

Corporate tax and accounting

Many happy returns?

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Why a low corporate tax bill is often not the good news it seems to be

WHAT is the next target in the campaign to clean up American capitalism? Perhaps tax trickery. Already, a Senate sub-committee and the Internal Revenue Service (IRS) are busily pursuing separate investigations into questionable tax structures. This week, there was talk of cutting taxes on profits earned abroad to 5.25% from 35%, for this year only, to tempt firms to repatriate money now in offshore tax havens and shelters.

This comes hot on the heels of a Congressional report on the Enron scandal, released in February. This devoted 2,700 pages to how the firm manipulated the so-called "tax-book" gap—the divergence between the profits that American firms report to the taxman and the accounting ("book") profits disclosed to the investing public—to inflate its reported profits while minimising its tax bill. Thanks not least to its use of tax shelters, in 1996-99 Enron reported to the taxman that it earned no taxable income even as it told Wall Street that it had made \$2.3 billion in book profits.

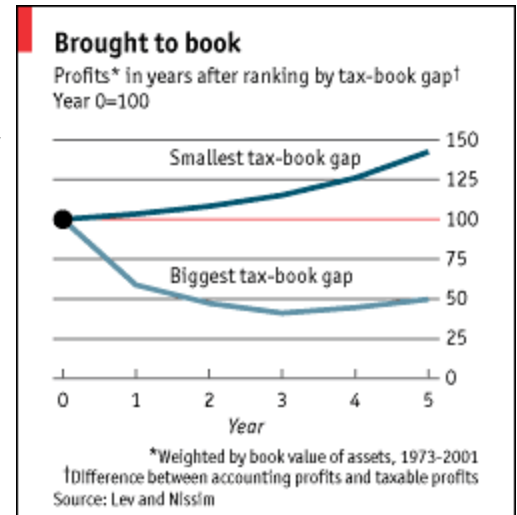
Step back from the scandal, and two things stand out. First, according to the report, Enron's accounting gymnastics were not necessarily illegal. Rather, they cleverly exploited inconsistencies in the different rules for tax and book accounting. Second, it is not just Enron. The tax-book gap has widened alarmingly across corporate America, especially since the late 1990s.

Some of the tax-book gap is readily explained by the treatment of depreciation, employee share options (which count against profits for tax but not for accounting purposes) and foreign income. But whereas these used to explain most of the gap, by 1998 they represented less than half of it, according to a study by Mihir Desai of Harvard Business School. The source of the rest of the gap was hard to explain, he charitably concludes.

Perhaps the gap is due to the growing use of Enron-style rule-gaming, which creates (briefly) healthy accounting numbers but cannot get past the more prudent tax rules. If so, a growing tax-book gap may herald accounting troubles to come.

Baruch Lev, of New York University's Stern School, and Doron Nissim, of Columbia Business School, analysed the tax-book gap of over 3,000 publicly traded American firms during 1973-2001. As the chart shows, they found that the 20% of firms with the smallest gap between tax and book profits showed strong average accounting profit growth over the subsequent five years. But the 20% of firms with the biggest tax-book gaps tended to see their profits deteriorate dramatically.

This finding is admittedly fairly rough and ready. Since, amazingly, American firms are not required to disclose how much tax they have paid during any given accounting year, the two academics had to estimate taxable profits from the meagre morsels of data included in company annual reports. The



information disclosed in accounts is notoriously long on numbers but short on substance. "Current tax expense", for example, is based on book accounting rules and so is uncorrelated with a firm's tax bill. Whereas many firms disclose a figure for cash paid to the taxman, they are not required to provide a breakdown for jurisdiction (foreign versus federal or state taxes) and do not specify the time period for which this tax was owed.

Open the books

At certain points in the past, disclosure of tax-return information was much fuller. President Taft, under whom the first corporate tax was levied in 1909, saw publication of tax returns as a way to discourage undesirable business conduct. Later presidents disagreed, but this view again prevailed during the Great Depression, when Congress passed a law making public selected bits of corporate tax returns—such as a firm's net income and tax liability—in so-called "pink slips". Intense lobbying by big business succeeded in repealing this law within a year. Since then, the government has not mandated any similar corporate tax disclosure. It was not until 1976, however, that tax-return information became wholly confidential—following allegations that President Nixon had used tax-return information against his opponents.

Investors would surely benefit from much fuller disclosure of a firm's tax return. But how best to disclose? The most radical solution—and the least likely—is to move closer to "tax-book conformity", with a single set of accounts for both the taxman and investors. Dual accounting, so the argument goes, is unduly complicated and can distort economic activity. For instance, employee share options became a popular form of compensation at least in part because they lowered taxable profits but left accounting profits intact.

One drawback of this solution is that Congress loves tinkering with the tax code in an attempt to change corporate behaviour, and is unlikely to give that up. Besides, the goals of tax and financial reporting are very different. Tax accounts are meant to provide authorities with a predictable, enforceable tax base. Financial reports are meant to capture the economic value of a firm's operations, and so contain myriad estimates and approximations. Resolving these two goals into one set of books is impossibly tricky. When it was tried, such as (until recently) in Germany, the needs of the taxman have tended to come before those of investors.

A second option is to publish corporate tax returns in full. Industry advocates, however, worry that tax disclosure would let competitors root out business secrets, and would lobby hard to stop it.

The best approach may be to require firms to publish a souped-up version of Schedule M-1, a table (rather superficially) reconciling taxable and accounting profits, that they already submit to the taxman. In a recent paper, George Plesko, of the Sloan School of Management, and Lillian Mills, of the University of Arizona, propose how that might be done in a way that gives investors a mechanism for linking a firm's taxable profits to its financial numbers. One change would be to specify explicitly what starting point should be used for tax-book reconciliation. Now, corporate taxpayers are required to use their "reported profit"—but can pick from global income, American income, or something between, and the choice results in wide swings in the tax-book gap. Mr Plesko and Ms Mills argue that the proper starting point is worldwide consolidated book profit.

In Congress these days, there is much implausible talk of fundamentally overhauling the corporate tax code—a process that history suggests would inevitably fall foul of political tinkering, if it were ever seriously attempted. But, for all this post-Enron bluster, it makes far more sense simply to make firms publish sufficient information for investors to tell if a low tax bill is in their interest or against it. What is more, it would be far easier to implement.