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Kentucky's Budgetary Exposure to Captive REIT Strategies

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 accomplishes this feat involves multiple subsidiary companies that conduct transactions with one another, the purpose of which is to minimize taxes to the greatest extent possible.

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 Kentucky, however, the response to Wal-Mart's use of captive REITs to avoid state income taxes has been fairly subdued. Is Kentucky, which passed a tax modernization package just two years ago, vulnerable to the types of aggressive tax sheltering strategies employed by Wal-Mart and others? What is the impact on the state budget? And what can be done to close these loopholes?

Understanding Captive REITs

In his February 1st article, *Wall Street Journal* 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.³ Many of these facilities are owned by REITs ("real estate investment trusts") 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. 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 so-called "passive income" such as rent.⁴ 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 to 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.

What about Kentucky's Tax Modernization?

In 2005, Kentucky passed a tax reform package advocated by Governor Ernie Fletcher. The plan, named *JOBS for Kentucky*, included a number of measures ostensibly designed to improve the state's business climate while remaining revenue-neutral.⁵ The major elements of the package included an increase in tobacco and alcohol taxes, a reduction in individual income taxes, the elimination of the corporation license tax and the institution of an alternative minimum calculation for corporate taxpayers.

The package also proposed to close a number of business loopholes by changing the statutes governing the determination of taxable activity, filing requirements and tax calculations while disallowing certain deductions including "commercially unreasonable" related party transactions. However, none of these loophole closures appear to address the captive REIT strategy employed by Wal-Mart and others.

Fiscal Impact of Captive REITs

Wal-Mart is the world's largest retailer, and the impact of its use of the captive REIT strategy is sizable. While it would be illuminating to view the corporate tax filings of Wal-Mart and other large retailers – and there has been an increasing call for allowing this in the wake of eroding state corporate income tax inflows⁶ -- such information is not public record. Nevertheless, it may be possible in the case of

Wal-Mart to arrive at a rough estimate of the tax revenues lost through its use of a captive REIT strategy.

Accounting experts engaged by the *Wall Street Journal* reviewed information made available in court filings regarding the scope of Wal-Mart's captive REIT strategy between 1998 and 2001.⁷ These experts estimated that the captive REIT strategy by itself reduced Wal-Mart's state taxes by 20% between the years 1998 and 2001. Wal-Mart claims to have paid more than \$40.4 million in state and local taxes in Kentucky during its fiscal year 2007.⁸ A review of Wal-Mart's financial statements suggests that roughly 25% of its state and local taxes come in the form of income taxes. Applying the Wall Street Journal estimate to Wal-Mart's reported tax payments suggests that through its use of captive REITs, Wal-Mart was able to shelter over \$3 million in tax revenues for its fiscal year 2007. Applying this result to prior years, Wal-Mart's total Kentucky tax avoidance may have exceeded \$20 million over the years 1998 – 2007.

A second method of estimating this impact yields an even higher figure. The *Wall Street Journal's* experts estimated the total loss of state tax revenues due to Wal-Mart's captive REIT strategy at \$350 million between 1998 and 2001. Since Kentucky is home to a little more than 2% of Wal-Mart's domestic stores, applying this percentage to the experts' estimate suggests that Kentucky lost roughly \$9 million per year over the four-year period surveyed due to Wal-Mart's captive REIT strategy.

The tax loss for more recent years would likely be larger due to sales and store growth in the state. In fact, Wal-Mart's fiscal year 2007 state and local income taxes are nearly three times what they were in 1998. Assuming this is a reasonable proxy⁹ for the growth in the scope of Wal-Mart's rent payments to captive REITs in Kentucky during this period, the resulting taxes avoided by Wal-Mart would total nearly \$30 million since 1998, including \$4 million in Wal-Mart's latest fiscal year.

Clearly these estimates are rough, especially since the *Wall Street Journal* estimate is based on data more than five years old. Nevertheless, it is clear that Wal-Mart has been able to reduce its Kentucky tax payments significantly through its use of captive REITs. Furthermore, looking solely at Wal-Mart's use of captive REITs fails to take at the fuller picture of corporate tax shielding efforts.

While the current furor touched off by the February *Wall Street Journal* article has focused the attention of states on the captive REIT strategy and has quickly generated proposed reforms in some states, this is just one mechanism employed by companies to shift profits to jurisdictions or entities that will limit or avoid tax exposure. Similar, but fundamentally different mechanisms abound, whereby certain

key assets are legally held in subsidiaries subject to low taxes and/or transfer payments are made between interrelated entities in a way to maximize expenses in high tax jurisdictions.

Furthermore, Wal-Mart is not the sole user of captive REIT or other profit-shielding strategies. While it is the world's largest retailer, other retailers as well as banks, especially entities that must operate numerous physical locations in a variety of states, have utilized similar strategies for tax avoidance. The February 1st Wall Street Journal article identifies AmSouth Bancorp, AutoZone¹⁰ and Bank of America as other entities having used captive REITs to reduce state taxes.

Legislative Changes Required

In order to recoup the estimated \$3 to \$4 million per year Kentucky is losing to Wal-Mart through the use of its captive REIT strategy and the untold millions other corporations are able to shelter, changes are needed to Kentucky's tax code. As previously noted, other states have reacted quickly to the realization of the scope of Wal-Mart's use of captive REITs to avoid state taxes. The volume of tax revenues being lost in Kentucky to such strategies requires quick action to close the loopholes.

Two main methods of thwarting the captive REIT strategy appear to have emerged. The first is to disallow the deductibility of dividend payments from REITs to parent corporations under certain circumstances. This change should stop the tax-shielding properties of the captive REIT as the rent income received by the REIT would become fully taxable. In the 2007 General Assembly session, Representatives Carolyn Belcher and Harry Moberly introduced HB 479 that would define REITs as being "captive" if they met certain ownership provisions and would disallow the deductibility of dividend payments if those criteria were met. While the fiscal analysis performed by the Legislative Research Council on the bill suggested it would result in additional tax revenues of \$20 million or more per year, the bill did not make it out of committee.

While disallowing the deductibility of dividends has the virtue of being a fairly simple change in the tax code, it would address only the captive REIT loophole, not the other similar schemes 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. Under combined reporting all subsidiaries in the corporate group operating under a "unitary business" file a single tax return.

In the case of Wal-Mart, if Kentucky mandated combined corporate reporting, Wal-Mart 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, captive REITs or other mechanisms to shift income or expenses between subsidiaries would be fruitless. Recent studies in other states have suggested that switching to combined reporting yields an additional 13 – 24% in corporate income tax receipts.¹¹ For Kentucky, this would mean an estimated annual increase in tax revenues of between \$159 and \$294 million.¹²

Twenty states now mandate combined reporting with four having changed to combined reporting since 2004. While combined reporting would address a variety of tax-shielding mechanisms and not just captive REITs, it would also require a more fundamental change to Kentucky's corporate income tax. The benefits of this change would not only be the collection of millions of dollars of tax revenue hidden away by corporate loopholes, but an inherently fairer corporate tax system. Large multistate tax corporations would no longer have the competitive advantage of using tax sheltering methods unavailable to small and privately owned businesses.

Conclusion

As the recent revelation about Wal-Mart has highlighted, tax sheltering remains a lucrative pursuit for a number of America's largest corporations. The tax savings attributable to just one user of captive REITs – Wal-Mart – has reduced its state taxes by hundreds of millions of dollars. Other than tax avoidance, there is no obvious economic reason for the use of captive REITs.

It appears that Wal-Mart's captive REIT strategy is depriving Kentucky of roughly \$3 to \$4 million in tax revenues annually. While this figure by itself is significant, it must be appreciated that no matter how giant a corporation Wal-Mart is, it is not alone in exploiting state tax loopholes. The total impact of all corporations engaged not only in captive REITs but other means of moving income and expenses between subsidiaries to lower or eliminate taxes in Kentucky is incalculable.

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 the tax sheltering properties of captive REITs and recovering the millions of dollars in lost Kentucky revenue that has resulted should be a priority.

The Kentucky Tax and Budget Initiative is part of the State Fiscal Analysis Initiative, a network of state level organizations coordinated through the Center on Budget and Policy Priorities. These organizations focus on budget and tax policies through public education and the encouragement of civic engagement.

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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 Walmartfacts.com. Accessed April 2007.

⁴ Scott, Matthew, “Wal-Mart Special: Tax Savings,” *FinancialWeek*, February 17, 2007

⁵ Fletcher, Ernie and Cowgill, Bradford L., *Governor Fletcher’s Jobs and Opportunity Bipartisan Solution for Kentucky*, 2005 Regular Session

⁶ For example, see Mazerov, Michael, *State Corporate Tax Disclosure: The Next Step in Corporate Tax Reform*, Center on Budget and Policy Priorities

⁷ Drucker, *Ibid*.

⁸ www.walmartfacts.com. Accessed April 2007.

⁹ As detailed in the Drucker article, the rent “payments” made by Wal-Mart stores to its captive REITs are a function of gross sales, so the relationship between company growth and the scope of tax savings through the use of captive REITs is direct and positive.

¹⁰ In 2004, the Kentucky Department of Revenue attempted to disallow a captive REIT operated by AutoZone from deducting dividends paid out to another Autozone subsidiary. AutoZone successfully appealed the action to the Kentucky Board of Tax Appeals.

¹¹ 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.

¹² Figures based on state corporate income tax receipts per Office of State Budget Director.

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