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The Paradox of Corporate Taxes

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The Carnival Corporation wouldn't have much of a business without help from various branches of the government. The United States Coast Guard keeps the seas safe for Carnival's cruise ships. Customs officers make it possible for Carnival cruises to travel to other countries. State and local governments have built roads and bridges leading up to the ports where Carnival's ships dock.

But Carnival's biggest government benefit of all may be the price it pays for many of those services. Over the last five years, the company has paid total corporate taxes — federal, state, local and foreign — equal to only 1.1 percent of its cumulative $11.3 billion in profits. Thanks to an obscure loophole in the tax code, Carnival can legally avoid most taxes.

It is an extreme case, but it's hardly the only company that pays far less than the much-quoted federal corporate tax rate of 35 percent. Of the 500 big companies in the well-known Standard & Poor's stock index, 115 paid a total corporate tax rate — both federal and otherwise — of less than 20 percent over the last five years, according to an analysis of company reports done for The New York Times by Capital IQ, a research firm. Thirty-nine of those companies paid a rate less than 10 percent.

Arguably, the United States now has a corporate tax code that's the worst of all worlds. The official rate is higher than in almost any other country, which forces companies to devote enormous time and effort to finding loopholes. Yet the

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government raises less money in corporate taxes than it once did, because of all the loopholes that have been added in recent decades.

"A dirty little secret," Richard Clarida, a Columbia University economist and former official in the Treasury Department under President George W. Bush, has said, "is that the corporate income tax used to raise a fair amount of revenue."

Over the last five years, on the other hand, Boeing paid a total tax rate of just 4.5 percent, according to Capital IQ. Southwest Airlines paid 6.3 percent. And the list goes on: Yahoo paid 7 percent; Prudential Financial, 7.6 percent; General Electric, 14.3 percent.

Economists have long pleaded for an overhaul of the corporate tax code, and both President Obama and Republicans now say they favor one, too. But it won't be easy. Companies that use loopholes to avoid taxes don't mind the current system, of course, and they have more than a few lobbyists at their disposal.

The official position of the Business Roundtable, one of the most important corporate lobbying groups, is telling. The Roundtable says it supports corporate tax reform. But it actually favors only a reduction in the tax rate. The group refuses to say whether it also favors a reduction of loopholes. In effect, the Roundtable wants a tax cut for its members regardless of how much the tax code is simplified — or whether the budget deficit grows.

The tax filings of companies, like those of individuals, are confidential. In their public reports to investors, however, companies are required to list something called "cash taxes paid" — the total amount of corporate income tax they paid that year, be it to foreign governments, the United States government or state and local governments.

This number varies significantly from year to year, depending on how many loopholes a company qualifies for. So looking at a single year's number is often misleading. But in a 2008 academic paper, three accounting professors — Scott

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Dyreng of Duke, Michelle Hanlon of M.I.T. and Edward Maydew of the University of North Carolina — suggested a new method for analyzing corporate tax avoidance.

It compares cash taxes paid over several years — like five, as in the analysis for The Times — to pretax earnings over that same period. The accounting experts I interviewed called it the best available method for looking at corporate taxes.

Some obvious patterns emerge. Companies that lost large amounts of money in previous years can subtract these subsequent losses from their initial profits and avoid taxes until they're turning a consistent profit. Yahoo falls into this category. Of all the reasons to have a low tax rate, this one may be the most defensible, economists say.

Other companies are able to avoid taxes by spending large sums on new equipment or buildings. Such spending can often be deducted. Southwest Airlines, for instance, has bought a lot of planes in the last five years. Several energy companies with tax rates below 2 percent, like NextEra, Xcel and Range Resources, have likewise been expanding.

A third group of companies simply seems to have become expert at avoiding taxes. When the three accounting professors analyzed more than 2,000 companies, they found big variations in tax rates within almost every subset of companies. Companies in the same industry often paid very different rates, even when they were similar in size.

G.E. is so good at avoiding taxes that some people consider its tax department to be the best in the world, even better than any law firm's. One common strategy is maximizing the amount of profit that is officially earned in countries with low tax rates.

Carnival pays so little tax partly because of a provision that lets some shipping companies legally incorporated overseas (Panama, in Carnival's case) avoid taxes. The fact that Carnival's executives sit in Miami and or that many passengers board in Baltimore, Los Angeles, Miami, New York and Seattle doesn't matter. Nor does the fact that Carnival isn't paying much tax in Panama.

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Companies that pay relatively high rates tend to be those that are not expanding rapidly and that are not as ingenious as G.E., at least on taxes. The average total tax rate for the 500 companies over the last five years — again, including federal, state, local and foreign corporate taxes — was 32.8 percent. Among those paying more than the average were Exxon Mobil, FedEx, Goldman Sachs, JPMorgan Chase, Starbucks, Wal-Mart and Walt Disney.

The problem with the current system is that it distorts incentives. Decisions that would otherwise be inefficient for a company — and that are indeed inefficient for the larger economy — can make sense when they bring a big tax break. "Companies should be making investments based on their commercial potential," as Aswath Damodaran, a finance professor at New York University, says, "not for tax reasons."

Instead, airlines sometimes buy more planes than they really need. Energy companies drill more holes. Drug companies conduct research with only marginal prospects of success.

Inefficiencies like these slow economic growth, and they are the reason that both conservatives and liberals criticize the corporate tax code so harshly. Mitch McConnell, the Republican Senate leader, says it hurts job creation. Mr. Obama, in his State of the Union address, said that the system "makes no sense, and it has to change."

A lot of economists agree. Then again, any system that creates as many winners as this one won't be changed easily.

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