

Summer 2006



# Sunshine For California

Shining Light On Corporate Tax Secrecy For  
Healthier State Budgets, Investments and Markets

**CALPIRG**  
Education Fund

# Sunshine For California

## **Shining Light On Corporate Tax Secrecy For Better State Budgets, Investments and Markets Summer 2006**

### Acknowledgements:

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## Executive Summary

Corporate tax avoidance leaves taxpaying households to pick up the tab for funding highways, schools, and other public structures. Much of the indirect costs of aggressive tax avoidance are also borne by investors who are unaware of these risky schemes. And everybody suffers when corporate profitability is determined by opportunities for tax evasion rather than efficiency or innovation.

### **Corporate tax avoidance is a rampant problem.**

- In California 78 percent of corporations paid no more than the \$800 minimum franchise tax in 2001. Worse, over half of *profitable* corporations paid no more than \$800 minimum, including 46 corporations with over \$1 billion in 2001 receipts.
- A study by the Multistate Tax Commission, a joint agency of state governments, estimates that by 2001 the growth of corporate tax sheltering accounted for \$12.4 billion in lost annual revenue beyond what occurred during the 1980s. According to mid-range estimates, California corporate tax revenue was 19 percent lower than it should have been.
- The federal Government Accountability Office estimates that underreported corporate income taxes and employment taxes cost the federal government \$84 billion in 2001. The GAO also reports that 33 percent of large U.S. corporations reported no tax liability in 1995, a percentage that rose to 45 percent by 2000.
- A study of 252 Fortune 500 companies between 2001 and 2003 found that they paid state taxes at only a third of the statutory rates and 71 of them paid no state taxes at all during at least one of these years.

Companies can practice a wide variety of tax-avoidance maneuvers, some of which are legal. Information about the use of particular tax schemes or basic information about whether corporations pay taxes remains hidden as corporate secrets.

### **Taxpayers pick up the tab when corporations avoid their taxes.**

The personal income tax is expected to provide 53.2 percent of revenues in the 2006-07 California state budget, up from 35.4 percent in 1980-81. Corporate tax receipts are meanwhile expected to provide 10.9 percent of General Fund revenues in 2006-07, down from 14.6 percent in 1980-81.

### **Corporations routinely report significantly lower incomes to California tax authorities than they do to their own shareholders;**

and they do so without any explanation for these differences. Corporations have a strong incentive to overstate their income to shareholders and to underreport income on their tax forms. The California Franchise Tax Board (FTB) calculates that corporations would contribute an additional \$1 billion to \$1.5 billion a year to the California state budget if they paid taxes on the income numbers that they tout to their shareholders. A Harvard study similarly found that for every \$1 in income reported to the federal government for tax purposes in 1998, \$1.63 was reported to shareholders.

### **Corporate tax secrecy obstructs good policy, sound investment, and market efficiency.**

Large nonprofit corporations must publicly disclose their detailed financial information. But for-profit corporations keep even their basic taxable income and the share they pay a se-

cret. The lack of transparency leaves legislators in the dark, misleads investors, and distorts markets.

- *Legislators* are responsible for fine tuning tax laws, but they lack basic information about what corporations actually pay or how tax avoidance schemes reduce revenue.
- *Investors* cannot assess the financial health of corporations that aggressively avoid taxes, defer their tax liabilities, or inflate profit claims to shareholders. California could have been spared great pain if tax authorities had compared Enron's reported \$3.625 billion in profits reported to their shareholders between 1996 and 2000 to the \$76 million reported to the IRS during this period. Studies show that the book-tax gap is a reliable predictor of tax evasion as well as poor future investment returns.
- *Market performance* suffers when corporate secrecy encourages tax evasion. Corporate tax avoidance skews the playing field toward economic activities that offer the most opportunity to avoid taxes rather than those that are most efficient or innovative. For instance, corporate tax evaders may pay lawyers and accountants large sums to create complex subleasing or debt-for-equity swaps that serve no productive purpose other than to reduce tax exposure.

### **Increased corporate tax transparency is a simple and effective solution.**

Requiring corporations to disclose and explain the gap between book and tax income would help reduce unlawful tax avoidance. Tax evasion thrives where its practices remain secret and reporting rules are inconsistent. Three kinds of reforms would promote transparency:

- *Corporations should be required to explain*

*discrepancies in the income numbers they report to tax authorities and their own shareholders.* In response to concerns about tax evasion, in tax year 2004 the IRS began requiring corporations with assets over \$10 million to file an additional form, the M-3, to reconcile differences between their reported income on financial and tax filings at the federal level. The Internal Revenue Service should make sure that all corporations are fully complying with the new requirement and enact penalties for non-compliance. In addition, California would benefit from a similar requirement at the state level, so that the Franchise Tax Board is equipped with the same detailed information to better target enforcement and minimize audits for law-abiding businesses.

- *Public disclosure of how much corporations and large companies pay* would make summary information accessible for journalists, watchdog groups, investors, analysts, and tax agencies. Corporate tax secrecy should not transcend the public's right to know summary information about specific companies. Greater transparency would help ensure corporate accountability while promoting public confidence in government and elevating public debate about taxes and budgets.
- *Reducing some differences in how book income and tax income are calculated* would simplify tax compliance and reduce opportunities for tax evasion.

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## Introduction

Californians wrangle over the proper distribution of taxes to fund important services such as schools, hospitals, public safety, and infrastructure. Citizens expect their legislators to fine tune tax laws to balance the proper incentives with a fair sharing of tax burdens. To ensure fairness and compliance with the law, tax-exempt organizations such as charities are required to disclose their finances on publicly available forms that anybody can view on the internet.<sup>1</sup>

But this is not the case with for-profit corporations. Amazing as it seems, no legislators, investors, media, or watchdog groups can view even summary information about taxes paid by particular companies. Legislators responsible for adjusting tax policies have little notion of what corporations actually pay. Investors have no way to know when high profits reflect risky tax avoidance positions. And markets are skewed toward less efficient corporations

with more aggressive tax strategies or activities that afford greater opportunities to escape taxes.

A major way that corporations avoid taxes is by routinely reporting lower profits to the state tax board than they report to shareholders. Unlike the IRS, California tax authorities do not yet require corporations to explain these differences. Corporations can tout high profits in glossy annual reports for investors, while reporting no profits to the tax board. Widespread abuse of double accounting allows corporations to manipulate profit numbers through a variety of schemes such as offshore tax shelters and billing themselves through fictitious subsidiaries. Enron is the best-known example of tricky accounting. The company reported \$3.625 billion in profits to their shareholders between 1996 and 2000. Yet the company reported only a small fraction of that amount, \$76 million, in profits to the IRS.<sup>2</sup>

### Book Versus Tax Income

“*Book income*” refers to the financial accounting information that companies file with authorities based on their books. The methods are governed by standard accounting rules that nonetheless leave discretion about how to record certain kinds of transactions.

“*Tax income*” or taxable income refers to the income a company discloses on its tax return. A *book-tax gap* describes the size of reporting differences between book income and tax income.

Tax rules and accounting standards sometimes dictate different ways of dealing with the same transaction. For instance, tax laws forbid companies from counting unused vacation time earned by employees as an accrued loss, but accounting rules allow such estimates. Accounting standards are meant to describe financial conditions; tax rules are also meant to motivate certain behavior, such as increased investment through accelerated depreciation allowances.

Different accounting standards do not fully justify the fact that book income is routinely higher than tax income. On the contrary, the reigning US Supreme Court case on the issue notes that whereas the tax system aims to recognize profits for adequate revenue collection, accounting principles should instead err conservatively on the side of understating profits, “possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets.” See *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979).

1. See National Center for Charitable Statistics (NCCS) <http://www.nccs.urban.org>

2. Desai, Mihir A. “The Divergence Between Book Income and Tax Income,” In James Poterba, ed., *Tax Policy and the Economy*, 17 (MIT Press, 2003), Table 1. These numbers, drawn from the Congressional Joint Committee on Taxation’s 2003 report, compare Enron’s net income reported in consolidated financial statements to taxable income reported on consolidated tax return.



## Tricks of the Trade: How companies avoid taxes

Corporate tax avoidance is a rampant problem that appears to be getting worse.

High-profile scandals are just the tip of an iceberg of tax avoidance. A Harvard study found that in 1998, for every \$1 in income reported to the federal government for tax purposes, \$1.63 was reported to shareholders. For some kinds of transactions the financial accounting procedures differ from the proper tax rules (see box). The Harvard study found nonetheless that at least \$154 billion of these disparities cannot be attributed to differences in accounting rules.<sup>3</sup> To put that sum in context, the amount exceeds that year's combined total federal spending on education, employment, training, social service, international affairs, general science, space, technology, energy, natural resources, environment, agriculture, commerce, housing credits, community and regional development, and general government put together.<sup>4</sup>

This paper outlines the problems associated with corporate tax avoidance and solutions aimed particularly at accounting for differences between corporations' taxable and book income. It explains some methods corporations use to avoid paying taxes. The paper describes how households end up picking up the tab left by reduced corporate tax revenues. Much of the indirect costs of aggressive tax avoidance are also borne by investors who are unaware of these risky schemes. And everybody suffers when corporate profitability is determined by opportunities for tax evasion rather than efficiency or innovation. Finally, the paper explains how greater tax transparency can solve these problems.

- The federal General Accountability Office estimates that underreported corporate income taxes and employment taxes cost the federal government \$84 billion in 2001. The GAO also reports that 33 percent of large U.S. corporations reported no tax liability in 1995, a percentage that rose to 45 percent by 2000.<sup>5</sup>
- A study by the Multistate Tax Commission, a joint agency of state governments, estimates that by 2001 the growth of corporate tax sheltering accounted for \$12.4 billion in lost annual revenue beyond what occurred during the 1980s. According to mid-range estimates, California corporate tax revenue was 19 percent lower than it should have been.<sup>6</sup>
- In California 78 percent of corporations paid no more than the \$800 minimum franchise tax in 2001. Worse, over half of profitable corporations paid no more than the \$800 minimum, including 46 corporations with over \$1 billion in 2001 receipts.<sup>7</sup>
- A study of 252 Fortune 500 companies between 2001 and 2003 found that they paid state taxes at only a third of the statutory rates and 71 of them paid no state taxes at all during at least one of these years. Corporations that avoided all state taxes during every year of the study included such major corporations as AT&T, Boeing, Eli Lilly, Merrill Lynch, ITT, and Toys "R" Us.<sup>8</sup>

3. *Ibid.*

4. *The President's Office of Management and Budget for the 1998 fiscal year reports the following allocations: education, employment, training, and social service, \$56 billion; international affairs, \$15 billion; general science, space, and technology, \$16 billion; energy, \$2 billion; natural resources and environment \$22 billion; agriculture, \$12 billion; commerce and housing credits, \$3 billion; community and regional development, \$11 billion; and general government, \$13 billion. The sum of these totals equals \$150 billion.*

5. *General Accountability Office, "Tax Compliance: Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting," Statement of David M. Walker Comptroller General of the United States testimony before the Committee on Finance, U.S. Senate, June 13, 2006.*

6. *Multistate Tax Commission, "Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections, Multistate Tax Commission (July 15, 2003), available at <http://www.mtc.gov/TaxShelterRpt.pdf>. While tax sheltering results in more lost revenue in California than any state, the rate of lost revenue falls below the average state rate of 31 percent. The estimates do not include improper conversion of companies into "S" corporations.*

7. *Jean Ross, "All Gain, No Pain: California's "No Tax" Corporations," California Budget Project (September 2004).*

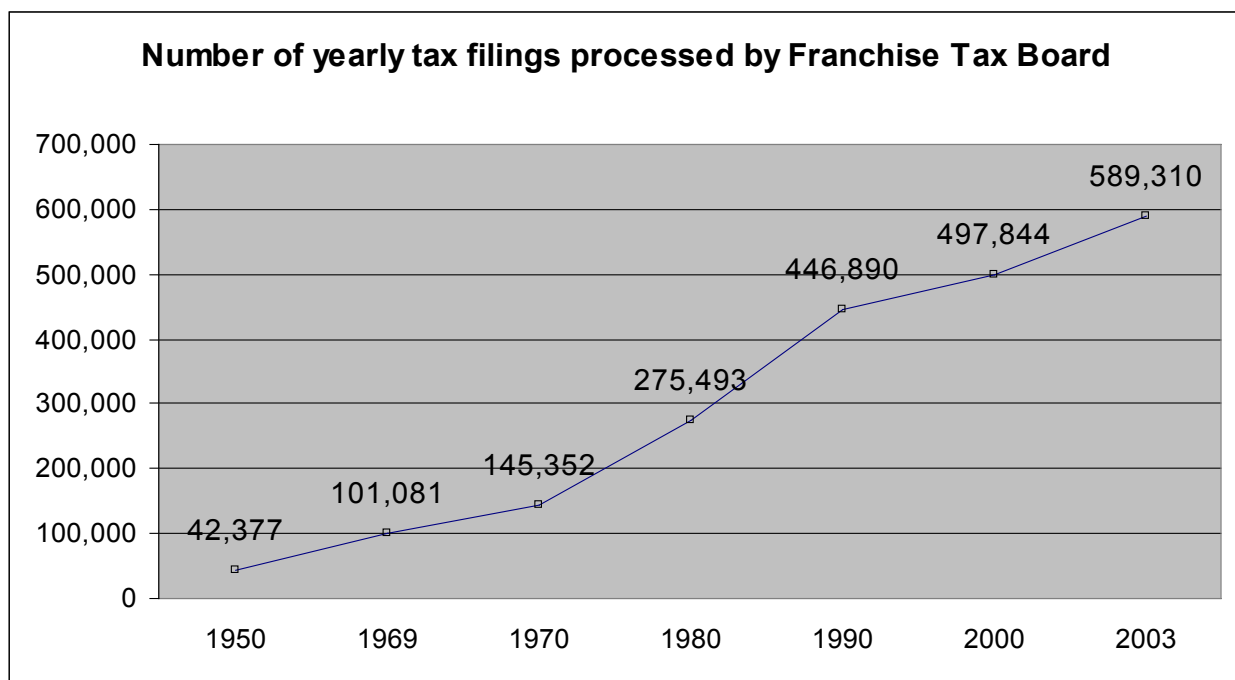
8. *Robert S. McIntyre and T.D. Co Nguyen, "State Corporate Income Taxes 2001-2003," Institute on Taxation and Economic Policy (Feb. 2005).*

Companies can practice a wide variety of tax-avoidance tricks, some of which are legal. Companies can simply not report income, abuse rules meant for small personal “S”-corporations, create phony losses through shell affiliate corporations, and exploit differences between tax income and book income to artificially inflate their earnings on glossy annual reports while minimizing those earnings in reports to tax authorities.

According to the California Franchise Tax Board, abusive tax schemes became increasingly common during the 1990s, partly as the result of decreased compliance activity by the IRS and partly because of “no efficient disclosure and reporting system for abusive tax schemes.”<sup>9</sup> Information about the use of particular tax schemes or basic information about whether corporations pay taxes remains hidden behind the veil of corporate privacy.

### Underreporting income

The most straight-forward way to avoid income taxes is simply to underreport income. Companies can rely on the fact that less than one percent of corporations will get audited, that authorities lack the resources to see enforcement cases through years of appellate court proceedings, and will likely settle on a compromise even if they have a strong case.<sup>10</sup> Enforcement staffing at the Internal Revenue Service and Securities Exchange Commission has not kept up with the increase of tax returns, much less the proliferation of tax-avoidance schemes. California’s Franchise Tax Board was similarly forced to eliminate 480 positions in the 2003 budget cuts. Meanwhile, the number of corporate filings that required processing and potential audits and enforcement rose steadily, more than doubling since 1980 to 589,310 in taxable year 2003 (see figure below).<sup>11</sup>



9. Franchise Tax Board website, “Frequently Asked Questions,” (last viewed July 20, 2006) [http://www.ftb.ca.gov/law/tax\\_shelter/ats\\_faq.html#ATS3](http://www.ftb.ca.gov/law/tax_shelter/ats_faq.html#ATS3). The FTB also mentions low penalties, high capital gains, and marketing of abusive tax schemes.

10. See Congressional testimony of Senior Urban Institute Fellow Leonard E. Burman before the Committee on the Budget United States House of Representatives on Waste, Fraud, and Abuse in Federal Mandatory Programs, July 9, 2003, available at [http://www.house.gov/budget\\_democrats/hearings/burman\\_july03.pdf](http://www.house.gov/budget_democrats/hearings/burman_july03.pdf)

Many corporations get away with paying much less than the statutory 8.84 percent tax rate by abusing the intent of “S” corporations, which are meant to be for smaller and more personal corporations where profits mainly go to a small group of board members. “S” corporations pay only a 1.5 percent tax rate on income, purportedly because the company’s shareholders will then pay personal income tax on it.<sup>12</sup> Unfortunately, the estimated number of large companies who abuse the “S” corporation status is such that California Tax Reform Association estimates that if California were to limit the “S” corporation status to just companies with profits of less than \$20 million, annual state revenue would increase by at least \$300 million dollars.<sup>13</sup>

### **Hiding profits across state lines**

Because of the lack of information, it is impossible to compare California’s book-tax gap to that of other states or the federal government. California filings by “C” corporations indicate that their total world-wide taxable earnings exceeded world-wide losses by almost seven-fold. For business activity apportioned to California, these same corporations reported profits as only half again greater than losses.<sup>14</sup> These figures do not in themselves measure tax fraud. They do suggest that corporations disproportionately apportion their taxable profits in other jurisdictions and their taxable losses in California.

In order to avoid California taxes, companies can incorporate in a lower-tax state such as Nevada, which has no corporate income tax.

California laws make it harder to earn income in California but pay taxes elsewhere. For instance, a company must file taxes in California if: workers in the company spend at least six months in California, have a California address or phone number, open a California bank account, or hire subcontractors in California. Corporations seeking to avoid California-based profits therefore have more success when they create separate corporations in California and Nevada, for instance. Creative accounting of fictitious transactions between these corporations can ensure that more losses are apportioned in California and more profit in Nevada where it cannot be taxed.<sup>15</sup>

Unlike some states, California’s modern tax laws prevent many kinds of corporate shell games that apportion profits to lower-tax jurisdictions and losses to the California side of operations. Corporations filing in California must follow standard methods of apportioning their total world-wide income according to three measures of in-state business activity: payroll, property values, and income from sales.<sup>16</sup> In 2003 corporations apportioned an average of 8.7 percent of their income to California business activity, down from 9.4 percent the year before. Corporations that do business in California or are registered or organized in-state must pay at least the state’s minimum \$800 franchise tax unless they are in the first year of operation.

### **Shifting income between companies**

Differences between book income and taxable income allow executives at publicly traded corporations to avoid an important constraint. On

11. Franchise Tax Board Annual Report 2004. The Franchise Tax Board (FTB) is California’s governmental entity responsible for administering California’s Personal Income Tax and the Corporation Tax. The FTB also administers the Homeowner and Renter Assistance (HRA) program, and other non-tax programs and delinquent debt collection functions, including child support debt collections and delinquent vehicle registration debt collections on behalf of the Department of Motor Vehicles.

12. The general “C” corporation rate is 8.84 percent, but 10.84 percent for banks and financial “C” corporations. Similarly, the “S” corporation rate is 1.5 percent, but 3.5 percent for banks and financial “S” corporations.

13. Lenny Goldberg, *Tax Policy for the 21st Century: Resolving California’s Long-term Structural Deficit*, California Tax Reform Association. Downloaded from <http://caltaxreform.org/?m=200605> in July 2006.

14. Authors calculations based on FTB reported world-wide profits of \$661.4 billion among companies that file in California, compared to world-wide losses of \$93.4 billion reported by these firms. Apportioned to California these firms reported profits of \$71 billion compared to total losses of \$47.6 billion. See *Franchise Tax Board Year Book 2004*, page 38. The disparity can not simply be explained by non-California operations being more profitable before taxes because of California’s unitary tax structure for apportioning tax liability.

15. See for instance, <http://www.nvadacorporationsonline.com/Strategies.htm>

the one hand, corporate executives like the way high income numbers elevate their stock price, garner support from board members, and court outside investment. On the other hand, high incomes expose companies to higher costs from income taxes. It is easy to see why self-interested executives might use accounting tricks to inflate their financial numbers and underestimate their taxable income, even if taxpayers and shareholders suffer as a result.

Companies can hide taxable income through complex accounting tricks that shift profits and losses across related businesses through complex transactions, leases, and loans. Investment banks, law firms, and auditors sometimes offer their customers “off-the-shelf” financial instruments to shelter gains and generate artificial losses. As former Treasury Deputy Secretary Stuart Eizenstat reflected at a conference of tax professionals in 2000, “We were outgunned and outmanned by tax shelter merchants. We were told that for each shelter we took action against, ten more were escaping without our notice. The situation was, and is, just like that of the mythical Hydra, except recast in the context of modern corporate finance.”<sup>17</sup> Among the tricks of the trade are:

- *Inventory manipulation* – Companies can count items in their inventory that have declined in value as losses for tax purposes without recognizing the increasing value of other inventory and without counting the declining values on their financial balance sheets.<sup>18</sup>
- *Foreign partnerships* – Companies can reorganize themselves to establish a

partnership in another state or country that holds title to assets used by the company. The foreign partner can reap profits under lower-tax foreign rules, while losses are allocated to the U.S. firm which uses them to offset their U.S.-based profits. The end result for the U.S. firm is that they have a partnership with healthy untaxed profits and can count paper losses against their U.S. profits to further reduce tax liability.<sup>19</sup> Moreover, in creating the foreign affiliate, the company can trade its real assets for overpriced stock that it then sells at a paper loss, perhaps – as Enron did – to its own employees.<sup>20</sup>

- *Intangible assets* – One academic study, using data from the foreign affiliates of U.S. firms located in Puerto Rico, found that companies often create tax shelters through the ways they value their “intangible assets,” such as their logo, copyrights, patents, or “know how.” The study found that companies with a greater portion of their assets accounted for as “intangible assets,” shifted more of their income to low-tax jurisdictions where affiliates were given ownership of the intangible assets. By paying their affiliates for the use of their logo, for instance, income can be continually shifted to the tax-free foreign affiliate while creating paper losses for the U.S.-based company which then pays for use of those assets.<sup>21</sup>
- *Synthetic leases* – Exploiting legal loopholes, these arrangements appear from an accounting standpoint as a lease of assets, but appear as a loan from a tax standpoint. Neither the asset nor liabilities such as interest obligations appear on the

16. The California portion of business income plus non-business income such as interest and dividends comprise the net taxable income from which California tax liability is determined. Franchise Tax Board Annual Report 2004, p. 42.

17. Stuart E. Eizenstat, Remarks to the Tax Executives Institute Mid-Year Conference, Washington, D.C., LS-476 (Mar. 20, 2000) available at <http://www.treas.gov/press/releases/ls476.htm>

18. Linda M. Beale, “Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-To-Market Safe Harbor” *Virginia Tax Review*, Vol. 24, Fall 2004

19. California’s unitary reporting rules attempt to prevent this tax shelter by requiring consolidated business groups to report world-wide business activity but partnerships may be hidden behind complex or business structures or personal ownership and foreign earnings can be easier to hide.

20. See Linda M. Beale, “Putting SEC Heat on Audit Firms and Corporate Tax Shelters.”

21. Grubert, H., and J. Slemrod. 1998. “The effect of taxes on investment and income shifting to Puerto Rico.” *The Review of Economics and Statistics* 80 No. 3 (August): 365-73.

balance sheet – thus improving the on-paper performance of the company’s return and its debt-to-equity ratio. The company can meanwhile count its interest payments for the lease and the accelerated depreciation of the assets as deductions on their taxes.<sup>22</sup>

- *Trust preferred stock* – Companies can create separate trusts to hold their debt then issue “trust preferred stock” to the original company. By doing so, the company removes debt from its financial balance sheet and simultaneously reduces its tax bill by deducting the interest payment to the trust as a loss for tax purposes paid to a separate partnership where distributions from that partnership are not then taxable.<sup>23</sup>

Without some supplementary source of guidance, overburdened tax authorities are often unable to unravel these sorts of complex financial schemes. They struggle to find abusive tax shelters or pursue them through drawn-out legal hearings. As then Treasury Secretary, Lawrence Summers noted, tax shelters are “structured to be impenetrable.”<sup>24</sup>

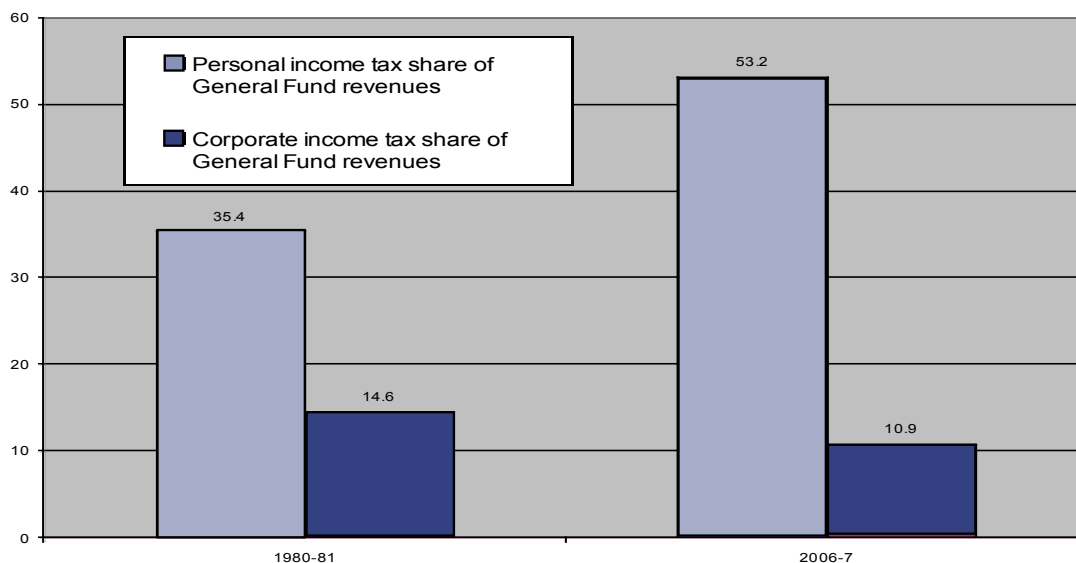
## The Problems of Corporate Tax Secrecy

### Problem #1: Corporate tax secrecy hurts tax-paying households

When companies avoid paying taxes, private citizens pay more. The personal income tax is expected to provide 53.2 percent of the California budget in 2006-07, up from 35.4 percent in 1980-81. Corporate tax receipts are meanwhile expected to provide 10.9 percent of budget revenues in 2006-07, down from 14.6 percent in 1980-81.<sup>25</sup>

Tax evasion and abusive use of tax shelters are not victimless crimes. The Franchise Tax Board states, “To the extent that government expenses are static and investments in abusive tax schemes reduce the tax burden of one segment of the public, *the real cost of abusive tax schemes is borne by taxpayers who correctly file their returns and pay their fair share of taxes.*”<sup>26</sup> Similarly, the larger the tax-book gap grows, the larger the revenue gap will grow between personal and corporate taxes. The Franchise Tax Board study estimates that California would raise an additional \$1 billion to \$1.5 billion if companies paid taxes on their

Personal income tax share rises as corporate share declines



22. Linda M. Beale, “Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-To-Market Safe Harbor” *Virginia Tax Review*, Vol. 24, Fall 2004

23. Ellen Engel, Merle Erickson, and Edward Maydew, “Debt-Equity Hybrid Securities,” *Journal of Accounting Research*, vol. 37, no. 2 (Autumn 1999).

24. Press Release, Lawrence H. Summers, *Tackling The Growth of Corporate Tax Shelters: Treasury, Secretary Lawrence H. Summers Remarks to the Federal Bar Association, Department of the Treasury Office of Public Affairs (Feb. 28, 2000)*, available at <http://www.treas.gov/press/releases/lh421.htm>, quoted in Beale (June 200), p. 246

book incomes rather than their (generally lower) tax incomes.<sup>27</sup>

Citizens also suffer when legislators lack the information to fine tune tax policy. In California, information about which corporate tax loopholes get abused and how much they cost the state remains shrouded in secrecy. If a company threatens to leave the state because of excessive corporate taxes and demands special incentives, lawmakers have no way to know even whether the individual company pays any tax. Legislators also remain in the dark about how legal loopholes lose the state revenues. Political leaders cannot ensure that companies pay their fair share when they lack basic information about how much particular companies pay.

## **Problem #2: Corporate tax secrecy hurts investors**

Decision-making requires information. Investors suffer when they are misled about the financial health and risks of companies. Poor investments can look good when managers abuse differences in accounting and tax reporting to overstate profits, hide risky tax-avoidance schemes, or disguise unscrupulous self-dealing.

Many of the legal accounting gimmicks that companies can play to escape taxation can create hidden problems for investors. For instance, companies may manipulate inventory changes or selectively recognize long-term contracts to tout large book profits to their shareholders but defer this income as unrealized for tax purposes. These manipulations may help a corporation make quarterly earnings goals and boost their stock price, but investors will see lower profits in the future when taxes finally must be paid on deferred profits

and book profits on long-term contracts have already been realized.

Aggressive tax shelters are also a hidden risk for investors because discovery by government auditors can drag down future returns. When accounting tricks are challenged by auditors, companies typically pay large amounts on accountants and lawyers to defend their actions; they may end up paying considerable tax and interest penalties; and litigation distracts management from ongoing business activities.

Enron showed how unscrupulous managers can use complex tax-avoidance accounting to siphon off funds for themselves and to abuse risky short-term schemes that endanger the company. According to Harvard Business School professor Mihir Desai, Enron used the distinctions between book and tax profits to misreport their business positions. Investors would likely have been alarmed if they were aware of Enron's low taxable income reports. Tyco similarly used a variety of tax-avoidance techniques to cheat shareholders.

Other academic and governmental studies similarly show that investors benefit when tax avoidance is more difficult:

- Baruch Lev of New York University's Stern School, and Doron Nissim, of Columbia Business School analyzed the tax-book gap of over 3,000 publicly traded American firms during 1973-2001. They found that firms with a smaller gap between tax and book profits showed stronger-than-average subsequent growth in accounting profits, while firms with the biggest tax-book gaps tended to see their profits deteriorate dramatically.
- Professor Desai at Harvard and other researchers find that managers divert larger

25. Jean Ross, "Who Pays Taxes in California?," California Budget Project, April 2006. Some of this shift likely results from S-corporation provisions introduced in the mid-1980's.

26. Franchise Tax Board website, "Frequently Asked Questions," (last viewed July 20, 2006) [http://www.ftb.ca.gov/law/tax\\_shelter/ats\\_faq.html#ATS3](http://www.ftb.ca.gov/law/tax_shelter/ats_faq.html#ATS3), emphasis added

27. Franchise Tax Board study, "Require Certain Corporations To Calculate Tax Liability Using Book Income," at the request of Assembly

amounts of money when they are making greater use of complex tax-sheltering devices. "Income that is sheltered from the tax authorities may be less visible to shareholders, and hence more easily diverted." This is logical because, "If any obfuscatory actions are taken to shelter income from tax authorities (e.g. the use of offshore tax havens or the creation of complex structures involving tax-indifferent parties), then it is easy to see how such sheltered income could be more easily diverted."<sup>28</sup>

- In a separate study, Desai and others examining Russian data find that stepped up tax enforcement leads to increased power for corporate boards and enhanced stock values. "an increase in tax enforcement can increase (rather than decrease) the stock market value of a company."<sup>29</sup>
- Using audit data from the IRS, scholars Hanlon, Mills, and Slemrod show that the rate of noncompliance on taxes is higher among companies where executive pay is determined more by bonuses and stock options. Investors are put at risk when executives are tempted to enrich themselves by cheating on corporate income taxes.
- Comparative international studies show that countries where government more effectively prevents tax evasion make it less costly for private investors in those countries to monitor their investments.<sup>30</sup>
- Another study by Eric M. Rice, an economist at Wellington Management Company found that noncompliance with tax laws is

lower among companies in more regulated industries or publicly traded corporations that must comply with SEC disclosure regulations.<sup>31</sup>

### **Problem #3: Corporate tax secrecy hurts markets**

Tax avoidance makes markets less efficient. When some companies get away with padding their profits through tax evasion, other potentially more efficient companies get placed at a competitive disadvantage. Noncompliance with tax laws diverts resources toward firms and industries with greater opportunities for noncompliance, rather than the firms and industries that are most efficient or innovative.

One defining characteristic of tax shelters, noted by the Treasury Department, is their lack of economic substance. The Treasury quotes Professor Michael Graetz as saying that a tax shelter is, "a deal done by very smart people that, absent tax considerations, would be very stupid."<sup>32</sup> Even when tax avoidance schemes are legal, the shifting of paper profits between legal entities or jurisdictions, tax avoidance can waste large amounts of time and energy. Lawyers and accountants get paid large sums to construct elaborate webs of financial transactions and shift paper profits across jurisdictions without any productive purpose. A study of businesses using the common tax shelter of trust-preferred stocks, found these maneuvers cost companies tens of millions of dollars on average. The deals nonetheless may have helped executives because they substantially reduced the debt-to-assets ratio investors saw on paper and saved about 28 cents in taxes for

member Johan Klehs (January 2006).

28. Mihir Desai and Dhammika Dharmapala, "Corporate Tax Avoidance and High Powered Incentives," *American Law & Economics Annual Meetings*, 2004, paper 7. See also Deasai, Dyck, and Zingales, (2003).

29. Mihir A. Desai, Alexander Dyck and Luigi Zingales, "Theft and Taxes," *European Corporate Governance Institute (ECGI) - Finance Research Paper Series*, no. 63 (2005).

30. Kirsten Ralf and Jean-Bernard Chatelain, "Tax Evasion, Investors Protection and Corporate Governance," *Money Macro and Finance (MMF) Research Group Conference, Money Macro and Finance Research Group (February 2005)*, p. 3.

31. Eric Rice, 1992. "The corporate tax gap: evidence on tax compliance by small corporations," in *Why People Pay Taxes*, edited by Joel Slemrod, 125-61. Ann Arbor, University of Michigan Press.

32. Department of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis, and Legislative Proposals*, (July 1999)

each dollar of preferred trust stock issued.<sup>33</sup> Similarly, companies may shift activities toward intangible assets, leasing, or subcontracting as a way to avoid taxes even if doing so is otherwise wasteful or inefficient.

It is no accident that countries where studies show rampant levels of tax fraud tend to be economic backwaters. The rule of law really does promote efficiency and economic growth.<sup>34</sup> One recently published Harvard study of investment returns in 49 countries concludes that countries with greater mandatory disclosure of financial information have stronger stock market performance.<sup>35</sup>

## Solving problems through increased tax transparency

*“Sunlight is said to be the best of disinfectants”*

– Supreme Court justice Louis Brandeis

Historically, tax disclosure has been a tool to combat corruption and abuses of power. During the first income tax used to finance the Civil War, newspapers published long lists of the profits and taxes paid. With the creation of today’s corporate income tax in 1909, President Taft saw public disclosure an important step “which may prevent a further abuse of power.”<sup>36</sup> Any individual had the right to inspect corporate returns of public corporations. The specific issue that most motivated corporate tax disclosure in 1909 was “stock-watering” of undercapitalized corporations in which the public innocently invested. The public right to know was also meant to ensure that certain businesses were not shown favoritism by tax authorities.

Corporations currently enjoy extraordinary tax secrecy compared to other publicly chartered entities. Heightened privacy is granted despite the fact that corporations’ legal status as “artificial persons” is bestowed with special legal privileges such as limited liability. Non-profit corporations with receipts over \$25,000 must disclose detailed financial balance information, and the taxable revenue listed on their forms is publicly available through online databases. California’s nonprofit 501 C(3) corporations must post their tax forms on the Attorney General’s website. Similarly, property and casualty insurers must prepare publicly available annu-

citing Professor Michael Graetz in Kenneth Kies, *Transcript of Federal Bar Association’s Fourth Invitational Biennial Conference on the Tax Legislative Process*, reprinted in *97 Tax Notes Today* 21-38 (Jan. 31, 1997)

33. Ellen Engel, Merle Erickson, and Edward Maydew, “Debt-Equity Hybrid Securities,” *Journal of Accounting Research*, vol. 37, no. 2 (Autumn 1999).

34. *Global Corruption Report 2001*, Transparency International (2001).

35. Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *What Works In Securities Laws?*, *The Journal of Finance*, vol 61, no 1, pp. 1-32 (2006).

36. Quoted in “Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives,” David Lenter; Joel Slemrod; Douglas Shackelford, *National Tax Journal* (Dec 2003) 56, 4.



al statements that more or less approximate taxable income and must be filed with Insurance Departments in states where they conduct business. Property values and property taxes are ordinarily public record throughout the United States and are also available online in many jurisdictions. But not corporate taxes.

Until 1976 income taxes for both individuals and companies were public record. In the aftermath of allegations that President Nixon had improperly used tax return information against his political opponents, corporate confidentiality was folded in with new protections for personal tax returns. State and federal government employees with access to tax return data were forbidden from disclosing the information even to other parts of the government, except in the necessary course of tax administration or in the course of criminal investigations. State legislators and other policy makers have no way of knowing which companies pay any taxes or how much they pay in different taxes to the state or localities.

Proponents of business tax secrecy argue that disclosure could violate corporate privacy or divulge important business secrets. If executives were required to publicly disclose marketing plans or intimate details of their lives, this would be true. But corporate disclosure rules do not ask for proprietary or personal information. Disclosing corporate taxes does not endanger the privacy of personal tax returns in any way.

There is no reason businesses should not be open about what they contribute to the jurisdictions where they operate. A Harvard Business School study of potential disclosure rules concludes, “it is not clear what proprietary ideas would become accessible by competi-

tors through the public disclosure of tax returns that is not already available, or should be available, through public financial statements.”<sup>37</sup> True business secrets would include information about advance permits or applications for trademarks or patents. Ironically, this information is already disclosed to government permitting or patent offices without violating privacy.

### **Solution #1: Increase transparency in book-tax differences**

Federal government recognition of the growing book-tax gap led to a new requirement that, starting in the tax year 2004, corporations and consolidated tax groups with assets over \$10 million must reconcile their tax income and book income on a Schedule M-3 form. Smaller companies with at least \$250,000 must fill out a simplified M-1 form.<sup>38</sup>

Unfortunately, the state of California does not currently require the same level of reporting for state taxes. The publicly disclosed portion of corporations’ SEC financial disclosures, moreover, provides little useful information for individual states. It reports only the total amount of all state taxes paid in a year without breaking down payments by state. There is no way to know if taxes were paid to California as opposed to other states. Federal financial disclosures also have different rules about reporting affiliated companies on the same return. Federal filings do not suffice for state-level audits of tax returns.

Knowing the size of the book-tax gap for individual corporations would help the Franchise Tax Board to target audits on tax evaders without inconveniencing law-abiding businesses. Academic studies of companies audited by the IRS reveal that those with larger book-tax gaps are found to require larger upward ad-

37. Mihir A. Desai, “The Degradation of Reported Tax Information,” *Journal of Economic Perspectives* 19, no. 4 (Fall 2005).

38. Income is highly concentrated in large California’s corporations. Although filings from corporations with in-state profits exceeding \$5 million comprised just 0.2 percent of total corporate filings in 2003, they accounted for 65.6 percent of net profits and 72.6 percent of taxes

justment in their tax bill than companies with smaller book-tax gaps.<sup>39</sup> A 1999 Treasury study on growing corporate tax evasion similarly identified “inconsistent financial accounting and tax treatments” as one of a short list of factors suggesting the presence of a corporate tax shelter.<sup>40</sup> Discrepancies between book and tax income, in other words, really do indicate greater likelihood of tax evasion. Enhanced disclosure about the basis for book-tax discrepancies would therefore make tax collection more efficient. As the FTB itself concludes, “The book-to-tax-income reconciliation would be a significant audit tool. This tool could assist auditors in identifying tax shelter activity and could dissuade some taxpayers from entering into tax avoidance schemes.”<sup>41</sup>

Reconciling tax and book income would also help investors. As the FTB finds, “Requiring publicly traded corporations to provide detailed information relating to differences between book and taxable income would provide investors protection against corporations manipulating accounting transactions to overstate book income.” The company costs of reconciling book and tax income, moreover, would be minimized by the fact that corporations, partnerships, and private companies with over \$10 million in assets already file the federal M-3 form.

## **Solution #2: Public accountability through public disclosure**

According to the Commissioner of the IRS, “As long as financial accounting standards differ from the tax rules, there will be a continu-

ing tension between increasing book earnings in order to drive up share value, and lowering taxable earnings to minimize tax payments and maximize cash flow. If we are not willing to operate the two systems by the same set of rules, it makes sense to discuss whether corporate tax returns should be public. ...making corporate tax returns or a portion thereof public, would likely improve compliance.”<sup>42</sup>

Corporate tax secrecy should not transcend the public’s right to know, at least for summary information about corporate tax burdens. Public disclosure of taxable income and tax payments should be required for all large businesses and corporations, as it is in many other countries.<sup>43</sup> Public disclosure makes information accessible for journalists, watchdog groups, investors, analysts, and tax agencies. Greater transparency would help ensure corporate accountability. It would also promote public confidence in government, deter potential conflicts of interest, and elevate debate about tax and budget issues.

Receipt of particular subsidies, development grants, and tax giveaways should also be public knowledge. Nine states currently have some form of annual report with company-specific information about company receipt of tax expenditures. These states are: Illinois, Connecticut, Minnesota, Ohio, Louisiana, North Carolina, North Dakota, Maine, Texas, Washington, and West Virginia.<sup>44</sup> The first four of these states publicly disclose their reports over the internet. Illinois provides the most comprehensive disclosure program on tax giveaways and subsi-

*assessed. Large corporations have some of the highest profits of all California businesses. Their size and complexity gives them both the greatest incentive and opportunity to evade California taxes.*

39. Mills, Lillian. “Book-tax differences and Internal Revenue Service adjustments,” *Journal of Accounting Research* 36 (1998): 343 - 356.)

40. Department of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* vol. 14 (1999), cited in Beale (Fall 2004), p. 352.

41. Franchise Tax Board, “Analysis of Amended Legislation AB 675,” Attorney Patrick Kusiak, amendment date June 20, 2006.

42. Mark W. Everson, “Remarks of the Commissioner of Internal Revenue Before the National Press Club,” March 14, 2006. Available at [http://www.hrpolicy.org/downloads/2006/IRS\\_Everson\\_Remarks\\_031406.pdf](http://www.hrpolicy.org/downloads/2006/IRS_Everson_Remarks_031406.pdf)

43. For a discussion of public tax disclosure in other OECD countries, see David Lenter, Joel Slemrod, and Douglas Shackelford, “Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives,” *National Tax Journal* (December 2003).

44. In Nebraska, company-specific information is released to the Legislature but not to the public. In some states where company-specific information is available to the public, it is not however prepared in a database or at a central location. North Dakota’s company-specific information will not be published until 2007. See [http://www.goodjobsfirst.org/pdf/disclosure\\_chart.pdf](http://www.goodjobsfirst.org/pdf/disclosure_chart.pdf).

dies. It compares progress to project goals that were agreed upon as conditions for receipt of tax expenditures, including wages and health benefits. The program is accompanied by revenue recapture provisions in case companies fail to live up to promises.

Ideally, tax disclosure rules should apply to large privately held companies and partnerships as well as to publicly traded corporations. Summary tax data should be publicly disclosed over the internet listing what companies actually paid in taxes to state and local government. It should include property and excise taxes, and company profits as disclosed to stockholders where applicable. Fines for noncompliance should be automatic the way they are for household taxpayers. And the burden of compliance should be minimized by requiring more detailed accounting only for large companies or those with suspicious practices such as large book-tax gaps or offshore subsidiaries in tax havens.

### **Solution #3: Decrease differences between tax and book income**

One way to simultaneously reduce tax evasion and investor misinformation is to decrease differences in the reporting systems themselves. Greater conformity between financial and taxable income reporting systems would constrain executives from abusing either system. Executives would avoid inflating their book profits because doing so would increase their tax liability. And especially executives who own publicly traded company stock might avoid disguising corporate profits because doing so would make the business less attractive to investors.

Improving the tax system this way is not a new or unfamiliar idea.

- A Presidential Task Force appointed by the Nixon Administration urged greater conformity between tax and book income, noting that it would increase compliance with the law and that “Business taxpayers would have greater confidence in the fairness and integrity of the tax if such differences were minimized.”<sup>44</sup>
- A feature of the Reagan Administration’s 1986 tax reforms that never became law was to create a higher alternative minimum tax for corporations with higher book than tax incomes.<sup>45</sup>
- Increased book-tax conformity was one of the alternatives considered by President Bush’s Tax Reform Panel. The Panel’s report states that “The Panel also evaluated a proposal to tax large entities based on net income reported on financial statements instead of requiring a separate calculation of income tax purposes. Although the Panel has decided not to include that proposal as part of the Simplified Income Tax Plan, the Panel recommends that it be studied further.”<sup>46</sup>

Comprehensive tax-book conformity would mean that businesses would simply be taxed on their financial income. One problem with such an approach is that it might hand the professional boards that determine accounting standards undue power in establishing tax policy. Another issue is that the Tax Code is currently relied upon to provide a variety of incentives and disincentives to shape taxpayer behavior. Tax credits encourage everything from home ownership, to durable investment, to solar power.

Rather than create full uniformity between tax

45. *Report of the President’s Task Force on Business Taxation*, (Washington, D.C., 1970)

46. *Staff of Joint Committee on Taxation, 106th Congress, Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)*, at 244–45 (Joint Comm. Print 1999), cited in *Beale (Fall 2004)*, p. 351.

and accounting rules, a better solution is to require conformity in specific domains where there would otherwise be strong incentives for misreporting. Machine repair companies might, for instance, be required to value their parts inventory for taxable purposes the same way they do for financial accounts. Abusive tax shelters should be closed through rules that would simplify tax compliance by requiring businesses to use the same generally accepted accounting principles for tax liability that they do for accounting purposes. For even greater flexibility, companies might be allowed to use certain accounting methods, but only if they also calculate their taxable income the same way.<sup>47</sup>

## Bringing sunshine to corporate taxation in California

Clear options for improving corporate taxation are within reach. Requiring companies to disclose information reconciling book-tax differences to tax authorities would discourage tax evasion, protect investors, make markets more efficient, and hold down taxes for law-abiding citizens. Public disclosure of what large companies pay in taxes would indirectly achieve the same ends through the democratic process, and would enhance corporate accountability while elevating public debate about fiscal issues. For certain activities, taxable income should simply follow generally accepted accounting principles. None of these fixes are simple, but none nearly so complicated as the problems they would help to solve.

47. *Tax Panel*, page 131

48. Eligibility for LIFO inventory accounting methods have operated this way since 1939. The large number of exceptions that have arisen suggest that such contingent rules would not necessarily be a form of tax simplification. This discussion is drawn heavily from Beale (Winter 2004).

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