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Judge Rules Against Wal-Mart Over Its Tax-Shelter Dispute

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A North Carolina state court judge ruled against **Wal-Mart Stores** Inc. in a closely watched tax-shelter case involving an arrangement in which the retailer essentially paid rent to itself and then deducted the amount from its taxes.

In an order filed Friday, but signed on Dec. 31, Emergency Special Judge of Superior Court Clarence E. Horton Jr. ruled that Wal-Mart's structure had no "real economic substance" other than cutting taxes. The judge dismissed Wal-Mart's suit, in which it sought a refund of $33.5 million in taxes, interest and penalties that it paid after state tax authorities determined it had underpaid by that amount.

The ruling is the latest setback for the tax maneuver. At least three other states are challenging Wal-Mart's use of the tax strategy. Since a Wall Street Journal article on the topic last February, at least six states have passed laws seeking to prohibit the tax maneuver. In North Carolina, the judge's order didn't come after a trial, but was based on motions for summary judgment by both sides.

Wal-Mart said it is studying the order and hadn't decided whether to appeal. But the company said, "We believe that all taxpayers should have the right to rely on clearly defined tax laws that are reasonably and fairly enforced."

The dispute arose from Wal-Mart's use of a real-estate investment trust. A decade ago, the company transferred ownership of its stores to two REITs, of which Wal-Mart owned 99%, then paid tax-deductible rent to the REITs to use the stores.

REITs pay no corporate income tax as long as they pay at least 90% of their income to shareholders as dividends. However, those REITs were owned by Wal-Mart subsidiaries based in Delaware and therefore owed no tax on the receipt of those dividends. The result: Wal-Mart turned rental payments to itself into state-deductible expenses, even though the money never left the company.

For a four-year period, the setup saved the retailer an estimated $230 million on its tax bill in dozens of states.

In 2005, North Carolina tax authorities challenged the REIT tax benefits. Wal-Mart paid the bill sought by the state, and in March 2006 sued for a refund. The company argued the state didn't have authority to combine the results of the subsidiary that did business in North Carolina with those of the Delaware-based unit and the REIT.

"Plaintiffs do not deny the facts demonstrating the circular journey taken by the "rents" paid by these plaintiffs, but contend that on each leg of the journey plaintiffs were only taking advantage of a lawful deduction afforded them by then-existing tax law," wrote Judge Horton. "Such a piecemeal approach exalts form over substance, however ..."

"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," he added. "It is particularly difficult for the court to conclude that rents were actually 'paid,' when they are subsequently returned to the payor corporation."