



WAL★MARTWATCH

Wal-Mart's Tax Avoidance Schemes:

How the Use of Trademark Holding Companies and "Captive REITs" Have Cost States Millions

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Wal-Mart's State Tax Avoidance Schemes

Corporate tax loopholes are having a profound effect on state revenue collections, and mounting evidence demonstrates that for many years Wal-Mart aggressively has pursued them in order to avoid paying state taxes. The legality of certain tax schemes differs state to state and certain strategies are extremely complex, but the underlying results are the same: they have saved Wal-Mart from paying hundreds of millions of dollars in state taxes. According to a recent *Wall Street Journal*¹ article and Standard & Poor's Compustat system (which collects data from SEC filings) on average Wal-Mart has paid only about half of the statutory state tax rates for the past decade. As companies like Wal-Mart find more and more creative ways to avoid paying their share of state taxes, the burden on individual taxpayers will continue to grow. This paper will focus on two primary strategies utilized by Wal-Mart – trademark holding companies and “captive REITs” – and demonstrate how states have responded to them.

- *In 1995, the New Mexico Taxation and Revenue Department began an audit of WMR, a subsidiary of Wal-Mart created in 1991. Suspicion had arisen that Wal-Mart was using WMR as a **trademark holding company** for the sole purpose of withholding state tax. Though WMR ceased to exist as a separate entity as of February 1997, when it merged back into Wal-Mart, New Mexico completed its investigation and issued assessments in 1998. On May 1, 2006, a hearing officer upheld the assessment of \$11,630,226 in corporate income tax against Wal-Mart Stores, Inc.*
- *Wal-Mart is currently in court in North Carolina, seeking to force a refund of the \$30.2 million it claims the state owes it for improperly assessing corporate income tax. Wal-Mart has been using a “**captive REIT**” strategy to distort the company's true net income, and in the process cutting its state taxes by over 20% over one four-year period. Wal-Mart also sought – and was denied – a similar refund in Louisiana.*
- *New York Governor Eliot Spitzer has included closing the REIT loophole as a priority in his 2007 budget proposal, a move estimated could raise as much as \$104 million for the state in the next year. Massachusetts Governor Deval Patrick has discussed a similar proposal. Connecticut and Maryland have both announced recently they will examine the “captive REIT” strategy.*
- *The Multistate Tax Commission has been examining the use of “captive REITs” to avoid state taxes, alerting states to the issue and proposing legislative fixes to close certain loopholes. A report issued by the Commission in 2003 outlined the impact such loopholes have on state revenue collection.*

New Mexico tells Wal-Mart it must pay corporate income tax

The **trademark holding company** strategy typically involves transferring a company's trademarks, trade names, and service marks to a separately incorporated subsidiary, which then licenses the marks back to the original company – in this case back to Wal-Mart for use nationwide in individual stores, advertisements, etc.. At present, state courts have split on whether the use of trademark holding companies to avoid paying state taxes is protected by Supreme Court precedents.² Some state courts including Georgia, Maryland and New York have sided with companies, while others such as New Mexico, Massachusetts and South Carolina have sided with states. Tax experts contend that the strategy of placing such holding companies in a state like Delaware – Delaware does not tax the income of a corporation whose only activity in the state is the ownership, maintenance, and management of intangible assets – has resulted in billions of dollars in revenue losses for states.³

Wal-Mart established its own trademark holding company, WMR, Inc., in 1991. Set up in Delaware in a small one-room office, WMR never had more than two employees, and its property and payroll expenses represented less than 1/100th percent of its net income.⁴ Last year, the New Mexico Taxation and Revenue Department upheld an \$11.6 million corporate income tax assessment against Wal-Mart and WMR, holding the company could not shield itself from New Mexico earnings by transferring them to an out-of-state holding company.⁵

In her decision, a New Mexico Taxation and Revenue Department hearing officer noted that WMR was created “for the primary purpose of reducing state income taxes for Wal-Mart Stores, Inc.,” which “believed that WMR could shelter Wal-Mart Stores’ income from taxation by most states.”⁶ New Mexico argued WMR’s licensing activity within the state made it subject to New Mexico’s tax jurisdiction, and that equitable apportionment provisions in the state tax code allowed sourcing of WMR’s income to the state.⁷ Both of those propositions had been upheld previously by the New Mexico Court of Appeals in a comparable case against K-Mart.⁸ Similarly, it has been upheld that a foreign corporation licensing the use of its trademarks to a local affiliate has business activity within that state.⁹

The fundamental point of argument in cases such as these has revolved around the physical-presence standard laid out by the Supreme Court in 1992.¹⁰ The Due Process Clause of the U.S. Constitution “requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.”¹¹ As courts have noted, the basic concern of due process is fairness: in this case, whether a foreign corporation has sufficient contacts with a taxing state to put that corporation on notice that the taxing state will exercise power over it.¹² Due process does not, however, require that the taxpayer be physically present within the taxing state in order for that state to exercise power over it.¹³

The Supreme Court addressed this issue at least in part in *Quill Corporation v. North Dakota*, which involved an interstate mail-order business and held that an Illinois sales

and use tax imposed on out-of-state mail-order companies lacking a physical presence in the state violated the Due Process Clause and the Commerce Clause.¹⁴ The controversy now is whether the *Quill* physical presence test applies to income tax as well. In *Geoffrey, Inc. v. South Carolina Tax Commission*, the South Carolina Supreme Court held that a trademark holding company had a constitutional nexus with the state for income tax purposes despite a lack of physical presence because it licensed its intangibles for use in South Carolina.¹⁵ After the *Geoffrey* decision, states began to line up on either side – a number of states adopted *Geoffrey*-type nexus rules, while others ruled that the *Quill* physical presence test does apply to income tax.¹⁶

States such as Florida, Massachusetts, and New Jersey have adopted rules mirroring the *Geoffrey* decision.¹⁷ New Mexico courts have also held that the physical presence requirement does not apply to income tax. The court in *Kmart* repeatedly emphasized the Supreme Court’s narrow focus on sales and use taxes, and the clear impression it gave that it was not applying the physical presence requirement to any other taxes.¹⁸ The *Kmart* court did also look to other states as examples, including Illinois and Washington, among others.¹⁹ As the New Mexico court noted in upholding the Wal-Mart assessment, “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.”²⁰

WMR licensed the use of Wal-Mart’s trademarks back to Wal-Mart for use in its stores nationwide, and as such, depending on individual state laws and how individual jurisdictions have interpreted the *Quill* physical presence test, it is plausible that the assessments handed down by the New Mexico Taxation and Revenue Department could be replicated in multiple states.

Wal-Mart contests tax bill in North Carolina, Louisiana

WMR merged back into its parent company in February of 1997, and while the merger process was underway, Wal-Mart was already setting up a new tactic for handling its state tax bill. In the fall of 2006, Delaware corporate records show that Wal-Mart created a new structure of subsidiaries: (1) a **REIT**²¹ called the Wal-Mart Real Estate Business Trust; (2) a Delaware-based parent company for the REIT, called the Wal-Mart Property Co.; and (3) Wal-Mart Stores East Inc., parent of the Delaware firm.²²

Wal-Mart is taking advantage of a tax loophole that the federal government closed years ago, paying rent to itself then deducting it from state taxes in about twenty-five states. Data from filings with the Securities and Exchange Commission show that on average Wal-Mart has paid only about half the statutory state rates over the past decade.²³ North Carolina took a proactive approach, and computed Wal-Mart’s tax bills by combining the company’s tax return with those of the subsidiaries. The state combined the returns because it contended that Wal-Mart’s income tax return failed to disclose Wal-Mart’s “true earnings on its business carried on in the state.”²⁴

Wal-Mart paid the tax, and then filed suit against the North Carolina Secretary of Revenue, seeking a refund. The case is ongoing in North Carolina Superior Court, and North Carolina tax authorities have claimed the REIT strategy was a deliberate attempt to distort Wal-Mart's true net income.²⁵ Wal-Mart has challenged the legality of how the state calculated its tax bill – the “audit period” in question occurs between February 1, 1998 and January 31, 2002²⁶ - including violations of due process and the commerce clause of the U.S. Constitution, as well as violations of the North Carolina Constitution.

The case is reminiscent of a similar suit in Louisiana. The state, facing a \$500 million budget gap just a few years ago, went to court with Wal-Mart over the *Geoffrey* loophole. Wal-Mart paid \$15.4 million in back taxes which the state claimed it had avoided paying by using the loophole, and the retailer then took the State to court seeking a refund.²⁷ Records from the case are under seal, but the Louisiana Department of Revenue argued Wal-Mart's out-of-state subsidiary had an economic presence in the state, which subjected it to Louisiana income tax.²⁸ In April 2004, a district court judge in Baton Rouge refused Wal-Mart's request to force the state to pay back the \$15.4 million, and ordered the case to go to trial.²⁹

Regardless of outcome, these REIT cases illustrate exactly how much money corporations can hide by moving it around through subsidiaries instead of paying it in state tax. According to a N.C. Revenue Department auditor's report, over the four-year audit period, Wal-Mart and Sam's Club paid over \$7 billion to company controlled REITs estimated to have saved the company approximately \$230 million in state taxes nationwide.³⁰ Not every state has the capacity to challenge these practices – Maryland, for example, acknowledged it could be losing millions of dollars, but prior to its recent announcement that it would investigate the practice, the Maryland Comptroller's Office had maintained that under existing law it is a legitimate tax shelter³¹ - so unless loopholes are closed or legal action taken many states will continue to lose money.

What is particularly aggravating to officials is the way in which this particular REIT was set up – Wal-Mart satisfied a requirement that REITs have at least 100 owners by listing 99 Wal-Mart executives as non-voting, otherwise meaningless shareholders. As *The Wall Street Journal* revealed in excerpts from an Ernst & Young training manual, these contacts serve no business purpose other than “tax planning”.³² In addition, many criticize the REIT strategy because it allows companies to use public services such as police, fire, public highways, etc., without paying a fair share of the taxes that go to providing them.

New York, others, move to close loopholes

Many states, in addition to the federal government, have already moved to close such loopholes, and newly elected Governor of New York Eliot Spitzer is looking to do the same. Included in his budget for the upcoming year is a proposal to eliminate the tax deduction for some real-estate investments trusts, a move estimated could raise up to \$104 million for the state of New York.³³ The largest proposal in Spitzer's budget would require companies such as Wal-Mart to report all income earned including that from out-

of-state subsidiaries, so that the state can then determine what portion would then be subject to state taxes, which could raise as much as \$215 million next year for New York.³⁴ Many businesses in New York are referring to Spitzer's budget moves as tax hikes.

Maryland closed the *Geoffrey* trademark holding company loophole years ago, and in 2005 tried to do the same with REITs, but a bill introduced during the 2005 session died in the Maryland Statehouse.³⁵ Former New York Governor George Pataki proposed legislation similar to Spitzer's proposal in 2006, but it too was rejected by the New York legislature.³⁶

The defeats haven't stopped other states from moving forward. Officials in New Mexico are hoping that the recent Wal-Mart ruling will help push through a legislative measure that would change the state to a combined reporting system. Combined reporting systems have been initiated in several states in order to obtain a truer picture of a company's taxable income. The system works by requiring companies to combine profits from all related subsidiaries before determining what portion of their profits are taxable.³⁷ Efforts to pass similar legislation in New Mexico didn't make it in 2006, and members of both political parties expect large corporations to fight hard to defeat the measure again this year.³⁸ House Bill 535 is the third attempt to close the \$80 million dollar loophole in New Mexico.³⁹ Newly elected Massachusetts Governor Deval Patrick also is seriously considering a combined reporting system.⁴⁰ Patrick aides have said such a move could raise as much as \$200 million.⁴¹

The Multistate Tax Commission ("MTC"), an association of state revenue authorities, has started examining the use of REITs to avoid state tax, seeking to alert states to the issue and provide legislative answers to close the loophole.⁴² Among other things, they provide model legislation, and updates on the latest actions states have taken. Recently a Massachusetts Appeals Court denied the dividends-received deduction from the computation of net income for distributions received from a REIT to a corporate shareholder.⁴³

In 2003, MTC issued a report on corporate tax sheltering and the impact on state tax revenue collections.⁴⁴ The report found that combined reporting states are less affected by domestic tax sheltering than separate entity states – the median decline in effective corporate tax rates between 1986 and 1997 was 38.4 percent for separate entity states and 20.0 percent for combined reporting states.⁴⁵ As mentioned earlier, states such as New York and Massachusetts are both looking to move to combined reporting systems. Most recently, Connecticut Attorney General Richard Blumenthal announced he was launching an investigation into whether current Connecticut law can be enforced against Wal-Mart and others for their use of REITs.⁴⁶ In addition, Maryland State Comptroller Peter Franchot announced his office would be auditing companies that it suspected of using the "captive REIT" arrangement, and would disallow the deduction if it found those payments.⁴⁷ Until more states begin to take a proactive approach, Wal-Mart will continue to find new and creative ways to avoid paying the funds that otherwise would help support public services such as healthcare, education, and new highways.

End Notes:

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- ¹ Jesse Drucker, “Wal-Mart cuts taxes by paying rent to itself,” *The Wall Street Journal*, February 1, 2007.
- ² The use of trademark holding companies refers to when a company creates a subsidiary to which it then transfers its intellectual property. The holding company then licenses the trademark back to the parent company, and the licensing fees it receives are not subject to state tax. The royalty rates paid back to WMR from Wal-Mart were expressed as a percentage of Wal-Mart’s domestic sales.
- ³ Glenn R. Simpson, “Corporations evade taxes, we pay their share,” *The Wall Street Journal*, August 9, 2002.
- ⁴ *In the Matter of the Protest of Wal-Mart Stores, Inc. (Successor to WMR, Inc.)*, Decision and Order ¶¶ 46-55 (May 1, 2006).
- ⁵ Jason Trenkle, “State says Wal-Mart must pay New Mexico’s corporate income tax,” *New Mexico Business Weekly*, May 19, 2006.
- ⁶ State of New Mexico Taxation and Revenue Department Press Release: “Wal-Mart Corporate Income Tax Assessment Upheld,” May 3, 2006.
- ⁷ *Id.*
- ⁸ *Kmart Corporation v. Taxation and Revenue Department*, 131 P.3d 27 (N.M.Ct.App. 2001).
- ⁹ See *Lanco, Inc. v. Director, Division of Taxation*, 879 A.2d 1234 (N.J.Super.Ct. 2005); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C.Ct.App. 2004); *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993). Each case rejected the idea that a corporation must have a physical presence within a state in order to have taxable business activity within the state.
- ¹⁰ *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992).
- ¹¹ *Quill*, 504 U.S. at 306.
- ¹² *Kmart Corporation*, 131 P.3d at 32.
- ¹³ *Quill*, 504 U.S. at 308.
- ¹⁴ *Kmart Corporation*, 131 P.3d at 34.
- ¹⁵ *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15 (1993).
- ¹⁶ Christine C. Bauman and Michael S. Schadewald, “More states challenge trademark holding companies,” *The CPA Journal*, 2004.
- ¹⁷ *Id.*
- ¹⁸ *Kmart Corporation*, 131 P.3d at 34-5.
- ¹⁹ See *General Motors Corporation v. City of Seattle*, 25 P.3d 1022, 1028 (Wash. Ct. App. 2001); *Borden Chemicals & Plastics, LP v. Zehnder*, 726 N.E.2d 73, 80 (Ill. App. Ct. 2000). See also Michael T. Fatale, “State Tax Jurisdiction and the Mythical “Physical Presence” Constitutional Standard,” 54 *Tax Law* 105, 131 (“In general, the state court cases determine that, when a taxpayer has income derived from a state’s economic market, the taxpayer is subject to the state’s income tax.”)
- ²⁰ *In the Matter of the Protest of Wal-Mart Stores, Inc.*, Decision and Order 24.
- ²¹ REIT stands for real-estate investment trust, and it works as follows using Wal-Mart as an example: One Wal-Mart subsidiary pays rent to a REIT, which is entitled to a tax break if it pays its profits out in dividends. The REIT is 99%-owned by another Wal-Mart subsidiary, which receives the REIT’s dividends tax-free. When it comes time to pay state taxes, Wal-Mart then gets to deduct the rent as a business expense, even though the money has stayed within the company.
- ²² Drucker, *supra* note 1.
- ²³ *Id.*
- ²⁴ David Ranii, “Wal-Mart contests state’s tax bill,” *The News & Observer*, July 7, 2006.
- ²⁵ Drucker, *supra* note 1.
- ²⁶ *Wal-Mart Stores East, Inc. v. E. Norris Tolson*, Defendant’s Amended Complaint ¶ 4 (March 31, 2006).
- ²⁷ Alan Sayre, “States take aim at ‘Geoffrey’ tax loophole,” *The Associated Press*, June 24, 2004.
- ²⁸ *Id.*
- ²⁹ Sprawl-busters.com *Newsflash!*, “Wal-Mart corporate tax shelter worth millions” <<http://www.sprawl-busters.com/search.php?readstory=1468>> (accessed February 10, 2007).
- ³⁰ Drucker, *supra* note 1.
- ³¹ Jay Hancock, “Wal-Mart: Always low taxes,” *The Baltimore Sun*, February 7, 2007. See also: Tricia Bishop, “Franchot to change policy on REIT rents,” *The Baltimore Sun*, March 6, 2007.

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- ³² Drucker, *supra* note 1.
- ³³ Jay Gallagher, "Business leaders see tax hikes in Spitzer budget," *Gannett News Service*, February 2, 2007.
- ³⁴ *Id.*
- ³⁵ Hancock, *supra* note 31.
- ³⁶ Gallagher, *supra* note 33.
- ³⁷ The New Rules Project *Retail*, "State Tax Fairness: Combined Reporting" <<http://www.newrules.org/retail/taxfaircombined.html>> (accessed February 27, 2007).
- ³⁸ Jason Trenkle, "Tax fixes try for comeback in 2007 legislative agenda," *New Mexico Business Weekly*, December 25, 2006.
- ³⁹ David Miles, "Bill targets multistate corporations' tax liability," *The Santa Fe New Mexican*, February 17, 2007.
- ⁴⁰ Steve Bailey, "Extreme tax games," *The Boston Globe*, February 21, 2007.
- ⁴¹ Peter J. Howe, "Patrick's tax plan targets multistate corporations," *The Boston Globe*, February 21, 2007.
- ⁴² Drucker, *supra* note 1.
- ⁴³ <http://www.mtc.gov/>. See specifically: <http://www.mass.gov/atb/2005/05p450.doc>
- ⁴⁴ Multistate Tax Commission Report, "Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections," July 15, 2003.
- ⁴⁵ *Id.*
- ⁴⁶ Don Michak, "Wal-Mart dodging state taxes?," *Connecticut Journal Inquirer*, March 1, 2007.
- ⁴⁷ Jesse Drucker, "States move to close tax shelter that benefits Wal-Mart, others," *The Wall Street Journal*, March 7, 2007.

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Additional Links:

Center on Budget and Policy Priorities <http://www.cbpp.org/>

Federation of Tax Administrators <http://www.taxadmin.org/>

The Institute on Taxation and Economic Policy <http://www.itepnet.org/>

Multistate Tax Commission ("MTC") <http://www.mtc.gov/>

MTC Resources page <http://www.mtc.gov/Resources.aspx?id=68>

MTC PowerPoint on "captive REITs"
www.mtc.gov/.../Committees/Litigation_Committee/Resources/MTC_AttyConCall_Jan25_07_to%20Post.ppt

National Association of Real Estate Trusts <http://www.nareit.com/index.cfm>

State of New Mexico Taxation and Revenue <http://www.tax.state.nm.us/>

New York Office of the Governor <http://www.ny.gov/governor/index.html>

New York State 2007-08 Executive Budget
<http://publications.budget.state.ny.us/executive.html>

North Carolina Department of Revenue <http://www.dornrc.com/index.html>

The Real Estate Roundtable <http://www.rer.org/>

State Fiscal Analysis Initiative <http://www.statefiscal.org/>