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

IN THE MATTER OF THE PROTEST OF
WAL-MART STORES, INC. (Successor to **No. 06-07**
WMR, Inc.); ID No. 02-344332-00 4
ASSESSMENT NOS. 2219795 & 2219796

DECISION AND ORDER

A formal hearing on the above-referenced protest was held on November 14, 15 and 16, 2005, before Margaret B. Alcock, Hearing Officer. Wal-Mart Stores, Inc. ("Wal-Mart") was represented by 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 April 21, 2006, 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

General Background

1. Wal-Mart Stores, Inc. ("Wal-Mart") is a Delaware corporation with its principal place of business, headquarters, and commercial domicile in the State of Arkansas. Stipulated Fact ("SF") 3, 6.

2. On December 13, 1991, WMR, Inc. ("WMR"), a wholly owned subsidiary of Wal-Mart, was incorporated under the laws of the State of Kansas. SF 2, 3.

3. WMR's principal place of business, headquarters, and commercial domicile was located outside the State of New Mexico. SF 5.

4. During the period at issue in this protest, WMR had sufficient nexus with New Mexico to subject it to New Mexico's gross receipts and income taxing jurisdiction. SF 1.

5. On February 1, 1997, WMR ceased to exist as a separate entity when it merged with Wal-Mart, which was the surviving corporation of the merger. SF 4.

6. WMR was audited by the Department, which completed its audit report in January 1998. Exhibit 317.

7. On February 19, 1998, the Department issued Assessment No. 2219795 to WMR in the total amount of $5,537,551.87, representing $3,475,285.25 of gross receipts tax, $1,714,738.08 of interest, and $347,528.54 of penalty, for tax reporting periods December 1991 through March 1997. SF 8.

8. On February 19, 1998, the Department issued Assessment No. 2219796 to WMR in the total amount of $6,814,981.50, representing $4,261,302.00 of corporate income tax, $250.00 of franchise tax; $2,127,274.30 of interest, and $426,155.20 of penalty, for tax years ending January 31, 1992 through January 31, 1996. SF 7.

9. On May 20, 1998, pursuant to an extension of time granted by the Department, WMR filed a written protest to Assessment Nos. 2219795 and 2219796. SF 9; Hearing File.

10. On July 14, 2003, Wal-Mart was substituted for WMR as the protestant in this protest. SF 10.

Formation of WMR

11. From 1983 until his retirement in 2003, James A. Walker, Jr., was the corporate controller of Wal-Mart. SF 11.

12. At the time of his retirement from Wal-Mart, Mr. Walker was an officer of Wal-Mart with the title of Senior Vice President/Controller. SF 12.

13. Wal-Mart's tax department, including corporate tax, reported directly to Mr. Walker, who is a certified public accountant in the states of Arkansas and Tennessee. SF 13; Transcript, Volume I ("TR I") I at 56.

14. In the early 1990s, Jerry Orr was director of Wal-Mart's tax department. SF 14.

15. Part of Mr. Orr's job was to reduce Wal-Mart's costs by reducing taxes. From time to time, in the performance of his job as Director of Taxes, Mr. Orr presented various proposals for reducing Wal-Mart's tax liabilities to Mr. Walker. SF 15.

16. In late 1989, Irving Yacht of Corporate Financial Consulting Services, Inc. approached Mr. Orr with an idea for establishing a wholly-owned subsidiary of Wal-Mart to own and manage certain of Wal-Mart's intellectual property. SF 16.

17. In July 1990, Mr. Orr and Mr. Yacht met with Mr. Walker to discuss the establishment of a Delaware holding company to provide some state tax savings for Wal-Mart. Exhibit 2.

18. In October 1990, Mr. Orr sent a memorandum to Mr. Walker summarizing the concept of a Delaware holding company (also known as a passive investment company or "PIC") and some of the benefits it would provide to Wal-Mart. Exhibit 2.

19. Mr. Orr explained that a PIC "is a corporate structure that enables a company to shelter significant amounts of income from state taxes" and that a retailer "which derives a significant amount of its income in nonunitary states, can <u>reduce</u> <u>its</u> <u>state</u> <u>income</u> <u>tax</u> <u>liability</u> <u>between</u> <u>25-40%</u>." (emphasis in the original). Exhibit 2.

20. Mr. Orr stated that appropriate business reasons would have to be developed for the transaction, although "[a] company does not need ironclad reasons, just plausible ones." Exhibit 2.

21. Mr. Orr's memo set out the steps needed to establish a PIC's nexus with a state such as Delaware (which does not tax intangible income), including the following: renting or leasing office space, installing a telephone, using stationery with the PIC's name on it, opening a bank account in the PIC's name, paying wages for secretarial and accounting services, preparing and keeping minute books in the PIC's office, arranging for annual board meetings to be held in the PIC's state of domicile, and maintaining some assets in the PIC's state. Mr. Orr noted that "most of the above activities can be performed, on behalf of the retailer, by an outside third party for a reasonably small fee." Exhibit 2.

22. The plan to create an intangible holding company to hold Wal-Mart's trademarks was ultimately approved by Wal-Mart's executive committee, which consisted of the Chairman of the Board, the CEO, the President, the CFO, the COO and the Controller, Mr. Walker. SF 18 & 19.

23. In September 1991, Wal-Mart entered into an agreement with Corporate Financial Consulting Services, Inc. for its assistance with regard to making WMR a reality. SF 20; Exhibit 3.

24. On December 13, 1991, Wal-Mart's Board of Directors authorized the formation of WMR and Articles of Incorporation for WMR were filed in the State of Kansas. SF 21, 22; Exhibit 4.

25. Upon the incorporation of WMR, a board of directors was appointed, officers were elected, and WMR was duly organized. SF 24.

26. On December 13, 1991, Wal-Mart executed a Subscription Agreement for the acquisition of 1,000 shares of WMR stock. SF 26.

27. On December 13, 1991, pursuant to the Subscription Agreement, Wal-Mart transferred $10,000 in cash and its trademarks and all pending applications for registration for trademarks to WMR in exchange for 1,000 shares of WMR common stock, par value $0.10. The 1,000 shares of common stock constituted all of the issued and outstanding shares of WMR stock. Upon the issuance of the 1,000 shares of WMR, WMR became a wholly-owned subsidiary of Wal-Mart. SF 27.

28. On December 13, 1991, Wal-Mart transferred its registered trademarks of "Wal-Mart," "Wal-Mart Supercenter," "Sam's Club," "Sam's Wholesale Club" and "Hypermart USA," which included trade names and designs, to WMR pursuant to a document entitled Assignment Agreement. SF 28.

29. On December 13, 1991, WMR entered into a License Agreement with Wal-Mart pursuant to which WMR licensed to Wal-Mart the use of WMR's trademarks within the United States, its possessions and territories. SF 29.

30. With one exception, all of the trademarks transferred to WMR and licensed back to Wal-Mart were registered with or registrations were pending with the United States Trademark and Patent Office. WMR and Wal-Mart filed registration statements with the U.S. Patents and Trademarks Office indicating the change of ownership. SF 30.

31. North Dakota was the only state in which any of the trademarks were registered and in that case the registrations were limited to "Sam's Club" and "Sam's Wholesale Club." SF 31.

32. None of the trademarks were ever registered in the State of New Mexico. SF 32.

33. The License Agreement required Wal-Mart to pay a royalty to WMR at a fair market royalty rate to be determined by an independent third-party appraiser. SF 33 & 34.

34. The royalty rates for the domestic use of the trademarks were established by a valuation done by Merrill Lynch Business Brokerage and Valuation, a division of Merrill Lynch, Pierce, Fenner & Smith Incorporated, and supported by a written report dated June 11, 1992, which concluded that a fair market royalty rate, expressed as a percentage of sales, for Wal-Mart's use of WMR's trademarks was as follows:

WAL-MART	2.00%
WAL-MART SUPERCENTER	2.00%
SAM'S CLUB	0.75%
HYPERMART USA	0.25%

SF 35.

35. The royalty rates determined by Merrill Lynch were used as the royalty rates under the License Agreement. SF 36.

36. All activities leading up to and including the execution of the Assignment Agreement, the License Agreement, and all documents relating to the formation of WMR took place outside of New Mexico. SF 37.

37. All documents relating to the organization of WMR, including the Assignment Agreement and the License Agreement, were executed in Delaware. SF 38.

38. On December 23, 1991, WMR qualified to do business in the State of Delaware. SF 23.

Operation of WMR

39. WMR's income during the audit period was "business income" within the meaning of NMSA 1978, § 7-4-2 and Regulation 3.5.1.9 NMAC. SF 83.

40. WMR had no property or payroll in New Mexico for purposes of computing the property and payroll factors under the standard apportionment formula set out in the Uniform Division of Income for Tax Purposes Act. SF 82.

41. No WMR documents were executed in New Mexico. SF 67.

42. No WMR corporate decisions were made in New Mexico. SF 66.

43. WMR's billings to and receipts from Wal-Mart for royalties due under the License Agreement occurred outside of New Mexico. SF 41 & 42.

44. All meetings of WMR's board of directors, as well as its annual shareholder meetings, were held in Delaware. SF 39 & 40.

45. As suggested in Jerry Orr's October 1991 memorandum, WMR used the services of Delaware Trust Company, a third-party "substance provider," to establish WMR's operations in Delaware. TR I at 165-166, 173.

46. Beginning in December 1991, Delaware Trust Company subleased a one-room office located at 913 Market Street, Wilmington, Delaware, to WMR for an annual rental of $5,000. Pursuant to the sublease agreement, Delaware Trust Company provided all utilities, cleaning services, and general reception services (including telephone answering and receipt of mail and deliveries), as well as listing WMR's name in the Wilmington, Delaware, telephone director. SF 56; Exhibits 46 & 47.

47. WMR purchased or leased the office furniture, equipment, and supplies used in the Market Street office. SF 57.

48. From February 1992 to August 1994, Amanda Foster was employed as WMR's part-time office manager at a salary of $4,000 per year, while also serving as a director and assistant secretary of WMR. During this same time period, Ms. Foster was a full-time account representative for Delaware Trust Company. SF 47; Exhibits 16, 22, 25, 26, 29 & 30.

49. From August 1994 through June 1995, Francis B. Jacobs II was employed as WMR's part-time office manager at a salary of $2,000 per year, while also serving as a director and assistant secretary of WMR. SF 49; Exhibits 32 & 35.

50. In 1995, WMR moved its office space from the Delaware Trust Company Building to the Silverside Carr Executive Center, where it leased an office for $800 per month. Ferm Associates, the building's owner, provided all utilities, janitorial services, mail and package receipt services, mail forwarding services, reception services, and a conference room. SF 56; Exhibit 48 & 50.

51. WMR also leased two desks, two swivel chairs, and one credenza from Ferm Associates. Exhibit 49 & 51.

52. From June 1995 to February 1997, WMR had two employees: a part-time administrative assistant; and a certified public accountant who managed the office on a full-time basis at a salary of $7,000 per month for the first three months of his employment and on a half-time basis at a salary of $3,500 per month thereafter. SF 47, 49, 51-53; Exhibits 37 & 54.

53. WMR's property and payroll expenses represented only $1/100^{th}$ percent of its net income. Exhibit 317 at F5 through F 5.4.

54. Many of WMR's day-to-day operations in Delaware were contracted out to third parties. Exhibits 16, 43 & 44.

55. WMR's part-time employees did not perform the activities necessary to protect and defend WMR's trademarks, and these duties remained with Wal-Mart's legal department and internal audit group. TR I at 100-102; Exhibits 15 & 16.

56. Section 5.1 of the License Agreement between Wal-Mart and WMR required Wal-Mart to "defend, at its expense, any challenge to the Licensed Marks by third parties," regardless of

whether the challenge was based on facts in existence before, on, or after the date of the License Agreement; Section 5.2 required Wal-Mart to "take all actions reasonably necessary or appropriate" to terminate any debasement, infringement or unauthorized use of the Licensed Marks and to "otherwise protect" WMR's trademarks. Exhibit 15 at 7.

57. Pursuant to a contract between Wal-Mart and WMR, Wal-Mart's Internal Audit Division monitored Wal-Mart's use of WMR's trademarks in no less than 250 Wal-Mart retail store locations from November 1992 through December 1997. Wal-Mart's internal audit group monitored Wal-Mart's use of WMR's Marks by physically viewing the marks in a variety of different store settings and completing a form regarding the use of the marks for each store so monitored. SF 58; Exhibit 24.

58. Pursuant to a letter agreement between Ernst & Young and WMR, Ernst & Young agreed to visit 25 Wal-Mart stores annually and complete a Quality Assurance Monitoring Checklist for each store. The agreement specified that these checklists "will not be made available to any parties nor used for any purpose other than in connection with inquiries or audits by various taxing jurisdictions." No Wal-Mart locations in New Mexico were monitored by Ernst & Young. SF 59 & 60; Exhibit 27.

59. WMR was established for the primary purpose of reducing Wal-Mart's state tax liabilities (Exhibits 2 & 3), but was not a sham corporation. SF 46.

60. Both James Walker and the Wal-Mart attorneys he consulted believed that there might be an added benefit to creating a separate trademark holding company in the event Wal-Mart decided to enter international markets where federal tax law would require it to charge royalty fees. TR I at 75, 77-78, 97-99.

61. On August 18, 1992, WMR entered into a Trademark License Agreement with Controladora Club Aurrera, S.A. de C.V., a Mexican corporation owned by Wal-Mart ("Wal-Mart JVC"), and Neuva Aurrera, S.A. de C.V., a Mexican corporation unrelated to WMR and Wal-Mart ("CIFRA JVC"), both of which were parties to a joint venture to own and operate Wal-Mart and Sam's Club retail stores in Mexico. Pursuant to this Trademark License Agreement, WMR granted a license to its trademarks throughout Mexico for a royalty equal to .1% of the gross sales of each Licensee under the joint venture. SF 43.

62. The Trademark License Agreement with Controladora Club Aurrera, S.A. de C.V. related to the first Wal-Mart store opened outside of the United States, its possessions and territories. SF 44.

63. Wal-Mart through Wal-Mart JVC had a 50% interest in the joint venture with CIFRA JVC at the time of its formation. SF 45.

Wal-Mart's State Tax Deductions

64. Wal-Mart used the trademarks it licensed from WMR in New Mexico. SF 68.

65. Wal-Mart claimed a deduction on its New Mexico corporate income tax returns for the royalties it paid to WMR for the use of WMR's trademarks. SF 69.

66. WMR loaned Wal-Mart several millions of dollars on a regular basis, which loans were evidenced by promissory notes bearing a market rate of interest which were executed by Wal-Mart in favor of WMR. SF 63; Exhibits 132-147.

67. Wal-Mart claimed a deduction on its New Mexico corporate income tax returns for the interest it paid to WMR. SF 69.

68. On audit, the Department did not challenge the deductions claimed on Wal-Mart's corporate income tax returns for royalty and interest expenses paid to WMR. SF 70.

Delaware Intangible Holding Companies

69. Delaware-based intangible holding companies ("IHCs") are exempt from Delaware income tax. SF 71.

70. Delaware IHCs are required to file an annual information return with the Delaware Division of Revenue. SF 72.

71. There were approximately 5,000 IHCs registered in Delaware in 1997. TR I at 74.

72. There are at least four categories of Delaware IHCs, which are used by a wide variety of companies in different industries, including retail, manufacturing, pharmaceutical, aerospace and defense. TR I at 164, 167.

73. The operation of IHCs varies depending on the type of assets involved. TR I at 165, 168.

74. Some IHCs have full-time employees that devote full-time effort to managing company assets. TR I at 165, 169, 172-173.

75. Other IHCs engage in limited activities confined to bookkeeping and helping to facilitate the work of outside attorneys, accountants, and investment advisors. These companies generally own little tangible personal property and often carry out their work with part-time employees. TR I at 166, 168, 170-172.

76. It is unknown how many of the 5,000 IHCs registered in Delaware in 1997 were of the “limited activity” type or how many were—like WMR—subsidiary corporations to which a parent company had transferred trademarks that were then licensed back to the parent. TR I at 173-175.

The Department's Audit

77. In the mid-1990s, Frank Shaffer, a Department auditor, first learned that WMR might present a fact situation similar to that in *Geoffrey v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993) *cert. denied* 510 U.S. 992 (1993), the first state tax case involving a subsidiary corporation created to hold and license back a parent company's trademarks. TR II at 219-222.

78. In 1995, the Department began to collect information concerning WMR and sent a corporate income tax auditor to perform a joint field visit to Bentonville, Arkansas, with an auditor from the Alabama Department of Revenue, which was also reviewing WMR's operations. SF 74-78.

79. During the same time period, Frank Shaffer began to review corporate income tax returns filed with the Department to determine whether any other companies were taking large royalty deductions that might indicate the same kind of trademark assignment and license back situation used in *Geoffrey*. TR II at 224.

80. Although there was a belief among the states that trademark holding companies were being established, Mr. Shaffer did not find such companies in the course of his review of New Mexico corporate income tax returns. TR II at 226.

81. The Department eventually identified two trademark-holding companies as audit prospects: the first was KPI (a subsidiary of Kmart), which was assessed in 1997; the second was WMR. TR II at 228-229; Exhibit 317.

82. After its auditor's 1995 field visit to Arkansas, the Department continued to gather information concerning WMR. In May 1997, WMR provided additional information requested by the Department, explaining that "[i]t has taken slightly longer than originally

planned to gather some of the information since some of it had to come from the parent company, Wal-Mart Stores, Inc., as well as WMR, Inc." Exhibit 318.

83. The Department completed its audit of WMR in January 1998 and issued its assessments against WMR in February 1998. Exhibit 317.

84. Following the audit of WMR, the Department set up a project to identify similar trademark holding companies, which resulted in the assessment of approximately 25 companies, eight of which were related entities. SF 79; TR II at 229.

85. The Department has not attempted to assess other types of intangible holding companies that earn income from passive investments, nor does the Department have a policy concerning such companies. TR II at 230-231.

ISSUES TO BE DECIDED

Issue I: Whether Wal-Mart is liable for the gross receipts taxes assessed on WMR's royalties from granting Wal-Mart a license to use WMR's trademarks in New Mexico.

Issue II: Whether Wal-Mart is liable for the corporate income and franchise taxes assessed against WMR.

Issue III: Whether the Department was required to adopt a regulation addressing WMR's specific fact pattern before applying an alternative apportionment formula to WMR's business income.

Issue IV: Whether WMR's failure to report New Mexico corporate income and franchise taxes on its royalties from granting Wal-Mart a license to use trademarks in New Mexico was negligent, thereby justifying the Department's assessment of penalty.

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, MPC Ltd. v. New Mexico Taxation & Revenue Department*, 2003 NMCA 21, ¶ 13, 133 N.M. 217, 62 P.3d 308. Accordingly, it is Wal-Mart's burden to present evidence and legal argument to show that it is entitled to an abatement, in full or in part, of the assessments issued against it.

DISCUSSION

Issue I: Whether Wal-Mart is liable for the gross receipts taxes assessed on WMR's royalties from granting Wal-Mart a license to use WMR's trademarks in New Mexico.

This issue has been decided by the New Mexico Supreme Court's decision in *Kmart Corporation v. Taxation and Revenue Department*, 2006-NMSC-006. *See*, stipulation of the parties filed June 16, 2005. Pursuant to the court's analysis of New Mexico's Gross Receipts and Compensating Tax Act as it existed during the audit period, Wal-Mart is not liable for the gross receipts tax, penalty, and interest assessed against WMR under Assessment No. 2219795.

Issue II. Whether Wal-Mart is liable for the corporate income and franchise taxes assessed against WMR.

Wal-Mart has stipulated that WMR had sufficient nexus with New Mexico to bring it within New Mexico's taxing jurisdiction. Wal-Mart argues, however, that no tax is due because none of WMR's income was attributable to New Mexico under the standard three-factor apportionment formula set out in New Mexico's Uniform Division of Income for Tax Purposes Act ("UDITPA"). The Department contends that WMR's income was properly sourced to this state under the alternative apportionment formula set out in NMSA 1978, § 7-4-19 of UDITPA, and that the royalties WMR received from the use of its trademarks in New Mexico are subject to the state's corporate income tax.

A. Allocation and Apportionment of Income Under UDITPA. In dealing with income that has been earned by a multistate taxpayer, New Mexico has adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA"), NMSA 1978, §§7-4-1 to 7-4-21, to allocate and apportion the taxpayer's income.[1] Under UDITPA, a state must first distinguish between nonbusiness income, which is allocated to a single state (usually the state of the taxpayer's commercial domicile), and business income, which is apportioned among all of the states in which the taxpayer has business activity. In this case, the parties have stipulated that the income in dispute was business income, which is generally apportioned according to a three-factor formula based on a corporation's property, payroll and sales within a state compared with its property, payroll and sales everywhere. A percentage is calculated for each of the three factors, and the average of the three percentages is then applied against the corporation's total income to determine the amount the state will tax. NMSA 1978, §§ 7-4-10 through 7-4-18.

The United States Supreme Court has noted that UDITPA's three-factor formula has become "something of a benchmark against which other apportionment formulas are judged." *Container Corp. of America v. Franchise Tax Board,* 463 U.S. 159, 170 (1983). It further noted that the three-factor formula has gained such wide approval "because payroll, property and sales appear in combination to reflect a very large share of the activities by which value is generated." *Id.*, 463 U.S. at 183. Since its enactment, however, UDITPA has recognized that the three-factor formula will not always operate to fairly apportion a business's income and that some provision must be made for unusual cases or business activities that depart from those normally

[1] UDITPA was approved by the National Conference of Commissioners on Uniform State Laws in 1957. New Mexico adopted a version of UDITPA in 1965 (1965 N.M. Laws, ch. 203) and joined the Multistate Tax Compact (which incorporates UDITPA as Article IV) in 1967 (1967 N.M. Laws, ch 56, currently codified at NMSA 1978, §§ 7-5-1 et seq.).

contemplated by the formula. For this reason, NMSA 1978, § 7-4-19 (§18 in the original version of UDITPA) provides as follows:

> If the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act 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.

As noted by Professor William J. Pierce, recognized as the drafter of UDITPA, the national economy was primarily based upon manufacturing and merchandising at the time UDITPA was drafted, and the allocation and apportionment provisions were designed with those types of businesses in mind. For this reason, the equitable apportionment provision of UDITPA

> gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle the constitutional problem as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problem for the multitude of taxpayers with individual business characteristics.

W.J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 781 (1957).

B. Application of UDITPA's Standard Three-Factor Formula to WMR's Income.

Wal-Mart maintains that WMR's business income should be apportioned under UDITPA's standard three-factor formula and challenges the Department's authority to fashion an alternative apportionment formula under § 7-4-19. Wal-Mart contends that application of the three-factor formula results in a New Mexico apportionment factor of zero because all of WMR's property, payroll and sales were located in Delaware. Wal-Mart further argues that even if its receipts from licensing trademarks used in New Mexico were treated as New Mexico sales, those receipts still would be sourced to Delaware under the provisions of NMSA 1978, § 7-4-18, which states as follows:

> 7-4-18. Determination of sales in this state of other than tangible personal property for inclusion in sales factor.
>
> Sales, other than sales of tangible personal property, are in this state if:
>
> A. the income-producing activity is performed in this state; or
>
> B. the income producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

Because WMR's licensing activities take place both in and outside New Mexico, WMR argues that all of its licensing receipts must be sourced to Delaware, where it incurred the greatest proportion of the costs attributable to managing its trademarks. Based on Wal-Mart's analysis, WMR's New Mexico sales factor (as well as its property and payroll factors) is zero, resulting in no tax due to New Mexico.

C. Application of UDITPA's Alternative Apportionment Formula to WMR's Income. In the course of its audit of WMR, the Department determined that UDITPA's standard three-factor formula did not fairly represent the extent of WMR's business activity in New Mexico. Based on this finding, the Department invoked the authority granted in NMSA 1978, § 7-4-19 and applied a modified formula to determine WMR's tax liability to New Mexico.

Pursuant to Subsection B of § 7-4-19, the Department first excluded the property and payroll factors from the formula because those factors (consisting of a one-room rented office in Delaware and the salaries of one or two part-time employees) were de minimis and did not materially contribute to WMR's ability to generate its royalty income. The Department then applied a modified sales factor calculated by comparing the amount of royalty income generated from the use of WMR's trademarks in New Mexico to the royalty income generated from the use of the trademarks everywhere. This is the same methodology approved by the New Mexico Court of Appeals in *Kmart Properties, Inc. v. New Mexico Taxation and Revenue Department*, 2006-NMCA-26 (2001), *cert. quashed*, 2006-NMSC-6 (2005), a case involving legal issues that Wal-Mart has admitted "are for all practical purposes identical" to those in the current protest. *See*, WMR, Inc.'s Response to Department's Request for Hearing, filed May 2, 2003.

Now, however, Wal-Mart maintains that the *Kmart* decision is not dispositive of this case, asserting that the court of appeals' opinion should be "disregarded" because the court "failed to recognize that 'income-producing activity' is a term of art and failed to identify any income-producing activity that was performed directly by KPI in New Mexico."[2] Wal-Mart's brief at 23, 24. In making this argument, Wal-Mart relies on Subsection (B) of Regulation 3.5.18.8 NMAC under § 7-4-18, which defines the term "income-producing activity" as follows:

> B. "Income producing activity" defined.
>
> (1) The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the taxpayer in the regular course of its obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a taxpayer such as those conducted on its behalf by an independent contractor. Accordingly, income producing activity includes but is not limited to the following:
>
> (a) the rendering of personal services…;
> (b) the sale, rental, leasing, licensing or other use of real property;
> (c) the sale, rental, leasing, licensing or other use of tangible personal property;
> (d) the sale, licensing or other use of intangible personal property.
>
> (2) The mere holding of intangible personal property is not, of itself, an income producing activity.

[2] As an initial matter, it is clear that an administrative hearing officer does not have the authority to "disregard" a decision of the New Mexico Court of Appeals based on a taxpayer's assertion that the court misinterpreted the law.

Wal-Mart argues that Wal-Mart—not WMR—was the entity directly engaged in using WMR's trademarks in New Mexico and that this activity cannot be attributed to WMR.

The first problem with Wal-Mart's argument is that § 7-4-18 and Regulation 3.5.18.8 set out the rules for apportioning income under UDITPA's standard three-factor formula—it does not control the application of alternative apportionment methods under § 7-4-19, which authorizes "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." Wal-Mart's arguments concerning the Department's failure to follow the standard apportionment rules of § 7-4-18 simply ignore the fact that the Department's apportionment formula was based on a different statute.

Second, Wal-Mart's contention that the definition of "income-producing activity" in Regulation 3.5.18.8(B)(1) under § 7-4-18 precludes licensing receipts from being sourced to the place where licensed property is used is in direct conflict with Subsection C(2) of the same regulation, which states as follows:

> (2) Special rules. The following are special rules for determining when receipts from the income producing activities described below are in this state:
>
> (a) gross receipts from the sale, lease, rental or licensing of real property are in this state if the real property is located in this state;
>
> (b) gross receipts from the rental, lease or licensing of tangible personal property are in this state if the property is located in this state. The rental, lease, licensing or other use of tangible personal property in this state is a separate income producing activity from the rental, lease, licensing or other use of the same property while located in another state; consequently, if property is within and without this state during the rental, lease or licensing period, gross receipts attributable to this state shall be measured by the ratio which the time the property was physically present or was used in this state bears to the total time or use of the property everywhere during such period;

Under these special rules, business income from renting, leasing, and licensing real and tangible personal property is sourced to the situs of the property from which the income is derived.

Assume, for example, that WMR leased 10,000 cash registers to Wal-Mart in exchange for a fixed percentage of the sales rung up on each cash register; that the lease agreement was signed and possession of the cash registers was transferred to Wal-Mart in Delaware; and that 75 of the 10,000 cash registers were subsequently installed in Wal-Mart's New Mexico stores. Under the special apportionment rules quoted above, WMR's receipts from the 75 cash registers located in New Mexico would be sourced to New Mexico, even though Wal-Mart—not WMR—was the entity directly engaged in using the cash registers within the state.

Regulation 3.5.18.8(C)(2) treats the use of licensed tangible personal property by a third-party as an "income-producing activity" of the entity that owns the property. Regulation 3.5.19.11A(3) under § 7-4-19 sets out the same rules for sourcing income from licensing intangible property:

> A. The following special rules are established in respect to the sales factor of the apportionment formula.
>
> ....
>
> (3) Where the income producing activity in respect to business income from intangible personal property can be readily identified, such income is included in the denominator of the sales factor and, if the income producing activity occurs in this state, in the numerator of the sales factor as well. For example, usually the income producing activity can be readily identified in respect to…income from the sale, licensing or other use of intangible property;

Here, WMR licensed its trademarks to Wal-Mart in exchange for a percentage of sales of "Licensed Products," which are defined as "retail and wholesale store services, goods sold in connection therewith, and such other specified goods and services as may be offered by the Licensee with the Licensor's approval" Exhibit 15, page 1. The income generated from WMR's licensing activity can be readily traced to the sales made at each store using WMR's trademarks. The Department therefore determined that the "all or nothing" rule set out in § 7-4-18(B) should not be applied in determining WMR's sales factor. Instead, pursuant to the authority granted in §

7-4-19, the Department calculated the sales factor by comparing WMR's royalties from the use of its trademarks in New Mexico to its royalties from the use of its trademarks everywhere. This is the same methodology approved by the court of appeals in Kmart, *supra*, ¶ 52, where the court found that "where the income producing activity producing business income from intangibles can be readily identified, that income should be sourced to that state *and not the state with the greatest cost of production*." (emphasis added). Despite Wal-Mart's contentions to the contrary, the court's clear statement of the law on this issue is binding on the parties to this case and on the Hearing Officer.

The Department's method of calculating WMR's sales factor finds additional support in J. R. Hellerstein and W. Hellerstein, *State Taxation: Constitutional Limitations and Corporate Income and Franchise Taxes*, ¶ 9.18[5][a] (3rd ed. 2001), which notes that the all-or-nothing rule of UDITPA's standard formula "is subject to criticism" when applied to receipts from intangibles:

> Services by the licensor's employees and agents are likely to be of comparatively minor importance in the realization of income from such intangible property…. Consequently, the income-producing activity test for attributing such receipts to the numerator of a single state's sales factor is distorting and ordinarily will not reflect fairly the source of the income.

Id. Hellerstein concludes that a more satisfactory approach is the one adopted by the Department, where "the royalties are included in the numerator of a state's sales or receipts factor to the extent of the use by the payor of the rights granted under the license, franchise, or other agreement." *Id*. This was also the conclusion of the Department's economic expert, Dwight Grant, who gave his opinion that WMR earned its income at the site of the sales on which WMR's royalties were paid. As Professor Grant explained:

> I believe that WMR earned that income at the source of sales. So if they had sales in New York City, and they were taking 2 percent of those sales, on sales in Wal-

> Mart Supercenters, then they were earning income in New York…. If they had sales in New Mexico at a Supercenter, and they were taking 2 percent of that, then they effectively earned that in New Mexico, as an economic matter.

TR III at 368-369.

In summary, the Department's determination that the royalties WMR received from Wal-Mart's use of WMR's trademarks in this state should be sourced to New Mexico, rather than to Delaware, is supported by Regulation 3.5.19.11A(3) under § 7-4-19 and the court of appeals' interpretation of that regulation in the *Kmart* case, by a well-known treatise on corporate income tax, and by the testimony of the Department's expert witness.

D. Justification for Use of an Alternative Apportionment Formula. Section 7-4-19 authorizes the use of an alternative formula when the standard formula does not "fairly represent the extent of the taxpayer's business activity in this state…." Regulation 3.5.19.8.2 states that:

> Section 7-4-19 permits a departure from the allocation and apportionment provisions of Sections 7-4-2 to 7-4-18 only in limited and specific cases. Section 7-4-19 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 7-4-2 to 7-4-18.

As the party who wishes to depart from the standard three-factor formula under UDITPA, the Department has the burden of justifying any modification of the standard formula. *Kmart, supra,* ¶ 50. *See also*, *Twentieth Century-Fox Film Corp. v. Department of Revenue,* 700 P.2d 1035, 1043 (Ore. 1985) (describing criteria for adjustment of UDITPA formula). Wal-Mart maintains that the Department has not met its burden, first, because WMR did not perform any business activity in New Mexico and second, because WMR did not present an unusual fact pattern.

Business Activity. Wal-Mart's argument that WMR had no "business activity" in New Mexico is virtually identical to its argument concerning WMR's "income producing activity." *See*, Part II(B), *supra*. In each case, Wal-Mart contends that WMR's activities were confined to

Delaware because that is where the assignment and management of its trademarks occurred. The term “business activity” is defined in Regulation 3.5.3.7 NMAC as “the transactions and activity occuring in the regular course of a particular trade or business of a taxpayer.” WMR’s licensing of intangible property for use in New Mexico was part of its regular trade or business. As previously discussed, the regulations under UDITPA treat the use of licensed property by a third party as an income-producing activity of the entity that owns the property. It can be presumed that a corporation having income-producing activity in New Mexico also has business activity within the state. This was certainly the conclusion of Dwight Grant, the Department’s expert witness, who gave his opinion that WMR had “business activities where the sales of Wal-Mart, the licensee, occur.” TR III at 370.

The assessment against WMR was issued under the authority of NMSA 1978, § 7-2A-3 of New Mexico’s Corporate Income and Franchise Tax Act, which states:

> A tax to be known as the “corporate income tax” is imposed…upon the net income of every domestic corporation and upon the net income of every foreign corporation employed or engaged in the transaction of business in, into or from this state or deriving any income from any property or employment within this state.

This statute defines the activities that will subject a corporation to tax in New Mexico; UDITPA sets out the rules for allocating and apportioning the income generated by those activities. In *Kmart, supra*, ¶¶ 12, 13 the New Mexico Court of Appeals specifically rejected KPI’s contention “that its corporate business was conducted solely within the territorial boundaries of Michigan,” finding that: “KPI takes a narrow view of its licensing agreement with Kmart Corporation that ignores its substance. The licensing agreement ties KPI to New Mexico, and to other states outside Michigan where Kmart has its stores.” In cases with similar fact patterns, other state courts have also held that a foreign corporation licensing the use of its trademarks to a local affiliate has business activity within that state. *See*, *Lanco, Inc. v. Director, Division of Taxation*, 879 A.2d 1234 (N.J. Super. Ct. 2005), *cert. granted*, 2006 NJ LEXIS 133 (Jan. 30, 2006) (a foreign corporation licensing trademarks for use by an affiliated retail business in New Jersey was subject to a state tax imposed on corporations "engaged in business activities within the state"); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 126 S.Ct. 353 (2005) (a foreign corporation licensing trademarks for use by an affiliated retail business in North Carolina was subject to state income and franchise taxes imposed on every corporation "doing business in this state"); *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13, 18 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993) (a foreign corporation licensing trademarks for use by an affiliated retail business in South Carolina was subject to a state tax imposed on corporations "engaging in or transacting an activity within South Carolina for the purpose of financial profit or gain").

In each of these cases, the court looked to the substance of the transaction and rejected the argument that a corporation must have some physical presence in a state in order to have taxable business activity within the state. In *Geoffrey*, *supra*, which first addressed the fact pattern presented by the creation of a subsidiary corporation to hold the trademarks of its retail parent, the court noted that "the real source of Geoffrey's income is not a paper agreement, but South Carolina's Toys R Us customers." *See also, Geoffrey, Inc. v. Oklahoma Tax Commission*, 2006 OK Civ App. 27, ¶ 19 (Okla. Ct. App. 2005). Here, too, the real source of WMR's income was not the limited clerical work performed by its part-time employees in Delaware, but the purposeful licensing of its trademarks for use at Wal-Mart stores throughout the United States, including New Mexico.

Unusual Fact Pattern. Citing to Regulation 3.5.19.8.2 NMAC, Wal-Mart argues that the Department was not entitled to invoke the provisions of § 7-4-19 because WMR did not present an "unusual fact situation." In support of its argument, Wal-Mart relies on the testimony of Philip Zinn, who provided evidence concerning the number of intangible holding companies ("IHCs") registered in Delaware during the audit period. Mr. Zinn identified four categories of Delaware IHCs used by a wide variety of companies in different industries, including retail, manufacturing, pharmaceutical, aerospace and defense. Based on information obtained from a Delaware tax official, Mr. Zinn testified that there were approximately 5,000 IHCs registered in Delaware in 1997.[3] Wal-Mart argues that this fact is sufficient to show that WMR did not present an unusual fact pattern justifying the Department's deviation from the standard three-factor formula set out in UDITPA. As discussed below, there are several problems with Wal-Mart's argument.

In determining whether a particular fact pattern is unusual, that pattern must be placed in context: a characteristic that is shared by three out of every ten people would not be unusual; a characteristic that is shared by three out of every 100,000 people would be unusual. In this case, Wal-Mart has not provided any frame of reference for determining whether WMR was unusual within the context of IHCs, much less in the context of all corporations subject to payment of state income tax. Mr. Zinn testified that the operation of IHCs varies depending on the type of assets involved. Mr. Zinn explained that some companies have full-time employees that devote full-time effort to managing company assets. Other IHCs engage in limited activities confined to

[3] Mr. Zinn gave his opinion that there could be as many as 5,000 additional IHCs that failed to register, but did not provide any basis for that opinion, other than a reference to his "thought process in terms of my experience." (TR. I at 174). Mr. Zinn also testified concerning assessments issued by other states against IHCs such as WMR. This testimony was based largely on second-hand information, including newspaper articles and informal discussions with third parties. Except for the information concerning the total number of IHCs registered in Delaware, I do not find Mr. Zinn's testimony concerning the number of IHCs in existence during the audit period to be reliable.

bookkeeping and helping to facilitate the work of outside attorneys, accountants, and investment advisors. These companies generally own little tangible personal property and often carry out their work with part-time employees. Mr. Zinn was unable to say how many of the 5,000 IHCs registered in Delaware in 1997 were of the "limited activity" type or how many were—like WMR—subsidiary corporations to which a parent company had transferred trademarks that were then licensed back to the parent. There was no evidence concerning the number of IHCs registered in states other than Delaware. There was no evidence concerning the ratio of IHCs to the total number of corporations engaged in business throughout the United States. In the absence of such information, testimony that there were 5,000 IHCs registered in Delaware during 1997 is meaningless for purposes of determining whether WMR's business model and method of operation were unusual.

In any event, the real issue in this case is not whether the fact pattern presented by WMR was unusual from a numeric standpoint, but whether it was unusual within the context of UDITPA. A review of the regulations under § 7-4-19 makes it clear that application of an alternative apportionment formula depends on the nature of a taxpayer's business, not on the number of taxpayers engaged in that business. No one would dispute that there are many banks, railroads, airlines, and trucking companies operating within the United States. Nonetheless, corporations engaged in these businesses are subject to the equitable adjustment provisions of § 7-4-19. *See*, Regulation 3.5.19.9(C) NMAC. This is not because the banking and transportation industries are rare or unusual in a numeric sense, but because these industries do not conform to the business model used to develop UDITPA's standard three-factor formula. The fact that § 7-4-19 is routinely applied to large-scale industries also dispels Wal-Mart's contention that the unusual fact situation justifying application of an alternative apportionment formula must, in every instance, be "unique and nonrecurring."

As previously noted, the three-factor formula was designed specifically for the manufacturing and mercantile industries. Pierce, *supra*, at 749. *See also*, Hellerstein, *supra*, ¶¶ 918, 920[1]. Its underlying assumption is that the three factors of payroll, property and sales "appear in combination to reflect a very large share of the activities by which value is generated." *Container Corp. of America v. Franchise Tax Board.*, 463 U.S. 159, 183 (1983). In this case, WMR's operations bore no resemblance to the business model for which UDITPA's three-factor formula was designed. The primary activity generating income (or value) for WMR was the licensing of its trademarks for use in Wal-Mart stores throughout the United States. As discussed below, WMR's property and payroll in Delaware contributed very little to the generation of this income.

Under UDITPA, the property factor includes only real and tangible property, reflecting the fact that at the time UDITPA was drafted, income from intangible property was not a significant portion of the national economy. As a result, WMR's trademarks—the very property employed to generate its income—are not even considered by the formula. The only property that would be included in WMR's property factor is the rental value of its one-room Delaware office and the furniture and equipment located in that office. As the Department determined, such property is de minimis and does not "reflect a reasonable sense" of how WMR's income was generated. *See, Container, supra*, 463 U.S. 159, 169.

With regard to the payroll factor, WMR did not have any employees in New Mexico or in any of the other states (except Delaware) where its trademarks were used. Instead, WMR's License Agreement required Wal-Mart to use *its* employees to defend, protect, and enhance

WMR's trademarks. Even many of WMR's day-to-day operations in Delaware were contracted out to third parties, as reflected in WMR's "Business Purpose and Operations Narrative," admitted as Exhibit 16:

> The company has a part-time employee, Amanda Foster, who is a full-time account representative for Delaware Trust Company (a service provider). While Amanda is available to handle any problems that arise with our account, our primary account manager with Delaware Trust is Barbara Steen. Barbara pays the bills for WMR, handles any state filings that are due and invests the royalty funds received from the licensees….
>
> WMR has retained the outside Delaware accounting firm of Wade & Santora to prepare quarterly financial statements and provide quarterly journal entries that summarize WMR's accounting activity….
>
> WMR has entered into a contract with Wal-Mart Stores' Internal Audit Group to perform various test functions in conjunction with their normal store audits. These functions are designed to monitor the quality of the licensee's facilities and the product presentation. Internal audit then provides copies of their findings to WMR and WMR's outside auditing firm, Ernst & Young….

During the period February 1992 to June 1995, WMR operated with one part-time office manager who was paid between $2,000 and $4,000 per year. Between mid-1995 and February 1997, when WMR was merged into Wal-Mart, WMR had two employees: a part-time administrative assistant and a certified public accountant who managed the office on a full-time basis for the first three months of his employment and on a half-time basis thereafter. Clearly, this skeleton staff cannot be credited with making any substantial contribution to the generation of WMR's income.[4] As was the case with the property factor, including WMR's minimal payroll in the apportionment formula would only serve to dilute and distort the apportionment factor ultimately applied to apportion WMR's income to New Mexico.

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[4] In fact, WMR's payroll was considerably less than KPI's payroll, which the court found to be de minimis in *Kmart*. While KPI employed two attorneys plus support staff for a payroll of approximately $200,000 per year (Department Decision and Order No. 00-04), WMR employed only one part-time employee during most of the audit period at a salary of $2,000 to $4,000 per year.

In *Kmart*, the New Mexico Supreme Court found that KPI was created for the purpose of reducing its corporate parent's state tax liability. 2006-NMSC-006, ¶ 5. Similarly, the facts of this case establish that WMR was created for the primary purpose of reducing Wal-Mart's tax liability in states that allow separate entity reporting.[5] To a large extent, this explains why WMR did not incur the level of property and payroll expenses that would be expected of a corporation managing trademarks that generated annual royalties in the hundreds of millions of dollars. Pursuant to the terms of the License Agreement, most of the duties connected with the protection and defense of the trademarks remained with Wal-Mart's internal audit and legal divisions. Although WMR contracted with Ernst & Young to perform quality assurance inspections of Wal-Mart stores, WMR was prohibited from using the information generated from these inspections "for any purpose other than in connection with inquiries or audits by various taxing jurisdictions." Exhibit 27.

In deciding this case, it does not matter whether Wal-Mart's tax planning strategy is seen as an attempt to "game the system" or as a reasonable business decision designed to reduce corporate liabilities. What matters is that WMR did not represent the type of business model contemplated when UDITPA was drafted and was certainly "unusual" when viewed in that context. Because WMR's property and payroll contributed little or nothing to the generation of income from the use of its trademarks, the apportionment factor resulting from UDITPA's standard three-factor formula did not fairly represent the extent of WMR's business activity in New Mexico and was properly adjusted under the provisions of § 7-4-19.

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[5] The Department has not attempted to establish that tax avoidance was Wal-Mart's *only* reason for creating WMR and has admitted that WMR was not a sham corporation. This does not preclude a finding, which is amply supported by the record in this case, that tax-planning considerations were the *primary* motivation for WMR's creation. Nor does it preclude the Department from considering the unusual fact pattern resulting from Wal-Mart's tax-planning strategy when determining how best to apportion WMR's income.

Reasonableness of Alternative Apportionment Formula. The final issue to be addressed is whether the alternative apportionment formula adopted by the Department is reasonable. In *Twentieth Century-Fox*, *supra*, the Oregon Supreme Court set forth the following test for determining whether an apportionment formula is reasonable:

> We believe that in the context of UDITPA, reasonableness has at least three components: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of taxpayer's income; (2) the division of income does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in Oregon.

700 P.2d at 1043. Parts 1 and 3 of the Oregon court's test are merely restatements of the standard for judging the fairness of an apportionment formula under the Due Process and Commerce Clauses of the Constitution, as set forth in *Container Corp. of America*, *supra*. In that decision, the United States Supreme Court described its "internal consistency" and "external consistency" tests as follows:

> The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency—that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed. The second and more difficult requirement is what might be called external consistency—the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.

Id., 463 U.S. at 169.

In this case, the Department's apportionment formula meets the internal consistency test. The New Mexico apportionment factor is calculated by dividing WMR's royalties from licensing its trademarks in New Mexico by its income from everywhere. If each state calculated its apportionment factor in the same way, using WMR's royalties from licensing its trademarks for use within that state's borders as the numerator of the fraction, no more than 100 percent of

WMR's income would be subject to tax. The external consistency test is also met. The apportionment formula closely reflects how WMR's income is generated since it is tied directly into the activity that generates WMR's income, *i.e.*, the licensing of its trademarks. Because the formula sources income to New Mexico based on a comparison of the royalty income WMR derives from licensing its trademarks here to its total licensing royalties, it accurately reflects the economic reality of how WMR earns its income in this state.

The Department's formula does not create or foster a lack of uniformity among UDITPA jurisdictions. Regulation 3.5.19.11A(3), the regulation the Department relied on to source the income WMR derived from licensing its intangible property, tracks the Multistate Tax Commission's model regulation, which is likely to be followed by other UDITPA jurisdictions. It would also be reasonable to expect other taxing jurisdictions to eliminate the property and payroll factors from the formula, given the almost non-existent relationship between WMR's property and payroll in Delaware and its ability to generate revenues from the licensing of its trademarks throughout the United States. In *Geoffrey, Inc. v. Oklahoma Tax Commission*, 2006 OK Civ. App. 27, ¶ 6 (Okla. Ct. App. 2005), for example, the court upheld the Tax Commission's application of a modified one-factor apportionment formula to calculate Geoffrey's Oklahoma income, finding that use of Geoffrey's sales factor was an accurate reflection of the trademark holding company's business in Oklahoma.

Finally, it should be noted that the Department's apportionment factor for WMR closely tracks the apportionment factor for Wal-Mart during the audit years. This is not simply a coincidence. As recognized in *Kmart*, a trade name cannot be disconnected from the goodwill of an ongoing business. *Kmart*, *supra*, at ¶ 26. In this case, WMR's trademarks and goodwill are tied to the on-going business of Wal-Mart, some of which is carried on in New Mexico. Had

Wal-Mart not shifted a portion of its income to WMR in order to avoid taxation in states like New Mexico, that income would have been taxed to Wal-Mart at essentially the same rate it is being taxed to WMR. As the Department's expert witness testified, the close relationship between these numbers provides some confidence that the Department's single-factor formula accurately reflects WMR's business activity in New Mexico. TR at 398-399.

Issue III. Whether the Department was required to adopt a regulation addressing WMR's specific fact pattern before applying an alternative apportionment formula to WMR's business income.

Wal-Mart argues that the Department's modification of the standard UDITPA apportionment formula violated NMSA 1978, § 9-11-1, *et seq*., of the Taxation and Revenue Department Act and NMSA 1978, § 14-4-1 *et seq*., of the State Rules Act because "it has attempted to establish a broad policy of general application through litigation." Wal-Mart's brief at 25. In this case, however, the "policy" on which the Department relied was already set out in § 7-4-19 of UDITPA, which authorizes the use of an alternative apportionment formula whenever the standard formula does not "fairly represent the extent of the taxpayer's business activity in this state" and in Regulation 3.5.19.11A(3), which sets out special rules for sourcing income from the licensing of intangible personal property. Nonetheless, Wal-Mart argues that the Department could not apply § 7-4-19 to WMR until the Department adopted an additional regulation alerting taxpayers that an intangible holding company created to hold its parent's trademarks in order to shelter income from state taxation would be subject to the provisions of the statute.

If accepted, Wal-Mart's argument would defeat the underlying purpose of § 7-4-19. In discussing this section of UDITPA, commentators have noted that:

> [U]nusual situations, which should be excepted from the application of general rules, frequently arise. Such situations may be impossible to anticipate or difficult

> to describe with sufficient precision to permit drafting of a provision in the statute setting forth precisely the rules to be applied. Accordingly, it is common in allocation statutes to include a general relief provision authorizing the administrator to depart from the general rule if necessary to obtain fair or equitable results….

Keesling & Warren, *California's Uniform Division of Income for Tax Purposes Act* (Part I), 15 UCLA L Rev 156, 170 (1967). Section 7-4-19 provides state tax administrators with the flexibility to deal with situations that the drafters of UDITPA were unable to anticipate or describe with sufficient precision to address in the statute itself. Over time, recurring fact patterns relating to broad categories of taxpayers—such as the financial, transportation, and broadcasting industries—can be identified and addressed in regulations. Other situations must be dealt with on an ad hoc basis. Requiring the adoption of regulations to cover every situation that might arise would be asking the Department to do something that the drafters of UDITPA themselves recognized was impractical.

Wal-Mart's assertion that the State Rules Act prohibits the Department from resolving disputed issues by adjudication, rather than by rule making, is incorrect. Subsection C of § 14-4-2 of the State Rules Act specifically excludes from the definition of "rule" an "order or decision or other document issued or promulgated in connection with the disposition of any case or agency decision upon a particular matter as applied to a specific set of facts…." The issue raised by Wal-Mart is similar to that raised by the taxpayer in *Rauscher, Pierce, Refsnes, Inc. v. Taxation & Revenue Department*, 2002-NMSC-13, 132 N.M. 226, 46 P.3d 687. There, the New Mexico Supreme Court rejected the taxpayer's argument that the decision of the Department's administrative hearing officer was "so novel as to constitute rule making." As the court stated:

> In the present case, the hearing officer was interpreting the Act and relevant regulations in an attempt to resolve the dispute between Rauscher and the Department. While the hearing officer's decision, as well as the opinion of the Court of Appeals, will affect parties other than Rauscher, the effect will be similar

> to the effect any judicial determination of a dispute between particular parties has on third parties. To the extent those parties are similarly situated, the determination in this case will be relevant precedent.
>
> We conclude that the hearing officer did not create a new administrative rule, and that the Court of Appeals did not err in rejecting Rauscher's argument for purely prospective application of its determination. The tasks the hearing officer was asked to perform were judicial in nature. Rauscher's protest raised factual and legal questions under existing law, which the hearing officer resolved by adopting an interpretation of the statutes that resolved these questions. We agree with the Court of Appeals that the principles governing the prospective application of administrative rules are not applicable.

2002-NMSC-13, ¶¶ 43-44. Even when an administrative decision serves to establish a new rule, that does not mean the rule must be given a purely prospective application. In *Hobbs Gas Co. v. Public Service Commission*, 115 NM 678, 682, 858 P.2d 54, 58 (1993) (which was decided well after enactment of the State Rules Act), the New Mexico Supreme Court determined that the question was not whether an agency may establish the law through adjudication, but "whether to apply the ruling prospectively or retroactively." *Hobbs*, *supra*, 115 N.M. at 682, 858 P.2d at 58. To address this issue, the court adopted the five-part test set out in *Retail, Wholesale & Department Store Union v. NLRB*, 466 F.2d 380, 390 (D.C.Cir.1972), which "elucidated the balance suggested in *Chenery"* by focusing on the following factors:

> (1) whether the particular case is one of first impression, (2) whether the new rule represents an abrupt departure from well established practice or merely attempts to fill a void in an unsettled area of law, (3) the extent to which the party against whom the new rule is applied relied on the former rule, (4) the degree of the burden which a retroactive order imposes on a party, and (5) the statutory interest in applying a new rule despite the reliance of a party on the old standard.

Hobbs, *supra*, 115 N.M. at 682, 858 P.2d at 58.

This case, like *Rauscher*, *supra*, involves a dispute between the taxpayer and the Department that must be decided on its individual facts. The Department's modification of UDITPA's standard apportionment formula was not based on the general characteristics of any recognized industry, but on the facts pertaining to WMR's individual property, payroll and sales factors. In the mid-1990s, Frank Shaffer, a Department auditor, first learned that WMR might present a fact situation similar to that in *Geoffrey, supra*. In 1995, the Department began to collect information concerning WMR. At about the same time, Mr. Shaffer began a review of corporate income tax returns filed with the Department to determine whether any other companies were taking large royalty deductions that might indicate the same kind of trademark assignment and license back situation used in *Geoffrey*. Although there was a belief among the states that trademark holding companies were being established, Mr. Shaffer did not find such companies in the course of his review of New Mexico corporate income tax returns.[6]

The Department eventually identified two trademark-holding companies as audit prospects: the first was KPI, which was assessed in 1997; the second was WMR. The Department completed its audit of WMR in January 1998 and issued its assessments against WMR in February 1998. Following the audit of WMR, the Department set up a project to identify similar trademark holding companies, which resulted in the assessment of approximately 25 companies, eight of which were related entities. The Department has not attempted to assess other types of intangible holding companies that earn income from passive investments, nor does the Department have a policy concerning such companies.

Given this background, the Department's decision to invoke the provisions of § 7-4-19 to apply an alternative apportionment formula to WMR's New Mexico income did not constitute "a broad policy of general application" requiring prior rulemaking. At the time WMR was assessed in 1998, the Department had identified only one or two other intangible holding companies licensing trademarks to a retail parent operating in New Mexico. This level of activity was not

[6] While Wal-Mart suggests that the Department's research was inadequate, the testimony of Philip Zinn concerning his involvement with the "Geoffrey Coalitition" makes it clear that trademark holding companies such as WMR were careful not to bring themselves to the attention of state tax authorities. *See*, TR I at 192-200.

sufficient to require the Department to adopt a regulation before proceeding to audit. Even taking the additional 25 corporations (8 of which were related entities) assessed after 1997 into account, the tax-planning strategy represented by these trademark holding companies does not constitute an "industry" similar to the banking, broadcast and transportation industries for which regulations have been adopted under § 7-4-19. It is also worth noting that on February 1, 1997, before the Department even completed its audit, Wal-Mart abandoned its decision to maintain a separate trademark holding company and WMR was merged into Wal-Mart. Kmart reached a similar decision, and KPI was also merged into its parent corporation. *Kmart, supra*, 2006 NMSC 006, ¶ 1. There would be little reason for the Department to adopt a regulation to address a situation that no longer existed.

The Department's use of an alternative apportionment formula was based on the facts it discovered through its audit of WMR, which are discussed in some detail in the previous sections of this decision. The formula ultimately fashioned by the Department was not particularly novel, but followed existing law. Section 7-4-19 puts all taxpayers on notice that if the application of the standard three-factor formula does not fairly represent a taxpayer's activities in New Mexico, the Department is authorized to modify the formula. Subsection B of § 7-4-19 specifically provides that one method of modification is "the exclusion of any one or more of the factors." With regard to the sourcing of income from intangibles, Regulation 3.5.19.11A(3) provides that "where the income producing activity producing business income from intangibles can be readily identified, that income should be sourced to that state and not the state with the greatest cost of production". *Kmart*, *supra*, 2006 NMCA -26, ¶ 52.

As the Department points out in its response brief, § 7-4-19 is just as much a part of UDITPA as § 7-4-18 and the other provisions cited by Wal-Mart. Based on the clear notice provided by § 7-4-19 and the accompanying regulations, it is difficult to believe that any taxpayer generating millions of dollars of income from the licensing of intangible property throughout the United States—while paying out less than 1/100th percent of this amount in property and payroll expenses—would be surprised by a determination that the standard three-factor formula does not fairly represent the extent of the taxpayer's business activity in the various states. Wal-Mart has failed to establish that WMR reasonably relied on any existing regulation or policy when it decided not to report or pay corporate income tax to New Mexico. There is no evidence that Wal-Mart or WMR even considered the application of UDITPA to WMR's royalty income. Instead, the October 9, 1990 memorandum from Jerry Orr to James Walker (Exhibit 2) and WMR's responses to the Department's auditors (Exhibit 317 at B2.8) indicate that WMR was relying on the argument that it did not have nexus with New Mexico to support its position that no tax was due.

The Department's application of § 7-4-19 to WMR's royalty income did not represent a change in any existing policy. Nor did it represent a novel or unexpected interpretation of existing statutes and regulations. Instead it represented the application of existing law to an unusual situation of recent development. Unlike the cases on rulemaking cited by Wal-Mart, the alternative apportionment formula applied to WMR was crafted by the Department based on the specific facts uncovered during its audit and was not intended to have "unvarying application" to a broad category of taxpayers. *See*, *Metromedia, Inc. v. Director, Division of Taxation*, 478 A.2d 742, 753 (N.J. 1984) (proposed audience share factor was intended to be "a rule of unvarying application" to the broadcasting industry); *CBS v. Comptroller of the Treasury*, 575 A.2d 324, 330 (Md. 1990) (the audit announced "a substantially new generally applicable policy with respect to apportionment of the network advertising income of national broadcasting corporations"); *cf., Comptroller of the Treasury v. SYL, Inc.*, 825 A.2d 399, 417-418 (Md. 2003) (distinguishing the *CBS* case and holding that the decision to tax the royalties of an intangible holding company created to hold its parent's trademarks was not impermissible rulemaking because "application of Maryland's income tax to the case does not involve a change in the Comptroller's policy"). Under the facts of this case, the Department was not required to engage in prospective rulemaking before applying the provisions of § 7-4-19 to WMR.

Issue IV: Whether WMR's failure to report New Mexico corporate income and franchise taxes on its royalties from granting Wal-Mart a license to use trademarks in New Mexico was negligent, thereby justifying the Department's assessment of penalty.

NMSA 1978, § 7-1-69(A) 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" to pay taxes due to the state. Regulation 3.1.11.11 NMAC sets out several situations that may indicate a taxpayer has not been negligent, including "reasonable reliance on the advice of competent tax counsel or accountant as to the taxpayer's liability after full disclosure of all relevant facts." In this case, the plan for creating WMR was presented to Jerry Orr, Wal-Mart's Director of Taxes, by Corporate Financial Consulting Services, Inc. Mr. Orr then presented the plan to James Walker, Wal-Mart's Vice President and Controller, who was a certified public accountant. The plan was subsequently reviewed by Wal-Mart's legal department. Since the primary purpose for creating WMR was to reduce Wal-Mart's state tax liabilities, there is little doubt that Wal-Mart's tax accountants and attorneys carefully scrutinized the nexus arguments that formed the heart of Corporate Financial's tax planning strategy. There is also little doubt that WMR relied on the tax advice received from its parent company when deciding whether it was required to file corporate income tax returns with states which, like New Mexico, allowed separate entity reporting. Accordingly, WMR comes within the exception to negligence provided in Regulation 3.1.11.11 and penalty is not due.

CONCLUSIONS OF LAW

A. Wal-Mart filed a timely, written protest to Assessment Nos. 2219795 and 2219796, and jurisdiction lies over the parties and the subject matter of this protest.

B. Pursuant to the New Mexico Supreme Court's holding in *Kmart Corporation v. Taxation and Revenue Department*, 2006 NMSC 006 and the parties' June 16, 2005 stipulation, Wal-Mart is not liable for the gross receipts tax, penalty and interest assessed against WMR under Assessment No. 2219795.

C. WMR had both business activity and income-producing activity in New Mexico.

D. The apportionment factor resulting from UDITPA's standard three-factor formula did not fairly represent the extent of WMR's business activity in New Mexico and was properly adjusted under the provisions of § 7-4-19.

E. WMR presented an unusual fact pattern justifying modification of UDITPA's standard three-factor apportionment formula under the provisions of § 7-4-19.

F. The royalties WMR received from Wal-Mart's use of WMR's trademarks in New Mexico were properly sourced to this state by the Department.

G. WMR's property and payroll contributed little or nothing to the generation of income from the use of its trademarks, and elimination of those factors was appropriate under the alternative apportionment provisions of § 7-4-19.

H. The Department's use of a modified one-factor apportionment formula using WMR's sales factor was reasonable; the modified formula meets the tests of internal and external consistency and the division of income under the formula reflects the economic reality of KPI's business activities in New Mexico.

I. The Department was not required to engage in prospective rulemaking before applying the alternative apportionment provisions of § 7-4-19 to WMR.

J. Wal-Mart reasonably relied on the advice of its accounting and legal staff and was not negligent in failing to pay New Mexico corporate income tax during the audit period.

IT IS THEREFORE ORDERED THAT:

The Department abate the gross receipts tax, penalty and interest assessed against WMR under Assessment No. 2219795;

The Department abate the penalty assessed against WMR under Assessment No. 2219796; and

Wal-Mart pay the corporate income and franchise taxes assessed against WMR under Assessment No. 2219796, plus interest accrued to the date of payment.

DATED May 1, 2006.