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Why Wal-Mart Set Up Shop in Italy --- Retailer Has No Stores, As Tax Spat Lays Bare

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More than 4,500 miles separate a small Wal-Mart Stores Inc. office in Florence, Italy, from the company's dozens of Illinois retail outlets. But thanks to a convoluted tax arrangement, court records show, Wal-Mart's Italian operation has helped the giant retailer cut its state tax bill in Illinois by millions of dollars a year.

Wal-Mart set its affairs so that its Italian outpost 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. Because technically its only employees are based in Italy, the real-estate unit claims its operations are foreign, exempt from Illinois corporate income taxes.

Earlier this year, the Illinois Department of Revenue objected to the Italian tax maneuver, demanding $26.4 million in back taxes, interest and penalties. Wal-Mart paid the amount in dispute and then sued the state for a refund, according to a complaint filed in May in Illinois Circuit Court in Springfield, Ill.

A Wal-Mart spokesman declined to comment beyond a prepared statement: "We have a disagreement with the state of Illinois over our tax liability last year, and we've asked a judge to resolve that for us." He declined to explain why Italy was chosen as the home of this particular foreign operation or whether Wal-Mart has other such arrangements.

The dispute with Wal-Mart is part of a wider effort by some states to crack down on what they believe is abusive use of so-called 80/20 companies. These companies are domestic subsidiaries that conduct at least 80% of their business overseas. States typically don't tax income from outside the U.S., and many companies have used 80/20 subsidiaries to legitimately shield foreign operations from state taxation.

But authorities in several states have challenged a number of companies over the 80/20 units, claiming the structure was improperly used to shift income away from the purview of state taxing authorities.

The misuse of 80/20 companies is "shocking to the conscience," said Brian Hamer, director of the Illinois Department of Revenue. "These kinds of manipulations clearly were never contemplated by the state legislatures," added Mr. Hamer, who wouldn't comment on any single company or legal case. "It ought to have been clear to businesses that this was highly questionable conduct."

Illinois tax authorities are in a dispute with McDonald's Corp. over nearly $11 million stemming from its use of an 80/20 subsidiary. Details are sketchy, but McDonald's, based in Oak Brook, Ill., says in court papers that a Delaware financing unit that owns restaurants in St. Thomas, Virgin Islands, conducts 80% or more of its business activity outside the U.S., exempting its operations from being included in Illinois tax calculations.

Meanwhile, Minnesota tax authorities are taking issue with interest payments made by Burlington Northern Santa Fe Corp. to a pair of Delaware subsidiaries doing business in Canada. The railway company deducted the interest associated with the payments but didn't pay taxes on most of the income received by the subsidiaries. The state's revenue department says in an audit report that this was "done purely for tax avoidance purposes." The Fort Worth, Texas, company paid a disputed $4 million in back taxes and interest and sued the state in May for a refund.

A McDonald's spokeswoman said: "We believe the results of our business have been properly reported to the state of Illinois." A Burlington Northern spokesman declined to comment.

At the prodding of the Illinois revenue department, that state's legislature in 2004 passed a law essentially shutting down the abusive use of 80/20 units. The Minnesota state legislature enacted one change in 2005 and has considered several other bills since then to shut down alleged abuse of the structure.

Wal-Mart's Italian tax-planning maneuver is the latest disclosure of a strategy by the firm to cut state taxes. A page-one article in The Wall Street Journal in February focused on how the Bentonville, Ark., retailer cut taxes in some states by paying rent to a real-estate investment trust it owned, even though the money never left the firm.

That REIT strategy has been challenged by tax authorities in several sates; some have enacted laws to close the REIT structure since the Journal article.

However, the REIT tax structure saved money only in some states -- those that tax income solely from operations within their borders. This taxation system, known as "separate reporting," can make it simpler for companies to shift income out of state to tax-friendly jurisdictions such as Delaware or Nevada.

But "combined reporting" states such as Illinois are much tougher. They add together all profits of a company's domestic operations, regardless of what state they are in, and then allocate a portion of those profits to their state. Theoretically, combined reporting makes it harder for companies to shift income to more advantageous locales.

Because Illinois rules apply only to domestic profits -- not world-wide income -- companies can get around the rules by figuring out ways to effectively shift income overseas.

Wal-Mart's 80/20 structure worked like this: The company first transferred its Illinois stores to its in-house REITs, paid rent to the REITs and then deducted those payments from its taxes. The REITs, in turn, paid that money to their 99% owner, a Wal-Mart unit based in Delaware.

Ordinarily, Illinois's combined-reporting rules wouldn't permit a company to cut its taxes by shifting income to a Delaware unit. But in late 2001, Wal-Mart formed a Delaware subsidiary called WMGS Services LLC, records show. WMGS, with offices in Florence, was a wholly owned subsidiary of Wal-Mart Property Co., which also was 99% owner of Wal-Mart's main REIT.

In its filing, Wal-Mart contends that Property Co.'s ownership of the Italian unit converted Property Co. into an 80/20 company. In other words, at least 80% of its employees and its property were overseas, exempting its income from taxes.

Though Property Co. is the 99% owner of the REIT -- which owns dozens of stores in Illinois -- Wal-Mart says Property Co. owns no real estate itself. And although Wal-Mart has more than 48,000 employees in Illinois, the firm contends Property Co. has no employees in the state, either.

The only employees of Property Co. were in Italy, the company says. Property Co. was set up to own the majority of the shares of Wal-Mart's main REIT and has no employees anywhere, Wal-Mart has said in court records elsewhere. (In its court filing in Illinois, Wal-Mart says that WMGS's employees and property were in Turin, Italy; an official with the company in Florence and a Wal-Mart spokesman in the U.S. say the company doesn't have an office in Turin.)

WMGS employs 22 people at its office in central Florence, according to a company official who answered the door there on a recent weekday morning. The office is responsible for procuring merchandise from around Europe, he said. Wal-Mart has no stores in Italy.

Rosamaria Mancini contributed to this article.

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

BY JESSE DRUCKER

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."