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Rich Tax Breaks Bolster Makers of Video Games

By DAVID KOCIENIEWSKI

The United States government offers tax incentives to companies pursuing medical breakthroughs, urban redevelopment and alternatives to fossil fuels.

It also provides tax breaks for a company whose hit video game this year was the gory Dead Space 2, which challenges players to advance through an apocalyptic battlefield by killing space zombies.

Those tax incentives — a collection of deductions, write-offs and credits mostly devised for other industries in other eras — now make video game production one of the most highly subsidized businesses in the United States, says Calvin H. Johnson, who has worked at the Treasury Department and is now a tax professor at the University of Texas at Austin.

Because video game makers straddle the lines between software development, the entertainment industry and online retailing, they can combine tax breaks in ways that companies like Netflix and Adobe cannot. Video game developers receive such a rich assortment of incentives that even oil companies have questioned why the government should subsidize such a mature and profitable industry whose main contribution is to create amusing and sometimes antisocial entertainment.

For example, Electronic Arts of Redwood City, Calif., shipped more than two million copies of Dead Space 2 in the game's first week on the market this year. It shows a total of $1.2 billion in global profits the last five years using an accounting method that management says captures its operating profits.

But largely because of deferred revenue, deductions for executive stock options and a variety of accounting requirements, the company officially reports a net loss for the period. And the company reports that it paid out $98 million in cash for taxes worldwide in those years.

Neither corporations nor the government make tax returns public, and the information most companies disclose in their regulatory filings is insufficient to determine how much they pay in federal taxes and how that compares to the official United States corporate rate of 35 percent.

All told, the federal government gave $123 billion in tax incentives to corporations in 2010, according to the Joint Committee on Taxation, with breaks for groups and people as diverse as Nascar track owners, mohair producers, hedge fund managers, chicken farmers, automakers and oil companies.

Many tax policy analysts say the breaks for the video game industry — whose domestic sales of $15 billion a year now exceed those of the music business — are a vivid example of a tax system that defies common sense. Most times, subsidies begin as a way to nurture a fledgling industry that will not be profitable for years or to encourage a business activity deemed to have a broad benefit to society, like reducing pollution or improving public health.

But it’s a lot easier to create a tax break than to eliminate it. That leaves a generous assortment of tax incentives available to all types of companies, like Electronic Arts, with skilled accounting departments.

Electronic Arts has also lobbied successfully for more tax assistance. The architect of the company’s strategies in recent years was Glen A. Kohl, a tax lawyer colorful enough to publicly compare himself to Bruce Springsteen and to joke in the pages of The Wall Street Journal that his dog, Rubin, shared the name of the Treasury secretary under whom he served (Robert E. Rubin).

After working in the Treasury Department during the Clinton administration, Mr. Kohl entered the private sector and became head of E.A.’s tax department in 2004, leading the company as it aggressively lobbied for a federal tax break on domestic production and set up a matrix of offshore subsidiaries, many in low-tax countries.

As a result, the company with the defiant sales slogan, “Your Mom Hates Dead Space 2,” in effect gets financial help from moms and other United States taxpayers to reduce its federal tax bill.

Company officials say they have no qualms about taking all the tax breaks legally available to them. To do otherwise would be like a consumer “insisting on paying full price during a store sale,” wrote Jeff Brown, a company spokesman. Even E.A.’s competitors acknowledge that its tax strategies aren’t particularly aggressive compared with others in the industry.

Furthermore, Electronic Arts officials say that in recent years the company has paid a substantial portion of its profits in taxes, but declined to discuss details of its financial reports.

Several tax experts noted that one of the company's biggest tax advantages is a tool available to all companies, a deduction related to the stock gains on options exercised by its executives. (Tax practitioners also said that the company's losses, under generally accepted accounting principles, provided the most meaningful picture and reflected the standard approach used by other companies.)

Industry advocates say that without these incentives the United States would forfeit its technological edge — and the 32,000 direct jobs in the gaming industry — to countries like Canada, which offers video game developers even greater tax subsidies.

"Software and high-tech industries are the brain trust of the U.S.," said Shane T. Frank, chief operating officer of Alliantgroup, a consulting firm that helps video game companies and other businesses take advantage of the tax credit for research and development. "We can't afford to lose that knowledge and those high-paying jobs to India or anywhere else."

Trying to Lure Jobs

One reason Electronic Arts and other video game companies have a bounty of tax incentives that other industries envy is that elected officials from across the political spectrum find it hard to resist offering incentives to encourage technological research — and jobs.

When the tax code was rewritten in 1954 — nearly 20 years before the first commercially successful video game was released — Congress included a new break allowing companies to deduct all laboratory-based research and experimentation costs immediately. Part of the intention was to simplify the tax code. But with the cold war and nuclear arms race making Americans fearful that the country's technological edge was eroding, Daniel Reed, chairman of the House Ways and Means committee, also promised the tax break would indirectly bolster national security by stimulating "the search for new products and new inventions upon which the future economic and military strength of our nation depends."

In 1969, the I.R.S. expanded that tax break to allow companies to deduct the cost of software development, which was a small part of a business that was then dominated by bulky mainframe computers. When the video game industry sprouted in the early 1970s, game developers reaped substantial tax savings because most of their costs were for software development.

Electronic Arts, founded in 1982, has since become one of the world's dominant video game companies — producing popular titles like SimCity, FIFA soccer, Harry Potter and Madden NFL — and has benefited mightily from that tax incentive.

The company's software development costs — including salaries for the designers — have totaled nearly $6 billion over the last five years, and the company says it deducted all but a small amount of those expenses immediately. Companies that produce movies or compact discs, by contrast, face tighter restrictions which often require them to spread out the deduction on most production costs over a number of years. While video game makers have often compared themselves to movie companies when seeking tax incentives, the game developers' ability to write off the vast majority of their development costs immediately gives them a substantial financial advantage over other entertainment companies in taxes and cash flow.

Video game companies also get other research-related breaks. In 1981, as Americans worried that Japan's growing dominance in the auto business would be followed by a decline of the high-tech industry in the United States, Congress added another research and development credit, this time specifically for companies that increased their R.& D. spending from the previous year. The hope was that by encouraging companies to invest more in research, the private sector might create the next Bell Laboratories and inspire the kind of technological breakthroughs that benefit society as a whole.

Within a few years, the credit was being claimed by businesses with little technological background — fast-food restaurants, hair stylists and fashion designers. So Congress tried to restrict what research would qualify. The credit was denied for social science research and marketing. The narrowest definition, proposed by the Clinton administration, was to allow the credit only for research that produced an actual innovation, but that measure met determined opposition from business lobbyists. By the time the Treasury Department ruled in 2002, an appointee of President George W. Bush decided to drop it.

"It seemed as though it would be impossible to enforce," said Pamela F. Olson, then the assistant secretary for tax policy, and now a tax lawyer at Skadden, Arps, Slate, Meagher & Flom. "Because you couldn't be certain that someone wouldn't come back later and challenge things, by saying that what seemed like an innovation at the time had actually been discovered before."

The failed attempts to restrict the R.& D. credit to basic research have been a boon for video game companies. Even when companies are merely creating new versions of existing games — conducting research that would have little value to anyone but themselves — their development processes usually involve enough experimental uncertainty to qualify for the tax break.

During the last five years, Electronic Arts has claimed tens of millions in tax savings from research and development credits for its various games, according to the company's regulatory filings. (Company officials declined to specify how much of that total came from the federal government.)

At the same time, the I.R.S. and the United States Tax Court have denied the credit for some projects that would have benefited the community as well as the companies receiving it. In 2009, for instance, the federal tax court denied Union Carbide's attempt to claim a research and development credit for its project to reduce the pollutants released from the smokestacks of a refinery in Louisiana. Union Carbide failed to meet the experimental threshold for the credit, though video game makers often seem to have little trouble meeting the requirement.

Video game industry officials say that by improving technology, they are indirectly helping society at large.

Dean Zerbe, national managing director at Alliantgroup, said that the military had used some video game technology to train soldiers and pilots. Electronic Arts said it donated some games to the military, schools and charities.

Even those who support subsidies for technological research complain that the current research and development credit is woefully designed — favoring big companies over start-ups and often subsidizing businesses for research they would have done anyway.

Michael D. Rashkin, author of "Practical Guide to Research and Development Tax Incentives," said that the video game industry had failed to name a technological breakthrough that had helped anyone beyond its shareholders, employees or customers.

"The research credit benefits the wrong companies and encourages the wrong kind of research," said Mr. Rashkin, a tax expert and executive at Marvell Technology, a company based in Santa Clara, Calif. "By diverting funding and attention from where it could be most useful, the credit is hobbling American innovation."

Yet, given the sharp decline in American manufacturing jobs over the last half century, subsidies for research and development still have wide support. The Obama administration has proposed making the research and development tax credit permanent (it has been renewed every two years since 1981), and expanding it, at a cost of more than $100 billion over the next decade.

Looking for More

Electronic Arts has not been content to merely collect the many benefits from existing tax breaks. Mr. Kohl, who had an extensive background in mergers and acquisitions law, arrived at the company in 2004, the same year Congress passed a domestic production deduction that was intended to cut taxes on companies that export. When President George W. Bush signed the law in October, it listed an assortment of industries eligible for the break, including sound recordings and computer software, but did not specify video games.

Electronic Arts paid $60,000 early the next year to hire a prominent Washington tax lobbying firm. Soon after the law was signed, its lobbyist, Jonathan Talisman of Capitol Tax Partners, was granted a meeting with the Treasury Department’s deputy assistant secretary of tax policy — the same office Mr. Kohl once held — to ask that the deduction be extended to video game companies and the revenues they earned from online subscriptions. When the I.R.S. issued its final regulations, video games and their online revenues were specifically cited as qualifying for the deduction. That deduction last year equaled 9 percent of its production costs, offering E.A. significant tax savings.

Company officials point out that the deduction is available to a wide range of industries. “The credit is not specific to video games,” said Mr. Brown, the spokesman. “It’s designed to encourage any domestic manufacturing in the United States — from soft drinks to steel, to movies, music and newspapers.” During Mr. Kohl’s seven years at the company, Electronic Arts also became more aggressive about assigning its intellectual property offshore, a move that often reduces a company’s tax bill. Mr. Kohl, who declined to be interviewed, is now running the tax department at Amazon, which is leading the legal battle by Internet retailers who want to avoid collecting state sales taxes from customers.

In 2003, before joining Electronic Arts, Mr. Kohl co-authored a widely-cited proposal urging the federal government to crack down on corporate tax avoidance, warning that “the tax shelter problem is simply too detrimental to the tax system not to act.” As head of tax at Electronic Arts, he became a noted expert in using foreign subsidiaries to legally, and sharply, cut a corporation’s United States tax bill. As a co-chairman of the Silicon Valley Tax Directors Group, he also moderated a seminar in 2010 that showed technology companies how to use offshore subsidiaries to reassign the licensing of their intellectual property and, in some cases, reduce their effective federal tax rate substantially from 35 percent.

Electronic Arts has more than 50 overseas subsidiaries, according to its recent regulatory filings, many in low-tax countries like Bermuda, Singapore and Mauritius. The company has also accumulated more than $1.3 billion in profits offshore, where it will not be taxed by the United States unless it is brought back into the country.

Company officials say its overseas activities are not an attempt to avoid United States taxes and instead reflect how much of its business takes place in other countries. “E.A. is a global company with a majority of our customers and roughly 50 percent of our revenue generated outside of the United States,” Mr. Brown said. “Naturally we hire, build facilities, copyright our trademarks, invest and pay taxes in countries outside of the U.S.”

Jockeying for Developers

As Congress and the Obama administration wrestle with the next round of budget cuts this fall, and a possible overhaul of the tax code, they will determine whether the types of subsidies offered to E.A. and other corporations are worth the billions in forgone revenue annually to the Treasury. While Britain and some nations in the European Union have been paring back their tax subsidies for game developers, Canada has been trying to lure them and their jobs from below the border. In 2008, Ontario paid one game company a subsidy of more than $321,000 for each job to relocate from the United States. More recently, Montreal persuaded the game company THQ to relocate 800 production jobs there, closing studios in New York and Phoenix, with a rich package of incentives.

E.A. has 750 employees in Montreal, where all video game companies receive a tax credit equal to 37.5 percent of their payroll, and has announced plans to hire more there. Over all, 4,500 of Electronic Arts’ 7,600 employees are in the United States.

There are signs that more tax breaks may be in store for game manufacturers. States have been offering an escalating collection of incentives to try to attract the companies — more than 20 states now offer video game developers tax breaks to cover their wages, development and manufacturing costs.

Several recent studies have raised doubts about the effectiveness of subsidies offered by state and local governments, and Michigan this year reduced its breaks for game developers. But Texas officials say its tax breaks for game developers are more beneficial than those given other businesses, in part because the average salaries in the industry exceed $80,000 a year.

Game developers are pushing for more. John S. Riccitiello, the chief executive of Electronic Arts, was among the business leaders who successfully lobbied the City of San Francisco to drop its payroll tax last year to help retain social media companies like Zynga, maker of

FarmVille and other games. The video game industry's trade group, the Entertainment Software Association, this year recruited 39 members of Congress to form the E-caucus, which will advocate for legislation to benefit game developers. Representative Kevin Brady, a Republican from Texas who sits on the tax-writing Ways and Means Committee, said that the caucus has not asked for tax breaks.

But industry officials say they eventually hope to persuade Congress to make video game companies eligible for the federal tax breaks now available to film and television producers. Michael D. Gallagher, chief executive of the software group, said that the industry would not push for the breaks now, given the nation's budget problems, but might do so later.

"It certainly is a worthwhile policy goal," Mr. Gallagher said.