Bending the Tax Code, and Lifting A.I.G.'s Profit

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Last week, the American International Group reported a whopping $19.8 billion profit for its fourth quarter. It was a quite a feat for a company that was on its death bed just a little over three years ago, so sick that it needed a huge taxpayer bailout.

But if you dug into the numbers, it quickly became clear that $17.7 billion of that profit was pure fantasy — a tax benefit, er, gift, from the United States government. The company made only $1.6 billion during the quarter from actual operations. Yet A.I.G. not only received a tax benefit, it is unlikely to pay a cent of taxes this year, nor by some estimates, for at least a decade.

The tax benefit is notable for more than simply its size. It is the result of a rule that the Treasury unilaterally bent for A.I.G. and several other hobbled companies in 2008 that has largely been overlooked.

This rule-twisting could deprive the government of tens of billions of dollars, assuming the firm remains profitable. The tax dodge — and let's be honest, that's what it is — also will most likely help goose the bonuses of A.I.G.'s employees, some of whom helped create many of the problems that led to its role in the financial crisis.

"We suggest that Congress give its members standing to challenge such manipulation in court," J. Mark Ramseyer, a Harvard professor, and Eric B. Rasmusen, a professor at Indiana University, wrote in a paper last year. The paper provocatively asked: "Can the Treasury Exempt Its Own Companies From Tax?" (While the paper addressed A.I.G, it focused on the tax treatment bestowed on another bailout recipient, General Motors. Citigroup, Fannie Mae and Freddie Mac also received similar treatment.)

Here's the back story: A.I.G.'s tax benefit comes in large part from its immense "net operating losses" during its depths of despair in 2008 before its rescue. The government had to dump $182 billion into the company after it was crippled by bad bets it had made insuring mortgage-backed securities.

The tax benefit comes in the form of something called net operating losses — NOLs in Wall Street parlance — that could be worth more than $25 billion, possibly more. Those losses can be very valuable, in part because companies can spread them over many years to lower or wipe out their income tax bills.

However, according to longstanding tax laws, if a company files for bankruptcy or is taken over, it loses the ability to use its net operating losses. A.I.G. would fit that profile perfectly: on the verge of bankruptcy, the federal government took control of A.I.G., exchanging its bailout billions for shares in the company. The government — taxpayers — still own 77 percent of the company, down from 92 percent three years ago.

Still, the Treasury issued “notices” exempting A.I.G. from losing its right to make use of its net operating losses. In total, the insurer estimated that those losses were worth $26.2 billion as of 2009, and it claimed almost $9 billion in other “unrealized loss on investments.”

Analysts at Bank of America and JPMorgan Chase last year estimated that the tax benefits from the losses propped up A.I.G. stock by $5 to $6 a share. Its shares closed at $28.66 on Monday, just shy of the $29 mark that the government says it needs to sell its shares to break even.

A.I.G. believes that these losses are so valuable that it has a poison pill to bar a corporate takeover.

All of this brings us to the inevitable questions: How did this happen? Why would Treasury exempt A.I.G. from the law? And if taxpayers own a majority of A.I.G., aren’t we the beneficiaries of the rule-bending?

A Treasury spokeswoman declined to comment, as did a spokesman for A.I.G.

However, senior Treasury officials said privately that they had exempted A.I.G. because they did not consider the rescue to be a traditional takeover. The original law preventing companies from using the losses after a takeover were intended to prevent corporations from buying failing companies with lots of losses simply for the tax benefits.

Moreover, the officials said A.I.G.’s tax benefit would help taxpayers because it would raise the insurer’s share price. That may be true, but that assumes that the government is able to sell its shares and exit its investment. That’s still a big “if.” (Though I do bet it will eventually happen.)

The tax break for A.I.G. also perversely benefits employees who are paid based on the company’s performance and usually in stock, which is being lifted by this backdoor handout. The biggest beneficiary is Robert H. Benmosche, A.I.G.’s chief executive since 2009, who has been granted tens of thousands of shares.

In the meantime, the government — desperate to increase revenues — is missing an easy stream of guaranteed taxes from a company that taxpayers bailed out. Sure, the tax bill might hurt the price of A.I.G.’s stock price in the short term, but if Mr. Benmosche does his job right, the company won’t have to post fantasy profits.