

## *Lost in Translation: Detecting Tax Shelter Activity in Financial Statements*

*Abstract - Whether financial statements of public U.S. corporations provide sufficient information to the public to determine a corporation's tax payment to the U.S. Treasury and its involvement in "tax shelter" transactions has been much debated since the well publicized collapses of Enron Corporation and WorldCom, Inc. In this paper, we use specific examples to demonstrate how "income tax note" data can be analyzed to answer these two questions and, in so doing, point out the limitations of using financial accounting information to address tax-related issues. We conclude with suggestions to increase the transparency of a corporation's tax activities through enhanced disclosure.*

### INTRODUCTION

On July 8, 2002, Senator Charles E. Grassley, chairperson of the Senate Committee on Finance, wrote a letter to then Secretary of the Treasury O'Neill and then Commissioner of the SEC Pitt and posed the following question:

I am writing to raise the question of whether the information contained in the corporate tax returns of publicly traded companies could be of benefit to government regulators as well as shareholders and workers . . . In addition, I would appreciate your views on whether sufficient tax information is already publicly available. 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 (Grassley, 2002).

Since that time, there has been increased scrutiny and debate over whether current financial accounting rules adequately portray the tax status of a publicly-traded company. This debate intensified at the Senate Committee on Finance Hearings related to the Joint Committee on Taxation's Investigative Report on Enron Corporation in February 2003.<sup>1</sup> In his opening statement, Senator Grassley announced that the attendees were "about to witness a shocking event in the history of American corporate tax policy and financial accounting. We are going to have the veil torn off the world of tax shelters and

<sup>1</sup> The list of witnesses and the testimony presented at this hearing are available at <http://www.senate.gov/~finance/sitepages/hearing021303.htm>.

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#### **Gary A. McGill**

*Fisher School of Accounting, University of Florida, Gainesville, FL 32611-7166*

#### **Edmund Outslay**

*Eli Broad Graduate School of Management, Michigan State University, East Lansing, MI 48824-1121*

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manipulation of accounting” (Grassley, 2003). As a follow-up to this hearing, the National Tax Association, in conjunction with the University of North Carolina Tax Center and the Urban-Brookings Tax Policy Center, sponsored a conference devoted to the issue of whether there should be public disclosure of corporate tax returns.<sup>2</sup>

In this paper, we briefly describe the current rules that govern “accounting for income taxes” and provide examples of the extent to which a reader of financial statements could “forensically” detect tax shelter behavior. In so doing, we evaluate whether it is the responsibility of financial accounting rules to provide such information and, if not, what other avenues are available to make such behavior more transparent to government agencies and the public.

#### THE BOOK AND TAXABLE INCOME GAP

Interest in the difference between a corporation’s reported income for financial accounting purposes (“book income”) and its corresponding taxable income dates back to the mid-1980s, with the publication of studies showing that large corporations were reporting record amounts of book income to shareholders while at the same time reporting losses for tax purposes to the U.S. Treasury (Stickney, Weil, and Wolfson, 1983; Citizens for Tax Justice, 1985; Outslay and Wheeler, 1986). These studies attracted national media attention (O’Shea, 1985; Gerth, 1985), and subsequently prompted Congress to enact measures in the Tax Reform Act of 1986 that were designed to align book income and taxable income more closely (e.g., the repeal of the completed contract method of accounting for tax purposes) or to impose an “alternative minimum

tax” (AMT) on a tax base that was more representative of the corporation’s economic income. The Joint Committee on Taxation listed the following as one of the compelling reasons for the enactment of the corporate alternative minimum tax in 1986:

In particular, Congress concluded that both the perception and the reality of fairness have been harmed by instances in which corporations paid little or no tax in years when they reported substantial earnings, and may even have paid substantial dividends, to shareholders. Even to the extent that these instances may reflect deferral, rather than permanent avoidance, of corporate tax liability, Congress concluded that they demonstrated a need for change (U.S. Congress, Joint Committee on Taxation, 1987, p. 433).

Included as one of the “adjustments” to taxable income in computing the AMT base was an add-back (subtraction) of fifty percent of the difference between book income and taxable income (called the “book untaxed reported profits” (BURP) adjustment). This adjustment, which seemed like a good idea on paper, proved to be extremely complicated to calculate and was replaced in two years with an adjustment based on a corporation’s earnings and profits (“ACE” adjustment). Empirical research also indicated that corporations subject to the BURP adjustment managed book income to avoid or mitigate its effects (Gramlich, 1991; Dhaliwal and Wang, 1992; Manzon, 1992; and Boynton, Dobbins, and Plesko, 1992).

At the same time that Congress wrestled with creating a tax system that would mitigate the differences between book and taxable income, the Financial Accounting Standards Board (FASB) embarked on a comprehensive review of the measurement and reporting rules pertaining to a

<sup>2</sup> The three papers presented at this conference in April 2003 are published in the December 2003 issue of the *National Tax Journal*.

corporation's tax provision (expense) for its reported book income. Under former *Accounting Principles Board Opinion No. 11* (APB 11), a corporation computed its book tax provision by adjusting its book income for *permanent differences* (items that would only ever appear on either the tax return or the income statement, but not both) and multiplying the result (*book equivalent to taxable income*) by the appropriate tax rate. The total provision was then bifurcated between the portion that was currently payable and the portion that was deferred until a later period. The deferred portion was computed as the difference between the total provision and the current payable. For balance sheet purposes, only deferred tax liabilities were recognized (reflecting the accounting predilection for conservatism). Balance sheet deferred taxes were not adjusted for any changes in tax rates and, therefore, became unreliable indicators of a corporation's future tax obligations (analysts sometimes referred to this account as a *UGO—unidentified growing object*—and struggled to treat it as debt or *de facto* equity). With regard to APB 11, commentators observed 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" (Clowery, Outslay, and Wheeler, 1986, p. 992).

The FASB decided that the primary focus of accounting for future tax benefits or obligations should be the balance sheet rather than the income statement and subsequently enacted *Statement of Financial Accounting Standards No. 109* (FAS 109), which became effective in 1992. FAS 109 recognizes that deferred income taxes are assets and liabilities and not residual charges. As a result, a corporation computes the two components of its tax provision (current and deferred) independently (the current year deferred tax expense or benefit is measured as the change dur-

ing the year in the corporation's balance sheet deferred tax liabilities and assets). The FAS 109 approach takes into account changes in enacted tax rates as well as the probability that a corporation will recognize its reported future tax benefits.

One result of the changes in the way in which corporate tax liability was computed ("base broadening") and the manner in which it was reported for financial accounting purposes was a convergence of book and taxable income during the early part of the 1990s (Plesko, 2004; Mills, Newberry, and Trautman, 2002; U.S. Congress, Joint Committee on Taxation, 1999b). This convergence was short-lived, however, as proactive tax planning that was designed to "enhance shareholder value" (i.e., increase book income) became more prevalent in the mid-1990s. Plesko documents:

Pre-tax book income of active corporations . . . grew from \$752.7 billion for 1996 to \$819.6 billion for 1997, and fell slightly for 1998 to \$816.7 billion. Similarly, tax net income grew from \$660.2 billion for 1996 to \$693.6 billion for 1997, and also fell for 1998 to \$657.7. . . . The net effect of these differential growth patterns was to increase the difference between pre-tax book income and tax net income from \$92.5 billion for 1996 to more than \$159.0 billion for 1998, an increase of 71.9 percent (2002, p. 116).

Unlike the book and tax differences of the 1980s, the current phenomenon cannot be explained by the traditional book-tax differences (e.g., international operations, stock option deductions, and depreciation). Desai (2003) finds that these factors explain less than 50 percent of the current book-tax differences and concludes that, "taken together, the evidence suggests that the large unexplained gaps between tax and book income that have arisen during the late 1990s are at least partly associated with increased sheltering activity" (p. 172). Citizens for Tax Justice (2002b)

also documents a growing divergence between book profits and tax burden, noting in their most recent study that from 1996 through 2000, ten large profitable companies enjoyed a total of \$50 billion in corporate tax breaks, reducing their combined tax rate to 8.9 percent on \$191 billion in U.S. book income.

Not unexpectedly, these new data, coupled with the well-publicized accounting irregularities involving Enron Corporation and WorldCom, Inc., prompted government agencies and others to embark on comprehensive analyses of the factors behind the growing book-tax disparity. One factor identified by several agencies was the trend to treat corporate tax departments as profit centers, charged with enhancing shareholder value ("adding to the bottom line"), rather than as cost centers, charged with meeting only the firm's compliance obligations in a timely manner. A U.S. Treasury study found that the growth in book-tax disparities:

is consistent with the trend to treat corporate in-house tax departments as profit centers, and the pressure to increase shareholder value and remain competitive. Corporate managers are placing greater emphasis on keeping the corporation's effective tax rate . . . low and in line with that of competitors . . . A successful shelter with a book-tax disparity is Elysium for a corporation; it not only reduces the corporation's tax liability, but also reduces its effective tax rate (U.S. Department of the Treasury, 1999, p. 14).

The Joint Committee on Taxation reported, in its written testimony at the Senate Committee on Finance Hearings on Enron Corporation, "In the mid-1990s, Enron's management began to view the role of its tax department as more than managing its Federal income tax liabilities. Rather, Enron's tax department became a source for financial statement earnings, thereby making it a profit center for the company"

(U.S. Congress, Joint Committee on Taxation, 2003a, p. 7). Even more egregious was the finding of the bankruptcy trustee investigation of WorldCom, Inc. (Beresford, Katzenbach, and Rogers, 2003). There, management informed the tax department as to what the company's effective tax rate was going to be for the coming year or quarterly accounting period and told them to make sure the company achieved this rate through whatever means possible.

In their defense, the corporate community responded that this preoccupation with book-tax differences as indicators of tax shelter behavior was misplaced. In his testimony before the U.S. House of Representatives Committee on Ways and Means, a spokesperson for the Tax Executives Institute, pointed out that:

it is odd that the Treasury and Joint Committee staff both focus on book-tax differences as an indicator of a corporate tax shelter. These differences are not so much "indicators" as they are an unavoidable byproduct of the Internal Revenue Code that Congress—often with Treasury's direct support—has crafted. . . . I do not believe my company [BellSouth Corporation] had any corporate tax shelters on the 1998 tax return. . . . But I do know that we had more than 125 separate items disclosed on our company's Schedule M-1 reconciling book and tax income (Shewbridge, 1999).

## TAX SHELTERS AND FINANCIAL ACCOUNTING

The term *tax shelter* defies precise definition. According to the American Heritage dictionary, a tax shelter is "a financial arrangement . . . that reduces taxes on current earnings" (American Heritage Dictionary, 2000). Under this definition, the tax deductibility of interest on a mortgage to purchase a home would meet the definition of a tax shelter; (in fact, all of the

items identified by the Joint Committee on Taxation as *tax expenditures* would meet this definition). As the term is used today, a *tax shelter* generally connotes a plan or arrangement that is designed principally to avoid or evade the Federal income tax and is characterized as generating tax benefits (losses) without incurring economic losses or risk (U.S. Congress, Joint Committee on Taxation, 1999a). Such transactions often are conducted with a “tax indifferent party” (e.g., a foreign or tax-exempt entity). Bankman (2004) defines a tax shelter as a transaction that is marketed and tax-motivated, that under at least one literal reading of the governing statute or regulation misstates economic income, and that, in so doing, reduces the tax on capital in a manner inconsistent with any purposive or intentionalist reading of the statute or regulation. The American Institute of Certified Public Accountants (AICPA) defines an *abusive tax shelter* as “one having no business purpose other than tax avoidance, unless clearly contemplated by tax rules” (American Institute of Certified Public Accountants, 2003, Question and Answer 1).

The idea that tax shelter behavior can (should) be detected (detectable) by examining financial accounting statements stems from the U.S. Treasury white paper on tax shelters issued in 1999 (U.S. Department of the Treasury, 1999). The report noted that “[w]hile corporate tax payments have been rising, taxes have not grown as fast as have corporate profits. One hallmark of corporate tax shelters is a reduction in taxable income with no concomitant reduction in book income. The ratio of book income to taxable income has risen fairly sharply in the last few years. Some of this decline may be due to tax shelter activity” (U.S. Department of the Treasury, 1999, p. ii). The report identified seven characteristics of a tax shelter, one of which was “inconsistent financial accounting and tax treatments”

(U.S. Department of the Treasury, 1999, p. 14), the goal of which was to keep the corporation’s effective tax rate low and in line with its competitors. The Joint Committee on Taxation study on tax penalties and interest defined a tax shelter arrangement as one that is “reasonably expected to create a ‘permanent difference’ for U.S. financial reporting purposes under generally accepted accounting principles” (U.S. Congress, Joint Committee on Taxation, 1999a, p. 235). Bankman (2004) also notes that a traditional characteristic of a tax shelter is financial accounting treatment that differs from tax treatment and that does not produce any non-economic loss.

The rules that govern accounting for a corporation’s tax-related activities are themselves written within a “concepts” framework that delineates the goals of financial reporting in general. *Statement of Financial Accounting Concepts No. 1—Objectives of Financial Reporting by Business Enterprises* (Financial Accounting Standards Board, 1978) lists two overall goals for financial reporting:

- Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence (§34).
- Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change its resources and claims to those resources (§40).

With respect to the first goal, reasonable people could argue over what *reasonable understanding* and *reasonable diligence* mean (an academic colleague of ours once told his audience of doctoral students that if they didn't understand his work, that meant their "consumption skills were underdeveloped"). Clearly, future tax obligations constitute claims to the firm's economic resources and would come under the umbrella of the financial reporting framework.

FAS 109 lists two objectives for reporting the tax-related results of a firm's activities: (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 (Financial Accounting Standards Board, 1992, ¶¶ 6–7). The standard 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 (Financial Accounting Standards Board, 1992, ¶8). A *temporary difference* generally is defined as an amount that will appear on both the financial statement and the tax return but in different accounting periods. An item that produces a future tax obligation creates a *deferred tax liability*, whereas an item that produces a future tax benefit creates a *deferred tax asset*.

FAS 109 (¶¶ 43–49) also governs financial statement disclosure of the tax

consequences related to transactions summarized in the financial statements. In particular, a publicly-traded corporation must disclose the total of all deferred tax liabilities and all deferred tax assets (separately) and the types of temporary differences and tax carryovers that comprise a "significant" portion of the deferred tax liabilities or assets. A corporation 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.

More germane to tax shelter activity, public corporations must reconcile (using percentages or dollar amounts) (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 from applying domestic Federal statutory tax rates to pretax income from continuing operations (sometimes referred to as the *hypothetical federal income tax expense*). Further, a public corporation must 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. *SEC Regulation S-X, Rule 4-08(h)* 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" (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 five percent of the hypothetical tax unless 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 “economic” tax rate.

A key to understanding where and how tax shelter behavior might appear on financial statements is to understand the basic terminology that relates to book–tax differences and why such differences might arise. In particular, a reader of financial statements must understand that the book–tax difference can be due to several factors. First, the corporation may use different methods (sanctioned by Congress and the FASB) to compute income or expenses (e.g., straight–line depreciation for book purposes and accelerated depreciation for tax purposes). Such differences in accounting methods usually produce a temporary difference. Second, the book and tax rules differ with respect to the amount of income or expense to recognize (e.g., not all book income is taxable, not all book expenses are deductible, and not all tax deductions are expenses for book purposes). These differences in book and tax rules usually produce a permanent

difference. Third, different entities may appear on the two statements. In particular, subsidiaries incorporated outside the United States appear on the income statement but not on the U.S. tax return. Also, income or loss from equity investments in other corporations (20–percent to less than 80–percent owned) appear on the income statement in the year accrued but do not appear on the U.S. tax return until the investor corporation receives the income or sells the investee stock. This book and tax anomaly can produce either a temporary difference or a permanent difference. McGill and Outslay (2002) and Hanlon (2003) provide a more thorough discussion of these book and tax differences. Figure 1 summarizes the relation between book and taxable income.

**ANSWERING THE BIG QUESTION:  
DID ENRON PAY TAXES?**

Despite the goal of financial accounting reporting to recognize the amount of taxes payable or refundable for the current year, most analysts likely would agree with Robert Willens of Lehman Brothers, who was quoted in *Business Week* as saying, “Truth is, figuring out how much tax a company actually pays is impossible . . .

Figure 1. Reconciling Book and Taxable Income

<p><b>Income Statement</b></p> <p>Book income</p> <p>– <u>Book expenses</u></p> <p>Net income before tax</p> <p>– <u>Tax expense (provision)*</u></p> <p>Net income after tax</p>	<p><b>± Book/tax differences</b></p> <p>•Temporary#</p> <p>•Permanent^</p> <p>•Entities^</p>	<p><b>Tax Return (Form 1120)</b></p> <p>Gross income</p> <p>– <u>Deductions</u></p> <p>Taxable income</p> <p>× <u>Tax rates</u></p> <p>Federal income tax</p>
<p><b>*Income Tax Note</b></p> <p>U.S.</p> <p>Current</p> <p>Deferred</p> <p>Foreign</p> <p>Current</p> <p>Deferred</p> <p>State &amp; local</p>	<p><b>^ETR Reconciliation</b></p> <p>Hypothetical expense</p> <p>+ State &amp; local</p> <p>± Foreign taxes</p> <p>± <u>Permanent differences</u>^</p> <p>Book tax expense</p> <p>^ Tax effects (× 35%)</p>	<p><b>#Balance Sheet</b></p> <p>Deferred tax assets#</p> <p>Deferred tax liabilities#</p> <p># Temporary difference × 35%</p>



Tax disclosure is just inscrutable" (Gleckman, Foust, Arndt, and Kerwin, 2000, p. 40). Prior to the Joint Committee on Taxation report on Enron (U.S. Congress, Joint Committee on Taxation, 2003b), there were widely varying estimates of how much federal income taxes Enron actually paid in 2000 based on the information the company provided in its income tax note to its financial statements. Estimates ranged from \$(278) million (Citizens for Tax Justice, 2002a) to \$34 million (Seida, 2003) to \$62 million (Witt and Behr, 2002) to \$112 million (Brumbaugh, 2002; Kessler, 2002). Table 1 presents data related to Enron's income taxes for 1998–2000 (Note 5 to the company's financial statements). Citizens for Tax Justice (2002a) arrived at their estimation by subtracting Enron's reported tax benefit from employee stock

option exercises (\$390 million) from its reported federal income tax expense "payable currently" of \$112 million. Seida (2003) concluded that Enron paid no federal income taxes because of the existence of a net operating loss carryover, but the company likely paid alternative minimum tax of at least \$34 million because the deferred tax asset related to the "alternative minimum tax credit carryforward" increased from \$220 million in 1999 to \$254 million in 2000. Witt and Behr (2002) speculated that Enron paid \$62 million because the company reports "cash paid" for income taxes (net of refunds) of \$62 million. Finally, a spokesperson for Enron was quoted as saying the company paid \$112 million because that is the amount of federal income taxes "payable currently" reported in the income tax note.

TABLE 1  
ENRON CORPORATION: SELECTED INCOME TAX FOOTNOTE INFORMATION

Components of income before income taxes (in millions)	2000	1999	1998
United States	\$640	\$357	\$197
Foreign	773	771	681
Income before income taxes	\$1,413	\$1,128	\$878
Total income tax expense (benefit) (in millions)			
Payable currently			
Federal	\$112	\$29	\$30
State	22	6	8
Foreign	93	48	50
Total payable currently	227	83	88
Payment deferred			
Federal	13	–159	–14
State	14	23	11
Foreign	180	157	90
Total deferred	207	21	87
Total income tax expense	\$434	\$104	\$175
Effective tax rate reconciliation			
Statutory federal income tax provision	35.0%	35.0%	35.0%
Net state income taxes	2.5	1.8	1.7
Tight gas sands tax credit	—	(0.5)	(1.4)
Foreign tax rate differential	(2.4)	(7.0)	0.8
Equity earnings	5.3	(10.1)	(4.3)
Minority interests	—	0.8	0.8
Basis and stock sale differences	(11.9)	(10.8)	(14.2)
Goodwill amortization	1.6	1.6	2.0
Cash value in life insurance	—	(0.9)	(1.1)
Audit settlement	—	(1.8)	—
Other	0.6	1.1	0.7
Book effective tax rate	30.7%	9.2%	20.0%

Note: Book effective tax rate is total income tax expense divided by income before income taxes. Source: Enron Corporation's 2000 Annual Report.



As reported by the Joint Committee on Taxation in its analysis of the company's tax returns (U.S. Congress, Joint Committee on Taxation, 2003b), the "real" answer was \$63.2 million, comprised of regular federal income tax of \$21.3 million and alternative minimum tax of \$41.9 million, and neither of these figures appeared in the financial statements.

Why the mystery? As detailed in McGill and Outslay (2002), the taxes currently payable amount is a repository ("bestiary") for estimations and adjustments other than the tax liability that appears on the income tax return. In particular, the current portion of the tax provision likely contains an estimation of taxes that may have to be paid in the future should the Internal Revenue Service audit the tax return and propose additional taxes ("deficiencies") plus interest and penalties (this estimation often is referred to as a *tax contingency reserve* or a *tax cushion*).<sup>3</sup> In addition, the current amount may include a *true-up (return-to-provision)* adjustment to account for the difference between income taxes estimated to be payable when the Form 10-K is filed and the actual tax payable when the tax return is filed (often six to seven months later). Finally, the current amount does not take into account the tax benefits from stock option adjustments. The magnitude of this omission has been well documented in Hanlon (2003) and Hanlon and Shevlin (2002). This latter omission will change somewhat when and if the FASB's revised statement on accounting for stock options (FAS 123) becomes effective.<sup>4</sup>

The Enron conundrum illustrates the limits of current reporting rules in answering the "big" question (i.e., how much did the corporation pay the U.S. Treasury in income taxes). We next turn our attention to the "trees" in the forest. To what extent can a reader of financial statements glean information about specific tax-reduction transactions from the reporting of the tax benefits related to temporary and permanent differences. Senator Carl Levin (2003) might call this exercise the search for MEGOs.<sup>5</sup>

### TEMPORARY DIFFERENCES AS EVIDENCE OF TAX SHELTER ACTIVITY

*Temporary differences* reflect those book and tax differences that will appear on both the income statement and the tax return, but in different periods. The future tax obligation or future tax benefit that results from these differences is recorded on the balance sheet as either a *deferred tax liability* or a *deferred tax asset*, respectively. An important point to make is that proactive tax reduction strategies (one firm's term for tax shelters) that result in temporary differences do *not* affect book income, only the timing (present value) of cash flows (remember from the earlier discussion that the total tax provision is computed on *book equivalent to taxable income*, which is pretax book income adjusted for *permanent differences*).<sup>6</sup>

In the case of tax shelters, the transaction likely would involve the acceleration of a tax deduction over its subsequent book counterpart or the acceleration of

<sup>3</sup> Intel Corporation restored \$600 million to its net income in 2000 after overestimating its tax contingency reserve for years that were settled on audit.

<sup>4</sup> Under the proposed revision to FAS 123 (Financial Accounting Standards Board, 2004), the "expense" related to stock option exercises will be reported on the income statement in the year in which the stock option is granted. The estimated tax benefit from the exercise will reduce the tax provision (i.e., become a deferred tax asset). When the corporation receives the actual deduction at the date the option is exercised, any difference between the estimated tax benefit and the actual tax benefit will be reported in shareholders' equity.

<sup>5</sup> *My Eyes Glaze Over*.

<sup>6</sup> This assumes there is no adjustment for enacted changes in future tax rates, which would require an adjustment to the balance sheet totals for deferred tax assets and liabilities, which would increase or decrease the current year tax provision amount.

a book deduction over its subsequent tax counterpart. In the former case, the book–tax difference would be a *taxable temporary difference* that would translate into a deferred tax liability in the income tax note and ultimately the balance sheet (although on an aggregate basis). In the latter case, the book–tax difference would be a *deductible temporary difference* that would translate into a deferred tax asset in the income tax note. We illustrate both of these types of transactions, pointing out how they appear in the income tax note and the limits to their interpretation.

### *First Union / Wachovia Bank and LILLO Transactions*

The extent to which First Union Corporation (subsequently acquired by Wachovia Corporation) engaged in lease-in/lease-out (LILLO) transactions and the tax savings they generated became the subject of a Public Broadcasting Service documentary on its Frontline® program entitled *Tax Me if You Can*, which aired on February 19, 2004.<sup>7</sup> These transactions involved leasing public works (e.g., subway or sewer system) from a U.S. or foreign municipality (a tax-indifferent party) with a subsequent lease back to the municipality in such a way that the municipality received a significant portion of the lease payment upfront (as much as 90 percent of the lease term) and the “investor” was able to deduct the amount paid over a short period of time (five years) for tax purposes but amortize the amount over a long period of time (forty years) for accounting purposes.<sup>8</sup> Two questions that arose in the production of the show were (1) what amount, if any, of federal income

taxes did Wachovia Corporation pay in 2002 on pretax book income of \$4,667 million; and (2) what amount of cumulative tax savings did the company receive as a result of its leasing activities. Not surprisingly, Wachovia’s management did not volunteer answers to either question, leaving only the financial statements as a source of information. Wachovia Corporation’s income tax note for 2000–2002 from its 2003 annual report is presented in Table 2 as a reference to the discussion.

The “easy” answer to the first question would be that Wachovia Corporation received an income tax benefit (refund) of \$159 million in 2002, taken from the negative federal income tax currently payable. As with Enron, however, the deferred tax asset related to the alternative minimum tax credit carryover increased by \$110 million from 2001 to 2002. Additionally, the company reports cash paid of \$568 million for income taxes in its 2002 Statement of Cash Flows. Subtracting the current payable for state and local income taxes (\$202 million) and the current payable for foreign income taxes (\$127 million) from \$568 million yields an estimated current payable for federal income taxes of \$239 million. However, Wachovia reports an increase in its federal net operating loss carryover, which could lead to the interpretation that the companies included on the financial statements had negative taxable income and, therefore, no current federal income tax obligation.

Stymied in our ability to precisely answer the “big” question, we turn to the more specific question regarding the amount of tax benefits Wachovia garnered from these leasing transactions.<sup>9</sup> Conspic-

<sup>7</sup> The broadcast itself, along with transcripts and related documents, can be accessed at the program’s website—<http://www.pbs.org/wgbh/pages/frontline>.

<sup>8</sup> The details of one type of these transactions can be found in Rev. Rul. 2002–69, 2002–44 L.R.B. 760 and Rev. Rul. 99–14, 1999–1 C.B. 835.

<sup>9</sup> It should be pointed out that Wachovia never admits to engaging in LILLO transactions in the financial statements. SunTrust Bank accused First Union of engaging in these “tax shelters” during their battle to acquire Wachovia Bank (Mollenkamp, 2001). The producer of the Frontline® documentary got an official of Dortmund, Germany to identify First Union / Wachovia as the lessor of the city’s sewer system.

TABLE 2  
WACHOVIA CORPORATION: SELECTED INCOME TAX FOOTNOTE INFORMATION

Components of income before income taxes (in millions)	2003	2002	2001
United States	—	—	—
Foreign	—	—	—
Income before income taxes	\$6,080	\$4,667	\$2,293
Total income tax expense (benefit) (in millions)			
Payable currently			
Federal	\$956	\$(159)	\$483
State	68	202	81
Foreign	167	127	74
Total payable currently	1,191	170	638
Payment deferred			
Federal	511	949	13
State	131	(31)	23
Foreign	—	—	—
Total deferred	642	918	36
Total income tax expense	\$1,833	\$1,088	\$674
Effective tax rate reconciliation			
Statutory federal income tax provision	35.0%	35.0%	35.0%
Tax exempt interest	(2.6)	(2.8)	(4.0)
Net state income taxes	2.1	2.4	3.0
Life insurance, increase in cash surrender value	(2.4)	(2.6)	(3.8)
Foreign tax rate differential	0.5	0.6	0.8
Subsidiary stock, recognition of basis differences	(0.9)	(7.0)	(2.6)
Goodwill amortization	—	—	3.3
Tax credits, net of related basis adjustments	(2.2)	(3.0)	(4.7)
Change in deferred tax asset valuation allowance	0.2	0.4	0.6
Other, net	0.4	0.3	1.8
Book effective tax rate	30.1%	23.3%	29.4%

Notes: The income tax note does not provide a geographic breakdown of income. Book effective tax rate is total income tax expense divided by income before income taxes. Source: Wachovia Corporation's 2003 Annual Report.

uous in the itemized deferred tax liabilities is \$6,759 million related to "leasing activities." Over the period 1999–2002, this account grew by \$2,937 million. This change in the deferred tax liability equates to a change in a *taxable temporary difference* of approximately \$8,400 million (\$2,937 / .35) over three years! Such a large increase in a single account certainly could raise eyebrows, but its interpretation could furrow them, too. As one respondent to the Frontline® documentary observed, there likely are billions of dollars of "legitimate" (non-LILO) leasing transactions included in this account (e.g., capital lease versus operating lease for book and tax purposes). Disaggregating the types of leasing activities that led to this account is not possible to a reader of the financial

statement. Its magnitude might prompt a shareholder to ask a question about the nature of the account at the company's annual meeting. The book–tax difference also should be reported in the Schedule M–1 to the company's federal income tax return (Boynton and Mills, 2004; Mills and Plesko, 2003), which might induce an Internal Revenue Agent to investigate its components more carefully.

#### *Hewlett–Packard Company and Capitalized Research and Development Expenditures*

Recently, we received an inquiry from a reporter for a financial news organization relating to an increase in Hewlett–Packard Company's deferred tax asset entitled

“Capitalized research and development.” The reporter observed that the account increased from \$849 million in 2002 to \$1,775 million in 2003, a total of \$926 million. This translates to an increase in the current year *deductible temporary difference* related to this item of \$2,646 million (\$926/35 percent). The company expended \$3,652 million on R&D in 2003, as reported in its income statement. The reporter wondered what the increase meant (or, more likely, was there a good story there). Table 3 presents selected portions of Hewlett-Packard Company’s income tax note for 2003.

Here the answer was easier to provide. The company discloses in its income tax

note that it has foreign tax credit carryovers of \$572 million that expire in 2006 and 2007. Under Reg. Sec. 1.861-17, a corporation must apportion its R&D costs to the numerator of its foreign tax credit limitation calculation, thus potentially reducing the amount of foreign tax credit available in the current year.<sup>10</sup> A common planning technique in situations like this is to amortize the R&D for tax purposes over five or ten years (allowed under Internal Revenue Code sections 174 and 59(e)) while expensing the entire amount for book purposes. The excess of the current year book deduction (\$3,652) over the current year tax deduction (\$730 mil-

TABLE 3  
HEWLETT-PACKARD COMPANY: SELECTED INCOME TAX FOOTNOTE INFORMATION

Components of income before income taxes (in millions)	2003	2002	2001
United States	\$661	\$(3,655)	\$(2,481)
Foreign	2,227	2,634	3,272
Income before income taxes	\$2,888	\$(1,021)	\$791
Total income tax expense (benefit) (in millions)			
Payable currently			
Federal	\$(127)	\$(768)	\$(178)
State	38	115	17
Foreign	533	334	1,239
Total payable currently	\$444	\$(319)	\$1,078
Payment deferred			
Federal	(254)	(1)	(1,008)
State	—	—	—
Foreign	159	202	41
Total deferred	(95)	201	(967)
Total income tax expense	\$349	\$(118)	\$111
Effective tax rate reconciliation			
Statutory federal income tax provision	35.0%	35.0%	35.0%
Net state income taxes	0.8	6.9	1.5
Foreign tax rate differential	(23.9)	(36.0)	(38.1)
Nondeductible goodwill	—	17.5	6.6
In process research & development	—	27.2	1.6
Acquisition related charges	—	7.1	1.8
Divestitures	—	(12.9)	1.1
Research & development credit	(1.9)	(3.9)	(2.6)
Valuation allowance	1.2	16.7	6.2
Other, net	0.9	0.8	0.9
Book effective tax rate	12.1%	(11.6)%	14.0%

Note: Book effective tax rate is total income tax expense divided by income before income taxes. Source: Hewlett-Packard Company’s 2003 Annual Report.

<sup>10</sup> The foreign tax credit limitation is computed for each category of foreign income as follows: foreign source taxable income / total taxable income × pre-credit U.S. tax liability. Expenses allocated to the numerator reduce the ratio, thus potentially reducing the foreign tax credit available to offset a company’s U.S. income tax liability.

lion if amortized over five years) yields a deductible temporary difference of \$2,922 million. This equates to an increase in the deferred tax asset related to this item of \$1,023 ( $\$2,922 \times 35$  percent). The difference in this amount from the \$926 change in deferred tax assets is likely due to rounding and the reduction (“draw down”) of the deferred tax asset for prior year deferred R&D tax deductions that were subsequently deducted on the current year tax return. Hewlett-Packard’s apparent use of an available R&D tax amortization option certainly reduces its Federal income tax costs but most observers would not consider this a “tax shelter” transaction.

#### PERMANENT DIFFERENCES AS EVIDENCE OF TAX SHELTER ACTIVITY

*Permanent differences* are those book and tax differences that will appear on either the income statement or the tax return, but not both. The tax “cost” or tax “benefit” that results from these differences is recorded in the income tax note as part of the reconciliation of the company’s hypothetical tax provision (pretax book income  $\times$  35 percent) or its hypothetical effective tax rate (35 percent) with the actual tax provision or effective tax rate (provision / pretax book income). Tax strategies that produce permanent differences *do* affect book income, thus impacting earnings per share and, consequently, shareholder value.

Given the increased focus of corporate tax departments on enhancing shareholder value, an analysis of a public corporation’s itemized tax provision reconciliation items would seem to be a promising avenue in uncovering tax shelter activities. In the case of tax shelters, the transaction likely would involve the recognition of book income that is not taxable, tax deductions that are not treated as expenses for book purposes, and the recognition of income taxed at less than 35 percent. Purveyors

of tax strategies that produce these types of desirable permanent differences often “sell” the shareholder value component using what we might call a multiplier formula, as follows:

$$[1] \quad \Delta ETR = \Delta EPS$$

$$[2] \quad \Delta \text{market capitalization} = \Delta EPS \\ \times P/E \text{ multiple} \times \text{number of} \\ \text{shares outstanding,}$$

where  $\Delta ETR$  is the change in the corporation’s book effective tax rate,  $\Delta EPS$  is the change in the corporation’s earnings per share,  $\Delta \text{market capitalization}$  is the change in the corporation’s market capitalization, and *P/E multiple* is the corporation’s stock price / earnings per share.

An example that corporate managers buy into this formula is the recent discussion in the Proxy Statement by management of Tyco International Ltd. in response to a shareholder proposal to have the company move its parent company back to the United States from Bermuda. In recommending that shareholders reject the proposal, management gave the following rationale:

The tax consequences to the Company of such a move depend on a number of factors and cannot be predicted with precision. Had the Company been a U.S. corporation during fiscal year 2003, we estimate that the effective tax rate on income from continuing operations excluding special charges would have increased from 28.1% to between 35% and 37% (a percentage increase of approximately 25% or more). The Company would expect a similar or even greater increase in its effective tax rate for future years under current U.S. tax law if it became a U.S. corporation. *The Board believes that the resulting impact on the Company’s 2003 earnings could have caused a reduction*

*in the Company's market capitalization amounting to \$4 billion to \$5 billion.* [emphasis ours] Moreover, this impact on market capitalization could increase as the Company's earnings grow.

Assuming the move would increase the company's book effective tax rate by seven percentage points, the income tax provision (books) would increase (net income would decrease) by \$126 million (.07 × \$1,800 pretax book income in 2003). This equates to a decrease in earnings per share of \$0.06 (\$126 / 2,000 shares outstanding). At the time of the statement, the company's P/E multiple was approximately 40. Inserting these calculations into the multiplier formula results in the following projected change in market capitalization:

$$\begin{aligned} [3] \quad \text{A market capitalization} &= .06 \times 40 \\ &\times 2,000 = \$4,800 \text{ million.} \end{aligned}$$

#### *Enron Corporation's Effective Tax Rate Reconciliation for 1998–2000*

Table 1 presents Enron Corporation's effective tax rate reconciliation for 1998–2000. Items that reduce the book effective tax rate include *basis and stock sale differences* (reductions of 14.2 percent, 10.8 percent, and 11.9 percent), *cash value in life insurance* (reductions of 1.1 percent, 0.9 percent, and 0.0 percent), and *foreign tax rate differential* (increase of 0.8 percent; reductions of 7.0 percent, and 2.4 percent). The corporation provides no explanation for what lies behind these accounts. Again, this lack of details stems from the fact that SEC Regulation S–X, Rule 4–08(h)(2) states that reconciling items in the effective tax rate computation *should* [emphasis ours] be stated separately if they equal or exceed five percent of the “hypothetical tax expense” (income before taxes times 35 percent for U.S. domiciled companies). Further, the regulation states

that no reconciliation is required if the total reconciling differences are less than five percent of the hypothetical tax unless the reconciliation would be “significant in appraising the trend of earnings.”

The public learned from the Joint Committee Report on Enron (U.S. Congress, Joint Committee on Taxation, 2003b) the nature of the transactions that produced these summarized book–tax differences (e.g., Project Tanya and Project Condor, corporate-owned life insurance (COLI) policies, and the use of subsidiaries (250) in low-tax (haven) countries). Unfortunately for analysts and shareholders, this information was gathered over the course of a year through in-depth interviews with company personnel, a “luxury” the public does not have. For the Internal Revenue agent, information regarding the first two permanent differences might be detailed on Schedule M–1, lines 7 (book income not included in taxable income) and 8 (tax deductions not expensed for book purposes).

#### *IBM Corporation and “Portable Profits”*

In some cases, corporations are more forthcoming about their activities, particularly as they relate to international activities. A case in point is IBM Corporation, which began reporting a significant change in the reconciling item entitled *foreign tax rate differential*. This item was a positive six percentage points in the 1994 ETR reconciliation but dropped to a negative six percentage points by 1998 (this 12 percentage point change “created” more than \$2.50 in earnings per share in 1998). In the text accompanying the reconciliation in its 1998 income tax note, the company stated that “[a]s part of its global strategies involving the relocation of certain of its manufacturing operations, the company transferred certain intellectual property rights to several non–U.S. subsidiaries in December 1998.” This migration of intellectual property to holding companies in

low-tax jurisdictions is perfectly legal, although the IRS often challenges the cost-sharing arrangements that are part of developing new intellectual property. Such forthrightness could forestall analyst and shareholder inquiries, but could also alert competitors (and the IRS) to the company's global tax and business strategies.

THOUGHTS ON THE DISCLOSURE ISSUE

In our testimony at the Enron hearings, we stated that we believe current accounting disclosure rules do not provide sufficient tax information to determine a corporation's tax status, and we supported 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 (McGill and Outslay, 2003). There currently is no indication that the FASB intends to revisit FAS 109 in the near future, despite some overtures from the FASB User Advisory Group to increase the transparency between book and tax differences (Burkholder, 2004). As we said in our testimony, "[a]ccounting 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" (McGill and Outslay, 2003).

Given that the FASB believes the current reporting rules governing accounting for income taxes provide information that is useful in making rational investment decisions and are comprehensible to persons who are willing to devote a reasonable amount of diligence to understanding the income tax note, any enhancement of the current reporting environment likely will have to come from the government, whether it be Congress (please no), Treasury, or the Securities and Exchange Commission (SEC). For example, it has been suggested that public corporations provide "segmental" data regarding the

taxes paid on a jurisdictional basis. The SEC also could require a break-down of the taxes currently payable by component, perhaps along this line:

	Estimated federal income tax liability per tax return	\$
±	Tax benefits related to stock option exercises	
±	Change in tax contingency reserve	
±	Change in return to accrual adjustment	—
	Federal income taxes currently payable, as reported	\$==

The proposed Schedule M-3 (Boynton and Mills, 2004; Mills and Plesko, 2003) will provide enhanced details of book-tax differences and their categorization as either a temporary difference or a permanent difference. As we see it, the big issue is whether to make the Schedule M-3 publicly available or internal to the Treasury. At least initially, we believe the schedule likely will receive more private sector support if it remains confidential. Such enhanced disclosure will not be cost beneficial to any of the parties involved without a commitment by the IRS to train its agents in the accounting rules that pertain to measuring and reporting income taxes. Otherwise, agents may waste their own and taxpayers' time pursuing book-tax differences that pertain to non-controversial tax planning.

We reiterate our position in our testimony at the Enron hearings that Congress should resist the temptation to conform the rules that apply to computing book income and taxable income. One need only read the Supreme Court's opinion in *Thor Power Tool, Inc.*, 439 U.S. 522 (1979), to appreciate the very different objectives that underlie these two reporting regimes. We also agree with Lenter, Shackelford, and Slemrod (2003) and the Tax Executives Institute (Glennie, 2003) that Congress

should not make corporate tax returns publicly available. The cost of exposing a corporation's confidential business strategies to competitors is not outweighed by giving the public the opportunity to sift through a document that could approach 10,000 pages.<sup>11</sup>

We would prefer that any changes in the public reporting of a corporation's tax status come from either the FASB or the SEC. Ray Beeman, our discussant, made the very insightful comment that accounting statements are snapshots of a moving picture and by their very nature, are at best a blurry representation of a corporation's continuing activities. The current rules do not need a major overhaul, but some improvement in the level of detail provided, particularly as it relates to the "current" portion of the tax provision, would go a long way to helping readers fathom one of the more "inscrutable" sections of a company's financial statements.

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<sup>11</sup> In his letter to the shareholders in Berkshire Hathaway, Inc.'s 2003 annual report, Warren Buffett noted that the company's tax return exceeded 8,400 pages.



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