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Corporate Profits Take an Offshore Vacation

Last week, Merck, the pharmaceutical multinational, announced that it will pay 2.3 billion dollars in back taxes, interest and penalties in one of the largest settlements for tax evasion the U.S. Internal Revenue Service (IRS) has ever imposed. Merck had cooked its tax books by moving ownership of its drug patents to its own Bermuda shell company -- an entity that has no real employees and does no real work -- and then deducting from U.S. taxes the huge royalties it paid itself. While setting up a shell company is not inherently illegal, it is if tax authorities determine that its only purpose is to evade taxes. Bermuda is a tax haven that has no levy on royalties. Merck also faces legal action in Canada for 1.8 billion dollars in back taxes and interest.

What Merck did isn't unusual but in fact is becoming common for multinationals in the era of globalisation. It's one of the ploys in a corporate bag of tricks called profit laundering. A company figures out how to move its book profits offshore so it can evade millions and even billions in taxes to the country where it really operates. In an era where much of a company's assets may be intangible intellectual property -- patents, logos, manufacturing processes -- this strategy can make reported profits and taxes disappear.

People understand that nations' economies are hurt when jobs move overseas. But what happens when intellectual capital, on which the increasingly knowledge-based economy depends, is also moved out? IRS Commissioner Mark Everson said last June, "Tax issues associated with the transfer of intangibles outside the United States have been a high risk compliance concern for us and have seen a significant increase in recent years. Taxpayers, especially in the high technology and pharmaceutical industries, are shifting profits offshore."

The cost of manufacturing drugs or computer technology is minimal compared to the cost of research and development. So, beginning in the early 1990s, several dozen pharmaceutical and computer companies established subsidiaries in Bermuda and other tax havens to game the system. They set up shell companies and transferred patents or logos or other intangible property there. Then, when profits rolled in, the company paid big license fees or royalties to its own shell -- at the price it decided -- and deducted that from home taxes. Revenues were sucked out of the U.S. or other countries even though the patents were created and were still used for work within home borders.

Although almost 60 percent of U.S. pharmaceutical companies' sales take place in the U.S., where the government's refusal to control drug prices makes profits higher than elsewhere, the companies report to the IRS that their profits come largely from international sales. The world's biggest drug firm, Pfizer, with most of its sales in the U.S., said that in 2004 it had 4.4 billion dollars in pretax profits in the United States and 9.6 billion dollars internationally.

Last year, Martin Sullivan, a former U.S. Treasury Department economist, noted in the journal *Tax Notes* that pharmaceuticals had accelerated their movement of profits to low-tax jurisdictions. He wrote that "In 1999, foreign profits accounted for 39.2 percent of worldwide profits of large U.S. drug companies. By 2005 that percentage had jumped to 69.9 percent." He figured that the companies' foreign assets were 41 percent and their sales 43 percent of the world total, so that foreign profits should be 43 percent. But the companies reported them as 66 percent, cheating the U.S. of 23 percent of profits. That amounted to nearly three billion dollars a year from nine drug companies, including Merck, which cut 1.5 billion dollars from its taxes over a decade.

Prime technology companies playing the offshore game are Microsoft and Google. Microsoft gets about 75 percent of its 40 billion dollars in revenue from licensing fees. A few years ago, it set up an Irish subsidiary called Round Island One Ltd. to own its 16 billion dollars worth of copyrights on software developed in the U.S. In 2004, it shifted nine billion dollars in profits to Ireland and thereby avoided paying some 500 million dollars in U.S. taxes. Using the Irish company, Microsoft also avoids taxes elsewhere in Europe, the Middle East and Africa. The maneuver helped Microsoft drop its worldwide tax rate from 33 percent to 26 percent.

Google similarly set up an Irish subsidiary, Google Ireland Holdings Ltd, which in 2004, its first year, helped the company avoid paying about 131 million dollars in U.S. taxes. Google noted in its annual report that year that it expected its effective tax rate to drop even more significantly. It explained, "This is primarily because proportionately more of earnings in 2005 compared to 2004 are expected to be recognised by our Irish subsidiary, and such earnings are taxed at a lower statutory tax rate (12.5 percent) than in the U.S. (35 percent)." Both companies may have some minimal operations in Ireland, but the issue is how much value they allot to that jurisdiction for tax purposes.

IBM didn't use an offshore shell but shifted royalties to another operating location. According to *The (London) Observer*, whistleblower Gerard Churchhouse, a former IBM marketing manager, revealed that in the early 1990s, IBM U.S. was losing money, so IBM UK transferred artificially high royalties to the U.S. company. He said it thereby evaded as much as 1.4 billion dollars in British taxes. Churchhouse said he was fired for raising the issue with his bosses. IBM refused to confirm or deny his story, but in 2001 it paid the British Inland Revenue about 1.4 billion dollars to settle claims of tax evasion.

The situation is getting worse. According to Sullivan, U.S. Commerce Department data show that U.S. companies increased the profits assigned to 18 tax havens by 68 percent, from 88 billion dollars in 1999 to 149 billion dollars in 2002. He said the increase in offshore profits was not related to increased economic activity and that, "subsidiaries of U.S. corporations now generate profits mainly in tax havens rather than in locations in which they conduct most of their business." The result of this and other sorts of tax trickery is that nearly two-thirds of the companies operating in the United States reported owing no taxes from 1996 through 2000, according to a 2004 report by the investigative arm of Congress, the Government Accountability Office.

Jack Blum, an expert on tax evasion and former counsel for the Senate Foreign Relations Committee, said, "Since the 1960s the percentage of tax revenue at the federal level that comes from corporations has declined from around 30 percent to around 8 percent. A substantial portion of this decline is the consequence of the ability of companies with global operations to shift income to

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jurisdictions where tax collectors cannot find it." The U.S. Treasury and IRS say they are reviewing accounting rules on transactions involving intellectual property, but the U.S. government has failed to adopt tough measures to end royalty-shifting.

Most of the 2.3 billion dollars Merck has to pay is back taxes and interest; only 100 million dollars is penalty. No Merck official has been charged with a crime. That signals that companies have little to lose by continuing their tax scams. The Financial Times reported in 2004 that Merck "would have failed to meet consensus earnings forecasts without the improved [tax] rates." Merck may think it took a profitable risk.

About the Author: *Lucy Komisar is a New York-based investigative journalist writing a book on the international impact of the offshore bank and corporate secrecy system.*