

# **Diminishing Returns: A Tax Maneuver In Delaware Puts Squeeze on States**

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**Trademark-Holding Companies  
Help Limited, Many Others  
Save Millions of Dollars**

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**One Address for 670 Firms  
By Glenn R. Simpson**

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WILMINGTON, Del. -- Limited Brands Inc. takes in tens of millions of dollars each year from its thousands of retail stores in 48 states. But when it comes to paying state taxes, the Columbus, Ohio, retailer prefers to deal with Delaware, which collects no income taxes on out-of-state holding companies and investment firms.

Limited bases seven subsidiaries in a drab office building in the heart of this city's downtown. The subsidiaries, which don't produce anything tangible and don't employ anyone from Limited, are big money-makers. Their primary function is to hold the trademarks for famous Limited chains such as Bath & Body Works and Victoria's Secret, and charge their retail siblings huge fees for use of the brand names. The arrangement transfers hundreds of millions of dollars each year away from Limited's retail outlets in high-tax states and into the Delaware subsidiaries, which don't pay a penny of state tax.

In the view of many state tax authorities, it's just one of the more striking examples of an increasingly alarming manipulation of the tax system. At a time when offshore tax havens are drawing intense heat on Capitol Hill for their role in siphoning off federal revenue, state officials complain that domestic tax havens such as Delaware and Nevada are going unchecked.

Some tax experts contend that the strategy is inflicting billions of dollars in revenue losses on states. Corporate tax receipts have plummeted over the past decade as a share of states' total tax revenue, according to several studies, and many states have begun to see major revenue shortfalls.

The average effective state tax rate for corporations -- what companies really pay, as opposed to what the tax schedules say they should pay -- has declined from 9.6% in 1980 to about 5.2% today, says Dan Bucks of the Multistate Tax Commission, which represents state revenue agencies.

"It's a matter of fairness," says Norris Tolson, North Carolina's Secretary of Revenue. "It's not fair to the corporations that do properly report their income or to the millions of working people who pay their taxes without trying to avoid them."

Companies that use the maneuver say they aren't breaking any laws, and in fact the rules are very murky. Decisions by state courts have been mixed, and many legal experts believe it would take a Supreme Court decision to settle the issue. Many companies also argue their duty to shareholders demands that they seek any legal way to lower their tax burden.

For its part, Limited says it isn't using Delaware to dodge taxes at all, and that it has other good business reasons for its holding-company structure. "We currently pay income taxes as well as sales and use taxes on all retail transactions completed by every Limited Brands retail business in every state in which we operate," Limited spokesman Anthony Hebron says.

For a long time, most state authorities were content to ignore the tactic, which wasn't thought to be widespread. But in recent years, as the scope of the activity has become clearer and as states have begun facing a budget crunch, authorities have launched a counterattack. In tax proceedings around the country, they've targeted at least 50 well-known companies, including Toys "R" Us Inc., ConAgra Foods Inc., Home Depot Inc., Kmart Corp., Gap Inc., Sherwin-Williams Inc., Tyson Foods Inc., Circuit City Stores Inc., Stanley Works, Staples Inc., and Burger King Corp., a unit of Diageo PLC. (Please see full list at [WSJ.com](http://WSJ.com)). The companies all say what they are doing is legal.

The state complaints typically allege that the companies use empty corporate shells, engage in sham or tax-motivated transactions, and use other ruses to make it look as if they have legally separated themselves from their trademark subsidiaries.

The strategies mirror better-known methods that U.S. firms use to minimize their federal tax burden, such as placing patents and other intellectual property in overseas tax havens so that royalties can accumulate untaxed.

For example, the retail operations of Toys "R" Us pay millions of dollars in "licensing fees" to a Delaware subsidiary called Geoffrey Inc. for the right to use the Toys "R" Us name on signs outside stores. And Home Depot stores direct royalties to a Delaware-based holding company called Homer TLC Inc., which is in turn a wholly owned subsidiary of Home Depot Inc.

Often, trademark-holding companies then return the cash to where it came from -- stores, in the case of retailers -- in the form of operating loans. The stores then pay interest to the subsidiaries, which further reduces the stores' taxable earnings.

The strategy appears to have originated when a handful of lawyers and accountants in the 1980s picked up on the ramifications of a 1967 Supreme Court case involving a catalog company called National Bellas Hess. The court ruled that states have the power to force companies to collect sales taxes only when they have a physical presence in the state. Many catalog firms began refusing to collect state sales taxes from their customers. Internet retailers later came to rely upon this standard to avoid collecting sales taxes on many of their sales, and some "bricks and mortar" retailers have bemoaned the rulings for that reason.

But lawyers and accountants began telling retail chains that they, too, could take advantage of the law, even if they have walk-in stores in virtually every state, by establishing a wholly owned holding company in a low-tax state and transferring valuable intellectual property to it. The marketing of such plans grew after the Court in a 1992 case affirmed its earlier ruling.

"Our position is that these cases stand for the proposition that if a company has no physical presence, they should not be taxed at all," says Limited attorney Paul Frankel of the firm Morrison & Foerster, referring to the Delaware subsidiaries. He also represents most of the other companies fighting state tax authorities on the issue.

Mr. Frankel argues that some states can blame their own legislatures. California and some two dozen other states are largely immune to the holding-company strategy because they tax companies on a "unitary" basis, combining all of a company's operations for tax purposes rather than targeting the in-state subsidiary or the Delaware holding company. "If they've got a problem, they can do what California does," Mr. Frankel says.

Several states have tried to legislate a California-style tax system, but the efforts failed amid opposition by the companies that benefit from existing law. A coalition of companies is also lobbying Congress to prohibit states from challenging the trademark-holding-company strategy.

State courts have split on whether the strategy is protected by the Supreme Court's precedents. Georgia, Maryland and New York judges have sided with the companies, and Massachusetts, New Mexico and South Carolina courts have backed tax authorities.

Numerous law and accounting firms now market the strategy, including accounting giant PricewaterhouseCoopers LLP. One PwC consultant has testified in New Mexico state court that he helped establish more than 50 intellectual-property-holding companies. A PwC spokesman said the firm has taken note of states' concerns and makes sure its clients comply with the tax laws.

Since 1991, Kmart has followed a plan developed by PwC predecessor PriceWaterhouse titled, "Utilization of an Investment Holding Company to Minimize State and Local Income Taxes." In 1995 alone, New Mexico records show, Kmart shifted \$317.5 million out of various states and into its Michigan-based trademark-holding company, Kmart Properties Inc. Like Delaware and Nevada, Michigan imposes minimal taxes on some types of holding companies.

Last November, the state prevailed over the company in the New Mexico Court of Appeals, winning a judgment for \$2.7 million in back taxes, penalties and interest. Kmart says it has appealed to the state Supreme Court.

Limited has attracted the most attention from tax authorities. North Carolina says the company owes about \$1 million for 1994, and the state is expected to seek similar or greater amounts for subsequent years.

Limited engaged in "hocus pocus bookkeeping and deceptive accounting practices . . . designed to avoid payment of state income tax," alleged Jack Harper, a lawyer for the state of North Carolina, in its 1998 case brought against Limited's Delaware subsidiaries. The case was upheld in May by the state's Tax Review Board. Limited is appealing in state court.

Maryland is seeking \$6.3 million from 21 Limited entities, while New Jersey says the Limited subsidiary that holds the Lane Bryant trademarks has failed to file tax returns or pay business taxes in the state since 1983. Iowa and New York also brought claims against either the firm or its trademark units.

In a 1995 legal battle with New York state, an administrative law judge accepted the company's argument that the trademark subsidiaries had a legitimate business purpose. The judge wrote that they were "viable corporations, each of which was engaged in the registration and protection of the trademarks it owned."

Limited says it began using Delaware for its business-friendly legal system, which allows firms to limit legal liability and defend themselves against hostile takeover attempts. Then the company found it was also a useful way to manage trademarks. By separating them into individual assets, it can easily spin them off or sell them as units, the company has said in court documents. Limited founder Leslie Wexner pioneered the "private label" business, in which firms build a strong identity with consumers by marketing their own goods through small, single-brand outlets instead of large department stores. Examples of successful launches include Abercrombie & Fitch, which has since been spun off.

Limited's Delaware subsidiaries are housed in a Wilmington building occupied by Delaware Corporate Management Inc., a local firm that caters to absentee corporations. DCM says thousands of U.S. firms use its services, including some 670 that occupy the same 20-story building as Limited.

For a few thousand dollars a year per client, DCM provides all the accoutrements of an office, including an address in the business district -- 1105 North Market Street -- office space, furniture, mail collection and stationery.

DCM spelled out the "Delaware Holding Company" strategy in a memo to a prospective client: "When a company holds the rights to patents, trademarks, or copyrights and receives royalties or other income from these rights in a state which taxes this income, significant savings in state and local taxes can be realized."

When more than half a dozen of Limited's trademark subsidiaries signed up with DCM in 1987, DCM promised to provide everything necessary for the subsidiaries to look like genuine corporate branches, including "telephone listing and answering," "mail forwarding as instructed," and "clerical and secretarial support," according to documents obtained by North Carolina in its tax case.

The rent, divided into tiny fractions by the hundreds of absentee corporate tenants that use DCM, worked out to a few hundred dollars a year for each of Limited's entities, "much like a time-share arrangement," the North Carolina Tax Review Board found.

DCM also provides the holding companies with contract corporate officers and auditors so that firms don't need to incur the expense of putting anyone on their own payroll. Former DCM president Edward J. Jones, a certified public accountant who helped sign up Limited, has served as an outside director for hundreds of Delaware holding companies, according to a case Massachusetts tax authorities successfully brought against clothing retailer Syms Corp., another Jones client. Mr. Jones, who is retired, didn't return phone calls seeking comment.

Limited enlisted a Wilmington lawyer, Louis S. Black Jr., to serve on the boards of its Delaware subsidiaries. Mr. Black, a well-known authority on Delaware corporate law, charged \$50 for every board meeting he attended. The meetings were conducted at his own law firm, Morris, Nichols, Arsht & Tunnel, across the street from DCM's offices.

Ellen Roberts, vice president for investor relations and media communications at DCM's parent, Wilmington Trust, says she can't comment on Limited or other specific clients but confirms that DCM sometimes rents space on a fractional basis and performs other services such as those described in the Limited documents. The services are designed to help companies meet legal requirements for residency, also known as "nexus," she says.

In each of the 1992, 1993 and 1994 tax years, Limited's retail operations annually transferred about \$300 million in licensing fees into their Delaware counterparts, plus more than \$50 million a year in interest on loans. All told, the transfers amounted to nearly \$1.2 billion, according to documents filed in the North Carolina case. In its latest fiscal year, Limited reported net income of \$518.9 million on sales of \$9.36 billion.

But while Limited's tax returns show billions of dollars flowing into Delaware and back out again, North Carolina's tax authorities concluded that no money actually changed

hands. "No checks were written nor were there any physical transfers of funds between the parties," the North Carolina tax-review board found. There were no wire transfers, and the promissory notes issued by the Limited to document the loans were marked, "Do not collect."

A lawyer familiar with Limited's position says the state's analysis shows a lack of understanding of how some businesses operate. "This is the way hundreds of companies manage their trademarks and their transactions," the lawyer says.

