Global Shell Games

How corporations operate tax free

BY SEN. BYRON DORGAN

REMEMBER THE PENTAGON'S $600 toilet seats and $426 hammers? Now there's a new list to think about: Ball point pens purchased from Trinidad for $8,500. Disposable plastic gloves from Japan at $46.22 a piece. Wrist watch batteries from China at $8,252 each. Apple juice from Israel at $2,052 a liter.

It's a shopping spree a defense contractor might love. But this time the Pentagon is not involved; nor any other part of the government, for that matter. Instead the strange prices are the work of multinational corporations, and one of the biggest tax avoidance scams this country has ever seen. The ideological Right makes a big deal over what it calls "Tax Freedom Day"—the day on which Americans supposedly have fulfilled their tax burden for the year. They neglect to mention that every day is tax freedom day for these multinationals. More than two-thirds of foreign-based multinationals doing business here—and only a slightly smaller fraction of U.S.-based multinational firms—pay no federal income tax at all. Many of the rest are paying a relative pittance. As a result, U.S. taxpayers are losing over $40 billion a year by one estimate, which is enough to pay for a prescription drug benefit in Medicare. Considering that corporate profits have soared in recent years something here does not compute. The manipulation of prices at the border is a big part of this screwy equation.

It points to one of the great contradictions in the push for globalization. From its proponents we hear no end of rhapsodizing over the new "world without borders" that is going to bring peace and prosperity without end. Yet when the discussion turns to the rules of trade, as opposed to the theology of it, then the advocates often sing a different tune. They suddenly become dogged defenders of the very same national borders they deride as obsolete. They want to wipe out national boundaries when it means lowering standards for such things as workplace safety, the integrity of the food supply, and the like. But they want to maintain a balkanized world when national boundaries serve to protect them against higher standards.

Tax policy is an example. It is not a coincidence that as global trade has expanded, the tax burden has shifted increasingly onto working people. In the U.S., corporations are contributing a paltry 10 percent of the federal income tax burden, about one-half the level they paid in the 1960s, with further declines projected in coming years. It is a symptom of a set of ground rules that let corporations reap the greatest benefits of trade and make workers bear the primary burdens. It is what happens when the trade debate wafts off into the slogans of the global economy and doesn't attend to the details—details that may leave ordinary Americans with the short end of the stick.

Moving Out

If there is one provision in the U.S. tax laws that demonstrates the hypocrisy of some free-traders, it is the subsidy for corporations that move their plants abroad. Globalization is supposed to give us a market free of preferences and subsidies, in which nations compete according to their "natural advantage." Yet the same people who preach about this idealized world market support a tax system that violates it in the most fundamental way. The U.S. tax code actually rewards companies that move their factories, know-how, or financial operations abroad. Close shop in the U.S., shift your assets to Singapore, China, or Bermuda, and the U.S. Treasury rewards you for your trouble. Under a practice called "deferral," runaway plants pay no tax at all on

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their earnings abroad until they bring that income back into the U.S., which may be never.

This may strain belief. Corporations already have no shortage of enticements to abandon the U.S. in favor of such locales—sweat-shop wages, weak environmental standards, sometimes even slave labor. The last thing the federal government should do is create a tax bribe on top of all that—or so one would think. Yet that's exactly what Congress has done. This reward system for runaway plants, and other assets, costs federal taxpayers some $3.4 billion a year and rising. It is part of why the U.S. has lost well over 3 million well-paying manufacturing jobs since 1979.

Why does such a thing exist? Deferral illustrates a basic principle of tax boondoggles: "Once in, never out." There is no provision in the tax code called "deferral." It is the result of other provisions drafted for other purposes. It was tolerable in the beginning because multinationals were not that large a part of commerce. In the aftermath of World War II, when Europe was devastated and America had productive capacity to spare, it seemed justifiable. As Europe and Asia became commercial rivals, however, deferral became an indiscriminate subsidy the U.S. could not afford.

But by this time it had a big corporate constituency that had latched onto deferral as a way to multiply the benefits of tax havens around the world. Try to change it, and you will be accused of trying to dismantle the free enterprise system, and of turning America into the next Haiti. I speak from experience on this.

Nowadays the subsidy lobby argues that deferral is necessary for U.S. companies to compete in foreign markets. But I cannot understand why the U.S. government should be so solicitous of U.S.-based firms if they aren't going to invest in the U.S in the first place. Why should American taxpayers pay for the services of a military defense that benefits these companies—including trade negotiations and defense—while they scramble around the globe looking for ways to avoid their fair share of the bill?

Lobbyists also say that the deferral bonus is only temporary, until the earnings come back into the U.S. Yet in practice those profits tend to pile up abroad where they can be used for currency speculation or new overseas investment. "There are huge sums out there—trillions of dollars," says Michael McIntyre, a law professor at Wayne State University. Moreover, tax lawyers have created a minor industry out of devising ways to bring those profits back into the U.S. without the tax collectors noticing. The 1986 tax reform act tightened up this area somewhat. But where there's a tax lawyer, there's a way. "I suspect there are people who do it regularly and are hoping not to be audited," says McIntyre, who used to devise such strategies himself.

But let's give them the benefit of the doubt. Let's grant, for the sake of argument, that corporations need deferral to compete in foreign markets. That still doesn't explain why they need it when they move plants abroad and then sell the products back into the U.S. In that case, the provision is a direct subsidy for putting U.S. factory workers out of work. It is a slap in the face to the company that strives to keep its jobs here at home.

The answer to the deferral problem is simple. I have been proposing it in Congress for several years. At the very least we ought to eliminate this practice when U.S. firms set up factories in foreign tax havens and then sell those products back into the U.S. This would provide a measure of justice for the company struggling to keep its workforce in the U.S., and it would move us a step closer to a global marketplace that functions the way its advocates say it should.

Shady Transfers

Moving plants and other assets abroad is one way multinationals avoid their fair share of the tax burden. Another is the use of accounting shell games to shift their income to outside the United States. This second scam is called "transfer pricing."

Multinationals can take advantage of transfer pricing because the face they present to tax administrators and other legal authorities is very different from the face they present to the public. To the public, Sony Corporation—to take a random example—is simply Sony. Whether people are shopping in New York or Topeka, Oslo or Gdansk, the company appears the same. And as a general rule when the company reports its earnings to shareholders, it does so as a unified world-wide business. To tax agencies, however, the multinational presents itself as a complicated network of affiliates legally organized hither and yon. There might be a Sony U.S., a Sony Brazil, a Sony in tax havens such as Singapore and Bermuda, ad infinitum. Sometimes there are valid reasons for such arrangements. But in practice, corporations can use their complex intra-corporate webs to play all sorts of games, and taxes are high on the list.

This is where the $8,252 wrist-watch batteries come in. The prices seem ridiculous, but only if you don't understand the game. The multinational doesn't really spend that money because it charges the inflated price to itself. It takes the money out of one pocket—its operations in the U.S.—and puts it into another, which is its operations abroad. The effect is to shift profits out of the U.S. and therefore beyond the shelter of the Internal Revenue Code. You can't make money buying ball-point pens for $8,500 and selling them for $3.98 and that's what transfer pricing is all about.

Transfer pricing is probably the single most important reason that so many major corporations pay little or no federal income tax. "The bottom line is that the American public is being robbed," says Finance Professor Simon Pak of Florida International University who has studied this question closely.

Professor Pak and his colleague, Professor John Zdanowicz, have estimated that this scam cost U.S. taxpayers some $43 billion last year, or more than $117 million a day. They reached this estimate by examining customs receipts, which declare the purchase or sale prices of products passing across the U.S. border. They tallied both the extraordinarily high prices for products coming into the country, and the extraordinarily low prices for products going out. (Low nominal export prices are another way to shift income out of the U.S.) Then they used a sophisticated computer model to make a conservative estimate of the revenue implications.

The results make the Pentagon procurement office seem a model of probity. I've already mentioned some of the super-high prices for imports. The export prices were just as absurd: There were missile launchers sold to Venezuela for $59.50; automatic teller machines to the Dominican Republic for $45.25; venetian blinds to Germany for 12 cents; tractors to Canada for $448.41. I know a lot of farmers in North Dakota who would like to get a deal like that.

A revenue loss of over $40 billion is not a small amount of change. But money is not the only issue. It undermines the legitimacy of the whole federal tax system when the large and powerful can avoid their share of the burden through strategies like these. One would think the Treasury would be concerned, and it is in a sense. Yet the way it tries to address the problem is so out of touch with reality that it seems lifted from an episode of the Keystone Kops.

Basically, the Treasury accepts at face value the lawyer's fiction that a multinational corporation is composed of truly independent entities, incorporated in different nations and seeking their own maximum advantage in the market. It pretends that Sony Bermuda, say, really is totally separate from Sony U.S., Sony Japan, and the rest. IRS agents literally comb through the transactions between a U.S. subsidiary and its affiliates abroad, and try to adjust them to "arms length prices"—i.e., what the price would have been if the entities really had been independent of one another.

Close shop in the United States, shift your assets to Bermuda, and the U.S. Treasury rewards you for your trouble.

This is like trying to disentangle a vat of spaghetti with a toothpick. Conceptually, the approach is totally out to lunch. The subsidiaries of a multinational corporation aren't independent. They are like organs of the same body. One reason a multinational exists is to overcome the limitations of arms-length dealing. "The very existence of integrated multinational corporations is evidence that the arms-length system does not reflect economic reality," says Reuven S. Avi-Yonah, assistant professor of law at Harvard University Law School.

In other words, the quest for an arms-length price for transactions within a multinational group is a quest for something that does not generally exist. Stanley I. Langbein, a professor at the University of Miami law school who served in the Treasury's Office of International Tax Counsel, agrees that the arms-length method "does not work and cannot be made to work."

The result is a hapless, bureaucratic undertaking that is an enormous drain on resources. The audit hours are endless, as is the resulting litigation. The General Accounting Office has called these cases "burdensome, time consuming, and expensive" for all concerned. In 1992, a survey found that some $32 billion in disputed revenue was tied up in pending Tax Court proceedings over transfer pricing issues, twice the amount of three years earlier. (The Tax Court has not made such a tally since.) In one such case, the defendant, Mobil Oil, submitted 1.3 million pages of unlabeled documents as evidence. One suspects that judges do not look forward to cases of this kind. But that Mobil Oil is willing to go to all that trouble suggests how much they stand to lose—or gain.

The sad part is, there's a better way. The states have had to deal with the basic problem—corporations operating across jurisdictional borders—much longer than the federal government has. And from necessity, the states devised a method that is relatively simple. It started with the railroads, which tried to tell the states that their property in a given jurisdiction was worth just the salvage value of the tracks and ties. "Wait a minute," the states replied. Those tracks were part of sprawling corporate enterprises, and you couldn't reckon the value of the part without taking into account the value of the whole.

So the states developed the "unit rule," which regards the railroad as what it is—a unitary business, though operating in different states and perhaps through various corporate entities. Accordingly, for purposes of property-tax assessment, the states apportioned the value of the whole over the various parts. Later, when the states enacted income taxes they applied this same basic method. They took the income of the entire enterprise and apportioned it among the different states according to a formula. If a tenth of the property, payroll, and sales were in a particular state, then a tenth of the income got reported there as well, regardless of the accounting gymnastics that a company might contrive. The formula determines only how much a company reports, not how much tax it pays. If the state wants to have low rates, or no tax at all, that's its own business.

The formula method isn't perfect of course. No method is. But compared to the Treasury's approach it is a big step forward. It renders moot much of the sophisticated tax lawyering and accounting shell games that corporations employ. If every nation employed a formula approach then tax administration would be simpler and companies could focus on their business rather than on tax avoidance, which would be good for all concerned.

Some states actually have applied the formula approach to multinationals, which was a natural extension. Is there that much difference—especially after NAFTA—between the border that runs between North Dakota and Montana and the one between those states and Canada? Yet most multinationals went ballistic, and the battle against the "unitary" method quickly became a cash cow on K Street—one of those contentious Washington issues that drags on for years beneath the radar of mainstream media. Eventually, pressure from multinational corporations became too great, and California—the leader in the simplification movement—had to relent. Other states followed suit. Today about half a dozen states permit multinationals to file as unitary businesses but don't require it. Once again, corporations can choose globalization when it suits them but can hide behind national borders when it doesn't.

The truly weird part is that Treasury has seen the futility of its archaic methods. It is moving slowly toward the formula approach—but in an obscure, case-by-case way. The latest chapter in this administrative fiasco is something called Advanced Pricing Agreements or APAs. Basically the corporations sit down with the IRS behind closed doors and negotiate their transfer prices. In effect, they negotiate their own tax bills; and as though that weren't bad enough, Congress, in its infinite solicitude, has made these agreements secret except for publication in vague general terms.

To put this another way, there are two income-tax systems in America today. Working people pay what they have to, while the largest corporations pay pretty much what they want to. The IRS actually has shifted audit resources in recent years so that it comes down harder on small taxpayers and easier on the bigger ones. The rampant corporate avoidance is taking us down the path of countries such as Italy, where people think that only suckers pay. Speaking of the secret APAs, Professor Avi-Yonah writes, "This is hardly the type of practice one wishes to encourage in a tax system based on both voluntary compliance and the impression that wealthy taxpayers are subject to the same standards as everyone else."

The practice also confirms what many Americans suspect about the global economy generally—that if you are a real person you bear the burdens, and if you are a large corporation then you enjoy the gains. The burdens should be shared so that the gains can be shared too.

As with deferral, the answer here is not hard. We need to develop consistent formulas to apportion the income of multinational firms. Such an approach would not be perfect. But it would be an improvement and it would demonstrate to people that the actual rules of trade are in synch with the rhetoric of globalization. People are getting taken; and unless we start looking at the details—unless we debate the rules of trade in concrete terms rather than as theologians—things are going to get worse. ●

The Courtier's Art

Flattery through the ages

By David Ignatius

MORE THAN A DECADE AGO, I SENT A LETTER to a college classmate and fellow journalist whom I'll call "K." I had not seen him in a while, and in the interim he had become a powerful figure in the media, and it worried me slightly that we had never quite clicked as friends. I don't recall precisely what I wrote, except that it offered generous praise—fulsome praise, even—for one of his acerbic columns in *The Washington Post.*

YOU'RE TOO KIND: A Brief History of Flattery
By Richard Stengel
Simon & Schuster, $25.00

Not long after that, "K" wrote a column about flattery. He noted the delicious pleasure he took in receiving insincere letters of praise from people who wanted to curry his favor. His theme was that insincere praise is really the best kind of all—because it shows how desperately someone wants to ingratiate himself. "After all," he wrote, "what do I care what this philistine oaf actually thinks about my article? On the other hand, there is a genuine if unintended compliment in the fact that he troubled to write—and the less he meant what he said, the greater the compliment." It was many years before I wrote another letter to "K."

But perhaps I flatter myself. Perhaps it was some other toadying letter that prompted "K's" acid response. Perhaps I have only imagined all these years that my insincerity rose to a level of obsequiousness that prompted his retort. Perhaps mine was only ordinary insincerity, and he had some entirely different fawning letter-writer in mind.

These are the sort of bilious thoughts that emerge from reading Richard Stengel's history of flattery. *You're Too Kind* is a learned and lucid examination of ass-kissing over the ages, and it will be a rare modern reader who does not at some point cringe with self-recognition. Even "K," I suspect, will see himself in this catalogue of courtiers and connivers. For as Stengel makes clear, flattery is the coin of our realm. And the most interesting form of ingratiation is one that will be familiar to *Washington Monthly* readers—who by definition are smart enough to see through the simpler forms of brown nosing and fawning praise—and must therefore play the Master Game, where flattery is coated in irony and cynicism. In the clever, meritocratic world we inhabit, as Stengel says, "You don't see ... fastball-over-the-center-of-the-plate flattery, but a slider that just nicks the corner." Do I flatter you, dear reader? I hope so.

What's eerie about this book is the universality of flattery. Stengel chronicles its persistence through all of recorded human history—from the ancient Egyptians to the Greeks, from the courts of medieval Europe to the corridors of Washington lobbyists. One would be tempted to say that man is the animal that flatters—except that Stengel shows that chimpanzees outdo humans in the ass-kissing department, taking the matter all too literally.

One of the most intriguing sections of the book, in fact, is Stengel's discussion of how chimpanzees curry favor through the ritual behavior of grooming. The fawning ritual begins with the subordinate chimp greeting the dominant "alpha" male. Stengel explains: "Sometimes the greeter kisses the feet of the alpha male and brings along objects, like a leaf or stick, as a kind of offering .... Females, instead of greeting the alpha male, present their backsides to be inspected and sniffed. Sometimes the alpha male will permit subordinates to fondle his scrotum, which is considered a form of reassurance for both the dominant chimp and the subordinate one."

"Their behavior should seem disconcertingly familiar," Stengel notes tartly. "Unlike us, however, chimps don't have the ability to weave the elaborate explanations that we use to justify our more craven conduct."

In the animal world, as in ours, deception has the

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