One Company's Plan to – Save Money, Live Better

Wal-Mart's State Tax Avoidance Schemes

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INTRODUCTION

Wal-Mart Watch has prepared this memorandum to illustrate how Wal-Mart, using tax avoidance schemes provided to it by the accounting firm Ernst & Young, has short-changed many states out of millions of dollars of state tax money. As revealed in a February 2007 *Wall Street Journal* story, Wal-Mart pays billions of dollars in rent per year, yet in many states the retail giant has been paying rent to itself and then deducting those amounts from its state taxes.[1]

As you know, corporate tax loopholes are having a profound effect on state revenue collections, and mounting evidence demonstrates that Wal-Mart has aggressively pursued them for many years in order to avoid paying state taxes. The tax schemes vary in complexity as well as legality from state to state, but the underlying results are the same: these strategies have saved Wal-Mart from paying hundreds of millions of dollars in state taxes.

Wal-Mart has been 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.[2] Many states have taken a proactive approach and computed Wal-Mart's tax bills by combining the company's tax return with those of tax-shelter subsidiaries created during the 1990s, contending that Wal-Mart's income tax returns have failed to disclose Wal-Mart's true earnings on its business carried on in a particular state.[3]

Wal-Mart's tax avoidance strategies appear to have originated in the mid-1990s when Ernst & Young helped Wal-Mart undertake a detailed corporate restructuring, which created a new structure of subsidiaries based on optimizing state tax reduction. A main component of the restructuring and tax reduction strategy was the creation of a captive Real Estate Investment Trust, or REIT. Created by Congress in 1960 as a means for allowing small investors to spread their risk when investing in commercial real estate, REITs aren't subject to corporate income tax on profits as long as they pay out at least 90% of those profits as dividends to shareholders.[4]

A captive REIT is a real estate investment trust that has more than 50 percent of the voting power or value of the trust owned or controlled by a single corporation.[5] Early on in the 1990s, big accounting firms such as Ernst & Young determined that by setting the REIT up as a subsidiary of the parent, tax breaks on REIT dividends could be combined with another tax law allowing parent companies to receive dividends from their subsidiaries tax-free – the combination of the two effectively allowed companies to avoid state taxation altogether.[6]

The *Wall Street Journal*, consulting with accounting experts, used an average state tax rate of 6.5% to calculate that for a four year period from 1998 to 2001, Wal-Mart's REIT payments saved the retailer approximately $350 million in state taxes – the loss of federal deductions that would have been triggered by larger state tax payments still left Wal-Mart with about $230 million in savings.[7] In Wisconsin, for example, public documents show that Wal-Mart had taken home to Arkansas approximately $852 million in net profits between the years 2000 and 2003, while over that same time period, Wal-Mart had paid only $3 million in corporate income tax – far below what the state's 7.9% corporate income tax rate would suggest the company owed, namely, about an additional $64 million.[8]

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[1] Jesse Drucker, "Wal-Mart cuts taxes by paying rent to itself," *The Wall Street Journal*, February 1, 2007.
[2] Id.
[3] David Ranii, "Wal-Mart contests state's tax bill," *The News & Observer*, July 7, 2006.
[4] Jesse Drucker. "Wal-Mart cuts taxes by paying rent to itself." *The Wall Street Journal*. February 1, 2007.
[5] Pennsylvania Department of Revenue, Limited Liability Companies and Business Trusts. Online at: http://www.revenue.state.pa.us/revenue/cwp/view.asp?a=11&q=225172.
[6] Jesse Drucker, "Wal-Mart cuts taxes by paying rent to itself," *The Wall Street Journal*, February 1, 2007.
[7] Id.
[8] Mike Ivey. "Wal-Mart: The Low Tax Leader, Always." *The Capital Times*. April 24, 2007.

Below, we discuss Wal-Mart's use of state tax avoidance strategies, and how North Carolina and other states have confronted the issue and assessed Wal-Mart for back taxes owed.

WAL-MART'S TAX HISTORY

Prior to engaging Ernst & Young to set up the captive REIT strategy, Wal-Mart was already playing games with its state tax bill. In 1991, the retailer established what is known as a trademark holding company ("THC"), a strategy that typically involves transferring a company's trademarks, trade names, and service marks to a separately incorporated but wholly owned subsidiary, which then licenses the marks back to the original company. As several states became aware of the scheme, some assessed Wal-Mart and other companies for back taxes in an attempt to recoup lost tax revenue.

In 1995, the New Mexico Taxation and Revenue Department began to collect information regarding Wal-Mart's THC and dispatched a tax auditor to perform a field visit to Bentonville, Arkansas.[9] In May, 2006, the New Mexico Taxation and Revenue Department upheld an $11.6 million income tax assessment against Wal-Mart, holding that the retailer had shifted earnings to its THC for the sole purpose of reducing income it reported in New Mexico for its in-state stores.[10]

Wal-Mart was involved in a similar dispute in Louisiana, in which the company was assessed and paid $15.4 million in back taxes.[11] In her decision, a New Mexico Taxation and Revenue Department hearing officer noted that WMR (Wal-Mart's THC) 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."[12] The language used in that New Mexico case, created "for the primary purpose of reducing state income taxes for Wal-Mart," is a common refrain when states describe Wal-Mart's restructuring and its use of the captive REIT strategy.
Wal-Mart's restructuring incorporated the creation of eight new Wal-Mart subsidiaries including: Wal-Mart Stores East, Inc.; Wal-Mart Property Company, a wholly-owned subsidiary of Wal-Mart East; and Wal-Mart Real Estate Business Trust, 99% owned by Wal-Mart Property Company.[13] Following the restructuring, Wal-Mart began transferring property ownership of its land and stores in 27 states over to its REIT.[14] Those states were generally non-unitary or separate entity states, which do not require or allow a corporation and its affiliated/subsidiary entities to file a combined tax return.[15]

The Wal-Mart money circle proceeded as follows: Wal-Mart East paid rent on the stores and the land to the REIT based on 2.5% of gross sales; the REIT then paid via wire its rental income on a quarterly basis to Wal-Mart Property Company as a dividend; the parent company, Wal-Mart Stores, Inc., wired funds to the REIT to cover the dividend payment to Wal-Mart Property Company, which immediately wired the dividend right back to Wal-Mart East.[16] The result of this circular process was that Wal-Mart turned rental payments into tax deductible expenses, despite the fact that the money never left the company.[17]

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[9] *In the Matter of the Protest of Wal-Mart Stores, Inc. (Successor to WMR, Inc.)*, Decision and Order ¶78 (May 1, 2006) ID No. 02-344332-00 4.
[10] Jason Trenkle. "State says Wal-Mart must pay NM's corporate income tax." *New Mexico Business Weekly*. May 21, 2006. See also: *In the Matter of the Protest of Wal-Mart Stores, Inc. (Successor to WMR, Inc.)*, Decision and Order (May 1, 2006) ID No. 02-344332-00 4.
[11] Alan Sayre. "States take aim at 'Geoffrey' tax loophole." *USA Today*. June 24, 2004.
[12] State of New Mexico Taxation and Revenue Department Press Release: "Wal-Mart Corporate Income Tax Assessment Upheld," May 3, 2006.
[13] Id. at ¶15.
[14] Id.
[15] *Wal-Mart Stores East, Inc. v. Reginald S. Hinton, Secretary of Revenue of the State of North Carolina*, Attachment to Order on Summary Judgment ¶14 (December 31, 2007) Case No. 06-CVS-3928.
[16] Id. at ¶17.
[17] Jesse Drucker. "States move to close tax shelter that benefits Wal-Mart, others." *The Wall Street Journal*. March 7, 2007.

THE ROLE OF ERNST & YOUNG

According to *The Wall Street Journal*, Ernst & Young began early on targeting banks for use of the REIT structure. In its internal sales training manuals, Ernst & Young explicitly tagged the scheme as a method to reduce taxes.[18] As part of its sales packages, Ernst & Young included hypothetical question and answer exchanges with clients regarding REITs, was very candid with its answers:

> *"Q: What's the business purpose?*
> *"A: Reduction in state and local taxes.*
> *"Q: What if the press gets wind of this and portrays us as a 'tax cheat'?*
> *"A: That's a possibility…If you are concerned about possible negative publicity, you can counter it by reinvesting the savings in the community."*[19]

Illustrating this point, Wal-Mart Vice President David Bullington testified in *Hinton* that during the process leading up to the restructuring, he expected 10 years of "audit activity, litigation, whatever" from the strategies that resulted in the restructuring.[20]

In 1997, Ernst & Young sent a detailed 25-page memorandum to David Bullington outlining the likelihood of state taxation of REITs. The memo informed Wal-Mart that the income tax laws of many states do not specifically address the taxation of REITs, and that REITs are generally accorded favorable state income and franchise tax treatment.[21] The memorandum points out that many states may reallocate income pursuant to state statutes embodying the authority granted to the IRS under Internal Revenue Code § 482, which often provide state revenue commissioners with discretionary abilities including the ability to disallow all or a portion of expenses paid to related parties and the ability to attribute income.[22]

Ernst & Young assures Wal-Mart, however, that charges for rent (such as the rent paid to Wal-Mart REIT) would not be considered an arbitrary shifting of income as long as Wal-Mart could express viable business reasons for the transactions.[23] In analyzing forced combinations by non-unitary states, Ernst & Young again points out to Wal-Mart that many non-unitary states have the statutory ability to combine affiliates, but these powers have seldom been used – and in any event, Wal-Mart would be able to express numerous business and legal reasons for the reorganizations and resultant inter-company transactions.[24]

Once Ernst & Young quashed for Wal-Mart the notion that a non-unitary state would be willing to combine their returns with those of its subsidiaries, it presented a state-by-state analysis of whether the REIT format would be successful, including an analysis of various states (Virginia's is reproduced below) found in its 25-page memo to David Bullington.[25]

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[18] Jesse Drucker. "Wal-Mart cuts taxes by paying rent to itself." *The Wall Street Journal*. February 1, 2007.
[19] Id.
[20] Deposition of David Bullington, July 20, 2007, p. 49.
[21] Memorandum from Ernst & Young LLP Project Team to David Bullington, March 25, 1997, p. 1.
[22] Id. at p. 3.
[23] Id. at p. 4.
[24] Id. at p. 8.
[25] Id. at p. 24.

Virginia

Conclusion: *The REITs should be accorded a dividend paid deduction. The REIT shareholders should not be subject to tax on the dividend income.*

REIT: *The REITs' income should not be taxed to the extent dividends are distributed to REIT shareholders.*

VA Sec. 58.1-402(A) and VA Reg. Sec. 630-3-402(1)(B)(2) specifically address the taxation of REITs. Under these provisions, a REIT's Virginia taxable income equals REIT federal taxable income plus any amount of capital gains, and any other income taxable to the corporation under federal law, except for the state modifications in subsections (B)-(D). IRC Secs. 857(b)(3), 857 (b)(4) and 857(b)(6). Since there are no state modifications which would negate the federal dividends-paid deduction, the REITs should be accorded a dividend-paid deduction. VA Sec. 58-1-402(A) and VA Reg. Sec. 630-3-402. Virginia draws no distinction between REITs organized as corporations or business trusts.

REIT Shareholder: *The REIT shareholders should not be subject to taxation on the REIT dividend due to the Virginia dividend received deduction.*

A separate Virginia "dividend received" deduction exists for dividends received from fifty percent or more owned subsidiaries. VA Sec. 58.1-402(C)(1); and VA Reg. Sec. 630-3-402.6(C)(10). Thus, the REIT shareholders should not be subject to tax on dividend income.

It is clear from company documents that Ernst & Young did not want to advertise the reorganization to state authorities or media, including in a memo to Wal-Mart's tax team:

> *We don't think there is much the state taxing authorities can do to mitigate those savings to Wal-Mart, however some states might attempt something if they had advance notification. We think the best course of action is to keep the project relatively quiet.* [26]

Meanwhile, through the deposition testimony of Wal-Mart Vice President David Bullington, one sees Wal-Mart trying desperately to articulate business reasons for its restructuring apart from state tax savings. These include centralizing payroll, licensing and real estate functions, creating an organizational structure that better represents the way management wants to manage its business, and protecting Wal-Mart officers, directors and shareholders from the expense and burdens of litigation arising from the ownership of real estate.[27] Yet in that same testimony, Bullington is quoted as saying: "No studies have been conducted by the company [Wal-mart] subsequent to the reorganization to quantify the consequences of the reorganization."[28]

Bullington is saying that a major corporation – in fact, the largest retailer in the world – underwent a massive reorganization with specified "business purposes" including centralization of payroll/licensing/real estate, creation of a uniform system of charging stores everything from rent to management fees to interest at real levels, and creating a more representational organizational structure. Yet, not once did that corporation undertake any study or create any report to quantify whether the reorganization was achieving its intended results. That, we argue, is because the

[26] Memorandum from Ernst & Young to Wal-Mart Stores, Inc. regarding "Wal-Mart State Tax Project." April 30, 1996.
[27] Second Affidavit of David Bullington, September 7, 2007, p. 11.
[28] Id.

sole purpose behind the reorganization and the "captive REIT" structure is to avoid paying state taxes.

THE NORTH CAROLINA ASSESSMENT AND COURT DECISION

On April 2, 2002, the North Carolina Department of Revenue began an audit of Wal-Mart and its subsidiaries.[29] Then, on May 2, 2005, North Carolina officially requested that Wal-Mart file combined returns for the four years at issue in the audit (1999-2002) resulting in an assessment of over $33 million which Wal-Mart paid.[30]

Wal-Mart then sued in North Carolina Superior Court, but the Department of Revenue in *Wal-Mart Stores East v. Hinton* successfully defended the assessment, arguing effectively that 1) Wal-Mart's North Carolina income tax returns did not disclose their "true" earnings for the period at issue in the case; 2) that the method of accounting used by Wal-Mart did not clearly reflect its income; and 3) that Wal-Mart conducted its business in such a way as to distort its "true net" income and the net income that should be attributed to North Carolina.[31] *See also*: N.C. Gen. Stat. § 105-130.6; G.S. § 105-130.15; and G.S. § 105-130.16.
The court in *Wal-Mart Stores East v. Hinton* determined through review of transactions between Wal-Mart subsidiaries that tax forms filed by Wal-Mart East did not disclose the true earnings of Wal-Mart East on its business carried on in the State of North Carolina.[32] It determined this through examination of the payment of rent from Wal-Mart East to Wal-Mart REIT, for which it took a rent expense deduction; the payment by Wal-Mart REIT to its parent Wal-Mart Property Company of this rent income in the form of dividends; and the payment by Wal-Mart Property Company of that dividend to its parent, Wal-Mart Stores East – as a result of these and other transactions, the report filed by Wal-Mart East did not disclose the true earnings of Wal-Mart East on its business carried on in the State of North Carolina.[33]

Superior Court Judge Clarence E. Horton Jr. wrote in his order that Wal-Mart's structure had no "real economic substance" other than cutting taxes.[34] In his order, he wrote:[35]

> *There is no evidence that the rent transaction, taken as a whole, has any real economic substance apart from its beneficial effect on plaintiffs' North Carolina tax liability. It is particularly difficult for the court to conclude that rents were actually 'paid,' when they are subsequently returned to the payor corporation.*

As Judge Horton in *Hinton* noted, following Wal-Mart's restructuring, the creation of Wal-Mart East, Wal-Mart Property Company and Wal-Mart REIT, and the transfer of property, all individual store accounts remained in the name of parent company Wal-Mart Stores, Inc.[36] Judge Horton wrote:[37]

> *Wal-Mart Stores Inc. managed all "cash" for Wal-Mart East, the Wal-Mart REIT, and the Wal-Mart Property Company through a cash management agreement. Wal-Mart*

[29] *Wal-Mart Stores East, Inc. v. Reginald S. Hinton, Secretary of Revenue of the State of North Carolina*, Attachment to Order on Summary Judgment ¶5 (December 31, 2007) Case No. 06-CVS-3928.
[30] *Wal-Mart Stores East, Inc. v. Reginald S. Hinton, Secretary of Revenue of the State of North Carolina*, Attachment to Order on Summary Judgment ¶6 (December 31, 2007) Case No. 06-CVS-3928.
[31] *Wal-Mart Stores East, Inc. v. Reginald S. Hinton, Secretary of Revenue of the State of North Carolina*, Attachment to Order on Summary Judgment ¶9 (December 31, 2007) Case No. 06-CVS-3928.
[32] *Wal-Mart Stores East, Inc. v. Reginald S. Hinton, Secretary of Revenue of the State of North Carolina*, Attachment to Order on Summary Judgment ¶11 (December 31, 2007) Case No. 06-CVS-3928.
[33] *Wal-Mart Stores East, Inc. v. Reginald S. Hinton, Secretary of Revenue of the State of North Carolina*, Attachment to Order on Summary Judgment ¶11 (December 31, 2007) Case No. 06-CVS-3928.
[34] Jesse Drucker. "Judge rules against Wal-Mart over its tax-shelter dispute." *The Wall Street Journal*. January 5, 2008.
[35] *Wal-Mart Stores East, Inc. v. Reginald S. Hinton, Secretary of Revenue of the State of North Carolina*, Attachment to Order on Summary Judgment ¶M (December 31, 2007) Case No. 06-CVS-3928.
[36] Id. at ¶19.
[37] Id.

East, the Wal-Mart REIT, and the Wal-Mart Property Company had bank accounts that were used exclusively for payment of dividends, and the daily deposits were "swept into" the accounts of Wal-Mart Stores Inc. Neither the REIT nor the Property Company has ever had any employees.

In *Hinton,* the court determined Wal-Mart's mid-90s restructuring was nothing more than a method of transferring money within the company to avoid paying state taxes. Wal-Mart will likely appeal the ruling. Strengthening that argument, an affidavit filed in North Carolina by former Wal-Mart controller James A. Walker Jr. stated that payments were made by simply debiting the account of one subsidiary and crediting the account of another – Wal-Mart basically served as a bank for both sides.[38]

THE WISCONSIN ASSESSMENT

The Wisconsin Department of Revenue completed an audit and assessment of Wal-Mart with issues similar to those being litigated in North Carolina. The State claimed Wal-Mart's methods for paying rent on its 87 Wisconsin properties were an "abuse and distortion of income."[39] The Revenue Department alleges that Wal-Mart owes nearly $18 million in back corporate income taxes, interest and penalties for 1998 through 2000.[40]

Wisconsin became a focus of Wal-Mart's use of tax strategies not long after the issue began making headlines in North Carolina. Nearly four months before the Revenue Department's assessment became public, the Milwaukee-based Institute for Wisconsin's Future made a curious discovery. Using documents that are public in Wisconsin, records showed that Wal-Mart had taken home to Arkansas approximately $852 million in net profits between the years 2000 and 2003.[41] Meanwhile, over that same time period, Wal-Mart had paid only $3 million in corporate income tax – far below what the State's 7.9% corporate income tax rate would suggest the company owed.[42] Simple math shows that Wal-Mart could have owed up to $67 million in taxes for those years or $64 million more than it actually paid.

In June of 2002, the Wisconsin Department of Revenue sent a Notice of Field Audit Action to Wal-Mart, notifying the company that it owed over $14 million in franchise taxes, interest and penalties for period beginning February 1, 1997 and ending January 31, 2000.[43] The Department listed the principal reason behind the assessment as the following:[44]

The principal cause for the increase in tax is due to the disallowance of the Dividend Received Deduction claimed on dividends received directly or indirectly from a related Real Estate Investment Trust (REIT), having nexus in Wisconsin; and certain adjustments to the apportionment factors.

The Revenue Department sent a similar notice regarding Sam's Club, assessing an additional $3.4 million for Sam's Club's activities within the state. Wal-Mart petitioned the Department to have the assessments "redetermined" which Wisconsin denied. Wal-Mart filed an appeal on June 12, 2007, and the case remains with the Wisconsin Tax Appeals Commission at this time.[45]

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[38] Drucker. "Wal-Mart cuts taxes by paying rent to itself." *The Wall Street Journal*. February 1, 2007.
[39] Steve Walters and Avrum D. Lank. "Wal-Mart owes back taxes, state says." *Milwaukee JournalSentinel*. August 25, 2007.
[40] Id.
[41] Mike Ivey. "Wal-Mart: The Low Tax Leader, Always." *The Capital Times*. April 24, 2007.
[42] Mike Ivey. "Wal-Mart: The Low Tax Leader, Always." *The Capital Times*. April 24, 2007.
[43] State of Wisconsin Department of Revenue. "Notice of Field Audit Action" and "Computation and Summary of Additional Franchise Tax, Interest & Penalty." June 28, 2002.
[44] Id.
[45] *Wal-Mart Stores East, Inc. v. Wisconsin Department of Revenue*. Petition for Review, filed June 12, 2007. Wisconsin Tax Appeals Commission Docket No. 07-1-128.

Bear in mind these earlier quotes:

- In New Mexico, the tax hearing officer wrote: "the trademark holding company was created "for the primary purpose of reducing state income taxes for Wal-Mart."[46]
- In North Carolina, Judge Horton in his opinion wrote: "There is no evidence that the rent transaction, taken as a whole, has any real economic substance apart from its beneficial effect on plaintiffs' North Carolina tax liability."[47]

In its response to Wal-Mart's Petition for Review to the Tax Appeals Commission, the Wisconsin Department of Revenue lays out similar arguments, at the center of which is the circular flow of funds, including Wal-Mart's Wisconsin income, that escapes Wisconsin taxation.[48] More specifically, the arguments point out the Wisconsin income was in fact taxed by no state, and that the Department's disallowance of the dividend deduction was necessary "to correct Wal-Mart's abuse and distortion of income, which is plainly intended for no purpose other than tax avoidance."[49]

Wal-Mart's appeal remains with the Wisconsin Tax Appeals Commission, where a telephone status conference was scheduled to be held for April 17, 2007.

THE ILLINOIS ASSESSMENT

On March 5, 2007, the Illinois Department of Revenue issued a Notice of Deficiency to Wal-Mart, assessing corporate income and replacement taxes in the amount of nearly $21 million dollars, plus interest and penalties of an additional $5.5 million.[50] In December 2001 in Turin, Italy, Wal-Mart opened a small office thousands of miles and one ocean away from its headquarters in Bentonville, Arkansas.[51] This tiny overseas office, WMGS Services, LLC, helped Wal-Mart cut millions from its state tax bill each year.

Wal-Mart set it up so that the Italian subsidiary is the only operating unit of a real-estate subsidiary that controls billions of dollars of the retailer's property in Illinois and other states – since technically its only employees are based in Italy, the real-estate unit claims its operations are foreign, and therefore are exempt from Illinois corporate income taxes.[52] WMGS is what is referred to as an 80/20 company, domestic subsidiaries that conduct at least 80 percent of their business overseas.[53] States typically do not tax income from outside the United States; for example, Illinois requires the use of the combined apportionment method when two or more persons (or a corporation and its subsidiaries) are engaged in a unitary business, however, Illinois's 80/20 rule was an exception to the combined apportionment requirement, as upheld in Zebra Techs Corp. v. Topinka, 344 Ill. App. 3d. 474, decided in 2003.[54] Under the 80/20 rule, foreign 80/20 subsidiaries were excluded from the unitary group.[55]

Since Illinois is a combined reporting state – which would require Wal-Mart to include any income of the REIT and of Wal-Mart Property Company on its Illinois return – the transaction cycle used in North Carolina and Wisconsin to evade taxes would not work. To get around this, Wal-Mart

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[46] State of New Mexico Taxation and Revenue Department Press Release: "Wal-Mart Corporate Income Tax Assessment Upheld," May 3, 2006.
[47] *Wal-Mart Stores East, Inc. v. Reginald S. Hinton, Secretary of Revenue of the State of North Carolina*, Attachment to Order on Summary Judgment ¶M (December 31, 2007) Case No. 06-CVS-3928.
[48] *Wal-Mart Stores East, Inc. v. Wisconsin Department of Revenue*. Answer to Petitioner's Petition for Review, filed July 19, 2007. Wisconsin Tax Appeals Commission Docket No. 07-1-128.
[49] Id.
[50] First Amended Complaint, *Wal-Mart Stores, Inc. v. Hamer*.
[51] Jesse Drucker. "Why Wal-Mart set up shop in Italy." *The Wall Street Journal*. November 14, 2007.
[52] Id..
[53] Id..
[54] 35 ILC 5/304(e).
[55] 35 ILCS 5/1501(a)(27).

created WMGS, a wholly-owned subsidiary of Wal-Mart Property Company, whose offices were built in Italy. Wal-Mart claimed that this Italian office, by virtue of becoming the only operating unit of Wal-Mart Property Company, converted Wal-Mart Property Company into an 80/20 company.[56] This meant that all that money Wal-Mart paid in rent to its REIT, which was then sent to Wal-Mart Property Company as a quarterly dividend, would not have to be included on Wal-Mart's Illinois state tax return under the 80/20 rule.

The loophole has since been closed by legislation appearing to originate out of the Illinois Governor's 2005 Fiscal Budget Proposal, which negated the combined reporting exception for foreign 80/20 companies.[57] The Illinois State Comptroller's Office explained:[58]

> *In Illinois, combined reporting is required for businesses related by common ownership and having integrated business activities (a "unitary business group"). However, under the waters' edge method of reporting, members of the unitary business group whose business activities are primarily outside the U.S. are not combined when apportioning income to Illinois. This provides an opportunity to avoid taxes by shifting income to the foreign members of the group. Under the new legislation, interest and intangible expenses and costs paid to foreign-based operations of a unitary business group are no longer automatically deducted from adjusted gross income.*

After receiving its Notice of Deficiency in March 2007, Wal-Mart paid the $26.4 million assessment while simultaneously filing a Notice of Payment Under Protest.[59] Wal-Mart has since filed a Complaint for Preliminary and Permanent Injunction and for Declaratory Relief in Illinois Circuit Court on May 23, 2007, and filed its First Amended Complaint for the same relief on November 21, 2007. The case remains in Circuit Court for the Seventh Judicial Circuit of Illinois, in Springfield.

Brian Hamer, the Director of the Illinois Department of Revenue, has called Wal-Mart's misuse of the 80/20 company "shocking to the conscience," admitting that "these kind of manipulations clearly were never contemplated by the state legislatures…It ought to have been clear to businesses that this was highly questionable conduct."[60]

CAPTIVE EMPLOYEE LEASING COMPANIES

An additional scheme for future investigation involves what are referred to as captive employee leasing companies. These can be used both as a way of shifting income out-of-state (as with intangibles holding companies) and as a way of minimizing unemployment compensation taxes.

As an example, the Economic Policy Institute and the Massachusetts Budget & Policy Center recently released a report analyzing various tax avoidance schemes, one of which was a case involving a major publicly-traded corporation that was paying most of its employees through a separate affiliated corporation that leased employees back to the primary corporation. The report described the matter as follows:

> *Under separate company filing, each corporation determines its own income and, if doing business in multiple states, apportions the income to Massachusetts based on the percentage of the company's property, payroll, and sales that are in the state.*

[56] Jesse Drucker. "Why Wal-Mart set up shop in Italy." *The Wall Street Journal*. November 14, 2007.
[57] 35 ILC 5/203(b)(E-13).
[58] Need the citation from Basev's email – 3/28/2008.
[59] Wal-Mart Stores, Inc. letter to Illinois Department of Revenue, Notice Section, Re: Payment Under Protest. April 30, 2007.
[60] Jesse Drucker. "Why Wal-Mart set up shop in Italy." *The Wall Street Journal*. November 14, 2007.

This means that if the percentage of the individual company's Massachusetts employees is reduced, the company pays less tax to the Commonwealth. In a recent case, a major publicly-traded corporation paid most of the employees through a separate affiliated corporation that "leased" the employees to the operating entity. The employees then performed services for the operating entity, but were not included in the operating company's payroll for apportionment purposes. The Department recently settled this matter, receiving payment from the taxpayer for $37 million.[61]

Wal-Mart, in 1996, incorporated in Delaware its own 100%-owned subsidiary called Wal-Mart Associates, Inc. to house its employees. It was determined that on December 31, 1996, all Wal-Mart employees (except for those at the London, Kentucky distribution center) would be transferred from the parent company to Wal-Mart Associates.[62] The bank account used as Wal-Mart's payroll account was placed in the name of Wal-Mart Associates, and Wal-Mart Associates' Federal ID number was placed on the account.[63] All W-2s sent out to employees read "Wal-Mart Associates, Inc." and carried Wal-Mart Associates' Federal ID number.[64]

It remains to be seen whether states will begin to investigate the possibility that Wal-Mart Associates is in fact a captive employee leasing company, one that could be used as an additional tax-avoidance measure in non-combined reporting states.

CONCLUSION

The end result of Wal-Mart's mid-90s restructuring promoted by Ernst & Young is that Wal-Mart has cost states millions of dollars in revenue by paying rent to itself, and then deducting that rent from its state tax bills.

Wal-Mart should pay its fair share of the tax dollars that support public schools, police and fire departments, and the public highways used to transport its merchandise from distribution centers to its stores across the country. The company must be stopped from shifting its burden onto small businesses and individual taxpayers simply because it has the resources and expensive tax advisors who have instructed them in how to do so.

Over time, Wal-Mart has pursued and utilized new tax avoidance strategies as states more aggressively take the company to task for its current ones. One can only imagine the multitude of tax avoidance strategies still being used, not yet uncovered by state revenue departments or the media.

The current state of the economy and budget crises in states around the country provide an incentive for states to close these corporate tax loopholes, examine Wal-Mart's tax strategies in their respective states and ensure Wal-Mart pays its fair share of taxes.

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[61] Robert Lynch, William Schweke, Nicholas Jenny, Noah Berger. "Building a Strong Economy: The Evidence on Combined Reporting, Public Investments, and Economic Growth." Economic Policy Institute; Massachusetts Budget & Policy Center.

[62] Wal-Mart Resolution Regarding Domestic Restructuring – Wal-Mart Plan of Restructuring. Passed by Wal-Mart Board, November 14, 1996.

[63] Letter from John D. Bax (Ernst & Young) to David Bullington (Wal-Mart) regarding Cash Management, from the Wal-Mart Domestic Restructuring File. December 4, 1996.

[64] Id.

APPENDIX

How Captive REITs Work
Wal-Mart's corporate tax structure is obviously complex - and that's how the company wants it. The chart below helps illustrate the different parties involved in a REIT strategy. The fact that all parties are owned by Wal-Mart raises questions about legality of this concept.