BIG FIRMS GET BIG BREAKS

Time to Reform the Reforms

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Gaming the System

News reports about companies like Enron breaking the law and suffering the consequences attract considerable attention. The public hears much less often about efforts undertaken daily by businesses trying to reduce or eliminate their tax liability. These activities are quiet, for the most part, because they are legal. Arguably, though, they often stretch the bounds of what was intended when tax laws and regulations were enacted—and they cost taxpayers a lot of money because someone has to make up the difference between what a state needs and what it is able to collect from business taxes.

A lot of what companies do to avoid taxes involves their ability to game a system under which one state’s tax laws might differ considerably from another’s. One example is the case of multi-state corporations artificially shifting income to corporations they own in low-tax or no-tax states. The “Geoffrey” case was one of the best known of these strategies. Geoffrey the Giraffe is the trademark of Toys R Us. The toy company created a company in Delaware that owned that trademark, and Toys R Us stores in many states paid this Delaware company a fee for using the trademark. This effectively shifted profits out of higher tax states and into Delaware. This was an advantage for Toys R Us because Delaware does not levy corporate income taxes on earnings from such intangible assets as trademarks. So, profits transferred in this manner are free of state corporate income taxes.

This practice originated in the mid 1980s and grew rapidly over the next decade. A number of large accounting firms actively market their expertise in helping clients figure out such loopholes. Because companies are not required to publicly disclose these transfers, it is not possible to know how much profits are being sheltered or taxes avoided through these schemes. When court cases have been brought against some of the retailers involved in such ploys, the findings have revealed millions and sometimes billions of dollars in transactions—with substantial state corporate tax losses.
The Real Estate Investment Trust Tax Dodge

One recent high-profile maneuver involves real estate investment trusts (REITs) which were created by federal legislation in 1960 as a way to open the real estate investment market to individuals who would pool their money and invest in significant amounts of real estate without actually acquiring the property. Traditionally, only the wealthy had access to these types of investments.

Today, wealthy multi-state corporations use REITs as vehicles to make sure the billions of dollars they pay in rent for retail facilities are actually paid to themselves. As a result, they avoid state corporate business taxes on the transactions. Retail stores and banks are among the businesses that have been using this strategy since the 1990s. Wal-Mart has used such arrangements aggressively in many states and state officials are starting to take notice. Regulators also are going after such companies as AutoZone Inc, Bank of America and, in New Jersey, UNB Investment Company.

A recent Wall-Street Journal article explains how the process works: One Wal-Mart subsidiary pays its store rent to a real estate investment trust that is entitled to a tax break if it pays its profits out in dividends. The REIT is 99 percent owned by another Wal-Mart subsidiary. If it has at least 100 shareholders and the income is paid out as dividends, the payments are not taxable transactions to Wal-Mart. The shareholders in the Wal-Mart scheme described in the article were 114 Wal-Mart executives who owned a combined total of one percent of the REIT shares without any voting rights. Wal-Mart Property, a Delaware-based parent company for the REIT, owned the other 99 percent and 100 percent of the voting shares. In Massachusetts, authorities noted that Bank of America’s REIT affiliate, Fleet Funding Inc., increased the salaries of the roughly 100 employees who were its REIT shareholders to compensate them for personal income taxes stemming from their one percent ownership, according to the Wall Street Journal piece.

Wal-Mart deducts the rent it pays from its state taxable income as a business expense. It pays the rent to a REIT subsidiary it controls, which then returns the rent to its shareholders, taking a deduction. The rent goes back out to shareholders as dividends that are not subject to corporate taxes. None of the transactions result in state tax liability because many states’ tax laws have provisions that attempt to guarantee that corporate income is not taxed twice. By cleverly applying the law against itself, Wal-Mart makes sure the income isn’t even taxed once. That’s what state regulators are trying to change.

Under typical circumstances, rent paid to a landlord would reduce a business’ taxable income. But it would be cash out the door, like most other tax-deductible expenses. In Wal-Mart’s case, though, another door opens, through which most of its tax-deductible rental payments come straight back to Wal-Mart via one of its subsidiaries.

The extent to which Wal-Mart’s machinations cost states lost revenue is starting to emerge. The Wall Street Journal cites a North Carolina Department of Revenue auditor’s report filed in court by Wal-Mart in which it states that Wal-Mart and Sam’s Club paid company-controlled REITs $7.27 billion between 1998 and 2001 that eventually came back to Wal-Mart in states across the country. Based on an average state corporate income tax rate of 6.5 percent, three accounting experts consulted by the Wall Street
*Journal* estimated that REIT payments led to state tax savings for Wal-Mart of roughly $350 million over just those four years.

In other recent developments:

- North Carolina ordered Wal-Mart to pay $33 million for back taxes, interest and penalties stemming from its captive REIT transactions.

- New York Gov. Elliot Spitzer estimated that eliminating captive REIT loopholes would bring the state $83 million a year.

- Fleet Funding’s REIT has led Massachusetts to seek more than $42 million in back taxes, interest and penalties.

- The Connecticut Attorney General announced he is launching an investigation into whether Wal-Mart, among others, are exploiting a loophole in state law that needs to be closed legislatively or whether current law can be enforced against them.

- Maryland’s state comptroller said he is auditing companies and expects the state has lost tens of millions of dollars a year through this captive REIT structure.

**What About New Jersey?**

There is at least some good news. New Jersey anticipated problems such as those described above and attempted to solve them in 2002 when the state enacted what at the time were seen as significant changes in how corporations are taxed by the state. The impetus for reform came from the realization that state corporate business tax receipts had stagnated during the 1990s even as corporate profits doubled.²

New Jersey recognized that multi-state and multinational companies had become increasingly sophisticated at using tax loopholes and accounting gimmicks to lower their state taxable income. The primary loophole cited by State Treasurer John McCormac was the ability of these companies to transfer profits off their New Jersey books and into out-of-state companies.

Two of many key issues addressed by the New Jersey Business Tax Reform Act of 2002 were: royalty, interest and dividend payments to affiliates, and combined reporting.

As with Toys R Us and the Geoffrey trademark, corporations prior to 2002 could legally avoid taxes by sending profits away in the form of royalty and dividend income to subsidiaries or affiliated companies in other states with lower tax rates or no corporate income tax at all on that form of income. Making such royalty payments was tax-deductible to New Jersey companies. If the subsidiary then returned the royalty income to the New Jersey company as a dividend, that flow of income was also not taxed if the dividends were paid to a New Jersey corporation by an 80 percent-owned subsidiary. And if the income were returned to the New Jersey company as interest, it was also a deductible expense.
To combat this, the 2002 Business Tax Reform Act gave the state Director of the Division of Taxation authority to disallow such deductions on a case-by-case basis if the corporation was transferring money simply to avoid New Jersey taxes. At the time, the administration estimated these changes would allow New Jersey to collect between $100 million and $150 million in additional corporate taxes each year.

In May 2004, dividend deductibility was the subject of a state tax court case and the Division of Taxation lost—at least temporarily. The case concerns $11.7 million in dividends paid in 1997 to UNB Investment Company by Bridgewater Mortgage, a real estate investment trust whose stock was entirely owned by UNB. Bridgewater Mortgage deducted the $11.7 million dividend it paid to UNB Investment Company from its New Jersey taxable income. UNB, in turn, excluded those same dividends from its New Jersey taxable income under the provision allowing a corporate taxpayer to exclude dividends from a subsidiary. Because of these two actions, the $11.7 million entirely escaped taxation in New Jersey.

Under audit, the Director of the Division of Taxation allowed Bridgewater Mortgage to deduct the $11.7 million transaction from its New Jersey taxable income but required UNB Investment Company to pay taxes on the dividend. And the state assessed an additional $263,941 in taxes plus interest.

The initial court ruling favored the state, saying this was indeed a case of tax avoidance and that the Director of the Division of Taxation had appropriately exercised his authority to disallow the deduction. But ultimately it was ruled that the state erred because no regulations had actually been written to enforce the new tax law provisions. However, in February 2006 New Jersey wrote the regulations that disallow deductions of dividends paid by a REIT to an affiliated company.

How much money did New Jersey lose from captive REIT relationships before 2006? To some extent, an estimate can be pieced together. Wal-Mart’s company spokesman said in Connecticut the REIT structure had been used for just over 10 years and currently is used in connection with all but two of the company’s 35 properties in the state. New Jersey has 53 Wal-Mart stores or Sam’s Clubs, with five more planned to open in the next year or so. Documents from the North Carolina Wal-Mart REIT case list eight Wal-Mart stores in New Jersey owned by Wal-Mart’s REIT—which means it probably exploited this loophole for a number of years.

While it cannot be said for certain how much has New Jersey lost as a result of Wal-Mart engaging in this tax avoidance scheme, it is reasonable to assume it is in the millions of dollars.

**The Case for Combined Reporting**

A better approach to sporadic and costly court challenges is to change state tax law. This has been accomplished in 20 states that now are not vulnerable to tax-evasion transfers because they have enacted a tax reporting policy known as combined reporting. Under
this requirement, corporations with common ownership and substantial inter-corporate transactions are required to file combined tax returns.

Combined reporting requires companies to put together profits from all related subsidiaries and only then determine what portion of those profits are taxable in that state. Multi-state companies must apportion their profits according to state formulas which consider how much of the company’s property, payroll and sales are in each state. The practice of combined reporting has twice been upheld by the U.S. Supreme Court.

The primary benefit from this is that it nullifies most tax avoidance schemes that rely on income shifts to reduce taxable income. States that do not require combined reporting have no alternative other than to continually attempt to monitor and interpret millions of dollars in inter-company transactions. This requires substantial state resources for auditors and lawyers. Experience shows it is difficult for these public servants to stay ahead of the highly compensated tax attorneys and accountants employed by companies to find and exploit new loopholes because they are constantly creating new ones.

Eighteen states already used combined reporting at the beginning of 2007. Since then, New York and West Virginia enacted combined reporting. And it is being advocated by the governors of Iowa, Massachusetts, Michigan, North Carolina and Pennsylvania—where Gov. Edward Rendell supports recommendations made by the Pennsylvania Business Tax Reform Commission to mandate combined reporting tied it to a decrease in the state corporate tax rate.

If Massachusetts and Pennsylvania join Maine, New Hampshire, Vermont and New York in passing combined reporting, New Jersey will be an outlier in the region.

New Jersey, meanwhile, still treats each subsidiary or affiliate corporation in a related family as a separate entity, allowing them to file separate tax returns. The only exception is casinos, which are required to file combined reports. In 1999 approximately 21,000, or eight percent, of the corporations filing New Jersey returns had related places of business outside the state and would have been affected by mandatory combined reporting. Most were large, profitable firms with affiliated companies both in and out of the state. These companies incur approximately 60 percent of the state corporate business tax liabilities, according to the Division of Taxation.4

The 2002 reforms gave the Director of the Division of Taxation the ability to require combined reporting on a case-by-case basis if abuse is suspected. To date, though, no corporation has been required to file a combined report. It is likely that any corporation required to do so under the current system would challenge the state in court, a time- and resource-consuming proposition for the government. The New Jersey Division of Taxation in 2006 had 451 auditors who performed more than 106,000 audits. Each auditor assessed on average $1 million more in taxes apiece. While this year and next the Division expects to hire more auditors, questions still remain as to whether they are a match for the legions of corporate tax attorneys and accountants. The most highly paid state auditor, with many years of experience, makes just over $100,000 a year—an entry level salary at some major accounting firms.
Combined Reporting in the 50 States, 2007

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Note: Nevada, South Dakota, Washington and Wyoming do not have corporate income taxes.

Requiring combined reporting would bring predictability and consistency to the corporate tax process, while providing the state with millions of dollars in much-needed revenue. And it will allow New Jersey auditors to piggy back on similar work in other states that require corporations to file combined returns. It will also level the playing field because local businesses today are more likely to have to pay taxes on all their profits; unlike multi-state firms, they have nowhere to shift them.

The Case for Greater Disclosure

It is very difficult to get information about which companies pay how much in state taxes. As is the case for individuals, tax returns are not public documents. Not since 1989 has New Jersey published information on overall corporate tax liability in the state. That report covered 1987 and showed that 216,572 corporations paid $1.1 billion in New Jersey corporate business taxes. Of these, 66 percent each paid less than $100. Just 1,468 corporations paid $100,000 or more in taxes and those companies paid 61 percent of the corporate tax collected in that year. The report did not identify any by name.

In 1987, the corporate business tax accounted for 17 percent—or $1.1 billion—of the revenues collected from New Jersey’s three largest state revenue sources: sales tax, personal income tax and corporate business tax. In 2007, even after recent reforms, the corporate business tax provides 13 percent, or $2.8 billion, of revenues from the three major levies. In 2002, it was big news when Gov. James E. McGreevey revealed that 30
of the state’s largest 50 employers paid lower taxes than a single mother with a child. It turns out this always was the case and we just did not know it.

During the 1980s, Washington-based Citizens for Tax Justice used information from corporate annual reports to shareholders and to the Securities and Exchange Commission to document that some of the largest, most profitable corporations in the country were paying little or no federal income tax. But the report could say nothing about corporate taxes in individual states because only aggregate state and local corporate taxes were required to be reported.

A few states have attempted to require more thorough corporate disclosure. Wisconsin actually has had a disclosure law since 1923 and in 1991 it was used to compile a list of major corporations doing business in the state that had paid only nominal state income taxes. In 1991, both Arkansas and West Virginia adopted statutes providing for disclosure of information on the dollar amount of certain specific credits taken by corporate and individual taxpayers though little information has ever been disclosed. Massachusetts in 1993 enacted a law requiring corporate tax disclosure from all publicly-traded corporations that do business in the state. The Massachusetts law lasted one day before it was repealed. None of these laws have yielded significant information.

The Montana Senate recently passed a bill requiring greater disclosure of corporate income tax information. Sen. Jim Elliott, chair of the Montana Senate Taxation Committee, expressed outrage at finding out that 40 percent of the top 500 national and multinational businesses in Montana paid under $500 in corporate income taxes—less than most individual Montana taxpayers. He introduced a bill to require publicly traded corporations to disclose basic tax information, such as how much income they made in the state and taxes paid. There is little hope that Montana’s lower house will vote in favor of this bill.

Motivation for these changes across the nation came from the public outcry resulting from reports that corporations were not paying their fair share of state taxes. The level of disclosure spurred by public discontent is important—in part because of how much money is involved. If corporations are inappropriately circumventing legislative intent and avoiding taxes, other taxes must be raised to meet state and local needs, or services will have to be reduced.

In Fiscal Year 2006, New Jersey collected approximately $2.8 billion from the corporate business tax (compared to $1.3 billion in Fiscal Year 2001 before the reforms). Knowing who pays the tax, and how much they pay, allows for debate on who should pay the tax. In the absence of such information, it is hard for policymakers and the public to form an opinion of what the tax system should look like.

Every so often, a glimpse into the way things work is offered, and it whets the appetite for more. Such a moment came during legislative hearings on New Jersey’s 2002 business reform tax package. Those in the hearing room were stunned to learn that the Great Atlantic & Pacific Tea Company (A&P) had paid only $200 a year in tax in each of the previous two years, while the owner of Pagano’s IGA, a small supermarket in Bayonne, told legislators he paid $3,000. This disclosure helped shape public consensus
in favor of raising taxes on large, profitable companies like A&P, and giving relief to smaller, less profitable operators.

As helpful as anecdotes and newspaper articles can be, they are not an adequate substitute for strong, fair laws and regulations that put the public first. In today’s environment, as one abusive tax avoidance loophole is closed, another is found. Corporations take advantage of wide legal elbow-room to seek to pay the least tax possible. It is clear that New Jersey, like other states, is losing money in this process. There needs to be far more discussion—with public input—of what constitutes a fair share of taxation for large, profitable businesses.

If New Jersey joined its neighbors in enacting combined reporting and engaged in meaningful reporting that disclosed how the system is being handled by corporate taxpayers, citizens could have more confidence that both government and business were acting in the state’s best interests.

5 This discussion about disclosure draws on a report, “Corporate Tax Policy and the Right to Know: Improving State Tax Policymaking By Enhancing Legislative and Public Access,” that was written by Richard D. Pomp for The Fiscal Policy Institute in December 1993.