

Business taxpayer ethics

Big name businesses skip taxes while schools flounder

By Edgar Gentle



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We are encouraged by the new administration's focus on ethics in government, and we are especially heartened by the attention paid to business ethics and accountability by the Sarbanes-Oxley Act passed by Congress in the wake of the scandals involving Arthur Andersen, Enron, WorldCom, and others.

The application of a few of the ideals put forth by Governor Riley and Congress to Alabama business taxpayers would be invaluable to our education system. Let's see how this would work.

Ethics pledge for big business

In keeping with Governor Riley's requirement that cabinet members sign an ethics pledge to follow the letter and spirit of Alabama ethics laws, publicly traded companies doing business in Alabama should sign a tax ethics pledge vowing to follow the letter and spirit of Alabama's tax laws. We can then be assured that the Education Trust Fund will not suffer the depletion of its revenue stream caused by tax avoidance schemes that have come to light in recent years.

Business tax revenues have dropped \$150 million per year between 1998 and 2001. Today, the Education Trust Fund faces a deficit of \$300 million. Creative business tax avoidance schemes on the backs of Alabama's children need to come to an

end.

The pledge form to correct this tax avoidance drain is given below. The pledge focuses on Alabama tax avoidance schemes that are considered abusive and exploit weaknesses in Alabama tax laws.

The tax avoidance sham by "Geoffrey"

During the past two years, newspapers have been replete with stories of complex accounting and tax planning measures taken by large multi-state companies to avoid paying Alabama income tax. The most popular mechanism has been the intangible asset shifting between affiliates sometimes called the "Geoffrey" scheme.

It works like this.

- A company is formed in Delaware or in another state or country that does not tax income received from licensing trademarks or receiving interest.
- This company then receives the business's trademark which it licenses back to the business in Alabama.
- The Alabama business then pays "rent" for using the trademark, which the trademark company then pays back and calls a "loan."
- The Alabama business deducts the rent, to escape income tax, and gets the money back as a non-taxable "loan."

Sometimes this sham transaction is by "book entry" only, with no money ever moving between the businesses. Sure, there is a so-called business purpose invented by the business, such as trademark protection, but everyone knows what is going on: income shifting to avoid Alabama income tax. The trademark company is often a sham, having no

employees and no physical location other than an address shared with hundreds of other companies.

Among companies publicly known to engage in this tax sleight of hand is The Limited (Abercrombie & Fitch, Structure, Bath and Body, Victoria's Secret).^[1] The revenue exported to Delaware is not used to pay any income tax to any state.

So, when the Governor and the legislature start trying to figure out how to buy textbooks and computers for our schoolchildren, they might go to the mall.

The following well-known companies doing business in Alabama seem to be engaging in the same "Geoffrey" activity:

Aaron Rents^[3]
MediaOne Holdings II Inc.^[2]
Beatrice^[3]
Oppenheimer Capital^[2]
Budget Rent-A-Car Corp. & Subs^[3]
Payless Shoesource Inc.^[3]
Burger King^[3]
Penske Performance Holdings Corporation^[2]
Chubb Holdings Inc.^[2]
Prudential International Investments Corporation^[2]
Colgate-Palmolive, Inc.^[2]
Radio Shack Corp.^[3]
Continental Airlines Purchasing Holdings^[2]
Seagram, Inc.^[2]
Gap Inc.^[3]
Shell Petroleum Inc.^[2]
Home Depot USA^[3]
Sherwin Williams^[3]
Honeywell International Inc. & Subs.^[3]
Snap on Tool^[3]
ITT Manufacturing Enterprises Inc.^[2]
Toys R Us^[3]
Kentucky Fried Chicken Corporate Holdings Ltd.^[2]
Tyson Foods Inc.^[3]
Kimberly Clark Corp.^[3]
Union Pacific Finance Co.^[3]
Kmart Corp.^[3]
Whirlpool Financial Corporation International^[3]
Long John Silver's^[3]
Yellow Freight System^[3]

Other schemes

Other popular tax avoidance schemes designed to deprive the state of sorely needed school revenues include real estate investment trusts (allowing business rental property to pay no income tax by returning rents received as deductible dividends to their owners), and limited liability entities (sheltering Alabama income with losses from other states).

Enough is enough - the same immoral financial planning attitude that led to the downfall of the unregulated practice of accounting is alive and well in the state income tax planning arena. Textbooks and teachers are sacrificed for the business bottom line in Alabama.

Business lobbying stops tax fairness

In an effort to eliminate this offshore tax avoidance scheme, the Department of Revenue and Governor Siegelman proposed a draft bill in December 2001 that would have disallowed such Geoffrey deductions. Due to lobbying efforts of big business, the resulting legislation only disallows the deduction if the licensing company does not pay tax on the receipt or there is a "substantial business purpose." I.e., a loophole.

Although there have been limited collections under this loophole-ridden statute, many "Geoffrey" businesses still claim not to owe any tax. If they pretend to be ethical citizens, Alabama businesses should eliminate the paper sham transactions by signing the tax pledge. During the campaign, Governor Riley promised to end these tax avoidance schemes if they were shown to him. Here they are.

Developing a defense

Another defense to these business income shifting schemes was developed by Congress this past summer. When an unusually large number of domestic companies moved their headquarters to offshore locations in an effort to slick Uncle Sam out of tax money through the same intellectual property "renting" scheme used to ship Alabama taxable income to Delaware, the Senate voted to bar companies seeking these tax havens from bidding on contracts under the new Homeland Security Act. It may be legal and a "jim-dandy" tax avoidance idea to set up shop in Delaware or Bermuda to get out of paying your taxes, but it is also legal for Alabama to keep you out of government work until you pay a fair share.

Alabama citizens should also think twice about buying the products of business tax cheats or investing in them.

This ethically sound tax integrity requirement should be adopted by the Governor. Our state should not take any bids from those companies participating in these tax avoidance schemes, and Alabama

should not do business with any company not willing to sign the tax ethics pledge.

This will help the state either way the multi-state businesses want to go. If they choose to sign the pledge, dismantle the sham structures, and pay their fair share, then we can better balance the education budget. If the big boys decide to pass up on this opportunity to come clean, then our home grown mom-and-pop retailers paying their taxes who've been going broke trying to compete against the behemoth chains will get a well-earned leg up.

You are now aware of the biggest problem. No studies need be done. No commissions need to be formed. The problem simply needs to be solved. If we are going to discuss accountability for the teacher who may lose his or her job due to budget cuts, it makes just as much sense to discuss business taxpayer accountability by paying taxes as good citizens.

The Alabama business tax avoidance problem cannot be ignored or taken lightly. State business tax has been targeted by this country's most talented accountants and tax attorneys since gaming the federal corporate income tax became more difficult with the revision of the Internal Revenue Code in 1986.¹⁰¹

Professor Pomp, a University of Connecticut tax law professor, states that "the changing nature of the state tax profession has resulted in the aggressive exploitation of even the slightest weaknesses in the tax's structure or framework," and "modern-day tax planning techniques result in a stealth attack on the tax base."

Alabama passed legislation in 2001 that allows the Alabama Revenue Commissioner to conduct a preemptive strike against business tax cheats under his so-called "48 powers" enacted in December 2001. These powers authorize Alabama to require what is called "unitary combined reporting."

Simply stated, such a reporting requirement would tax the business as a whole, no matter how creatively tax accountants have rearranged the business' piece parts to try to avoid tax. This regulation was already drafted by the Alabama Department of Revenue in the fall of 2002, as announced at the Hartmann Tax Conference in Nashville.

Now's the time to implement it, before the

schoolhouse lights go out and more teachers are fired. Commissioner Carlisle should act immediately to follow through on those powers given him by the legislature to correctly tax business income. As Governor Riley has said, the executive and legislative branches must work together to solve these problems.

It would also be wise to implement Sarbanes-Oxley Act-type regulations for Alabama business taxpayers. For example, corporate lawyers are now required by federal legislation to act as whistle blowers that report to their corporation's CEO and board when they find evidence of financial wrongdoing. The Securities and Exchange Commission lobbied to have these same lawyers report directly to the SEC, but these efforts fell short.

The Alabama Department of Revenue should establish regulations requiring attorneys and accountants who notice unscrupulous tax shelters and tax avoidance schemes being used by business to report them. CEOs and boards of directors should also sign their business tax return under penalty of perjury just as they are required to sign their quarterly financial statements submitted to the Securities and Exchange Commission under Sarbanes-Oxley.

Individual taxpayers are required to sign their Alabama tax returns, and managers of business taxpayers should do the same.

If companies followed through on these requests, it would go a long way toward restoring our faith that they are responsibly following the letter and the spirit of Alabama tax laws. Those companies who choose not to comply with these requests might be seen as an irresponsible investment for large institutional investors, such as the Alabama Employees Retirement System and the Alabama Teachers Retirement System. Investors have reacted much the same way in recent years toward mutual funds that invest in tobacco companies.

Legislators can lift veil of tax secrecy

We would also encourage our leaders to pay close attention to the actions of Alabama businesses. To do so, our legislature should lift the veil of secrecy from publicly traded companies by making their tax returns public, so that the Alabama taxpayer can be assured that they are paying their fair share. Such a bill has died in past sessions of the legislature, and we now need to pass it.

We need also be cognizant that a number of our legislators and cabinet officials serve on boards of corporations. They are privy to company operations and possible tax avoidance schemes. Their signing the Alabama business tax ethics pledge will allay any fears that they may favor their company's interest over those of the state.

These are but a few suggestions during this refreshing new age of ethical awareness. After all, support for ethics revolves around fairness. If we are going to get real about ethics, let's get real about the ethical treatment of our schoolchildren.

[1] Public Source: In the Matter of The Limited, Before the N.C. Tax Review Board, Adm. Decision No. 381 (2002)

[2] Public Source: They share this file drawer address with The Limited and hundreds of other companies: 1105 Market St., Wilmington, Delaware. The Limited, supra, at ¶ 124 and The OnLine Detective.

[3] Public Source: A Tax Maneuver in Delaware Puts Squeeze on Other States. *The Wall Street Journal*, August 9, 2002.

[4] Pomp "The Future of State Corporate Income Tax: Reflections (and Confessions of a Tax Lawyer)"

[5] Edison v. McCollgan, 184 P.2d16 (Cal. 1947); Joslin v. Dolan, 615 P.3d16 (Colo. 1980)