

# **The Wal-Mart Case**

## *Its Implications for All Corporate Income Taxpayers*

from the



**Helen Hecht**  
Vice Chair

May 25, 2006



***NMTRI: Working to Improve New Mexico's Tax and Fiscal Policies***

© 2005, New Mexico Tax Research Institute  
All rights reserved.

The Wal-Mart Decision  
Its Implications for All Corporate Income Taxpayers

Table of Contents

Background.....	2
The Facts in <i>Wal-Mart</i> .....	3
The Issue in <i>Wal-Mart</i> .....	3
The Power Limits of the Taxation and Revenue Department.....	4
What are the Implications?.....	6
Conclusion.....	7

## The Wal-Mart Decision Its Implications for All Corporate Income Taxpayers

As reported recently, the New Mexico Taxation and Revenue Department was the winner in an administrative hearing involving the corporate income taxes of giant retailer Wal-Mart Stores, Inc. *Wal-Mart* presented a number of issues similar to the *Kmart* case decided by the New Mexico Supreme Court in December, 2005. And for the most part, the decision in *Wal-Mart* relies heavily on *Kmart*. The main issue Wal-Mart sought to clarify was the extent to which the Department can change the standard apportionment formula and determine taxable corporate income on a case-by-case basis. The answer - the Department's discretionary power can be exercised on a retroactive basis within fairly broad limitations. (Note - the taxpayer at issue was an affiliate of Wal-Mart called "WMR," but WMR was eventually merged into Wal-Mart, so the decision bears the name "Wal-Mart" rather than WMR.)

### Background

To understand *Wal-Mart*, it is important to have a basic understanding of how state income tax apportionment works. States can't tax the entire income of a multistate company but must adopt rules for dividing up that income so that only a portion is taxed by a single state. Most states, including New Mexico, have adopted the rules found in the Uniform Distribution of Income for Tax Purposes Act (UDITPA), which is a multi-state act developed some fifty years ago. UDITPA applies a statutory formula to apportion "business" income for taxation in a particular state. ("Business" income is income from all sources except certain unrelated passive or investment activities.). The standard "three-factor formula" used by UDITPA is based on property, payroll and sales. (The term "sales" means all business receipts from any type of activity.) Under this standard formula, the percentages of company property, payroll and sales in a particular state are determined and then those percentages are averaged. The resulting average percentage is applied to company income to determine the portion of income taxable in the state.

The reason property, payroll and sales percentages were made part of the original formula for apportioning income under UDITPA was because they were seen as driving income. Over the years, states, including New Mexico, have issued generally applicable regulations (considered part of the standard formula) to help taxpayers determine things like what types of property are included in the property factor, what amounts should be used in determining payroll and where a sale should be "sourced" for purposes of the sales factor - that is, what state gets to include the sale in the numerator of its sales factor.

From this general discussion, no one should get the impression that the rules for apportioning income are uniform from state to state. States are not required to be uniform or consistent in how they determine the portion of multi-state income that each is entitled to tax. In fact, over the years, states have purposely become less and less uniform for a variety of reasons. For

example, the “standard” formula in a number of states now “double-weights” the sales factor. In other states, the “standard” formula is a single sales factor formula.

When the standard three-factor (single-weighted) formula was created under UDITPA, it was apparent that it might not be the appropriate formula in certain situations or industries. So, under UDITPA, states had the power to adopt special rules for certain situations and for particular industries. Under these regulations, the specific formula applied may be different than the standard formula.

UDITPA also gives state tax departments the power to vary the standard apportionment formula on a case-by-case basis whenever that formula and existing rules “do not fairly represent the extent of the taxpayer’s business activity” in the state. Specifically, the state can require (or the taxpayer can request) separate accounting; exclusion of one or more of the property, payroll or sales percentages from the formula; inclusion of one or more additional percentages in the formula; or application of any other method to effect “equitable” apportionment. The provision of UDITPA allowing changes to the standard formula is referred to as the “equitable apportionment provision.”

#### The Facts in *Wal-Mart*

In *Wal-Mart*, the facts were similar to *Kmart*. Wal-Mart filed in New Mexico on a separate entity basis (separate from any affiliates). As part of its state tax planning, it set up a wholly owned subsidiary to hold its trade names and trademarks. This “intangible holding company” subsidiary, called WMR, granted a license to use the intangibles to Wal-Mart, the retail company, in exchange for royalty payments. Those royalties were generally a percentage of the gross revenue of Wal-Mart. As a result, Wal-Mart had deductible royalty expenses that reduced its total income subject to tax. WMR had royalty income but was located outside the state and did not file income taxes in New Mexico.

In both *Wal-Mart* and *Kmart*, the Department assessed income tax directly against the royalty income of the intangible holding company subsidiary on a separate entity basis. (It also assessed gross receipts tax on the royalty receipts of these entities. This tax was eventually overturned in *Kmart*.)

#### The Issue in *Wal-Mart*

The issue here was: What formula should be used in apportioning the royalty income from intangibles? Wal-Mart argued that it should be allowed to apply the standard statutory apportionment formula. The Department argued it had the power to impose a different formula on a retroactive basis. Similar arguments had also been made in *Kmart*, but in *Wal-Mart*, the taxpayer introduced certain additional facts.

The statutory formula that Wal-Mart wanted to apply would have resulted in zero income being taxed in New Mexico. The intangible holding company, WMR, clearly had no

property or payroll in New Mexico and therefore its property and payroll percentages for income tax purposes were zero. WMR also argued that the sales factor should be zero under the general statutory rules for determining New Mexico sales. Under the Department's alternative formula, royalties earned by WMR based on Wal-Mart's New Mexico sales would be sourced to the New Mexico as part of WMR's sales factor and the property and payroll factors would be excluded. (Because both factors were zero, including them in the formula and averaging them with the sales factor would have had the effect of cutting the overall apportionment percentage to 1/3 of the sales factor.)

### The Power Limits of the Taxation and Revenue Department

Because the decision in *Wal-Mart* relied heavily on *Kmart*, the significance of *Wal-Mart* is that it addresses, in somewhat more depth, the power the Department has to apply a different apportionment formula to particular taxpayers and whether there are any limits on that power. (The specific alterations to the formula are discussed under Implications below.)

Under both *Wal-Mart* and *Kmart*, when the Department wants to apply a different apportionment formula to a particular taxpayer, it must first show that the standard formula does not "fairly represent" the taxpayer's business activity in the state. It must also show that the formula it wants to apply is reasonable under certain general criteria. These requirements set the outer limit of the Department's power. However, as experience over the last five decades has shown, any standard formula is, by nature, arbitrary. Therefore, it will generally be the case that some alteration for a particular business could make the formula more appropriate. Also, as both decisions point out, the economy and business activity have changed considerably since UDITPA was originally adopted. These widespread changes arguably make the standard three-factor formula less and less appropriate for a number of taxpayers. As a result, the outer limit of the Department's power is perhaps far greater than originally conceived.

In both *Wal-Mart* and *Kmart*, the facts presented were found to fall well within the outer limits of the Department's power. The question, then, is whether, once that limit is reached, the Department can simply proceed by audit and litigation to adjust apportionment formulas retroactively on a case-by-case basis. In other words, does the Department have unlimited discretion as to whether it will issue regulations or rules for particular situations and give notice to taxpayers that it intends to vary the rules that may apply to them.

Wal-Mart argued that this discretion should not be limitless but that two kinds of limits should apply. The first was a specific limitation adopted by the Department under its regulations, that the Department would alter the apportionment formula only in "specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results" under the standard formula. Wal-Mart presented information showing that, far from being "unique and nonrecurring," the use of intangible holding companies was fairly widespread, including some 5,000 registered in Delaware alone. However, the Hearing Officer rejected this fact as having no relevance and said the question was not whether the case was "unusual from a numeric standpoint" but whether it was

“unusual within the context of UDITPA.” To support this conclusion, the Hearing Officer cited the specific industries for which special apportionment formulas had been adopted by regulation (banks, railroads, airlines and trucking companies). The Hearing Officer reasoned that since there are large numbers of companies in each of these industries, therefore, the “unique and nonrecurring” limitation must not be a limitation based on numbers.

However, the regulation that imposes the unique and nonrecurring” limitation also clearly distinguishes the case-by-case discretion from the power to issue industry specific regulations. The “unique and nonrecurring” limitation governs case-by-case discretion and specifically does not apply to the issuance of industry-wide rules. In a separate section of the same regulation which imposes the unique and nonrecurring limitation, this is made clear: “In the case of certain industries such as air transportation, rail transportation, ship transportation, trucking, television, radio, motion pictures, various types of professional athletics and so forth, the [standard formula regulations] may not set forth appropriate procedures for determining the apportionment factors. Nothing in Section 7-4-19 NMSA 1978 [the equitable apportionment provision] or Sections 3.5.19.8 through 3.5.19.11 NMAC [sections containing, among other things, the unique and nonrecurring limitation] shall preclude the department from establishing appropriate procedures . . . for such industries.” In other words, while the Department’s discretion to change the standard formula on a case-by-case basis is limited to unique and nonrecurring cases, its power to issue industry-wide rules is not.

Even without this distinction, it is simply too difficult to believe that the words “unique and nonrecurring” do not mean “a small number.” If the unique and nonrecurring limitation is not to be interpreted to mean a small or relatively limited number of cases, then it follows that the Department has the power to affect large numbers of taxpayers by retroactively changing their apportionment formulas on a case-by-case basis. And, if, as the Department argued and the Hearing Officer agreed, the UDITPA rules were written primarily with manufacturers and retailers in mind, then virtually all other industries are potentially “unusual” in the “context of UDITPA.” This interpretation gives the Department the power on a case-by-case basis to change the apportionment formula for a substantial percentage of taxpayers.

The second limit that Wal-Mart argued should apply to the Department’s discretion is the principle that broad rules affecting multiple taxpayers ought to be adopted by the promulgation of regulations versus case-by-case litigation. This principle certainly has a long accepted and logical foundation. Any tax provision that is less than clear (and arguably, state corporate income tax law is full of such provisions) should be clarified by rules that apply on an evenhanded basis to every similarly situated taxpayer. Not only does such a principle create fairness, but it also serves to give notice to taxpayers and increases the predictability fundamental to business.

However, the Hearing Officer rejected any limit based on this principle and implied that regulations are necessary only where there is a “recognized industry.” Said the Hearing Officer, “the tax-planning strategy represented by these trademark holding companies does not constitute an ‘industry’ similar to banking, broadcast and transportation industries for

which regulations have been adopted under § 7-4-19.” This conclusion by the Hearing Officer ignores the fact that the Department has issued non-industry specific regulations under § 7-4-19. (See Regulations 3.5.19.10 and 3.5.19.11.) Nor is there any reason to think that non-industry specific regulations are not contemplated under the equitable apportionment provision.

### What are the Implications?

It is tempting to characterize *Wal-Mart* and *Kmart* as cases involving aggressive tax planning strategies and, therefore, applicable only in similar circumstances. In both cases, the facts presented and the decisions themselves, spotlight the companies’ tax-planning motivations. And it is clear that the Department targeted Wal-Mart and Kmart because it wanted to keep taxpayers from using intangible holding companies as tax planning devices. Even so, the motivation of Wal-Mart was specifically not, in and of itself, a factor in the Hearing Officer’s determination of the issues in the case. Therefore, there is nothing in the decision that would keep it from being applied in other contexts.

There are two main implications from this case for all New Mexico corporate income taxpayers. The first is that the Department has specific authority to make alterations to the standard three-factor formula on a retroactive basis. In particular, two kinds of changes are approved. The second implication, not discussed at all in the *Wal-Mart* decision, is that taxpayers may also have more support now to argue for alternative apportionment methods that are favorable to them.

The Department made two specific kinds of alterations to the standard apportionment formula which were approved in both *Wal-Mart* and *Kmart*. The first alteration was in the sourcing of certain kinds of receipts. The UDITPA statutes set out two basic rules for determining where sales (or receipts) are to be sourced. The first is for receipts from the sale of tangible property and the second, basically, is for everything else. The general statutory principle under this second rule is an “all-or-nothing” principle. Receipts are sourced to the *single state* where the taxpayer has incurred the predominant cost of income producing activity. (In *Wal-Mart*, this would have been the state of WMR’s domicile, Delaware.)

This all-or-nothing rule, which results in one state getting all the receipts from some multi-state activities, has been widely criticized. Over the years, states have departed from this statutory rule in order to achieve what they view as a better result. For example, a regulation adopted by New Mexico and other states allows a service performed in multiple states to be treated as different “income producing activities” in each state. Therefore, under this regulation, each state in which the activity is performed gets to treat part of the sale of the service as having occurred in that state, rather than being bound by the all-or-nothing rule. Similarly, New Mexico has adopted a regulation that treats the “income producing activity” of leasing tangible property as the act of leasing that particular property so that amounts are sourced to each state where specific property is located.

*Wal-Mart* continues this trend in undercutting the all-or-nothing rule. The Hearing Officer cited general criticism of the rule as the basis for the alternative formula put forward by the Department. So, although the rule is still set-out clearly in the language of the statute, taxpayers who seek to rely on that rule in the future should be aware that sourcing receipts from multi-state activity to a single state may not be permitted.

The second way in which the Department changed the standard apportionment formula was to exclude the property and payroll factors on the basis that they were *de minimus*. Under the standard rules, “property” does not include intangible property. It is not clear why the Department did not seek to include intangibles rather than simply excluding the entire factor. Exclusion of the factors is generally permitted under the equitable apportionment provision, but the Department has never issued a regulation governing when that exclusion will apply. In *Wal-Mart*, the facts showed that total property and payroll amounts of WMR amounted to only 1/100<sup>th</sup> of a percent of its net income. The Hearing Officer had no trouble finding these amounts to be *de minimus*. Moreover, it was determined that property and payroll had less to do with generating WMR’s revenue than might be the case for most taxpayers.

New Mexico’s filing instructions allow taxpayers to exclude any factor when the total amount of property, payroll or sales is less than 3% of net income. While this rule has not been treated as binding, it is possible that under *Wal-Mart*, the Department will seek to make this the default rule for excluding factors. It is not clear how many taxpayers such a rule might potentially affect.

Finally, what’s good for the Department may, in some cases, be good for the taxpayer. The equitable apportionment provision allows taxpayers to request a change in the apportionment formula if they believe it will more fairly represent their business activity. (Under regulations, certain procedures must be followed to claim an alternative method.) It would be interesting to see a taxpayer or two come forward and argue that an alternative formula should apply in their situation.

### Conclusion

With state corporate income tax – litigation is apparently the name of the game. Both the *Wal-Mart* and *Kmart* cases, though hard-fought and long in coming, simply raise more questions than they answer. Perhaps this is simply the nature of the tax. But one wonders if there would be more answers if the Department had given the time and effort spent on litigation to issuing guidance (regulatory or otherwise) and clarification instead.