ON THE MONEY

Dear Santa, just let us get back to break-even

BARRY RITHOLTZ

RITHOLTZ FROM G1

Here is the short list of what investors are hoping to find under their trees:

1 A consistent trend: Investors need some Dramamine after this year's wild swings. The second half of the year alone had more than a dozen swings between 5 percent and 20 percent. Despite all that, the market is unchanged year to date. It is the equivalent of a lump of coal in investors' stockings.

2 Yield, please: Those who live off of their investment portfolios are having a tough time. The 10-year Treasury is yielding less than 2 percent. Social Security recipients have seen almost nothing in terms of cost-of-living adjustments.

Santa, won't you please speak to Fed chief Ben Bernanke about normalizing the interest rate policy? We don't ask for much, just risk-free, tax-free, real annual yields of 4 to 6 percent.

3 More civil suits against corporate execs: We got an early Christmas present when the Securities and Exchange Commission filed suit against the chief executives (and other top officers) at Fannie Mae and Freddie Mac. These execs made "misleading and false disclosures" to investors about subprime exposure, according to the SEC.

There must be many more execs at various firms — AIG, Citigroup, Lehman Brothers, Bear Stearns, Merrill Lynch, Indy Mac, Bank of America, Countrywide and even Goldman Sachs — who similarly misled investors. Securing convictions and huge fines against those who misrepresented their financial condition to the public would go a long way toward restoring investor confidence.

4 Good advice: Why is reasonably priced, intelligent personal financial advice so difficult to come by? What most investors really need is someone they can respect and trust to help them plan for the future. We don't ask for much, just a person who will help us make money in good markets and prevent us from losing any in bad ones.

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5 A bottom in housing: The ongoing residential real estate debacle continued this year, with prices falling another 3.9 percent year-over-year last quarter. If housing prices do not stabilize, then the banks are still at risk, festooned as they are with bad mortgages. Without stable, financially secure banks, we cannot see any sort of sustainable market move. Hence, a bottom in housing prices would be a real treat.

6 Criminal indictments of robo-signers: Speaking of banks, they seem to have some employees who have violated the laws regarding perjury, foreclosure and litigation. Some of our state attorneys general have been very good this year at investigating them. The New York, Delaware, California and Nevada chief prosecutors deserve a little something extra in their stockings for so diligently pursuing these criminals. (A lump of coal, perhaps, for the rest?)

7 Please fix Europe: Our largest trading partners in Europe are a mess. Their banks are filled with a different sort of subprime junk — the sovereign debt of overleveraged nations. Anything you can do to help them out of their jam would be appreciated.

8 No more volatility: The roller coaster ride in the markets these past few years has given us motion sickness. How about a nice calm market for next year, even if the gains are in the single digits? That would suit us just fine.

9 Accelerate loss deductibility: Investors have lost thousands of dollars in the past three crashes (tech, housing and stocks). The maximum set off against profits is a mere $3,000 a year (married joint filers). At that pace, there are lots of investors whose losses will outlive them. Indeed, plenty of middle-class families still have losses from the dot-com crash alone that run into six figures. If Congress were to raise this to $10,000 or $20,000 a year, it would not cost that much but would be a huge benefit.

10 End of the bear market: It has been 12 years since the stock market peaked in March 2000. For all the ups and downs we've experienced, the major indices are essentially unchanged since 1999. Santa, won't you please end this bear market sooner rather than later? I know the last bear market lasted 16 years, until 1982, but I am not sure we can last six more years!

That's my investor's holiday list, Santa. Hope you can accommodate me.

— Barry

Dear Barry,

Thank you for your list. It is not every day that Santa gets a request for "more yield" or "criminal indictments," so it definitely caught my eye.

I have taken the liberty of forwarding parts of your list to different folks in the Capital — the SEC, Congress, Federal Reserve and White House. They can do more with your request than I can.

About your other list — the one with that Aston Martin (British racing green) on it? Forget about it; you haven't been THAT good this year.

Ho ho ho,
— Santa

Ritholtz is chief executive of FusionIQ, a quantitative research firm. He is the author of "Bailout Nation" and runs a finance blog, the Big Picture.

THE COLOR OF MONEY

The good, the bad and the ugly for consumers in 2011

COLOR FROM G1

selected school. I'm hoping the calculator will help families reduce the debt they take on.

There was a hallelujah moment when Bank of America backed off plans to charge certain customers $5 a month for using their debit cards to make purchases. See, your voice does count.

I also rejoiced when Maryland joined a growing number of states in which judges must demand greater proof from debt buyers before allowing them to sue consumers to recover alleged obligations. State courts have become burdened by collection cases.

The Maryland Court of Appeals directed debt-collection companies to present better proof of an existing debt. Companies also have to show that they own the debt they are trying to collect.

Still more good news: The Federal Reserve Bank of New York said overall consumer debt dropped about $60 billion to $11.66 trillion in the third quarter.

But the bank report also had some bad news. As consumers were cutting their mortgage and credit-card debt, they apparently were loading up on student loans. In the third quarter, total student-loan debt was $865 billion. That figure exceeds credit-card debt, which was $694 billion in the second quarter and $693 billion in the third. The New York Fed report is only the latest to reach a certain conclusion: Student-loan debt is reaching stratospheric heights. If families continue the current borrowing trend, total student-loan debt will soon reach $1 trillion.

The Census Bureau also delivered some bad news this year. Median household income was down in 2010. And the poverty rate increased. There were 46.2 million people living in poverty last year, up from 43.6 million in 2009 — the largest number in the 52 years for which poverty estimates have been published, the bureau said.

The ugliness of 2011 was displayed by the 44 Republican senators who wrote to President Obama in May, threatening to block anyone from taking the helm of the Consumer Financial Protection Bureau unless certain structural changes were made to how the agency was run. The changes they want will only weaken the bureau.

Because of this foolishness, Obama never nominated Elizabeth Warren to head the agency, although she should have been tapped because she came up with the idea for it. The person who was selected, Richard Cordray, a former attorney general of Ohio, is more than qualified. But the Republicans stayed true to their word. The bureau still has no director.

The blocking of Cordray was not only ugly but also unnecessary. For the first time, we have consumer-protection powers consolidated into one agency. In the letter sent to Obama, the senators claimed that they support strong and effective consumer protection. What a crock. If they truly want consumers to have a powerful advocate to prevent financial abuses, they would allow a director to be confirmed.

I know many people are still toughing things out and will continue to struggle in the coming year. But some good things happened in 2011 that will help give consumers a better grasp of their finances and protect them from no-account con artists.

Readers can write to Michelle Singletary c/o The Washington Post, 1150 15th St., NW, Washington, D.C. 20071. Or e-mail: singletarym@washpost.com. Personal responses may not be possible. Please also note comments or questions may be used in a future column, with the writer's name, unless a specific request to do otherwise is indicated.

Facilities stay in Puerto Rico, ownership shifts elsewhere

PUERTO RICO FROM G1

report by J.P. Morgan Chase. Companies including Apple, Google, Microsoft and Pfizer are lobbying Congress for a tax holiday to bring those profits home. Without such a break, any cash brought back to the United States would be taxed at the federal income-tax rate of 35 percent, with a credit for foreign income taxes already paid.

Medtronic, based in Minneapolis, paid income taxes in fiscal 2011 at a rate of less than half that — 16.8 percent. That's also about half Medtronic's rate under the old Puerto Rico tax credit.

As the Obama administration and congressional Democrats take aim at tax breaks for everything from corporate jets to private-equity manager compensation, the aftermath of the Puerto Rico credit's repeal shows just how difficult ending such breaks can be — and how determined well-funded tax planners and their corporate clients are to create new ones.

'Extraordinary' profit

Now the IRS wants to collect some of those lost taxes. It has identified as a top audit priority the sophisticated strategies U.S. companies used to shift income that once benefited from the old tax break in Puerto Rico.

In a memo sent to IRS auditors in February 2007, the agency called profit levels "extraordinary" in many of the offshore units created to take over for the subsidiaries that got the Puerto Rican break. In many cases, those units are generating "an inordinate amount of the profits, i.e., amounts in excess of what would be expected, based upon activity," according to the IRS memo.

The agency is in a $958 million fight with Medtronic in U.S. Tax Court over how it reorganized its Puerto Rican operations, as well as a $452 million court dispute with Guidant, now a part of medical device maker Boston Scientific, over a similar move.

Companies legally move profits offshore using "transfer pricing," the system of allocating income between units in different countries. This lets corporations such as Medtronic say that profit from a $5,000 pacemaker was earned in the Cayman Islands, even though the device was manufactured in Puerto Rico and sold in, say, Houston. The company has accumulated $14.9 billion in income allocated to its foreign subsidiaries on which it hasn't paid any U.S. income tax, according to its most recent annual report.

The profit shifting that can stem from transfer pricing costs the U.S. government an estimated $90 billion a year, according to Kimberly Clausing, an economics professor at Reed College in Portland, Ore. That's about double the Department of Homeland Security's annual budget and dwarfs the revenue loss from the various tax breaks under scrutiny. By comparison, changing the carried-interest provision that allows private-equity managers to pay taxes at a rate of 15 percent on most of their compensation would raise only about $2 billion a year for the federal government, according to the Joint Committee on Taxation.

Under U.S. transfer-pricing rules, offshore subsidiaries that license rights from their parent companies are supposed to pay an "arm's length" price, or what an unrelated company would pay. Such transactions often involve the transfer of intellectual-property rights and other intangibles, for which real-world comparisons can be difficult to find. The IRS objects when offshore subsidiaries pay their parent company a price that the agency claims is too low, which shifts taxable profit out of the United States.

"We are confident that Medtronic has met the requirement in establishing arm's-length pricing on all intercompany transactions," said Amy von Walter, a spokeswoman for the company. She declined to comment on specifics of the IRS dispute.

Medtronic says in court papers that its offshore unit paid the correct amount for rights moved out of the United States.

The story of the Puerto Rico tax credit and its aftermath illustrates the cat-and-mouse game that companies and the U.S. government play when Congress tries to close tax breaks. In this case, even bipartisan support did not stop companies from quickly finding a new legal way to avoid paying taxes.

SIMONE BARIBEAU/BLOOMBERG NEWS

Medtronic's heart device plant stands in Puerto Rico, but the company credits its income to a Cayman Islands mailbox.

"It is a cautionary tale," said Greg Ballentine, an economist with Charles River Associates, a consulting firm that advises companies on transfer pricing. "There is a very active and aggressive community of tax advisers out there, and they respond to whatever changes are made, congressional or regulatory. So the IRS is frequently several steps behind."

Puerto Rico became a haven for the manufacturing operations of U.S. companies in the 1960s, when the government used tax incentives to combat poverty and unemployment on the island, which now has about 4 million residents.

In 1976, Congress added a tax credit that effectively exempted from federal income taxes the profits that U.S. companies attributed to Puerto Rico. The combination of the break, proximity to the United States and plentiful industrial sites prompted multinational companies to flock to the island, with medical-device and pharmaceutical makers leading the way, including Pfizer, Eli Lilly and Merck.

Companies separately negotiated tax holidays from the Puerto Rican government to be largely exempt from the island's equivalent of a national corporate income tax, often paying at rates in the low- to mid-single digits.

By the mid-1990s, critics led by Rep. Bill Archer (R-Tex.), then the chairman of the House Ways and Means Committee, attacked the break as too expensive, costing the United States about $3 billion a year. In some industries, the tax subsidy was costing the United States as much as $72,000 per job, according to a study by the federal agency now called the Government Accountability Office. After a lobbying battle in 1996, the tax break was repealed, with a 10-year transition period for companies already benefiting from the credit.

"It pulled the rug from under our feet," said William Riefkohl of the Puerto Rico Manufacturers Association.

Archer, now a lobbyist for accounting firm PricewaterhouseCoopers, which represents multinationals on tax issues, said, "We were determined to let everybody know we were going to close corporate tax loopholes that clearly stood out as being appropriate for repeal."

The Joint Committee on Taxation projected that eliminating the break would raise close to $11 billion for the Treasury over the next decade.

"There was certainly an expectation the companies would react" after the repeal, said Daniel M. Berman, a deputy international tax counsel at the Treasury during the dispute over the tax break.

Berman was right. After losing the legislative fight, the tax-avoidance industry of accountants and lawyers sprung into action. While manufacturing facilities stayed in Puerto Rico, dozens of companies shifted the ownership of those assets to newly created subsidiaries in tax havens around the world.

Guidant, the medical-device maker once part of Eli Lilly and now owned by Boston Scientific, transferred assets formerly owned by its Puerto Rico subsidiary to a unit in the Netherlands, records show. Guidant says in its Tax Court filings that no taxes were due on the transfer of assets overseas and that intracompany royalties were priced properly. A spokeswoman for Boston Scientific, the second-biggest heart device maker, did not reply to requests for comment.

One leading strategist behind the new tax maneuvers was Ernest Aud Jr., a veteran international tax lawyer for accounting firm Ernst & Young in Chicago. Aud advised U.S. multinationals on how to turn the potential tax jam into an asset.

"I was probably the architect of a number of the early conversions," said Aud, now retired from Ernst & Young. "We were the ones that made companies aware that there was an opportunity — underscore 'opportunity' — to maybe do better under" the new arrangement than under the old Puerto Rico break.

Grand Cayman subsidiary

Among those seizing that opportunity was Medtronic. The corporation has grown from a medical repair shop founded by a Minneapolis engineer in his garage into the world's biggest maker of heart-rhythm equipment. It makes an array of other devices, including spinal technologies and insulin-delivery systems.

Dozens of pharmaceutical and medical-device makers that flocked to Puerto Rico, attracted by the various tax benefits. Medtronic opened its first factory in 1974 and expanded twice after that.

In August 2001 — about four years before the tax credit would disappear for good — Medtronic established a subsidiary in Grand Cayman, listing an address at an office now used by Intertrust Group, a corporate-services provider that helps firms establish shell subsidiaries in tax havens.

On paper, Medtronic transferred ownership of its Puerto Rican assets to this new Cayman unit, called Medtronic Puerto Rico Operations. The Cayman subsidiary is owned by a Dutch arm, which is in turn owned by a Swiss subsidiary, court filings show. In 2006, Medtronic transferred some of the Dutch company's assets to the unit in Zug, Switzerland, a popular destination for companies seeking Swiss tax holidays.

The Cayman entity also entered into an arrangement to pay royalties to the U.S. parent to use intellectual property and other rights covering devices it manufactures in Puerto Rico and then sells back into the United States. The IRS contends that Medtronic's Cayman unit underpaid for those rights, court papers show, shifting offshore income from U.S. sales. Taxes on such offshore profits are typically deferred indefinitely until the companies bring the earnings back to the United States.

Medtronic's tax rate has plummeted. In 1995, the year before congress abolished the Puerto Rico credit, the break cut 4.2 percentage points off the company's effective tax rate, helping to lower it to 33.5 percent. By 2011, Medtronic's tax rate was down to half that. Overall, the savings from the low-taxed overseas income boosted Medtronic's net income in fiscal 2011 by 30 percent, to $3.1 billion, based on tax disclosures in the company's most recent annual report.

The company has benefited from a "tax incentive grant" in Puerto Rico, according to the annual report, but does not disclose that rate. Owning its Puerto Rican assets through a Cayman shell company lets Medtronic move cash around the world without being subject to a Puerto Rican withholding tax, according to two people familiar with such structures.

As Shay put it, "The government underestimated how sophisticated and aggressive multinationals would be in shifting truckloads of profits out of the U.S."