apportionment**. If the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act [Chapter 7, Article 4 NMSA 1978] do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
> A. separate accounting;
> B. the exclusion of any one or more of the factors;
> C. the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
> D. the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.
>
> **7-4-20. Agreement authorized in unusual cases**. In circumstances within the scope of Section 7-4-19 NMSA 1978 and in other circumstances where the revenues of this state would not be adversely affected, the secretary is authorized to enter into an agreement in writing with any person with respect to the apportionment and allocation of that person's income. Except upon a showing of fraud or misrepresentation of a material fact or a change in the statutory law, such agreement shall be conclusive. Any agreement, however, may be terminated by either party by written notice thereof to the other party at least ninety days before the beginning of the taxable year to which the termination applies.

Under the authority granted in § 7-4-20, the 1974 Agreement altered the normal allocation and apportionment rules set out in UDITPA to establish an alternative means of determining whether certain items of AT&SF's income would be treated as business income subject to apportionment or non-business income to be allocated according to the provisions of UDITPA. AT&SF filed its New Mexico corporate income tax returns in accordance with the 1974 Agreement up through tax year 1996, the last year that AT&SF was listed as a separate entity on BNSFC's combined income tax return.

BNSFC maintains that AT&SF's right to apportion and allocate income under the 1974 Agreement survived AT&SF's 1996 merger with BN and that BNSFC was entitled to apply the terms of the Agreement to the total income of BNSF Rwy, the surviving corporation. The

Department does not dispute that the rights of AT&SF survived the merger. *See*, Department's Post-Hearing Brief at 2 ("the question is not whether a right obtained by AT&SF should survive the merger—those rights did survive"). The Department argues, however, that the Agreement was personal to AT&SF and could not be expanded to include the combined income of AT&SF and BN. Because AT&SF ceased to exist as a separate entity and BNSFC did not segregate or identify what portion of BNSF Rwy's 1997 income was attributable to AT&SF's historical operations, it is the Department's position that the 1974 Agreement was effectively terminated.[1]

I. **Transferability of Rights Created by the 1974 Agreement**.

A. **Assignment**. According to the Restatement (Second) of Contracts, § 317(2), a contractual right may be assigned unless:

> (a) the substitution of a right of the assignee for the right of the assignor would materially change the duty of the obligor, or materially increase the burden or risk imposed on him by his contract, or materially impair his chance of obtaining return performance, or materially reduce its value to him, or
>
> (b) the assignment is forbidden by statute or is otherwise inoperative on grounds of public policy, or
>
> (c) assignment is validly precluded by contract.

[1] In its reply brief, BNSFC suggests that the Department cannot raise the issue of BNSFC's failure to segregate income attributable to AT&SF's historical operations because this issue was not raised by the auditor. In fact, the auditor did ask BNSF Rwy to identify the source of its 1997 income during the audit but received no response. Tr. at 109. In any event, the issues to be raised at the administrative hearing are not limited to those identified by the Department's auditor, but to the issues set out in the parties' prehearing statement after the opportunity for full discovery. *See,* NMSA 1978, § 7-1-24(A) and ¶ 4 of the Scheduling Order filed on July 10, 2002. On page 6 of the prehearing statement filed on October 25, 2002, the Department stated: "The taxpayer makes no claim that the agreement should be applicable only to the residual operations of the former entity, and has not made any attempt to segregate income (dividends, interest and capital gains) of the former entity from the newly-created entity to allow some sort of equitable application of the agreement." At the administrative hearing, the Department's attorney elicited testimony concerning BNSF Rwy's failure to segregate AT&SF income from both the auditor and BNSF Rwy's tax manager. BNSFC raised no objection to this testimony.

These principles of contract law have been recognized by New Mexico's appellate courts. *See*, *Investment Co. of the Southwest v. Reese*, 117 N.M. 655, 662, 875 P.2d 1086, 1093 (1994) (assignments can occur without statutory authority unless proscribed by specific language or public policy); *Quality Chiropractic, PC v. Farmers Ins. Co. of Arizona*, 2002-NMCA-080, ¶ 25, 51 P.3d 1172, 1180 (assignments are only enforceable if they do not increase the burden on the obligor).

In this case, there is no prohibition against assignment in NMSA 1978, § 7-4-20, the statute authorizing the 1974 Agreement between the Department and AT&SF. The Agreement itself is also silent on the issue; it does not contain language prohibiting assignment, nor does it contain language binding the successors or assigns of the parties to the terms of the Agreement. *Cf.*, *Campbell v. Millennium Ventures, LLC*, 2002-NMCA-101, ¶¶ 17-18, 55 P.3d 429, 433 (personal services contract was assignable under provision binding successors and assigns); *Equifax Services, Inc. v. Hitz*, 905 F.2d 1355, 1361 (10th Cir. 1990) (covenant not to compete in employment contract that inured to the benefit of successors and assigns was enforceable by surviving corporation of a merger). In the absence of any direction in the statute or the Agreement, the next inquiry is whether allowing assignment of the 1974 Agreement would violate the intent and policy underlying § 7-4-20. This must be done by examining the Legislature's purpose in authorizing the Department to enter into special agreements with taxpayers. *See*, *In re Portal*, 2002 NMSC-011, ¶ 5, 45 P.3d 891, 892 (a court's interpretation of statutes must consider the object of the legislation and its construction must not render a statute's application absurd, unreasonable, or unjust).

The purpose that § 7-4-20 is intended to serve is one of equity. New Mexico adopted UDITPA in 1965. 1965 N.M. Laws, ch. 203, currently codified as NMSA 1978, §§ 7-4-1 to 7-4-21. As noted by the New Mexico Supreme Court in *Taxation and Revenue Department v. F.W.*

Woolworth Co., 95 N.M. 519, 525, 624 P.2d 28, 34 (1981), *rev'd on other grounds*, 458 U.S. 354, 102 S. Ct. 3128, 73 L. Ed. 2d 819 (1982):

> The purpose here is to provide a system by which each state in which a multistate corporation does business can obtain its fair share of income taxes and no more. We read the statutes as calling for a method of allocation which is fairly calculated to assign to New Mexico that portion of the net income reasonably attributable to the business done in this state. *See Butler Bros. v. McColgan*, 315 U.S. 501, 62 S. Ct. 701, 86 L. Ed. 991 (1942).

Under UDITPA, non-business income is generally allocated to the taxpayer's commercial domicile or to the location of the asset generating the income. Business income is apportioned among the states in which the taxpayer does business under a three-part formula set out in § 7-4-10. Section 7-4-19 allows for equitable adjustment in cases where the standard rules of allocation and apportionment "do not fairly represent the extent of the taxpayer's business activity in this state." Finally, § 7-4-20 provides that in circumstances "within the scope of Section 7-4-19 and in other circumstances where the revenues of this state would not be adversely affected" the Department may enter into an agreement with the taxpayer regarding the method to be used to allocate and apportion the taxpayer's income.

Regulation 3.5.19.8B NMAC under § 7-4-19 makes it clear that the circumstances justifying equitable adjustment are limited, explaining that:

> Section 7-4-19 NMSA 1978 may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions contained in Sections 7-4-2 to 7-4-18 NMSA 1978.

Other states have also interpreted the equitable relief provisions of UDITPA to apply only in unusual cases. *See e.g., Donald M. Drake Company v. Department of Revenue*, 500 P.2d 1041, 1044 (Ore. 1972) (the use of any method other than apportionment should be exceptional); *American Tel. & Tel. Co. v. Huddleston*, 880 S.W.2d 682, 691-692 (Tenn. App. 1994) (the variance provision applies only in unusual and limited circumstances and is to be interpreted narrowly in order to carry out the purpose of uniform apportionment under the act); *Deseret Pharmaceutical Co., Inc. v. State Tax Commission*, 579 P.2d 1322, 1326 (Utah 1978) (there are compelling reasons for giving the relief provisions a narrow construction).

NMSA 1978, §§ 7-4-19 and 7-4-20 authorize the Department to vary the standard allocation and apportionment methods set forth in UDITPA in unusual cases where those methods do not fairly represent the extent of the taxpayer's business activity in New Mexico. Section 7-4-20 also allows the Department to alter the statutory methods "in other circumstances where the revenues of this state would not be adversely affected." In either case, the underlying purpose of UDITPA dictates that any agreement reached between the Department and the taxpayer is personal to the taxpayer. To allow an individualized method of allocation and apportionment based on one taxpayer's unique circumstances to be applied to determine the tax liability of another taxpayer would lead to an absurd and unjust result. Despite the absence of express language in § 7-4-20 or in the 1974 Agreement between the Department and AT&SF, it is clear that the special allocation and apportionment method created by the Agreement was personal to AT&SF and was not a right that AT&SF could sell or assign to a third party.

B. **Merger versus Assignment**. The transfer of rights by corporate merger is a transfer by operation of law and not by assignment. For this reason, courts have held that non-assignment clauses are generally inapplicable to prevent the surviving corporation of a merger from succeeding to non-assignable rights of the merging corporations. *See*, *e.g*., *Alexander & Alexander, Inc. v. Koelz*, 722 S.W.2d 311 (Mo. App. 1986) (covenant not to compete passed to the surviving corporation of a merger); *International Paper Co. v. Broadhead*, 662 So.2d 277 (Ala. App. 1995) (state tax credit passed from merged company to surviving corporation); *Brunswick Corp. v. St. Paul*

Fire & Marine Ins. Co., 509 F.Supp. 750 (E.D. Pa. 1981) (provision requiring insurer's consent to transfer the rights and duties under a policy did not affect transferability through a statutory merger); *Knoll Pharmaceutical Co. v. Automobile Insurance Co. of Hartford*, 167 F.Supp.2d 1004 (N.D. Ill. 2001) (same).

Even in merger situations, however, courts have applied contract principals similar to those governing assignment to determine the extent of the rights transferred. *See,* Ballew, *The Assignment of Rights, Franchises, and Obligations of the Disappearing Corporation in a Merger*, 38 Bus.Law. 45, 55-59 (1982). The above cases all recognize that the transfer of contract rights in a merger cannot result in a material change to the contract or in increased risk to the obligor.

In *Alexander & Alexander, supra*, the Missouri appellate court reversed a lower court's ruling that the surviving corporation of a merger could not enforce a covenant not to compete entered into by one of its predecessor corporations. The court noted, however, that "[n]othing contained in the limited record available on this motion to dismiss indicates employees' duty not to compete will be materially altered by the merger," and restricted its holding as follows:

> We do not decide if the covenant here is otherwise enforceable. We hold only that the transfer in the circumstances involved in this case did not impose, as a matter of law, a material change in the obligations and duties of employees; and therefore the transfer does not automatically render such a covenant unenforceable.

722 S.W.2d at 313. This clearly signals that the outcome would be different in cases where the evidence indicated that the merger created a material change in the duties or risks imposed by the covenant.

In *International Paper Co., supra*, the court held that International Paper Company, the surviving corporation of a merger, was entitled to an Alabama investment tax credit held by Hammermill Paper Company, even though the agreement granting the credit to Hammermill prohibited assignment. As the basis for its decision, the court found that the statute creating the credit was intended to induce foreign corporations to invest heavily in certain economically depressed counties of Alabama. Hammermill had already qualified for the credit by investing $107 million in Alabama prior to the merger, and the court held that "[t]he objective of the statute would clearly be thwarted if IPCO is denied the right of its predecessor's statutory credit." 662 So.2d at 279. Under the facts of this case, allowing the tax credit to pass to the surviving corporation posed no increased risk to the State of Alabama because the credit was already an established liability at the time of the merger.

As pointed out in BNSFC's reply brief, New Mexico has taken a similar position with regard to its investment credit. Regulation 3.13.2.14 NMAC under NMSA 1978, § 7-9A-8 provides that the surviving corporation of a merger may "claim any amount of approved but unclaimed investment credit held by a predecessor." Similar to the holding in *International Paper Co.*, the regulation recognizes that established liabilities pass to the surviving corporation upon merger. Under the facts set out in the regulation, the investment credit must have been approved by the Department prior to the merger. In these circumstances, the credit is an existing liability, and recognizing the surviving corporation's right to the credit does not create any new or increased risk to state revenues.

Brunswick Corp., supra, and *Knoll Pharmaceutical Co., supra*, addressed the effect of a merger on a non-assignment clause in an insurance policy. In each case, the court held that the surviving corporation could enforce a policy issued to one of the merged corporations. As stated in *Brunswick Corp*., 509 F.Supp. at 753: "Upon a merger, all rights and duties of the merging corporations are automatically vested in the surviving corporation and the surviving corporation essentially stands in the same position as the merged corporation prior to the merger." The court found that the prohibition on assignment was intended to protect the insurer against increased risk, and that there was no increased risk associated with the merger because the insurer would only be liable on claims that arose out of the covered acts of the corporation to which the policy was originally issued. The insurer's liability could not be extended to include acts by the other party to the merger. *See also*, *Knoll Pharmaceutical Co*., 167 F.Supp.2d at 1010, FN 7 ("Here, similar to *Brunswick* and *Imperial Enterprises*, there is no increased risk associated with the statutory merger because Defendant Insurers are only liable on those claims against Knoll that arose out of the covered acts of Boots USA"); *Imperial Enterprises, Inc. v. Fireman's Fund Insurance Co*., 535 F.2d 287 (5th Cir. 1976) (in the absence of increased risk to insurer, no-assignment clause in fire insurance policy would not be applied so as to forfeit coverage as a result of a transfer through a statutory merger).

BNSFC raises a number of arguments as to why the reasoning applied in the above cases should not be applied here. First, BNSFC argues that "these cases do not raise the same issues for analysis because the Agreement contained no anti-assignment provision." Reply Brief at 15. As discussed under Point I(A), above, it is clear from the purpose and policy underlying the statutes authorizing the 1974 Agreement that the special reporting method created by the Agreement was personal to AT&SF and was not a right that AT&SF could sell or assign to third parties.

BNSFC also argues that the Department should have foreseen the possibility of merger and added an express provision to address this situation. None of the contracts in the cases discussed above contained such a provision. In addition, while the possibility of merger may seem obvious from the perspective of 2003, looking back on the boom years of the 1990s, it is not clear that this possibility would have been obvious during the recessionary years of the early 1970s. BNSFC presented no evidence concerning the business climate during that period to establish whether a reasonable person entering into a contract in 1974 would have foreseen and taken steps to protect himself against such an eventuality.

Finally, BNSFC argues that the 1974 Agreement could be terminated only in accordance with the specific termination provisions set out in the Agreement itself. Virtually all contracts have termination provisions, however. The 90-day notice provision in the 1974 Agreement is very similar to that in contracts that provide for automatic renewal unless one party gives the other timely notice of cancellation. In this case, the merger of AT&SF and BN took place on December 31, 1996, which was well after the date the Department could have terminated the Agreement for the 1997 tax year. Although the merger documents were public record, AT&SF did not give the Department personal notice of the merger. These facts are very similar to those set out by the court in *Imperial Enterprises, Inc., supra*:

> Upon consummation of the merger, Carpet Mills' assets, including the fire insurance policies, were transferred to Imperial Enterprises by operation of law. Articles of merger were properly filed in various state and local offices and the merger was reported in the newspaper. Carpet Mills did not, however, take any action to assign the policies to Imperial Enterprises. Fireman's Fund was not notified concerning the transfer of the policies and did not, of course, consent to it.

535 F.2d at 289. Six months after the merger, a costly fire occurred at a Carpet Mills plant. Fireman's Fund subsequently denied liability, claiming that Carpet Mills' merger into Imperial Enterprises constituted a wrongful assignment of the policy. In the court's analysis of the case, the fact that Fireman's Fund presumably could have discovered the merger and canceled the policy before the fire occurred was not a factor. Instead, the court employed a "risk-focused analysis" to determine whether transfer of the policy by merger increased the risks or hazards incurred by Fireman's Fund. 535 F.2d at 292.

The reasoning applied in all of the above cases mirrors the common law principle that an assignee stands in the shoes of his assignor and cannot acquire any greater rights than those held by the assignor. *Investment Co. of the Southwest v. Reese*, 117 N.M. 655, 661, 875 P.2d 1086, 1092 (1994); Restatement (Second) of Contracts § 336 (1981). While courts have held that the surviving corporation of a merger succeeds to all contract rights of the merged entities, those same courts have recognized that a merger cannot create any greater rights in the surviving corporation than were held by the merged corporation, nor can the merger serve to increase the risks to the other party to the contract. The same principles apply to the Agreement at issue here.

II. AT&SF's Merger with BN Increased the State's Risks under the 1974 Agreement.

The Department asserts that BNSFC's application of the 1974 Agreement to the 1997 income of BNSF Rwy, the surviving corporation of the merger of AT&SF and BN, expanded the scope of the Agreement and created an increased risk to the state's revenues. Neither the Department nor BNSFC presented any evidence concerning the circumstances that led the parties to enter into the 1974 Agreement. It must be assumed, however, that those circumstances met the requirements of NMSA 1978, §§ 7-4-19 and 7-4-20, the statutes authorizing the Agreement. As discussed in more detail in Point I(A), above, these statutes allow the Department to adjust the standard method of allocating and apportioning income in unusual cases where that method does not fairly represent the extent of a particular taxpayer's business activity in New Mexico.

The purpose of the 1974 Agreement was to craft a reporting method to insure that AT&SF paid New Mexico income tax on only that portion of its income reasonably attributable to its business activities in the state. The Department argues that the Agreement cannot be expanded to include the income of BN without putting the state's revenues at risk. The Department points out that the merger of AT&SF and BN resulted in a corporation of significantly increased size, both in terms of track mileage and in terms of revenues. Prior to the merger, AT&SF and BN both operated in New Mexico. The 1997 return filed by BNSFC did not indicate whether BNSF Rwy's reported non-business royalties, interest, and gains, the items covered by the 1974 Agreement, were attributable to investments previously owned by AT&SF or to investments previously owned by BN. Although AT&SF was the dominant company in the state, BNSF Rwy's tax manager acknowledged that it was reasonable to assume that some of the income on the 1997 return was attributable to assets originally held by BN. The tax manager testified that no attempt had been made to trace the source of the income back to AT&SF or BN. She did not know whether BN's investment philosophy was similar to that of AT&SF.

BNSFC's only response to the Department's argument is that AT&SF and BN were both operating railroad companies prior to the merger and that their combined railroad operations were continued by BNSF Rwy after the merger. This does not address the issue of whether applying the 1974 Agreement to the combined incomes of both companies created an increased risk to New Mexico's tax revenues. The 1974 Agreement was not based on the fact that AT&SF was a railroad. If it were, then the allocation and apportionment method set out in the Agreement would not be limited to AT&SF, but would apply to all railroads. Regulation 3.5.19.13 NMAC under NMSA 1978, § 7-4-19 sets out special rules for railroads to use in calculating corporate income tax due to New Mexico. These rules bear no resemblance to the reporting method set out in the Department's 1974 Agreement with AT&SF. This confirms that the Agreement was based on circumstances unique to AT&SF and not simply on the fact that AT&SF was a railroad company.

It is BNSFC's burden to establish that the Department's decision not to apply the 1974 Agreement to BNSF Rwy's 1997 income was incorrect and that the assessment of tax resulting from that decision should be abated. Based on the evidence presented at the administrative hearing, there is nothing to indicate that AT&SF and BN shared the unique circumstances that led the Department to enter into the 1974 Agreement. Nor is there any evidence that applying the special reporting method created for AT&SF to the combined income of AT&SF and BN would result in a fair allocation and apportionment of income to New Mexico. In the absence of such evidence, there is a real risk that allowing BNSF Rwy to apply the 1974 Agreement to the combined activities of AT&SF and BN would result in increased revenue losses to the state. It would also thwart the underlying purpose of UDITPA, which is to establish "a method of allocation which is fairly calculated to assign to New Mexico that portion of the net income reasonably attributable to the business done in this state." *Taxation and Revenue Department v. F.W. Woolworth Co.*, 95 N.M. 519, 525, 624 P.2d 28, 34 (1981), *rev'd on other grounds*, 458 U.S. 354, 102 S. Ct. 3128, 73 L. Ed. 2d 819 (1982). For these reasons, the Department was correct in concluding that the 1974 Agreement could not be applied to BNSF Rwy's 1997 income.

CONCLUSIONS OF LAW

1. The Taxpayer filed a timely, written protest to Assessment No. 2589486, and jurisdiction lies over the parties and the subject matter of this protest.

2. The special allocation and apportionment method created by the 1974 Agreement between the Department and AT&SF was personal to AT&SF and was not a right that AT&SF could sell or assign to a third party.

3. BNSF Rwy, the surviving corporation of the merger of AT&SF and BN, succeeded to AT&SF's rights under the 1974 Agreement by operation of law.

4. BNSFC's application of the 1974 Agreement to the 1997 income of BNSF Rwy, the surviving corporation of the merger of AT&SF and BN, expanded the scope of the Agreement and created an increased risk to the state's revenues.

5. Once AT&SF ceased to have any identifiable income to which the 1974 Agreement could be applied, and in the absence of any evidence that applying the Agreement to the combined income of AT&SF and BN would result in a fair allocation and apportionment of income to New Mexico, the object of the Agreement could no longer be met and the Agreement was effectively terminated.

For the foregoing reasons, the Taxpayer's protest IS DENIED.

DATED February 17, 2003.