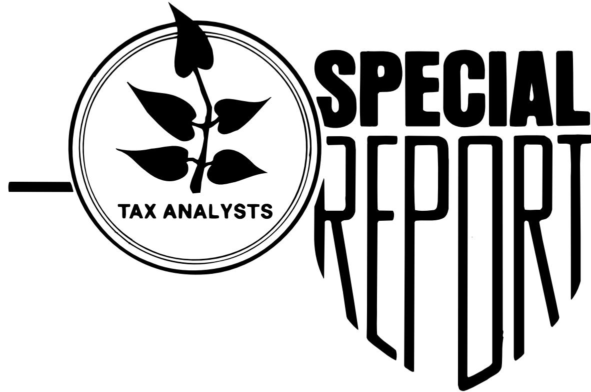

DID ENRON PAY TAXES?: USING ACCOUNTING INFORMATION TO DECIPHER TAX STATUS

By Gary A. McGill and Edmund Outslay

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Using Enron's Annual Report information, the authors demonstrate how currently available financial statement data can be used to guesstimate a publicly traded corporation's tax status. They summarize the existing financial accounting literature on income tax disclosure and point out the "gaps" in such disclosure that make it difficult (impossible) to precisely discern the corporation's federal income tax status.

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Confusion is the welcome mat at the door of creativity.
— Michael J. Gelb

I. Introduction

The much publicized collapses of Enron Corporation and WorldCom, Inc. have heightened the discussion regarding the need for more consistency between measures of book and taxable income and the adequacy of the current annual report disclosure of a publicly traded corporation's tax status. As a result of the speculation and confusion about whether these corporations paid federal income taxes despite reporting billions of dollars of book income, commentators and members of Congress are calling for, or at least questioning the need for, publicly traded companies to be required to make their federal income tax returns (or relevant summary information) available to government agencies and perhaps even shareholders and employees.[1] In a recent letter to Treasury Secretary O'Neill, Sen. Charles Grassley, R-Iowa, asked the Secretary for his views on whether sufficient tax information is publicly available.[2] Senator Grassley observed that "Commentators have stated that the tax puzzle of a corporation can be put together from SEC filings, annual reports, etc. However, we saw with the Enron Corp. many analysts providing an estimate of taxes paid, or not paid, that were wildly contradictory."[3]

In this report we demonstrate how currently available financial statement data can be used to guesstimate a publicly traded corporation's tax status. In so doing, we summarize the existing financial accounting literature on income tax disclosure and point out the "gaps" in such disclosure that make it difficult (impossible) to precisely discern the corporation's

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[1]*See* A. Murray, "Inflated Profits in Corporate Books Is Half the Story," *The Wall Street Journal*, July 2, 2002, p. A4, and letter from Sen. Charles E. Grassley, R-Iowa, to Treasury Secretary Paul O'Neill dated July 8, 2002, available at http://www.senate.gov/~grassley.

[2]Currently, section 6103(e)(1)(D)(iii) permits any bona fide shareholder of record owning 1 percent or more of the outstanding stock of such corporation to inspect the corporation's federal income tax return.

[3]Letter from Sen. Charles E. Grassley, *supra* note 1.

federal income tax status. We hope the methodology and ensuing discussion help legislators, government agencies, academic researchers, and analysts better understand current disclosure rules and evaluate whether these rules provide sufficient information about a corporation's financial accounting and tax status.

II. The Growing Book and Tax Income Gap

Public scrutiny of the discrepancies between publicly traded corporations' book and tax incomes began in earnest during the mid-1980s, as corporate tax revenues as a percentage of total tax revenues shrank as a result of very favorable tax provisions enacted in the Economic Recovery Tax Act of 1981.[4] The highly publicized Citizens for Tax Justice study interpreted the growing book-tax discrepancies as evidence of corporations' overindulgence in "corporate tax loopholes."

Subsequent to these initial studies, academic and government researchers began more in-depth analyses of corporate effective tax rates, which included discussions as to the appropriate measure of a corporation's tax burden.[5] These studies tended to focus on whether corporations were paying their "fair share" of the corporate tax burden relative to their "economic" income (a modification of book income).

A new wave of academic research has arisen in response to the U.S. government's concern with the rise in corporate tax shelters.[6] Whereas tax avoidance strategies in the 1980s tended to focus on book-tax temporary differences (for example, depreciation, leasing, completed contract method of accounting), recent tax shelters focus more on book-tax permanent differences (for example, income shifting to low-tax jurisdictions, tax-exempt income) that reduce the corporation's book "effective tax rate" and coincidently increase the corporation's after-tax book income.[7] All of these recent studies confirm that the discrepancy between book income and tax income increased during the 1990s.[8] Using data from the IRS Statistics of Income, Plesko 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.[9]

Determining the extent to which documented book and tax income discrepancies are due to tax avoidance strategies presents the biggest challenge to analysts. In the most extensive study to date, Desai shows that stock option exercises comprise a significant percentage of the discrepancy.[10] He also finds that traditional book-tax differences and earnings management do not fully explain the discrepancies and surmises the unexplained differences to be due to tax sheltering activities.

III. Corporate Income Tax Disclosure

Analysts of a corporation's tax burden must depend on financial accounting income tax disclosures to calculate the corporation's tax liability in the absence of publicly available firm tax return data. No less a corporate tax authority than Robert Willens was quoted in a recent *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."[11] A *Washington Post* article dealing with whether Enron paid taxes stated that "Accountants cautioned that it is difficult to determine from a company's financial reports how much tax it paid. . . . Tax and accounting experts differed over the best way to interpret some of the data contained in the Enron reports."[12] Writing in *CFO Magazine*, S. L. Mintz observed that "While tax information is readily available — as provisions on income statements, as deferred as-

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[4]*See, e.g.,* Citizens for Tax Justice, *Corporate Taxpayers and Corporate Freeloaders* (1985); E. Outslay and J.E. Wheeler, "The Phantom Federal Income Taxes of General Dynamics Corporation," *The Accounting Review*, October 1986, p. 760; J. E. Wheeler and E. Outslay, "The 1986 Tax Reform Effort — The Defense Industry and Senator Danforth's Complaints," *Tax Notes*, Sept. 29, 1986, p. 1305; and C.P. Stickney, R.L. Weil, and M. Wolfson, "Income Taxes and Tax-Transfer Leases: General Electric's Accounting for a Molotov Cocktail," *The Accounting Review*, April 1983, p. 439.

[5]*See, e.g.,* G.M. Clowery, E. Outslay, and J.E. Wheeler, "The Debate on Computing Corporate Effective Tax Rates — An Accounting View," *Tax Notes*, Mar. 10, 1986, p. 991; S. Gupta and K. Newberry, "Corporate Average Effective Tax Rates After the Tax Reform Act of 1986," *Tax Notes*, May 4, 1992, p. 689; General Accounting Office, "Tax Policy: 1988 and 1989 Company Effective Tax Rates Higher Than in Prior Years," *GGD-92-111*, Sept. 19, 1992; and D. S. Callihan, "Corporate Effective Tax Rates: A Synthesis of the Literature," *Journal of Accounting Literature* 13 (1994), p. 1.

[6]This issue returned to the public spotlight with a 1998 *Forbes Magazine* cover story dealing with the rise in aggressive tax shelters sold by lawyers and accountants. *See* J. Novack and L. Saunders, "The Hustling of X-Rated Shelters," *Forbes*, Dec. 14, 1998, p. 198.

[7]*See* S. L. Mintz, "A Taxing Challenge," *CFO Magazine*, Nov. 1, 1999.

[8]Department of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals*, July 1999, at pp. 31-33; R.S. McIntyre and T.D. Coo Nguyen, *Corporate Income Taxes in the* 1990s, Institute on Taxation and Economic Policy (October 2000); G.B. Manzon and G.A. Plesko, "The Relation Between Financial and Tax Reporting Measures of Income," *Tax Law Review* (forthcoming); L.K. Mills, K. Newberry, and W.B. Trautman, "Trends in Book-Tax Income and Balance Sheet Differences, *Tax Notes*, Aug. 19, 2002, p. 1109; and M. Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation. *NBER working paper 8866*, 2002.

[9]G. Plesko, "Reconciling Corporation Book and Tax Net Income, Tax Years 1996-1998," *Statistics of Income Bulletin*, Spring 2002, p. 111 at p. 116.

[10]M. Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," *supra* note 8.

[11]H. Gleckman, D. Foust, M. Arndt, and K. Kerwin, "Tax Dodging: Enron Isn't Alone. Plenty of Companies Pay Little or Nothing," *Business Week*, Mar. 4, 2000, p. 40.

[12]G. Kessler, "Enron Appears to Have Paid Taxes," *The Washington Post*, Feb. 3, 2002, p. A10.

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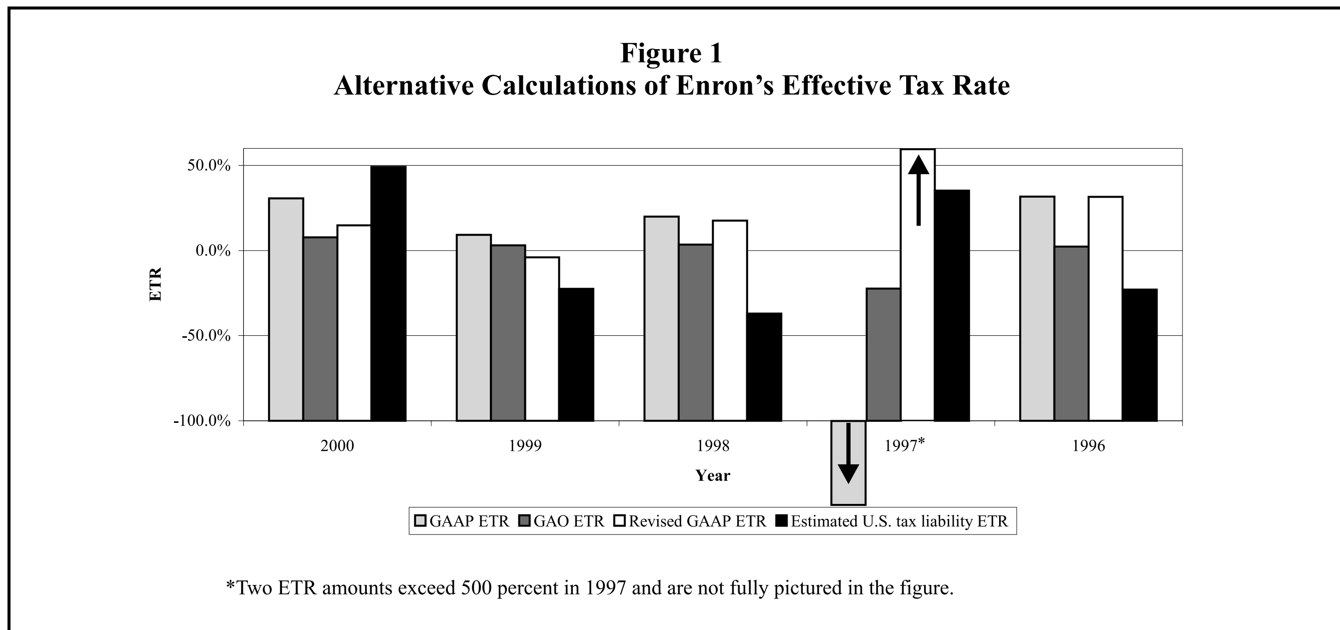
Figure 1
Alternative Calculations of Enron's Effective Tax Rate



*Two ETR amounts exceed 500 percent in 1997 and are not fully pictured in the figure.

sets and liabilities on balance sheets, as cash taxes on statements of cash flows, and often as footnoted items — the data resists comprehensive analysis. Further, little of it is reported in a consistent manner, even within industry groups."[13]

Much of the confusion can be traced back to the flexibility and "gaps" in Generally Accepted Accounting Principles (GAAP) regarding measurement and disclosure of a company's income taxes. As noted in *Tax Notes* as far back as 1986, "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."[14] Indeed, estimates of how much federal income taxes Enron paid in 2000 ranged from zero[15] to $62 million[16] to $112 million.[17] Table 1 presents data related to Enron's income taxes for the period 1996-2000 (Note 5 to the company's financial statements).

A. Accounting for Income Taxes

1. FAS 109. *Statement of Financial Accounting Standards No. 109* (*FAS 109*) primarily governs the measurement and reporting of a publicly traded corporation's income taxes (federal, state and local, and foreign). This statement, promulgated by the Financial Accounting Standards Board (FASB), applies to fiscal years beginning after December 15, 1992. FAS 109 states two objectives: (1) to recognize the amount of taxes payable or refundable for the current year; and (2) to recognize deferred tax liabilities and assets for the (expected) future tax consequences of events that have been recognized in a company's financial statements or tax returns.[18]

The statement attempts to implement its objectives through four basic principles: (1) A *current tax liability or asset* is recognized for the estimated taxes payable or refundable on tax returns for the current year; (2) A *deferred tax liability or asset* is recognized for the estimated future tax effects attributable to *temporary differences* and carryforwards; (3) The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; and (4) The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that based on available evidence, are not expected to be realized.[19] A temporary difference generally is an amount that will appear on both the financial statement and the tax return but in different accounting periods. An item that will produce a future tax liability creates a deferred tax liability, whereas an item that will produce a future tax reduction creates a deferred tax asset.

Unlike its predecessor, *Accounting Principles Board Opinion No. 11* (*APB 11*), FAS 109 recognizes that deferred income taxes are assets and liabilities and not residual charges (that is, the statement takes a balance sheet approach rather than an income statement ap-

[13]S.L. Mintz, "A Taxing Challenge," *supra* note 7.

[14]G.M. Clowery, E. Outslay, and J.E. Wheeler, "The Debate on Computing Corporate Effective Tax Rates — An Accounting View," *supra* note 5, at p. 992.

[15]Citizens for Tax Justice, "Less Than Zero: Enron's Corporate Income Tax Payments, 1996-2000" (Jan. 17, 2000).

[16]A. Witt and P. Behr, "Enron's Other Strategy; Internal Papers Reveal How Complex Deals Boosted Profits by $1 Billion," *The Washington Post*, May 22, 2002, p. A01.

[17]L.D. Brumbaugh, "Enron and Taxes" *Congressional Research Service Report RS21149*, February 12, 2002, and G. Kessler, "Enron Appears to Have Paid Taxes," *The Washington Post*, Feb. 3, 2002, p. A10.

[18]Financial Accounting Standards Board *Statement of Financial Accounting Standards No. 109*, para. 6 and 7.

[19]*Id.* at 3, para. 8.

Table 1
Enron Income Taxes Note Data (Note 5)

Components of income before income taxes (in millions)	2000	1999	1998	1997	1996
United States	$ 640	$ 357	$ 197	$ 96	$ 551
Foreign	773	771	681	(81)	304
Income before income taxes	$1,413	$1,128	$878	$15	$855
Total income tax expense (benefit) (in millions)	**2000**	**1999**	**1998**	**1997**	**1996**
Payable currently					
Federal	$ 112	$ 29	$ 30	$ 29	$ 16
State	22	6	8	9	11
Foreign	93	48	50	46	37
	227	83	88	84	64
Payment deferred					
Federal	13	(159)	(14)	(39)	174
State	14	23	11	(42)	(1)
Foreign	180	157	90	(93)	34
	207	21	87	(174)	207
Total income tax expense	$434	$104	$175	$(90)	$271
Effective tax rate reconciliation	**2000**	**1999**	**1998**	**1997**	**1996**
Statutory federal income tax provision	35.0%	35.0%	35.0%	35.0%	35.0%
Net state income taxes	2.5%	1.8%	1.7%	-140.0%	0.8%
Tight gas sands tax credit	0.0%	-0.5%	-1.4%	-80.0%	-1.8%
Foreign tax rate differential	-2.4%	-7.0%	0.8%	13.3%	0.0%
Equity earnings	5.3%	-10.1%	-4.3%	-253.3%	-3.3%
Minority interests	0.0%	0.8%	0.8%	186.7%	3.1%
Basis and stock sale differences	-11.9%	-10.8%	-14.2%	-526.7%	1.8%
Goodwill amortization	1.6%	1.6%	2.0%	60.0%	0.0%
Cash value in life insurance	0.0%	-0.9%	-1.1%	-46.7%	-3.2%
Audit settlement	0.0%	-1.8%	0.0%	0.0%	0.0%
Other	0.6%	1.1%	0.7%	153.4%	-0.7%
Book effective tax rate[a]	30.7%	9.2%	20.0%	-598.3%	31.7%

[a]Total income tax expense/Income before income taxes.

proach). As a result, an enterprise's deferred tax expense or benefit is measured as the change during the year in the enterprise's deferred tax liabilities and assets.[20] The enterprise must reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized.[21] A company's total income tax expense or benefit for the year is the sum of deferred tax expense or benefit and income taxes currently payable or refundable.[22]

Paragraphs 43-49 of FAS 109 govern the financial statement disclosure of the enterprise's income taxes. In general, paragraph 43 requires an enterprise to disclose the total of all deferred tax liabilities, the total of all deferred tax assets, the total valuation allowance, the net change in the valuation allowance for the year, and the types of temporary differences and tax carryovers that comprise a "significant" portion of the deferred tax liabilities or assets. An enterprise also must disclose components of the income tax provision allocated to continuing operations, including the current tax expense or benefit, the deferred tax expense or benefit, investment tax credits, the benefits of operating loss carryforwards, and adjustments to the beginning of the year valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years (paragraph 45).

Paragraph 47 requires a public enterprise to disclose a reconciliation using percentages or dollar amounts of (a) the reported amount of income tax expense attributable to continuing operations for the year to (b) the amount of income tax expense that would result

[20]*Id.* at 7, para. 16.
[21]*Id.* at 8, para. 17.e.
[22]*Id.* at 7, para. 16.

Table 2
Enron Stock Options Data (Note 11)

	2000[a]	1999[b]	1998	1997	1996
Exercised					
Shares (in thousands)	32,235	19,705	13,072	4,330	7,230
Weighted average exercise price of stock options granted	70.02	37.49	24.99	19.32	19.86
Weighted average exercise price of stock options exercised	24.43	18.08	15.70	11.65	12.21
Estimated compensation component of stock options exercised	45.59	19.41	9.29	7.67	7.65
Tax deduction related to stock options exercised (in millions)[c]	$1,114	$382	$121	$33	$55

[a]Year 2000 uses the tax benefit information provided by Enron ($390 million) grossed up by the statutory tax rate (35 percent).
[b]The calculations take into account a 2-for-1 stock split in 1999.
[c]Shares exercised x estimated compensation component of stock options exercised.

from applying domestic federal statutory tax rates to pretax income from continuing operations (sometimes referred to as the "hypothetical" federal income tax expense). Paragraph 47 also requires the enterprise to disclose the estimated amount and the nature of each "significant" reconciling item (this would include permanent book-tax differences, the impact of state and local income taxes and foreign taxes, and the effects of enacted tax rate changes on temporary differences). FAS 109 does not provide any materiality guidelines for the disclosure of individual reconciling items. 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.

2. APB 23. *Accounting Principles Board Opinion No. 23* (*APB 23*), issued in 1972, deals with "special areas" related to accounting for income taxes. APB 23 applies most frequently to the potential tax consequences related to reporting undistributed earnings of subsidiaries located outside the United States reported on the enterprise's income statement but not its tax return. APB 23 generally presumes that all undistributed income of a foreign subsidiary will be transferred to the parent company and deferred taxes should be recorded for this temporary difference, taking into account any deductions or credits available to the parent corporation.[23] This presumption can be overcome, in which case the parent company does not have to accrue income taxes, if "sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation."[24] This exception is referred to as the "indefinite reversal criteria." Where an enterprise chooses not to record deferred taxes on undistributed earnings of a foreign subsidiary, FAS 109 requires the enterprise to disclose the amount of the unrecognized deferred tax liability "if determination of that liability is practicable or a statement that determination is not practicable."[25] The great majority of publicly traded companies choose not to record deferred income taxes for undistributed earnings of their foreign subsidiaries, and many find it "not practicable" to estimate the deferred taxes that would be payable if such earnings were remitted.[26]

3. APB 25. *Accounting Principles Board Opinion No. 25* (*APB 25*), issued in 1972, deals with accounting for the tax benefits related to employee stock option exercises. Tax benefits related to stock option deductions taken on the tax return that will not affect book income (for example, employee exercises of nonqualified stock options) are recorded as an addition to the company's additional paid-in capital.[27] This accounting treatment overstates the "current" portion of the total tax provision reported in the enterprise's income statement by the amount of the stock option tax benefit.[28] The tax benefits also are reported in the company's Statement of Cash Flows as an operating cash flow.[29]

4. FAS 5. *Statement of Financial Accounting Standards No. 5* (*FAS 5*) deals with accounting for contingencies. Most enterprises include in their tax provision a "cushion" for anticipated tax deficiencies that might arise due to positions taken on the current year tax return. FAS 5 allows an enterprise to book an estimated loss from a loss contingency if it is "probable" the liability has been incurred at the date of the financial statement and the amount of the loss can be reasonably estimated.[30] Whether a potential deficiency due to a potential future IRS audit meets these criteria is subject to debate,[31] but the practice of recording a tax cushion

[23]Accounting Principles Board *Opinion No. 23*, para. 10, as amended by FAS 109, para. 287.f.

[24]*Id.*, para. 12

[25]Financial Accounting Standards Board *Statement of Financial Accounting Standards No. 109*, para. 44.c.

[26]An exception is Microsoft Corporation, which reported a deferred tax liability related to its undistributed international earnings of $1,667 million at June 30, 2001.

[27]Accounting Principles Board *Opinion No. 25*, para. 17.

[28]M. Hanlon and T. Shevlin, "Accounting for Tax Benefits of Employee Stock Options and Implications for Research," *Accounting Horizons*, March 2002, p. 1.

[29]*See* Emerging Issues Task Force *Issue No. 00-15*.

[30]Financial Accounting Standards Board *Statement of Financial Accounting Standards No. 5*: para. 8.

[31]*See, e.g.*, J.E. Wheeler, *Advanced Accounting: A Professional Approach* (Richard D. Irwin, Inc., 1981), p. 18.

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Table 3
Reconciling Enron's U.S. Federal Income Tax Payable Currently
(Excludes ESO Exercises)

		2000	1999	1998	1997	1996
	Net income before cumulative effect of accounting changes[a]	979	1,024	703	105	584
[Add/Sub]	Income tax expense (benefit)[a]	434	104	175	(90)	271
[Add]	Minority interests[a]	154	135	77	80	75
[Sub/Add]	Equity in earnings of unconsolidated affiliates[a]	(87)	(309)	(97)	(216)	(215)
[=]	*Before tax income (BTI)*	1,480	954	858	(121)	715
[Sub/Add]	State and local taxes (current)[b]	(22)	(6)	(8)	(9)	(11)
[=]	*Worldwide profit before tax*	1,458	948	850	(130)	704
[Add/Sub]	Foreign income (loss)[b]	(773)	(771)	(681)	81	(304)
	U.S. profit before tax	685	177	169	(49)	400
[Sub/Add]	U.S. deferred tax provision (drawdown)/0.35[c]	(37)	454	40	111	(497)
[Subtract]	Reduction in tax provision due to "permanent differences"[d]	(137)	(102)	(104)	(52)	(30)
[=]	*Estimated U.S. taxable income excluding ESO exercises*	511	530	105	10	(127)
[x]	35%	0.35	0.35	0.35	0.35	0.35
[=]	*Estimated pre-credit U.S. tax liability (benefit) without ESO exercises*	179	185	37	4	(44)
[Subtract]	U.S. tax credits[e]	—	(6)	(12)	(21)	(15)
[=]	*Estimated U.S. tax liability without ESO exercises*	179	180	25	(17)	(60)
[Compare]	Federal income tax payable currently[b]	112	29	30	29	16
	Over (under) estimated difference	67	151	(5)	(46)	(76)

[a]As reported in the Consolidated Income Statement.
[b]As reported in the Income Taxes Note to the financial statements (See Table 1).
[c]From the Income Taxes Note: 2000: 13/0.35; 1999: (159)/0.35; 1998: (14)/0.35; 1997: (39)/0.35; 1996: 174/0.35.
[d]From the Income Taxes Note: Includes only basis and stock sale differences, cash value in life insurance, goodwill amortization, other.
[e]From the Income Taxes Note: Alternative fuel credit under IRC section 29(a).

is common.[32] Although it would seem logical that a tax cushion would be included in the deferred portion of the tax provision, discussions with practitioners indicate that companies often record the cushion in the current portion of the tax provision. Weber and Wheeler note that "There is no accounting convention that specifically covers the reporting of tax audit cushions, and for obvious reasons, corporations do not generally disclose information about their cushion."[33]

5. SEC Regulation S-X, Rule 4-08(h). Rule 4-08(h) deals with income tax disclosures required by companies subject to SEC regulation. The primary disclosure requirement imposed by this rule is the bifurcation of income (loss) before income tax expense (benefit) as either domestic or foreign. Companies also are required to separately state the portion of the income tax expense related to federal income taxes, foreign income taxes, and other income taxes (state and local). Foreign income (loss) is defined as income (loss) that is generated from a registrant's operations located outside its home country. Rule 4-08(h)(2) also states that reconciling items in the effective tax rate computation should be stated separately if they equal or exceed 5 percent of the "hypothetical tax expense" (income before taxes times the applicable statutory federal income tax rate — currently 35 percent for U.S. domiciled companies). No reconciliation is required if the total reconciling differences are less than 5 percent of the hypothetical tax unless the reconciliation would be "significant in appraising the trend of earnings."

B. Gaps in GAAP Income Tax Disclosure

1. Interpreting the 'current' portion of the income tax provision. Many individuals, including analysts, view the "current" portion of a company's income tax provision as the amount that relates to the entity's current year taxable income. For example, in a recent *Business Week* article on how to interpret a company's income tax disclosure, the author stated that "if you look up the 'current' portion of its tax bill . . ., you can see that the company sent the IRS a check for $46.3 million, deferring the remaining $46.2 million."[34] Given that the current portion of the income tax pro-

[32]Dworin pointed this out in a 1985 *Tax Notes* article. *See* L. Dworin, "On Estimating Corporate Tax Liabilities From Financial Statements," *Tax Notes*, Dec. 2, 1985, p. 965. *FAS 5* does sanction the recording of a cushion when an enterprise is litigating a tax matter (para. 39).

[33]R.P. Weber and J.E. Wheeler, "Using Income Tax Disclosures to Explore Significant Economic Transactions," *Accounting Horizons*, September 1992, p. 14 at p. 17.

[34]A. Turgesen, "How to Spot Tax Tinkering," *Business Week*, May 20, 2002, p. 142.

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Table 4
Reconciling the Foreign Component of Enron's Income Statement

		2000	1999	1998	1997	1996
	Foreign income (loss)[a]	773	771	681	(81)	304
[Sub/Add]	Increase (drawdown) of non-U.S. deferred tax provision/0.35	(514)	(449)	(257)	266	(97)
	Estimated foreign taxable income	259	322	424	185	207
[x]	35% (U.S. statutory tax rate)	0.35	0.35	0.35	0.35	0.35
[=]	Tax on foreign income at the U.S. statutory rate	91	113	148	65	72
[Subtract]	Foreign taxes payable currently[a]	93	48	50	46	37
[=]	*Foreign taxes less (greater) than U.S. taxes on foreign income*	(2)	65	98	19	35
[Compare]	Foreign tax rate differential[b]	(34)	(79)	70	2	—
	Over (under) estimated difference	32	144	28	17	35

[a]As reported in the Income Taxes Note to the financial statements (See Table 1).
[b]Equals the "foreign tax rate differential" (from Table 1) x Income Before Income Taxes (from Table 1).

vision often becomes a clearinghouse for bestiaries such as the tax cushion and does not reflect the tax benefits of employee stock option deductions, a correspondence between the reported federal income tax "payable currently" and the check sent to the Internal Revenue Service would be surprising, if not only coincidental. Relying on the current portion of the tax expense as indicative of a corporation's tax status could lead to erroneous implications. For example, Microsoft Corporation reported current income taxes of $5,279 million for 2000, of which $4,744 related to U.S and state income taxes. The company noted that it "paid" income taxes of $1.1 billion in 2000. With a tax deduction of more than $15 billion related to employee stock option deductions not reported in the income statement,[35] it is likely that the company paid little, if any, federal income taxes in 2000.[36]

2. Estimating the tax benefits from employee stock option exercises. APB 25, para. 17, requires a company to record the excess of the tax benefit related to employee stock option exercises over the amount reported for net income purposes (which usually is zero) as an addition to paid-in-capital in the shareholders' equity section of the balance sheet. The tax benefits from employee stock option exercise also are included in the company's Statement of Cash Flows. The Emerging Issues Task Force recently reached a consensus that the income tax benefit realized from stock option exercise should be classified as an operating cash flow and should be separately disclosed if material.[37]

Not all firms disclose the tax benefit of stock options separately in their Changes in Shareholder Equity statement, necessitating an estimate using stock option information required under *Statement of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation.*[38] Relevant information required to be disclosed under this statement includes the number of options exercised during the year, the average exercise price, and the average exercise price of new options granted during the year. The average value of the stock when the options were exercised is not provided. As a result, studies analyzing the stock option benefits to individual companies have estimated the tax benefits (and resulting tax deduction) from such exercises using the following formula: Number of options exercised x (average price of new options granted — average exercise price).[39] Alternatively, the average price of new options granted could be replaced by the weighted average price of the company's stock for the year (this takes into account the volume of stock sold and the price at which sold for each trading day during the year).[40]

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[35]Dividing the reported tax benefit of $5,279 million by 35 percent translates to a deduction of slightly more than $15 billion.

[36]*See also* M. Hanlon and T. Shevlin, "Accounting for Tax Benefits of Employee Stock Options and Implications for Research," *supra* note 28, and M.A. Sullivan, "Stock Options Take $50 Billion Bite Out of Corporate Taxes," *Tax Notes*, Mar. 18, 2002, p. 1396, for a slightly different computation of the company's estimated stock option deduction.

[37]*See* Emerging Issues Task Force *Issue No. 00-15. See also* Financial Accounting Standards Board *Statement of Financial Accounting Standards No. 95 — Statement of Cash Flows* for a more thorough discussion of the components of a company's Statement of Cash Flows.

[38]M. Hanlon and T. Shevlin, "Accounting for Tax Benefits of Employee Stock Options and Implications for Research," *supra* note 28.

[39]Citizens for Tax Justice, "Less Than Zero: Enron's Corporate Income Tax Payments, 1996-2000," *supra* Note 15; M. Hanlon and T. Shevlin, "Accounting for Tax Benefits of Employee Stock Options and Implications for Research," *supra* note 28 and M.A. Sullivan, "Stock Options Take $50 Billion Bite Out of Corporate Taxes," *supra* note 36.

[40]M. Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," *supra* note 8.

Table 5
Estimating Enron's U.S. Federal Income Tax Liability (Includes ESO Exercises)

		2000	1999	1998	1997	1996
	Net income before cumulative effect of accounting changes[a]	979	1,024	703	105	584
[Add/Sub]	Income tax expense (benefit)[a]	434	104	175	(90)	271
[Add]	Minority interests[a]	154	135	77	80	75
[Sub/Add]	Equity in earnings of unconsolidated affiliates[a]	(87)	(309)	(97)	(216)	(215)
[=]	*Before tax income (BTI)*	1,480	954	858	(121)	715
[Sub/Add]	State and local taxes (current)[b]	(22)	(6)	(8)	(9)	(11)
[Subtract]	Deduction from employee exercise of ESOs[c]	(1,114)	(382)	(121)	(33)	(55)
[=]	*Worldwide profit before tax*	344	566	729	(163)	649
[Add/Sub]	Foreign income (loss)	(773)	(771)	(681)	81	(304)
	U.S. profit before tax	(429)	(205)	48	(82)	345
[Sub/Add]	U.S. deferred tax provision (drawdown)/0.35[d]	(37)	454	40	111	(497)
[Subtract]	Reduction in tax provision due to "permanent differences"[e]	(137)	(102)	(104)	(52)	(30)
[=]	*Estimated U.S. taxable income*	(603)	148	(16)	(23)	(182)
[x]	35%	0.35	0.35	0.35	0.35	0.35
[=]	*Estimated pre-credit U.S. tax liability (benefit)*	(211)	52	(5)	(8)	(64)
[Subtract]	U.S. tax credits[f]	—	(6)	(12)	(21)	(15)
[=]	*Estimated U.S. tax liability*	(211)	46	(18)	(29)	(79)
[Compare]	Federal income tax payable currently[b]	112	29	30	29	16
[Subtract]	Tax benefit from ESO exercise (deduction * 35%)	(390)	(134)	(42)	(12)	(19)
	Federal income tax payable currently adjusted for ESO exercises	(278)	(105)	(12)	17	(3)

[a]As reported in the Consolidated Income Statement.
[b]As reported in the Income Taxes Note to the financial statements (See Table 1).
[c]From Table 2.
[d]From the Income Taxes Note: 2000: 13/0.35; 1999: (159)/0.35; 1998: (14)/0.35; 1997: (39)/0.35; 1996: 174/0.35.
[e]From the Income Taxes Note: Includes only basis and stock sale differences, cash value in life insurance, goodwill amortization, other.
[f]From the Income Taxes Note: Alternative fuel credit under IRC section 29(a).

Enron provides an example of the complexities in estimating the tax deduction related to employee stock option (ESO) exercises. Table 2 presents data related to Enron's stock options over the period 1996-2000 (Note 11 to the company's financial statements). The company reports a tax benefit from employee stock option exercises of $390 million in 2000. No such disclosure is made for 1996-1999. 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. Using the "formula approach" we would estimate the tax deduction to be $1,470 million (32,235 thousand shares x ($70.02 - $24.43). The corresponding tax benefit would be $514 million. Using a weighted average stock price for 2000 of $83.13, our estimate of the ESO tax deduction increases to $1,892 million and the tax benefit increases to $662 million.[41] Depending on which calculation is used, one could make widely divergent estimates of Enron's tax status based solely on stock option exercises.

3. Disclosure of specific reconciling items. Companies are required to disclose individual items making up deferred tax assets and liabilities (temporary differences) only if they are "significant."[42] In the case of items that reconcile the company's book effective tax rate with the hypothetical (statutory) tax rate (including permanent differences), SEC regulation S_X, Rule 4.08(h)(2) requires specific identification only if the amount equals or exceeds 5 percent of the hypothetical amount or rate. Where reconciling items are combined, it is impossible to determine if the item represents a deduction or exclusion (in which the item needs to be grossed up to compute the tax return effect) or a credit (which reduces the company's tax liability but not its taxable income). Although the deferred tax portion of the tax provision is calculated as the difference between the beginning and ending balances in the deferred tax balance sheet accounts, the change in deferred tax assets and liabilities reported in the income tax note and the corresponding deferred tax expense for the current year often diverge widely. For

[41]The weighted average stock price was computed using data from the Center for Research in Security Prices (CRSP) database.

[42]Financial Accounting Standards Board *Statement of Financial Accounting Standards No. 109*, para. 43.

example, the change in Enron's net deferred tax liability from 1999 to 2000 was $230 million compared to the deferred tax provision of $13 million.

C. Investments in Other Companies

1. Financial accounting rules. The entities that are combined on a consolidated income statement often differ from the entities combined on a consolidated tax return, especially for multinational companies. For book purposes, a corporation must control (that is, own more than 50 percent of the voting interest of) another corporation before its income and expenses are consolidated.[43] Consolidated net income includes income from both U.S. and foreign subsidiaries and is reduced by any after-tax minority interest in the subsidiary's net income. Consolidating the income of more-than-50-percent-owned subsidiaries is mandatory for financial accounting purposes.

Corporations owning 20-50 percent of another corporation usually account for their investment under the equity method.[44] Under the equity method, the investor corporation reports its share of the investee corporation's net income or loss in its income statement in the year earned. The equity method assumes the investor corporation can "significantly influence" the investee corporation's financial and operating policies. Corporations owning less than 20 percent of the investee corporation can use the equity method if their ownership influence meets the equity method criterion.[45] Corporations owning more than 50 percent of a voting interest in another corporation also can use the equity method if the control is temporary.

Corporations owning less than 20 percent of another corporation usually use the cost method to account for such investments.[46] Under the cost method, book income from the corporate investee is reported when it is received as a dividend.

2. Tax accounting rules. Corporations can elect to consolidate the income and expenses of 80 percent-or-more-owned U.S. subsidiaries in computing taxable income.[47] All of the income of consolidated subsidiaries is reported in consolidated taxable income (that is, no subtraction is made for minority interests). The operations of foreign subsidiaries are not included on the consolidated U.S. tax return, except to the extent the subsidiary remits its earnings to the U.S. corporation in the form of interest, dividends (actual or deemed), fees, rents, and royalties. Income from less-than-80-percent-owned corporations (domestic or foreign) is reported for tax purposes only when it is received as a dividend. Consolidating the income of 80-percent-owned U.S. subsidiaries is elective for tax accounting purposes (although once elected, corporations must continue to file consolidated tax returns unless the Internal Revenue Service allows them to discontinue doing so, which is very rare).

3. Reconciliation issues. These differences in tax and accounting rules must be considered when estimating a corporation's tax status using financial statement information. Adjustments must be made to add back any minority interests and add back or deduct any equity loss or income reported on the income statement. Reconciliation is not possible to the extent the financial statements include income or loss from an entity that is more than 50 percent owned but less than 80 percent owned. Mills, Newberry, and Trautman note that anecdotal evidence from large case IRS audits indicate that very large U.S. corporations do not have many 50-to-less-than 80-percent-owned entities.[48]

IV. Estimating Enron's Tax Status

A. Reconciling Enron's FIT 'Payable Currently'

Table 3 provides a methodology for reconciling the federal income tax "payable currently" as reported by Enron in the Income Taxes Note to the financial statements.[49] The reconciliation begins with "net income before cumulative effect of accounting changes" as reported in the Consolidated Income Statement. We add back (subtract) the book "Income Tax Expense (benefit)" to put net income on a before-tax basis. We then add back the amounts representing minority interests and subtract out (add back) undistributed equity income (loss) to reflect the difference in book and tax accounting methods applied to less than 100-percent-owned consolidated subsidiaries and 20-to-50-percent-owned unconsolidated investees. The resulting amount, "before tax income" often is the denominator in the computation of a company's GAAP "effective tax rate" as reported in the Income Taxes Note to the financial statement. This is not the case for Enron, which does not make any adjustments for minority interests and equity income, but instead reports the tax effects of these items in its effective tax rate reconciliation.

We reduce before tax income by state and local taxes payable currently as reported in the Income Taxes Note to reflect the fact that these income taxes are deducted in computing a corporation's federal taxable income under section 164. This adjustment is consistent with the methodology used by Citizens for Tax Justice and the General Accounting Office in their computations of

[43]Financial Accounting Standards Board *Statement of Financial Accounting Standards No. 94 — Consolidation of All Majority-Owned Subsidiaries*.

[44]Accounting Principles Board *Opinion No. 18 — The Equity Method of Accounting for Investments in Common Stock*.

[45]Financial Interpretation No. 35 — *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock — An Interpretation of APB Opinion No. 18*.

[46]Under Financial Accounting Standards Board *Statement of Financial Accounting Standards No. 115 — Accounting for Certain Investments in Debt and Equity Securities*, corporations must include in income any unrealized gain or loss from marking-to-market trading securities, with a corresponding charge to deferred taxes.

[47]Sections 1501-1504.

[48]L.K. Mills, K. Newberry, and W.B. Trautman, "Trends in Book-Tax Income and Balance Sheet Differences, *supra* note 8.

[49]We are using Enron's terminology in all of the tables. Many U.S. companies refer to their "foreign" income as "international" or "non-U.S."

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Table 6
Alternative Calculations of Enron's Effective Tax Rate

	2000	1999	1998	1997	1996
Per Enron's Financial Statement (GAAP)					
Provision for income taxes/Income before income taxes[a]	30.7%	9.2%	20.0%	-598.3%	31.7%
GAO/JCT formula					
U.S. taxes payable currently/Worldwide profit before tax	7.7%	3.1%	3.5%	-22.3%	2.3%
Revised GAAP ETR adjusted for ESOs					
Revised provision for income taxes/Revised income before taxes[b]	14.7%	-4.0%	17.5%	564.2%	31.5%
Estimated U.S. tax liability/U.S. profit before tax adjusted for ESOs[c]	49.2%	-22.5%	-37.0%	35.2%	-22.9%

[a]From Enron's Income Taxes Note — see Table 1.
[b]Revised provision for income taxes = Provision for income taxes (Table 1) — ESO tax benefit (Table 5) (2000 = $434 - $390); revised income before income taxes = Income before income taxes (Table 1) — ESO tax deduction (Table 5) (2000 = $1,413 - $1,114).
[c]From Table 5.

corporate effective tax rates. One could argue that deferred state and local income taxes could be included in the adjustment in that Enron is an accrual-based company. However, under section 461(h), state and local income taxes are considered "payment liabilities" and are deductible in the year accrued only if paid within 8½ months after the close of the corporation's tax year. These liabilities likely are classified as payable currently. Also, anecdotal discussions with practitioners indicate that deferred state and local taxes could represent a tax cushion for such liabilities. The amounts in Enron's case are not material.

We next reduce "worldwide profit before tax" by income earned by entities located outside the United States as reported in the Income Taxes Note. We adjust the resulting "U.S. profit before tax," to reflect "temporary" and "permanent" differences as defined in FAS 109. Temporary differences are reflected in the deferred portion of the company's federal income taxes, as reported in the Income Taxes Note (see Table 1). We gross up the deferred tax charge (or drawdown) by the statutory tax rate (35 percent) to compute the tax return amount that created the deferred tax charge. We decrease book income by the adjustment where the deferred tax amount is positive (an increase in a deferred tax amount indicates that book income exceeds taxable income in the current period) and increase book income by the adjustment where the deferred tax amount is negative. Enron reports the tax effects of permanent differences in the reconciliation of its effective tax rate with the hypothetical rate in the Income Taxes Note (Table 1). Care must be taken to only include items that are reflected on the corporation's U.S. income tax return. We exclude items relating to "net state income taxes," "foreign tax rate differential," "equity earnings," "minority interests," "audit settlement," and the "tight gas sands tax credit" (reported separately in the Income Taxes Notes before 2000) from the adjustment because we already have adjusted net income for the item or the item does not pertain to permanent differences between U.S. book income and U.S. taxable income. We compute the tax effect of the permanent differences used in the adjustment by multiplying the percentage effect of the difference as reported in the ETR reconciliation times the company's "income before income taxes," which also is reported in the Income Taxes Note (see Table 1). We gross up the tax effect in dollars by 35 percent to compute the taxable income adjustment.

The adjustments for temporary and permanent differences produce Enron's estimated U.S. taxable income without considering employee stock option (ESO) exercises. This amount times 35 percent provides an estimate of the company's pre-credit U.S. tax liability without taking into account ESO exercises. We then deduct the estimated alternative fuel credit under section 29(a) as reported in the company's ETR reconciliations for years before 2000 (Enron did not report the section 29(a) credit separately in 2000). The result is the company's estimated federal income tax before ESO exercises. This amount should reflect the company's reported federal income tax payable currently as reported in the Income Taxes Note. Differences, which tend to vary widely for 1996-2000, could reflect the tax cushion, rounding differences, and amounts that cannot be accounted for due to lack of disclosure. For years 1998-2000, our estimated federal income tax payable and the company's reported federal income tax payable currently are in the same direction (all positive), whereas we estimate a federal income tax benefit in 1996-1997 while the company reports a positive federal income tax payable currently in those two years.

B. Enron's Foreign Income Tax Rate Differential

Table 4 presents a methodology for reconciling the company's reported "foreign tax rate differential" in the effective tax rate reconciliation. We adjust foreign income as reported in the Income Taxes Note (Table 1) for the deferred charge (drawdown) related to foreign income taxes. We multiply the resulting "estimated foreign taxable income" by 35 percent to compute the tax Enron would have paid on such income using the U.S. statutory tax rate. This amount compared to foreign income taxes "payable currently" should reflect the excess (shortage) of foreign income taxes relative

to the hypothetical amount. Except for 1999, the differences are fairly small, which could be due to rounding and the inclusion in "other" of permanent differences related to foreign income in the ETR reconciliation.

C. Enron's Tax Income Including ESO Exercises

In Table 5 we adjust Enron's net income to take into account the effect of tax return deductions generated by employee exercises of non-qualified stock options. Except in 2000, we use the same methodology as Citizens for Tax Justice and Hanlon and Shevlin. That is, we multiply the number of options exercised during the year times the difference between the average exercise price of new options issued during the year and the average exercise price of options exercised during the year. This information, reproduced in Table 2, can be found in the Common Stock Note (Note 11) to the company's financial statements. This calculation likely overstates the income tax deduction resulting from ESO exercises, as we showed previously.

Using the ESO tax benefit number reported by Enron in 2000 ($390 million), we estimate the corresponding ESO tax deduction to be $1,114 million ($390 million/0.35). Using the CTJ methodology and the information from Note 11 (Table 2), we would have estimated the tax deduction to be $1,470 million (32,235,000 shares times $45.59). Using the formula approach in 2000 would have increased the company's estimated tax benefit from $278 million to $403 million, an increase of $125 million. For 1996-1999, we are forced to use the formula approach because the company does not disclose the tax benefits from ESO exercises. We should note that not all of the stock options exercised were nonqualified options (the company does not get a tax deduction when employees exercise incentive stock options), which could account for some of the discrepancy. Required separate disclosure of the tax benefits in the Changes in Shareholders' Equity statement and the Statement of Cash Flows statement would allow analysts to more accurately determine the impact of ESO exercises on the company's tax status.

Factoring in the tax deduction for ESO exercises changes Enron's tax status significantly, as the company goes from being a "tax payer" to a "tax payee" in every year except 1999 (although a net operating loss carryback created by the ESO exercises in 2000 could have eliminated the company's federal income tax in that year as well).

D. Calculations of Enron's Effective Tax Rate

We use the calculations in Tables 3 and 5 to compute alternate measures of Enron's tax status as measured by its "effective tax rate." These alternative measures are summarized in Table 6. We compare the rates to the GAAP-reported number from the company's Income Taxes Note. The GAAP-reported ETR fluctuates wildly, from a low of negative 600 percent in 1997 to a high of 31.7 percent in 1996. Clearly, this company did not attempt to manage its book effective tax rate. The ETRs calculated using the General Accounting Office/Joint Committee on Taxation methodology, which focus on the federal income tax liability, are more stable (ranging from negative 22.3 percent in 1997 to 7.7 percent in 2000), perhaps leading one to conclude that the fluctuations in the company's worldwide ETR were due to its international operations.

We present two additional ETR computations. The first is a revised GAAP computation taking into account the tax deduction related to ESO exercises. The numerator (provision for income taxes) reflects the tax benefit from ESO exercises, and the denominator (income before income taxes) takes into account the tax deduction from ESO exercises. The revised ETRs are reduced in every case except 1997 from the current GAAP-reported rates. These revised numbers reflect the change in reported ETRs that would occur if Congress enacted the McCain-Levin proposal to require companies to reduce net income by the ESO tax deduction.

The next ETR calculations reflect the company's tax status using the company's estimated federal income tax liability (after ESO deductions) as the numerator and U.S. net income after ESO deductions as the denominator (see Table 5). This rate perhaps reflects most accurately the company's tax status in relation to its book income. Care should be taken in interpreting the results, however. The positive ETRs in 2000 and 1997 reflect a division of two negative numbers (a tax benefit divided by a book loss). One could interpret these numbers as reflecting the fact that the company received a tax benefit from the federal government at a rate higher than the statutory rate. The negative ETRs result from either a positive federal income tax liability divided by a book loss or a negative federal income tax liability divided by book income. Cases where the estimated federal income tax is negative and U.S. profit before tax is positive likely would be red-flagged as situations where the company was "overindulging" in corporate "tax loopholes" (temporary and permanent differences and credits, but not ESO deductions). Figure 1 illustrates the differing estimates of Enron's effective tax rate. The variability in the ETR calculations we could make regarding Enron calls to mind Mark Twain's observation that there are "lies, damn lies, and statistics."

V. Observations About the Disclosure Debate

Trying to understand the words and phrases found in a company's Income Taxes Note calls to mind the conversation between Alice and Humpty Dumpty in Lewis Carroll's *Through the Looking Glass*.

> "When I use a word," Humpty Dumpty said in a rather scornful tone, "it means just what I choose it to mean — neither more nor less." "The question is," said Alice, "whether you can make words mean so many things." "The question is," said Humpty Dumpty, "which is to be master — that's all."[50]

We hope the above analysis is useful to policymakers (tax and accounting), analysts, and "ordinary citizens" in helping to understand the limits of

[50]Lewis Carroll, *Through the Looking Glass and What Alice Found There* (Macmillan and Co., Ltd., 1899), chapter 6.

using financial statement information to decipher a publicly traded company's tax status. If anything comes from this exercise, we hope the reader will appreciate that reliance on the company's taxes "currently payable" as a measure of the corporation's current year tax status can be very misleading, despite the theoretical underpinnings of the term as defined in FAS 109. Estimating the corporation's "true" tax status requires a rather sophisticated understanding of the arcane world of "accounting for income taxes," a realm many tax and accounting practitioners would rather not visit if at all possible. However, most tax shelter products today have vitality because of their positive impact on the corporation's tax liability (reduced) and its earnings per share (increased).

Requiring corporations to make their tax returns public seems rather extreme because of the potential for giving away investment and finance strategies to competitors. Historically, tax return privacy has been a sacred right with virtually no exceptions.[51] However, the recent public disclosure of KPMG's client names in a tax shelter dispute with the IRS opens a crack in the privacy door previously thought to be sealed shut.[52] Commentators are rightly concerned with this precedent.[53] But disclosure is not an all-or-nothing proposition and probably should not require release of tax returns. More disclosure, perhaps in line with the recommendations by Citizens for Tax Justice,[54] would likely make a corporation's tax status more transparent and perhaps help analysts (including academic researchers) and policymakers understand how the current tax rules are applied domestically and internationally.

The difficulty in interpreting the effect of ESO exercises on effective tax rates is not likely to be solved with current proposals (and actions) to report the compensation expense related to ESO exercises in the income statement. The recent announcement by Coca-Cola Company, The Washington Post Company, Bank One, and General Motors that they would begin to include the expense related to stock option exercises will not make the tax effect of ESO exercises any more transparent than it already is (or isn't) because the book expense is estimated when the options are granted and the tax deduction is computed when the options are exercised, potentially resulting in vastly different amounts.

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[51] Section 6103.

[52] *See, e.g.*, "Taxpayer Confidentiality: Civilian Casualty in War on Shelters?" *Tax Notes*, July 22, 2002, p. 470.

[53] *See, e.g.*, "The IRS Out of Control," *The Wall Street Journal*, July 17, 2002, page A16.

[54] *See* R.S. McIntyre and T.D.C. Nguyen, *Corporate Income Taxes in the 1990s* (Institute on Taxation and Economic Policy, 2000, at p. 13. This report is available on the Citizens for Tax Justice website (http://www.ctj.org).

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