Statement of Edmund Outslay, Professor of Accounting and Information Systems, Eli Broad Graduate School of Management, Michigan State University, East Lansing, Michigan and Gary A. McGill, Professor of Accounting, Fisher School of Accounting, University of Florida, Gainesville, Florida

Before the U.S. Senate Committee on Finance Hearing on "Enron: The Joint Committee on Taxation's Investigative Report"

February 13, 2003

Chairman Grassley, Ranking Member Baucus, esteemed members of the Committee, I appreciate very much the opportunity to testify before the U.S. Senate Committee on Finance on issues raised by Enron's tax returns and practices. The following written testimony reiterates many of the points my colleague, Gary A. McGill, and I made in a recent paper entitled "Did Enron Pay Taxes? Using Accounting Information to Decipher Tax Status"(*Tax Notes*, August 19, 2002, pp. 1125-1136).

I. Introduction

As a result of the publicity surrounding the collapse of Enron Corporation and other major U.S. companies (e.g., WorldCom, Inc.), there has been a renewed interest in whether there should be more consistency between measures of book and taxable income and whether current accounting rules adequately disclose a publicly traded corporation's tax status. The U.S. Treasury recently issued regulations requiring more tax return disclosure regarding "tax shelters" with a goal being to make such transactions more transparent. The Enron collapse also precipitated speculation and confusion about whether the company paid federal income taxes despite reporting billions of dollars of book income. This speculation led individuals, public interest groups, and members of Congress to question whether publicly traded companies should be required to make their federal income tax returns (or relevant summary information) public or

whether financial accounting rules should be expanded to require such corporations to provide more details about their tax status in their accounting reports.

We believe current accounting disclosure rules do not provide sufficient tax information to determine a corporation's tax status. We support increased detail in the company's financial statements about the components of the company's tax expense, especially with regard to the taxes actually paid and the tax benefits from stock option exercises. We believe the public interest can be served without resorting to making corporate tax returns publicly available.

II. The Growing Discrepancy between Book and Tax Income

The current attention focused on discrepancies between publicly traded corporations' book and tax incomes harkens back to a similar period in the first half of the 1980s. As result of tax legislation enacted in the Economic Recovery Tax Act of 1981 (particularly accelerated depreciation and safe harbor leasing), corporate tax payments (and taxable income) shrank relative to reported accounting profits (see, for example, my paper with James E. Wheeler entitled "The Phantom Federal Income Taxes of General Dynamics Corporation," *The Accounting Review*, October 1986, pp. 760-774). Studies pointing out the growing discrepancies between book and tax income led Congress to enact major tax changes in the Tax Reform Act of 1986, including less generous tax depreciation, a repeal of the completed contraction method of tax accounting, and the enactment of the alternative minimum tax. One of the components of the alternative minimum tax was an add-back for fifty percent of the difference between a corporation's book and tax income, a provision that proved very difficult to calculate (and rationalize) and led corporations to "manage" their accounting earnings to avoid the tax. We should point out that much of the discrepancy between book and tax income during this period was due to "temporary differences;" that is, items that would eventually appear on both

statements but in different periods (for example, a corporation often would adopt accelerated depreciation for tax purposes and straight line depreciation for book purposes). These temporary differences would appear as "deferred tax liabilities" in the balance sheet but would not impact the company's book tax provision reported in the company's income statement (the book-tax discrepancy would appear as a deferred tax rather than a "current" tax payable). Enron reports a change in its deferred tax liability for "depreciation, depletion, and amortization" for 2000 of $6 million. Grossing up the amount by the 35 percent statutory tax rate, this represents an estimated book-tax difference for the year of $17 million. The cumulative deferred tax liability for this item is $1,813 million. On a cumulative basis, the book-tax difference from different depreciation accounting and tax methods is $5,180 million. The discrepancy between book and taxable income created by this item, while significant, should not be construed as evidence that the company is engaging in tax shelter activities. Rather, one could interpret this growing discrepancy as evidence the corporation was increasing its stock of capital, which is in line with what Congress intended when it enacted tax depreciation as an investment incentive.

The renewed interest of academic researchers into the book and tax income phenomenon stems from the U.S. government's concern over the rise of corporate tax shelters. Whereas tax planning strategies in the 1980s focused primarily on temporary differences, more recent tax planning strategies tend to focus on "permanent differences" (that is, items that appear on either the income statement or the tax return, but not both). The most prominent strategies that create permanent differences include income shifting to low-tax jurisdictions (including corporate inversions), using nonqualified stock options to create tax, but not book, deductions, and transactions that create tax credits (research and experimentation, foreign tax) or tax-exempt income (corporate life insurance polices on rank-and-file employees). The growth of these types

of tax strategies reflects a shift in the manner in which companies view the role of their tax departments, moving them from cost centers (compliance-oriented) to profit centers ("bottom line" oriented). Tax strategies that lower tax, but not book, income, show up in a reduced book tax provision, thus increasing after-tax income and lowering the company's book "effective tax rate" (book tax expense divided by before-tax book income). Evidence that tax planning has become an integral part of "earnings management" can be found in annual "tax efficiency scoreboards" published by journals such as *CFO Magazine* (see, for example, S. L. Mintz, "A Taxing Challenge," *CFO Magazine*, Nov. 1, 1999). Using data from the IRS Statistics of Income, our colleague George Plesko of MIT determined that the difference between pre-tax book income and tax net income grew from $92.5 billion in 1996 to $159.0 billion in 1998, an increase of 71.9 percent (see G. Plesko, "Reconciling Corporation Book and Tax Net Income, Tax Years 1996-1998," *Statistics of Income Bulletin*, Spring 2002).

To what extent these book and tax income discrepancies result from legal versus "aggressive" tax avoidance (evasion) strategies remains elusive to date. Recent studies have shown that a major component of the difference is due to stock option exercises by corporate employees, which could hardly be considered a "tax shelter" because the employees exercising the options pay tax on the difference between the stock's option price and its fair market value at the date of exercise (at rates as high as 38.6%). Recent revelations that many top executives may have been using partnerships to avoid this tax perhaps calls our assertion into question, although this is an individual, not a corporate, tax shelter issue.

III. Corporate Income Tax Disclosure Rules

Recent disclosure debates focus on two reporting issues: (1) What information regarding specific tax strategies should be reported to the Internal Revenue Service and (2) What

information regarding the net economic consequences of such strategies should be reported to the public. The former issue has received intense scrutiny and discussion with regard to the recently issued tax shelter disclosure regulations. One issue that deserves attention is the debate over whether a transaction that creates a certain dollar amount of book and tax difference (currently proposed to be $50 million) should automatically be classified as a "tax shelter" and be subject to separate identification and detailed disclosure. Efforts to carve out exceptions are on-going and likely will add significant complexity to these rules. We support increased reporting requirements with regard to tax shelter activities. An individual or firm willing to sell a tax strategy to a client should be willing to disclose its details to the tax authorities. However, we do not support efforts by Congress to define "economic substance." This venerated, albeit illusive, judicial principle should remain within the purview of the courts. Bright line tests invite even more transactions that depend on form rather than substance.

Our focus on Enron has been with regard to the current accounting rules dealing with the company's disclosure of its tax status. Analysts of the company's publicly available accounting data have computed widely divergent estimates of the company's most recent tax liability, ranging from zero to $112 million. No less a corporate tax authority as Robert Willens of Lehman Brothers was quoted in a *Business Week* article on Enron as saying "Truth is, figuring out how much tax a company actually pays is impossible…Tax disclosure is just inscrutable" (see H. Gleckman, D. Foust, M. Arndt, and K. Kerwin, "Tax Dodging: Enron Isn't Alone. Plenty of Companies Pay Little or Nothing," *Business Week*, March 4, 2000, p. 40). Writing in *CFO Magazine*, S. L. Mintz observed that the financial accounting information regarding Enron's tax status "resists comprehensive analysis" (S. L. Mintz, "A Taxing Challenge," *CFO Magazine*, Nov. 1, 1999).

The exasperation expressed by analysts that accounting information lacks precision when it comes to discerning the tax status of Enron or any public corporations is not new. As far back as 1986, my colleagues and I noted that "GAAP concerning accounting for income taxes and the related reporting requirements are so difficult to comprehend that they are subject to varying interpretations which lead to extreme diversity in the treatment of similar transactions" (see G. M. Clowery, E. Outslay, and J. E. Wheeler, "The Debate on Computing Corporate Effective Tax Rates – An Accounting View," *Tax Notes*, March 10, 1986, pp. 991-997). The question remains whether the "gaps" in "GAAP" (generally accepted accounting principles) regarding measurement and disclosure of a company's income taxes can be narrowed to both protect the corporation from disclosing privileged information and provide investors with a more accurate assessment of the company's tax status. We believe there is room for compromise.

Time and space do not allow us to discuss the accounting pronouncements that govern accounting for income taxes in any depth. We refer the interested reader to our August 19, 2002 *Tax Notes* article on the subject. We will focus our comments on the information disclosed in the Income Tax Note to the financial statements in the company's annual report.

Statement of Financial Accounting Standards No. 109 (FAS 109) requires that a publicly traded corporation present a reconciliation of its "hypothetical tax expense" (the tax expense that would have been reported if all of the company's pretax income from continuing operations was taxed at 35 percent) with its reported income tax expense. The company must disclose the estimated amount and nature of each "significant" reconciling item. The reconciling items include permanent book-tax differences, credits, and state and local income taxes and foreign taxes. SEC Regulation S-X, Rule 4-08(h)(2) states that reconciling items in the effective tax rate computation should be stated separately if they equal or exceed five percent of the "hypothetical

tax expense" or the reconciliation would be "significant in appraising the trend of earnings." This reconciliation provides the starting point for comparing a company's book effective tax rate with some other measure of its tax effective tax rate. Under FAS 109 a corporation also must disclose the amount of any unrecognized deferred tax liability on its reinvested non-U.S. earnings "if determination of that liability is practicable." Most companies omit this disclosure on the grounds that such determination is "not practicable."

Under current accounting rules, corporations are not required to provide details regarding any specific transaction that creates a permanent difference. For example, the amalgam of tax strategies that shift income from the United States to lower tax jurisdictions appear as one line item in the effective tax rate reconciliation provided the tax savings exceed the five-percent threshold. Looking at Enron's effective tax rate reconciliation from 1997-2000, we see a decrease in the "foreign tax rate differential" from 13.3% in 1997 to (7.7%) in 1999 and (2.4%) in 2000. In dollar terms, the results of international operations added $2 million to Enron's tax expense in 1997 whereas they reduced the company's tax expense by almost $80 million in 1999. Enron does not disclose any details about its international tax strategies regarding this change. Corporations occasionally explain changes in the reconciling item by stating that the change reflects the company's ability to shift income into lower tax jurisdictions. Corporations rarely provide details as to whether these tax savings were achieved through transfer pricing, financing structures, or corporate restructurings.

A significant permanent difference that does not appear in the effective tax rate reconciliation statement relates to the tax benefits from employee exercise of nonqualified stock options. Under current accounting rules (*Accounting Principles Board Opinion No. 25*) tax benefits related to stock option deductions taken on the tax return that will not affect book

income are recorded as an addition to the company's Additional Paid-in Capital. This accounting treatment overstates the reported "current" portion of the corporation's total tax provision reported in the income statement.

Analysts often are frustrated in estimating the tax benefits from stock option exercises because firms are not required to disclose the tax benefit separately in their Shareholder Equity statement. As a result, analysts must resort to estimating the benefit using the stock option information disclosed in a note separate from the Income Tax Note. The stock option note does not contain the pertinent information required for this calculation (number of options exercised during the year, the exercise price, and the fair value of the stock purchased), necessitating estimates that often are quite different from the actual benefits. Enron reports a tax benefit from employee stock option exercises of $390 million in 2000. By grossing up the $390 million tax benefit by 35 percent (the statutory tax rate), we estimate the tax deduction related to ESO exercises to be $1,114 million. This $1,114 million represents a permanent book-tax difference in 2000. Using the information provided in the stock option note, we would estimate the tax deduction to be $1,470 million (see our *Tax Notes* 2002 paper for the precise details). The corresponding tax benefit would be $514 million, a difference of $124 million. The calculation used would change an analyst's assessment of Enron's tax status.

The tax provision also likely includes an estimate ("cushion") for anticipated tax deficiencies that might arise due to aggressive positions taken on the current year tax return. Corporations may "hide" the cushion in either the current or deferred portion of the tax expense (shareholders may learn the amount of the cushion after the fact if litigation occurs).

IV. Thoughts about the Disclosure Debate

In his letter to then SEC chairman Pitt and then Treasury Secretary O'Neill, Senator Grassley asked whether "sufficient tax information is already publicly available" to determine a corporation's tax status. We would say no. Our analysis of Enron's tax status, which was prompted by Senator Grassley's query, demonstrates that current reporting leaves many gaps that require leaps of faith in estimating a corporation's tax status. There is far too much "noise" in the "current tax payable" portion of the Income Tax Note, which is further (often grossly) distorted by the fact that the tax benefits of stock option exercises are omitted from the computation (in 2000, Microsoft Corporation's "current payable" and its "taxes paid" differed by more than $4 billion).

The question is whether the solution requires surgery that is invasive or arthroscopic. Some commentators have suggested that the entire corporate tax return be made public. For a multinational corporation, such a return can exceed 10,000 pages. Very few investors would have the patience to sift through such voluminous materials. And even if they did, most would not be able to identify the specifics of the transactions that produced the reported information. Academic researchers and public interest groups likely would love such detailed information to be made publicly available. Such "sunlight" does not guarantee that a corporation's activities would become more transparent. For example, researchers who have examined the international reporting forms (Form 5471) attached to a U.S. corporation's Form 1120 have been unable to pin down with much precision how U.S. corporations are reducing their worldwide tax liabilities (for example, through transfer pricing or financing structures). Analysts would need access to the company or tax adviser's workpapers for the details. This issue has been on-going between taxpayers, their advisers, and the Internal Revenue Service since the Supreme Court's decision in *United States v. Arthur Young*, 465 U.S. 805 (1984).

Also at issue is the extent to which full disclosure of a corporation's tax return would give proprietary business data away to competitors. Historically, tax return privacy has been a sacred right with virtually no exceptions (IRC section 6103). Disclosure does not have to be an all-or-nothing proposition, however. An expanded Income Tax Note would be a step in the right direction. As we mentioned previously, the "current" portion of the income tax expense is virtually meaningless. The prevailing misconception is that this number represents the actual tax paid or payable within 12 months. If this account is going to continue to serve as a "garbage can" for tax cushions and represents a residual computation that is distorted by putting the tax benefits of stock option exercises in paid-in-capital, then a separate statement of U.S., state and local, and international income taxes paid in the current year should be mandatory. An alternative would be to make the first four pages of the Form 1120 publicly available, although such information would not disclose the corporation's international tax liability. We would also like to see the deferred tax asset and liability balances in the Income Tax Note tie out to the amounts reported in the balance sheet. A more truthful presentation of the deferred tax assets and liabilities in the Income Tax Note would bring to light more of the items that create book-tax temporary differences. Currently, deferred tax assets and liabilities can be hidden in other balance sheet accounts (for example, compensation).

The issue of what to do with the book-tax difference in accounting (or not accounting) for the tax deduction related to stock option exercises presents a thornier issue. The arthroscopic solution would be to require all corporations to separately disclose the tax benefits from stock option deductions in their Shareholders' Equity statement and their Statement of Cash Flows. Alternatively, the tax benefits could be taken directly to the book income tax provision and be reported as a permanent difference in the reconciliation of the company's effective tax rate. In

Enron's case, the $390 million stock option tax benefit would have reduced the company's tax expense from $434 million to $44 million in 2002. Enron would have reported an effective tax rate of 3.1%, and the permanent difference due to the stock option exercise would have shown up as a (27.6)%. Such reporting would have been more accurate in its depiction of the company's true tax status.

We do not support Congressional attempts to mandate comparability between financial accounting and tax accounting, especially with regard to stock option deductions. We are reminded of the Supreme Court's differentiation of the goals of financial and tax accounting in its decision in *Thor Power Tool Co. v. Commissioner*, 439 US 522 (1979):

> [T]he presumption petitioner postulates is insupportable in light of the vastly different objectives that financial and tax accounting have. The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistent with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

Those who advocate conformity between book and taxable income may find their victory to be Pyrrhic. The Internal Revenue Service has won many cases in which the taxpayer used generally accepted accounting principles for valuing inventory by arguing the accounting method did not produce a "clear reflection of income." We believe accounting principles should be left to the accounting establishment and tax rules left to Congress.

In summary, the issue as to whether Enron paid taxes opens debate on two fronts, both with the common theme of transparency. First, would tighter tax shelter disclosure rules have revealed more of the specifics of the company's tax strategies to the tax authorities. The likely answer is yes. Second, would more detailed accounting disclosure of the company's tax payments and its book-tax differences have painted a truer picture of the company's tax status. The likely answer also is yes. Accounting and tax reports should not be a cat-and-mouse game to the public or the government. The question becomes the size of the bell to put on the mouse. Regulations that label virtually every major transaction as a reportable tax shelter and disclosure rules that produce reams of detailed, yet impenetrable, information will have the perverse effect of producing less rather than more transparency.

Thank you for the opportunity to participate in this hearing. We welcome further dialogue on these important issues.