MARKET WATCH

When an Expense Is Not an Expense

Related Articles
• The New York Times: Your Money

Forum
• Join a Discussion on Investing

By GRETCHEN MORGENSON

CORPORATE profits are surging this year, to the delight of those who thought a slowdown might crimp results at United States companies. Earnings at S. & P. 500 companies rose 10.5 percent in the first quarter, 14.7 percent in the second.

All the more remarkable, then, that corporate tax receipts are down this year from last. Through July, according to the Treasury, corporations paid $140.7 billion, 6.4 percent less than in the corresponding period last year.

Obviously, companies are reporting lower earnings to the Government than they are to their shareholders. Nothing new there. After all, tax accounting methods differ from those used to compile shareholder reports.

But the downturn in tax receipts is new. Corporate tax receipts have not dropped since 1983, and that was when the United States was shaking off a crippling recession. And the decline comes at a time when individual tax receipts are running 6.7 percent ahead of 1998.

Forget, for a moment, what the drop might say about how inflated the earnings reported to shareholders have come to be. What's behind the decline?
Corporate tax shelters are an explanation offered by Christopher E. Bergin, editor of the magazine Tax Notes, which published an article about falling tax receipts in late July. "Increasingly, U.S. corporations are looking at their tax departments as profit centers," he said. Once, tax staffers were ridiculed as numbers nerds; now they are revered.

Martin A. Sullivan, the economist who wrote the Tax Notes article, said that if the decline in taxes continues through the rest of fiscal 1999, which ends in September, overall taxes paid by American companies as a percentage of their profits would be about 19.9 percent, the lowest rate since 1984. Five years ago, corporations paid 24.6 percent of profits in taxes.

The trend may indicate "that corporate tax receipts are being adversely affected by corporate tax shelters," Mr. Sullivan said.

What sorts of shelters? Only the financial engineers know for sure. But Robert Willens, managing director at Lehman Brothers, said corporations could legitimately reduce their tax bills by structuring asset sales as tax-free exchanges and using government-bestowed tax credits, like the one benefiting companies with heavy research and development costs. And, the more income a company generates overseas and leaves there, the lower its tax bill.

But one of the biggest contributors to the falloff in tax receipts may be **stock options**.

Here's why: Under shareholder accounting, **stock options** are not considered an employee compensation expense, even though they clearly are. So companies that use them -- and rare is the publicly traded company that doesn't -- effectively overstate their earnings.

But for tax accounting purposes, when an employee exercises an option, the difference between that option's strike price and the prevailing market value of the underlying stock is an expense to the company that issued the option.

So the widespread use of **options** not only hypes corporate earnings, it cuts companies' tax bills and Treasury receipts. What a combination.