

Business Week

MARCH 31, 2003

SPECIAL REPORT

The Corporate Tax Game

How blue-chip companies are paying less and less of the nation's tax bill

Walk into any of the thousands of hotels run by Marriott International Inc. (MAR) in glamorous cities and vacation spots around the world, and you know what to expect. The plush carpeting and twinkling chandeliers don't change much from Philadelphia to Paris. But there is something surprising about the company that manages the Marriott, Ritz-Carlton, and Renaissance chains: It has a sizable investment in, of all things, coal-treatment machinery.

Huh? Coal-scrubbing machines may not sound exactly synergistic for an elite hotelier, but the investment serves a different profit center, one that has become increasingly important for Corporate America: tax management, a euphemism for old-fashioned tax avoidance. Using tax credits stemming from a section of the tax code meant to encourage production of fuel from nonconventional sources, last year Marriott recorded a net tax benefit from the coal machines of \$74 million. It expects a similar savings in 2003 — in all, more than double its initial \$60 million investment. That bonus was the biggest factor in driving the company's effective tax rate down to 6.8%, from 36.1% in 2001, as Marriott clearly disclosed to shareholders. That tax boon accounted for more than a quarter of last year's \$277 million in earnings.

There's nothing illegal about what Marriott is doing, and in fact nothing unusual. The federal income tax rate for corporations is 35%, but few pay that much. Over the past decade, companies across the U.S. have aggressively pursued tax-reduction strategies like Marriott's. Many have achieved the Holy Grail of corporate finance: steadily growing profits coupled with a dramatically shrinking tax burden. To reach that goal, they are taking extraordinary steps — everything from making tax-favored investments to shifting profits to low-tax jurisdictions overseas to reincorporating in Bermuda or other tax havens.

Companies have also been helped in their quest by a tax code that has become ridiculously complex, a result of the annual welter of revisions from Congress and

dogged work by an army of lobbyists. But in the late 1990s, the hunt for tax breaks became a much bigger business. For one thing, a new class of professionals — Wall Street investment bankers — joined the legions of lawyers and accountants hawking tax-management services. "Squadrons of lawyers, accountants, and Wall Street structured-finance experts have made an art form of minimizing the U.S. multinational's effective tax rate within this maze of the U.S. tax code, tax treaties, and global tax systems," says Selva Ozelli, international tax editor for RIA, a New York provider of tax information and software.

As the economic expansion reached its zenith, there was a much bigger pot of earnings to protect — and bigger expectations to meet each quarter. Tax avoidance became a competitive sport, with even blue-chip companies aggressively benchmarking their effective tax rates against those of rivals. According to a recent Harvard University study, U.S. companies avoided paying tax on nearly \$300 billion in income in 1998. "In the bubble years there was a huge drive to increase earnings by any means," says former Internal Revenue Service Commissioner Donald C. Alexander. "One of the means was minimizing tax payments."

While the recent corporate scandals have shone a harsh light on weak corporate governance, excessive executive pay, and deceptive accounting, corporate tax avoidance has continued, largely under the regulatory radar. But that could change. The Treasury Dept. on Feb. 27 unveiled new regulations designed to curb what it describes as a proliferation of abusive tax shelters — transactions that cross the line from tax minimization to tax evasion. Even in Congress, which has been slow to tackle tax reform, there's hope that the big tax-cut bill to be pulled together later this spring will address some of the worst abuses. Some in Congress have also called on the Securities & Exchange Commission to consider a prohibition against accounting firms selling tax advice to audit clients.

Tyco and Enron may have been the masters, but it's not just corporate rogues that have taken tax games to new extremes. After all, Enron Corp. modeled its massive tax department on that of General Electric Co. (GE) and a host of other big companies, according to a recent Senate committee report. Tech companies like Microsoft (MSFT), Cisco Systems (CSCO), and Compaq Computer (HPQ) proved adroit at shrinking their tax bills in the '90s through many means. Claiming unfair competition from lower-taxed overseas competitors, manufacturers have taken steps, too. Cooper Industries Ltd. (RD) reincorporated in Bermuda last May. Stanley Works dropped plans to move domiciles to Bermuda last summer after a backlash from lawmakers.

That kind of corporate maneuvering, combined with a long-term trend in Congress of shifting more of the tax burden to individuals, has driven corporate taxes down dramatically over the past four decades. In 1965, U.S. corporate taxes amounted to 4% of gross domestic product, according to the Organization for Economic

Cooperation & Development which includes local, state, and federal income and capital-gains taxes in its calculation. By 2000, that figure had dropped to 2.5%. That's the reverse of the OECD nations as a group, which saw aggregate corporate tax receipts climb from 2.2% of GDP 38 years ago to 3.6% in 2000.

What has tax experts and academics puzzled is why the decline has picked up steam in the past few years. In 2002, corporate tax receipts fell to just 1.5% of GDP, far more than any change in the tax rules can explain. Many blame a greater willingness to push the envelope on tax management. "Companies are being much more aggressive," says University of Michigan Business School economist Joel B. Slemrod. "It became more acceptable to play the tax lottery."

So who's to blame? It's hard to fault companies for trying to minimize their tax bills by any legal means. But the system has gotten out of hand. A Byzantine tax code has created endless opportunity for well-financed companies to game the system. Massive resources in the form of tax lawyers, strategists, and lobbyists and shelter-type investments are aimed at nothing more productive than lowering corporate tax bills. That leads to economywide inefficiency and waste. It also leads to basic inequities when tax rates are determined by the ability to fund a sophisticated tax department.

Those inequities become even starker when lobbying is taken into account. Major companies can afford to hire high-powered lobbyists to push for tax breaks, creating yet more complexity with added loopholes and exceptions. In the mid 1990s, for example, Microsoft pushed for a tax break on exports similar to one that had been extended to other intellectual property creators, including movie studios and record companies. After being rebuffed by the IRS in 1995, Microsoft's lobbyists took the issue to Congress. The result: an 86-word provision, shoe-horned into a 1997 budget-reconciliation bill, extending the break to software companies. "Microsoft felt like it should get equal treatment under the tax law," says spokeswoman Caroline Boren, who declined to say how much the legislation saved the company or how much the lobbying effort cost.

The maneuvering by corporations has left the average American with a vastly larger portion of the federal tax burden. In 1940, companies and individuals each paid about half the federal income tax collected; now the companies pay 13.7% and individuals 86.3%. With the scales tipped so far in one direction, the issue of corporate tax avoidance is starting to attract attention in Congress. "If it isn't cut out, it spreads," says Senate Finance Committee Chairman Charles E. Grassley (R-Iowa). "It's much beyond the few obvious cases."

For too many companies, the bull market of the late '90s turned into an extended tax holiday, even as reported earnings soared. Companies serious about minimizing taxes built powerhouse tax departments staffed with former government tax experts. GE, Ford, and Merrill Lynch have all hired top-flight tax experts from the Treasury

Dept. and the IRS. John M. Samuels, hired by GE out of Treasury 20 years ago, went on to assemble an extraordinary team of tax talent. "The best tax law firm in the world," says Timothy J. McCormally, executive director of the Tax Executives Institute, "is the tax department at GE." GE spokesman David Frail says the company hires tax specialists from many places, including law firms, accounting firms, and other companies.

What strategies do those experts pursue? Exploiting low tax rates overseas was and is one of the most common methods of cutting the tax bill. The game has one simple goal and many routes to get there. The aim is to pile up income in low-tax nations while shifting expenses to high-tax nations. The most extreme version of this, and the tactic that has drawn the most fire, is to simply incorporate in a tax haven. Although it cost Tyco International Ltd. shareholders \$1 billion in capital-gains taxes when the company moved to Bermuda in 1997, by 2001 the company was saving \$600 million a year. Cooper Industries, Ingersoll-Rand Co., and a dozen or so others have made similar moves in the past five years. Washington has decried the trend, but Congress has yet to enact curbs.

Concern about these so-called corporate inversions may be taking attention away from a larger, more subtle migration of corporate income and assets toward countries with lower tax rates. Martin Sullivan, a tax economist, recently published a study showing a sharp drop in the foreign tax rates of U.S. multinationals — from 49.6% in 1983 to 22.2% in 1999. Sullivan found that only half of that came from government tax-rate reductions. The other half was the result of shifting income from foreign countries with a higher tax rate to those with lower rates. "This is the more insidious aspect of corporate expatriation," Sullivan says. "They're not moving their headquarters offshore, they're moving their assets."

A simple way to milk the system is by setting up transactions between different arms of the company. In one U.S. tax court case that is still pending, the IRS accused hotelier Hyatt International of paying too little for the Hyatt brand and other services provided by its U.S. parent. The IRS alleges that from 1976 to 1988, various Hyatt companies underreported income by \$100 million because of those lowball fees. In an October, 1999, ruling on some aspects of the case, U.S. Tax Court Judge Joel Gerber ruled that the \$10,000 one-time fee International had paid for each hotel bearing the Hyatt name was far too low. Hyatt declined to comment because the broad case is ongoing.

Tax lawyers report a steady stream of technology and pharmaceutical patents being moved overseas. That leaves Boston lawyer Avi M. Lev worried about the U.S.'s stature as a technology leader. "Many countries deliberately tax investment income at a lower rate to attract capital," he says. "We have a high rate because there's lots of good reasons to be here other than the tax rate. But with intellectual property, that tax competition is turned up a notch because intellectual property moves so freely,

by the signing of a document."

Pushing even a little income into a lower-tax venue can result in substantial savings for a big company. GE whittled its effective tax rate from 28.3% in 2001 to 19.9% in 2002, paying \$1.5 billion less in taxes on its \$17.9 billion in earnings before income taxes. The single biggest contributor to that decline has been tax credits the company receives on exports and a greater percentage of taxes paid overseas, often in lower-tax jurisdictions. CFO Keith Sherin recently assured analysts that such credits would continue to hold down GE's U.S. tax bill. Within the GE empire, GE Capital enjoys the lowest tax rate. The financing giant paid only 15% in taxes last year, excluding the effect of a reinsurance write-off. How did Capital do it? Good question. Unlike financial statements, tax returns are not public documents. Clearly it benefits from depreciation generated in its huge leasing operations and sizable overseas business. GE declined requests for interviews on the topic and provided only limited answers to written questions.

So much focus on tax savings, critics argue, results in inefficient uses of capital and resources, and some strange business decisions. Compaq Computer Corp., for example, purchased 10 million American depositary receipts of Royal Dutch Petroleum (RD) in 1992 and resold them minutes later at a loss. Its brief ownership, however, earned Compaq a \$22.5 million dividend and a foreign tax credit for the \$3.4 million in taxes it paid on that dividend to the Netherlands. It used the \$20.6 million loss from selling the stock to offset another gain, a benefit worth \$7 million — thus pulling off a hat trick of tax benefits. After years of litigation, in 2001 an appeals court ruled against the IRS, determining that Compaq acted within the law.

Another popular tax dodge that has incurred the IRS's wrath: corporate-owned life insurance policies. Companies including Wal-Mart Stores (WMT), Procter & Gamble (PG), and Winn-Dixie Stores (WIN) once took out life-insurance policies on employees designed to yield tax-free income for the company and a corporate tax deduction on the interest. The IRS says such arrangements serve no legitimate business purpose and has disallowed the deductions.

The payoff for such circumlocution is clear — a low tax bill equals higher earnings, and a higher stock price. David A. Guenther of the University of Colorado and Denise Jones of the College of William & Mary found that a reduction in a company's effective tax rate generally results in a rise in stock price. Two consecutive improvements gives a slightly bigger jolt, and moving income overseas results in the biggest jump of all. Thus, a good tax dodge can boost the stock price — and the value of executive stock options, which were handed out with such abandon in the late '90s.

Options not only created perverse incentives for executives to lower the tax rate; they also gave them the very tools with which to do so. When stock options are

exercised, the employee pays income tax on the gain. The company, however, doesn't book any expense, but gets a tax deduction equal to the difference between the exercise price and the price the stock is fetching in the market. Howard Schilit, president of the Center for Financial Research & Analysis Inc. in Rockville, Md., calls it "winning the lottery" for corporate tax departments.

The payoff was certainly Lotto-like. When option exercises peaked in 2000, the 50 companies in the S&P Global 100 that reported exercised stock options lowered their tax bills by a combined \$20 billion, says Charles W. Mulford, an accounting professor and director of the Financial Reporting & Analysis Lab at the Georgia Institute of Technology's Dupree College of Management. A half dozen were able to shave more than \$1 billion off their returns, including Microsoft (\$5.5 billion), Cisco Systems (\$2.5 billion), and Citigroup (C) (\$1.4 billion).

With the stock market decline, this tax bounty has shrunk but hasn't disappeared. The value of the stock-option deduction fell to \$11 billion in 2001 for the companies in Mulford's study. Some companies that had become accustomed to ever-growing stock-option deductions were hit hard. From 2000 to 2002, Microsoft Corp. saw its income-tax bill more than double, from \$800 million to \$1.9 billion. Cisco Systems Inc.'s (CSCO) tax bill nearly tripled during the same period, from \$327 million to \$909 million — even though net earnings fell from \$2.7 billion to \$1.9 billion. Cisco declined to comment. Microsoft spokeswoman Boren says: "Microsoft works hard to comply with the tax laws and to pay the legally proper amount of tax....The company claims all deductions to which it is legally entitled."

Companies with aggressive tax-minimization goals invariably claim that their strategies are necessary to compete globally. "The current U.S. tax law is poorly aligned with the tax systems governing our international competitors," says a spokesperson for Cooper Industries. "As a result, U.S. companies are at a competitive disadvantage in pricing their products and in competing for acquisitions."

While it's true some foreign companies, including some of Cooper's competitors, pay lower tax rates, many pay more. The U.S. statutory corporate tax rate of 35% is on the high end, and unlike many countries, the U.S. taxes global income; but foreign companies have other taxes. In France, for example, payroll taxes add significantly to the 30% statutory tax rate, sometimes boosting the tax bill above 60%. In Japan, Sony (SNE), NTT DoCoMo (DCM), and Toyota Motor (TM) all pay more than 40% a year in taxes.

Companies that move to zero-tax havens still operate on an uneven playing field — it's just that now they have the advantage. Disk-drive maker Seagate Technology (STX) became a Cayman Islands company in November, 2000. It paid an effective tax rate of 3% in the last six months of 2002. (The company operates tax-free in many Asian countries.) And although it was headquartered in Bermuda for only half

of last year, Cooper Industries paid an effective tax rate of 24%, down from 35% in 2000. That's on a par with German competitor Siemens and significantly lower than the rates of competitors it left behind like Eaton (ETN) and Emerson Electric (EMR).

While companies were mounting ever greater efforts to avoid taxes, the response from regulators was almost nonexistent. New York District Attorney Robert M. Morgenthau, who is prosecuting former Tyco (TYC) CEO L. Dennis Kozlowski, argues that regulators made a mistake in failing to go after corporations that undertook the most extreme tax maneuvers. Being passive, he says, ensured a growing trend of me-too tax schemes. "Why should I pay my taxes when my neighbor is not paying his or hers?" Morgenthau asks.

The IRS has a good defense. Its budget has been cut in recent years, and with the most aggressive tax shelters structured to involve many layers of transactions and dozens of tax returns, the workload is up. Even without the cutbacks, the rising complexity of the tax code has made enforcement harder than ever, and strategies for skirting the rules ever more plentiful.

There's no doubt that companies with powerhouse tax departments often end up manipulating the tax code in ways lawmakers never intended — and in many cases end up paying less than anyone ever envisioned. Taken to an extreme, tax games distort the system and waste resources on investments that serve little purpose beyond financial engineering. There's got to be a better way.

By Nanette Byrnes and Louis Lavelle
With Howard Gleckman in Washington and bureau reports