April, 2007
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TAX & BUDGET BRIEF

Combined Reporting:
A Solution to Corporate Tax Shelters in Kentucky

On February 1st of this year the *Wall Street Journal* broke a story about how Wal-Mart takes advantage of state tax reporting requirements to reduce its state corporate income tax payments.[1] Experts hired by the paper estimated that over a four year period, Wal-Mart reduced its state corporate income taxes by roughly $350 million. The mechanism through which Wal-Mart accomplished this feat involved setting up real estate investment trusts (REITs) owned by Wal-Mart and its subsidiaries. These so-called "captive REITs" owned Wal-Mart's store properties and charged rent to the Wal-Mart subsidiaries that operated the stores. While the Wal-Mart subsidiary was able to deduct the rent expense from its tax bill, the Wal-Mart REIT was able to collect rent income essentially tax-free.

The revelation that Wal-Mart has aggressively exploited such loopholes in roughly 25 states to reduce or eliminate its corporate taxes has refocused state policymakers on the ability of corporations to leverage complex legal structures to exploit tax laws to shift income and expenses to limit their state tax exposure. In the wake of the *Wall Street Journal* report, California, Connecticut, Maryland, Massachusetts, New York, and Louisiana have all passed or are considering legislation to eliminate the tax benefits of this practice.[2]

In the 2007 Regular Session, Kentucky also addressed the use of captive REITs by Wal-Mart and others. Governor Fletcher recently signed into law a provision that would eliminate the dividends-paid deduction for captive REITs, the mechanism by which these REITs escape Kentucky income taxes.[3]

The law eliminates these deductions beginning in 2007. However, it appears that Wal-Mart has been able to reduce its Kentucky taxes by tens of millions of dollars since the late 1990s through the use of captive REITs.

This particular case demonstrates how large multistate corporations can avoid paying millions of dollars in Kentucky income taxes before a loophole in the tax code can be addressed. Furthermore, even if this particular tax avoidance strategy has now been blocked, large corporations operating in Kentucky can continue to shield sizable amounts of income from taxation through other loopholes.

This report will discuss the strategies used by large corporations to escape state income taxation, using the captive REIT strategy employed by Wal-Mart as an illustrative example. It will also discuss the benefits of "combined reporting" a tax reporting approach mandated in twenty states that eliminates the tax sheltering abilities not only of captive REITs but of a number of similar methods large corporations employ to escape taxation.

Across State Lines: Using Complex Corporate Structures to Avoid Taxation

There are a number of ways in which large corporations can hide income from state corporate income taxation. Many rely on establishing subsidiary corporations and trusts in jurisdictions where corporate income taxes are low or where certain transactions are either untaxed or result in deductible expenses that can lower the corporation's income tax bill.

Once the appropriate subsidiaries are set up, the goal of the corporation is to recast typical business transactions in such a way that taxable income is recorded in subsidiaries that are untaxed or taxed at a low rate while expenses that reduce taxable income are recorded in subsidiaries that are taxed at a higher rate. Some examples that corporations have used in the past or are using today[4]:

- ***Intangible Asset Spin-Offs*** – This particular strategy is frequently used by banks and other financial intermediaries. The assets of the bank (typically loans and financial investments) are housed in a subsidiary. While the bank is incorporated in the state where its depositors are, the spin-off would be domiciled in a state either with no income tax or where "passive income" such as interest is untaxed. The interest payments and other earnings on these investments would result in tax-free income to the spin-off while the bank gets to deduct its expenses from its state income tax. The spin-off then either pays a tax-free dividend back to the bank or "loans" money back to the bank (the interest on which is also deductible).

- ***Passive Investment Companies (PICs)*** – These are similar to intangible asset spin-offs but can be used by non-financial commercial entities. Instead of housing financial investments in and out of a state subsidiary, intangible assets (typically intellectual property such as patents and trademarks) are transferred to a subsidiary known as a passive investment company or PIC. The corporation's subsidiaries operating in states subject to income tax enter into a license with the PIC whereby these subsidiaries get to use the intellectual property in exchange for royalty payments. As with the interest payments to the spin-off, the royalty income to the PIC is considered passive income and is untaxed while its other subsidiaries pay lower taxes after deducting royalty expenses paid to its sister company.

- ***Isolated Nexus*** – Nexus refers to a link between an entity and the state that must be established in order for the state to levy taxes on the entity. Large multistate corporations may attempt to avoid taxation by establishing multiple subsidiaries with the goal of either avoiding state nexus requirements or dividing the company's operations in such a way that the more profitable operations are housed within subsidiaries paying low state taxes with only minimal or unprofitable operations housed within subsidiaries paying higher taxes.

- ***Transfer Pricing*** – Large corporations may often conduct transactions with itself, such as an automobile corporation with an in-house machining subsidiary that sells parts to an assembly subsidiary. These transactions aren't subject to market pricing, but in order to record the transaction on the books of each subsidiary, a price must be determined. Corporations attempting to avoid state taxation will often inflate the price to artificially high levels when the selling subsidiary is in a state with low taxation or the purchasing subsidiary is in a high-tax state. Alternatively, the transfer price might be suppressed in order to minimize the income of selling subsidiaries in states with higher income taxes and minimize the cost to purchasing subsidiaries in states with lower income taxes.

A Closer Look: the Captive REIT

The captive REIT strategy is similar to the PIC, except that the assets being held are not intangible, but instead are physical properties. The strategy has worked because of tax advantages allowed to REITs and because some states treat rent payments for the use of those properties as untaxed passive income. A look at Wal-Mart's use of REITs provides further detail on the scope and operations of these tax sheltering strategies.

In his *Wall Street Journal* article, reporter Jesse Drucker demonstrates, through information received from sources and the review of court filings, how Wal-Mart's captive REIT strategy works. Wal-Mart operates over 4,000 facilities in the United States.[5] Many of these facilities are owned by REITs that are Wal-Mart subsidiaries. The operation of Wal-Mart's stores is conducted by a separate Wal-Mart subsidiary. While they have common ownership, the REIT charges the store operations subsidiary "rent" for its use of the property. No money changes hands however. The rent payment is merely recorded on the books of each subsidiary. The rent charged to the store operations subsidiary is deductible as a business expense for that subsidiary. However, the rent also appears as revenue on the financial statements of the REIT, and would therefore be taxable in theory.

To avoid this taxation, however, Wal-Mart's REITs are domiciled in states with favorable income tax laws. For example, Wal-Mart operates at least one REIT in Delaware, a state that does not tax passive income, including rent.[6] Additionally, the REIT pays out its profits to yet another Wal-Mart subsidiary in the form of dividends. The payment and receipt of these dividends are also shielded from taxation. Under federal and many state laws, REITs are not subject to corporate income tax as long as they pay out at least 90% of their profits as dividends and parent companies do not pay taxes on dividends they receive from their subsidiaries. By taking advantage of these laws, when Wal-Mart engages in an intercompany rent payment transaction it can fully deduct the "payment" portion of the transaction as an expense, but largely avoid paying taxes on the revenue generated by the "receipt" portion of the transaction.

Based on an extrapolation of the analysis performed by the *Wall Street Journal,* it would appear that Wal-Mart, solely through the use of captive REITs, has been able to reduce its corporate income tax payments to Kentucky by between $17 million and $25 million since 1998.[7] The total historical tax losses in Kentucky from captive REITs is undoubtedly higher as other retail and financial institutions are known or suspected of using captive REITs. An analysis performed by Kentucky's Legislative Research Commission suggested that by eliminating the deductibility of dividend payments by captive REITs, Kentucky will now be able to generate an additional $20 million or more per year in corporate income tax revenues.[8]

HB 258, which just passed at the end of the 2007 Regular Session, eliminates the deductibility of dividends paid by captive real estate investment trusts. The bill defines a REIT as captive if it meets the following requirements:

- Is not publicly traded;
- Is at least 25% owned by a corporation or at least 10% owned by a corporation that occupies property owned by the REIT; and
- Is not owned by another REIT.

By paying out essentially all of its income in the form of dividends to the parent corporation, captive REITs were able to escape or severely limit the taxes resulting from the rent payments they received. By eliminating the deductibility of the dividend payments, it is believed that captive REIT income would become taxable.

As HB 258 has just been signed into law, it is not yet clear whether it will have the intended result of taxing the income of captive REITs or whether large corporations will be able to find new ways to bypass the law, perhaps by establishing

REITs that operate in the same manner as Wal-Mart's captive REITs but do not meet the definition of "captive" under Kentucky law.

Regardless of how successful HB 258 will prove to be in closing the captive REIT loophole, this bill only attempts to close a single loophole. It does not address the other methods utilized by corporate groups to shift income away from taxation. Some states have realized that a more universal deterrent to corporate loopholes is needed and have mandated combined reporting for multistate corporations.

Ending Corporate Transfer Strategies: Combined Reporting

Under combined reporting all subsidiaries in the corporate group operating under a "unitary business" file a single tax return. As a result, a company would report the total revenues and expenses of all of its subsidiaries whether or not those specific subsidiaries operated in Kentucky or not. The total taxable income for the combined entity would then be apportioned to Kentucky based on some mechanism measuring the proportion of economic activity taking place in Kentucky (e.g. sales, payroll, property, etc.) as compared to other states.

The result of combined reporting is that since the entire corporate group is accountable to Kentucky for its operations, the use of transfer payments, PICs, captive REITs or other mechanisms to shift income or expenses between subsidiaries would be fruitless. Even if income were shifted to out-of-state subsidiaries, it would still be subject to Kentucky income tax.

Twenty states now mandate combined reporting with four having instituted combined reporting since 2004.[9] Mandating combined reporting in Kentucky would have two important benefits to our corporate tax policy. First, combined reporting would eliminate the inequity between large, multistate corporations and smaller Kentucky-based companies that either cannot establish subsidiaries with which to conduct tax-shielding transactions, or would find the legal and accounting costs to set up such a structure prohibitive. Combined reporting eliminates many of the tax benefits of these complex webs of interrelated companies, and thus eliminates one of the advantages large corporations have that their competitors do not.

The other advantage is additional revenues to fund programs throughout the state. Recent studies in other states have suggested that switching to combined reporting yields an additional 13 – 24% in corporate income tax receipts.[10] For Kentucky, this would mean an estimated annual increase in tax revenues of between $159 and $294 million.[11]

Conclusion

As the recent revelation about Wal-Mart has demonstrated, tax sheltering remains a lucrative pursuit for a number of America's largest corporations. The methods employed by corporations to shift income out of states with corporate income taxes have reduced these states' revenues by hundreds of millions of dollars. Other than tax avoidance, there is no obvious economic reason for the use of captive REITs, PICs, unrealistic transfer prices or the other mechanisms used by corporations to shield income.

By switching to combined reporting, Kentucky could not only even the playing field between Kentucky firms and their large multistate competitors but would potentially generate hundreds of millions of dollars of additional revenues each year.

Kentucky's 2005 tax reform was based on the proposition that the state's tax code needed to be modernized and that part of that modernization was to broaden the business tax base by closing available tax loopholes. It naturally follows that eliminating corporate tax shelters and recovering the millions of dollars in lost Kentucky revenue that has resulted should be a priority.

Kentucky Tax and Budget Initiative is part of the State Fiscal Analysis Initiative, a network of state level organizations working with the Center on Budget and Policy Priorities. These organizations focus on budget and tax policies through public education and the encouragement of civic engagement. Financial support for Kentucky Youth Advocates comes from the Annie E. Casey Foundation, the Open Society Institute and the Stoneman Family Foundation. The contents of this report are the sole responsibility of Kentucky Youth Advocates and do not necessarily reflect the opinions of any funder.

[1] Drucker, Jesse, "Wal-Mart Cuts Taxes by Paying Rent to Itself," *Wall Street Journal*, February 1, 2007.
[2] Scott, Matthew, "Wal-Mart Special: Tax Savings," *FinancialWeek*, February 17, 2007; Drucker, Jesse, "States Move to Close Tax Shelter That Benefits Wal-Mart, Others," *Wall Street Journal*, March 7, 2007.
[3] HB 258, 2007 Regular Session.
[4] Mazerov, Michael, "Combined Reporting: The Key to a Robust and Fair State Corporate Income Tax in West Virginia", Presentation to West Virginia Joint Committee on Finance, December 11, 2006.
[5] Walmartfacts.com. Accessed April 2007.
[6] Scott, Matthew, "Wal-Mart Special: Tax Savings," *FinancialWeek*, February 17, 2007
[7] Analysis performed by KYA based on Wall Street Journal analysis, Wal-Mart state income tax payments, 1998 – 2006, Wal-Mart Kentucky tax payments and the number of stores operating in Kentucky and nationally.
[8] Fiscal note to House bill 479, 2007 Regular Session. While HB 479 did not pass, its language, with some minor changes was included as an amendment to HB 258. The fiscal note to HB 258 declares the bill to be revenue neutral but recognizes that the elimination of dividend deductibility would be a revenue generator while other provisions of the bill unrelated to captive REITs would have a negative impact on revenues.
[9] Mazerov, Michael, "Growing Number of States Considering a Key Corporate Tax Reform", Center on Budget and Policy Priorities, April 5, 2007.
[10] Mazerov, Michael, "Combined Reporting: The Key to a Robust and Fair State Corporate Income Tax in West Virginia", Presentation to West Virginia Joint Committee on Finance, December 11, 2006.
[11] Figures based on state corporate income tax receipts per Office of State Budget Director.

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