Businesses crack the code

Bay Area's biggest companies lining up for huge tax breaks

By Daniel S. Levine and Thomas Pisarek

Here's something to ponder while you wait at the post office to send off your taxes next week: The Bay Area's largest corporations will save about $6.8 billion for 2003, thanks to tax breaks, tax shelters and the vagaries of accounting and tax rules.

In fact, 14 of the region's largest companies — each of which posted multimillion-dollar profits — will pay nothing in taxes this year or even get money back from the government for taxes paid in the past, according to a *San Francisco Business Times* study of 50 of the largest Bay Area companies.

Two Business Times reporters spent more than a month reviewing the fiscal 2003 financial statements from the Bay Area's largest public companies to determine what they actually paid in federal income tax. (See description of methodology, Page 33.) That number is not always obvious: The tax payments reported by companies in financial documents sometimes exclude a variety of tax breaks those companies enjoy.

The study found that these companies generated $34.3 billion in taxable profits in 2003. At the statutory rate of 35 percent levied on corporate profits, that would produce a collective tax bill of just over $12 billion. But the group paid just $5.2 billion — $6.8 billion less — an effective tax rate of just 15.2 percent.

Hitting bottom

The actual tax rates paid by large corporations in the Bay Area reflect the fall of U.S. corporate income taxes to historic lows. Corporate income taxes as a proportion of gross domestic profit fell to just 1.2 percent in 2003 from 4.1 percent in 1960. Meanwhile, individuals now provide an increasing portion of federal income tax revenue. By 2002, corporations provided just 14.7 percent of all income taxes collected by the IRS, compared with 57.3 percent in the 1940s, according to government data.

Recent tax breaks meant to spur investment during the recession are in part responsible for lower corporate tax rates being paid today. But aggressive tax sheltering, the shifting of profits to lower tax jurisdictions overseas and the use of stock options to compensate employees have also combined to drive down corporate taxes.

"Is there pressure (inside companies) to reduce the effective tax rate?" said Moses Awe, senior partner and head of the tax practice of Ernst & Young in San Francisco. "They are taking advantage of the rules in a fiduciary capacity so that their shareholders are getting a proper return, but they are not going over the line so they create all sorts of controversies in the future."

But not everyone agrees that corporations are paying their fair share. One former Bay Area CFO said corporate tax departments have become "profit centers" and others say when corporations don't pay, other taxpayers are left to make up the difference.

"If they don't pay what they owe, then somebody else has to pay more," said **Robert McIntyre**, director of **Citizens for Tax Justice**, a Washington, D. C.-based tax policy research group critical of corporate tax loopholes. "Or, the government goes bankrupt, or we don't get the homeland security and national defense and environmental protection and education. We all have a stake in everybody chipping in."

Gimme shelter

Tax experts say there has been an explosion in the use and complexity of corporate tax shelters since the 1990s. Estimates of the revenue lost to the U.S. Treasury as a result of tax shelters go as high as $50 billion a year.

A 1999 report from the U.S. Department of the Treasury said there is not only concern about the loss of income from corporate tax shelters, but also the "disrespect" they breed for the tax system. As evidence for the increasing use of corporate shelters, the Treasury Department noted that companies' book income (the amount they report to shareholders) had for years risen faster than their taxable income (what they pay taxes on).

Corporate tax shelters remain a top priority for the Internal Revenue Service, said Thomas Wilson, the agency's industry national director of communication, technology and media. Many tax shelters are tailored to a specific company's needs, he said. That can make deconstructing them difficult and outlawing them harder.

"Sorting the facts becomes a much more intensive

process, which of course makes them more resource-intensive than the shelters we dealt with some years ago," he said.

The IRS's ability to keep up with tax shelters is further complicated because the agency is often years behind in its corporate audits. That means that by the time the agency challenges a company on one type of shelter, a new and even more complex one may have sprung up in its place.

"We are in a constant mode of catch-up," Wilson said.

The IRS is working to cut the time between the filing and the completion of an audit to 22 months from the typical 60 months today, he said. It is also requiring disclosures about any transaction designed to shelter income from taxes when new returns are filed, so IRS auditors can immediately start work on those.

Options boost expenses

Stock options exercised by employees of the companies in the Business Times study sliced $1.7 billion off corporate tax bills. Though the difference between the exercise price of stock options and their market value at the time of exercise do not show up in the financial statements of companies as an expense, the IRS treats them as such.

Six companies in the study had tax benefits from the exercise of employee stock options large enough to more than wipe out their current federal tax liability. These include Yahoo, EBay, Adobe Systems, Maxim Integrated Products, Hyperion Solutions Corp. and Leap Frog Enterprises.

Other tax-cutting mechanisms are often harder to discern from public financial reports of companies. Sometimes companies highlight such means in a straightforward manner in the footnotes to their financial statements.

Such disclosures by Bay Area companies included:

- Oakland based Clorox Corp. enjoyed a $14 million tax credit as a result of its investment in 55 low-income housing partnerships.
- Cost Plus saved $3 million through wage and other tax credits.
- Numerous companies slashed their tax bills through research and development tax credits, including Nvidia ($12 million), Leap Frog ($4.8 million), KLA-Tencor ($3.3 million) PeopleSoft ($2.3 million) Hewlett-Packard ($1.9 million) and Cadence Designs ($2.8 million).

Shifting money

But some of the most beneficial transactions are those structured to shift income to low-tax jurisdictions and expenses to high-tax areas. These can be nearly invisible within a company's annual financial statements. These transactions, often involving a tangle of subsidiaries or partnerships, may show up as simply a number under an innocuous heading with no explanation.

Shifting revenues and expenses can pay huge dividends. For example, a 2001 study of documents related to an IRS investigation of an Indonesian joint venture between Chevron and Texaco by University of Sourthern Maine professor of accounting Jeffrey Gramlich and emeritus professor of accounting at the University of Michigan James Wheeler, calculated that the two oil giants, since merged, collectively avoided paying $8.6 billion in federal taxes and $433 million in state taxes since 1963. The joint venture, known as Caltex, pumped crude oil owned by the Indonesian government. Chevron and Texaco purchased the oil at about a 15 percent premium to market price.

Caltex also had to pay a 56 percent tax to the Indonesian government on its profits. But critically, the two oil companies also received additional oil from Indonesia to offset the taxes on the excess profit generated by the overcharges. As a result, the above-market prices for the oil generated large foreign tax credits for Chevron and Texaco, which used them to offset tax obligations to the United States. At the same time, the inflated prices created additional expenses that offset U.S. profits — without hurting profits showed to shareholders.

Chevron settled with the IRS in 1994 for $675 million and Texaco in 1997 for $484 million. The ruling from the IRS did not bar Chevron from continuing to take foreign tax credits on the taxes on the premiums paid for the oil. The company said it continues to do so.

"The issues raised are not new to either us or the IRS," said a spokesman for ChevronTexaco, who declined to comment on the findings of the two professors. "They have been thoroughly reviewed and audited by the IRS and were fully resolved and closed years ago."

The $4,896 tweezer

Shifting of income to foreign subsidiaries in lower tax jurisdictions doesn't always require esoteric machinations. All a U.S. company needs to do is sell to a subsidiary at low prices and buy from it at high prices. Even when a company is not buying and selling between itself, it must assign values to goods exchanged — such as integrated circuits made here, but assembled overseas. In accounting parlance, it's known as "transfer pricing" and it can be an effective way to cut a tax bill.

“We have just a totally inadequate structure for preventing artificial shifting of income internationally,” said Michael Mazerov, senior fellow at the Washington, D.C.-based Center on Budget and Policy Priorities. “The IRS does not have the resources to police billions of dollars of transactions that are occurring every day.”

A study by two finance professors for U.S. Sen. Byron Dorgan, D-N.D., on transfer pricing found the United States government lost $53.1 billion in tax revenue in 2001 alone caused by corporations understating the value of exports and overstating the value of imports.

The most egregious examples uncovered in the study by Simon Pak of Pennsylvania State University and John Zdanowicz of Florida International University included exports of toilets to Hong Kong for $1.75 each; automatic teller machines to France for $97; and prefabricated buildings to Trinidad for $1.20 each. Prices for imported goods included tweezers from Japan for $4,896 each; battery-powered smoke detectors from Germany for $3,800.86; and plastic buckets from the Czech Republic for $972.98.

“It keeps going up every year. The objective is to shift your taxable income to foreign countries so you minimize your global tax bite,” said Zdanowicz. “The key thing is what is normal and what is illegal.”

To avoid fights with the IRS and foreign tax authorities, companies are entering into advanced pricing agreements. This minimizes disputes with tax agencies, but doesn’t eliminate them. Oracle Corp., which is fighting over some transfer pricing issues with the IRS, has advanced pricing agreements in effect and is negotiating new ones to replace expiring ones.

Revamping the system

Not everyone thinks taxing corporations is a good idea, at least the way it’s done now. The effort to shelter income diverts senior management from economically productive activity and the structure of tax breaks reward some industries leaving others more heavily taxed.

“A lot of economists support a corporate tax of zero because there’s an understanding that corporations themselves don’t pay the tax. They essentially act as tax collectors for the government,” said Chris Edwards, director of fiscal policy for the Cato Institute, a Washington, D.C.-based, libertarian think-tank. “The actual burden is pushed through to one of three groups of people: workers, shareholders or consumers.”

Edwards thinks that, if not eliminated, corporate taxes should at least be revamped to make them more transparent and fair so high-tech companies don’t pay lower rates because of certain tax breaks while retailers pay higher ones because they don’t have research and development credits or use stock options as liberally. He believes taxing corporations based on their cash flows would solve many of the problems.

“If we simply taxed companies on their actual cash revenues and subtracted their actual cash expenses, we would eliminate things like depreciation and capital gains, which are sort of artificial constructions,” he said. “It’s those artificial constructions that companies like Enron spend all of their time manipulating because they are hard to verify.”

Congress seems inclined to continue cutting the tax bills of corporations. Tax cuts enacted in 2002 and 2003 are expected to save corporations $177.4 billion through fiscal 2005, according to the Joint Committee on Taxation, and proposals for additional cuts are on the way.

Massachusetts Sen. John Kerry has introduced the issue of corporate taxation into this year’s presidential campaign with a proposal that would cut the corporate tax rate to 32.5 percent from 35 percent, but eliminate the ability of corporations to defer paying taxes on foreign profits not taxed by another country. The plan also calls for a tax holiday on hundreds of billions of dollars in untaxed foreign earnings by taxing repatriated earnings at 10 percent for one year.

Tax experts say that the proposal, while interesting, is sketchy, and contend true reform will be difficult because of the political clout corporations yield in Washington.

“Running a tax system is like running levees on a river. If you don’t keep it fixed all the time, you are going to get a little hole and then another little hole and the channel shifts and the whole thing goes,” said **Michael McIntyre**, professor of law at Wayne State University in Detroit and an authority on tax issues. “Tax reform is a repair business. We’ve got a very cumbersome system for doing those repairs. It’s got to go through two houses of Congress and the president, and it’s not too hard for companies to block it.”

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