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Earnings and cash flow growth through tax gimmicks: Figuring this out could make you money

Champion Enterprises, a manufactured home builder, stock went from about $3.00 to $16.00 between ‘03 and ’06. It received a $63.5 million tax refund in ’03, and didn’t pay federal income taxes from ’04 through the recent second quarter because of tax loss carry forwards. It recently announced on its second quarter conference call that it would now be reversing its tax valuation reserve, and would have to start paying taxes. Think about how much this affected the future earnings and cash flow models of analysts. The stock fell 20 % the day after earnings were announced, after falling about 40 % over the previous few months. It also missed its earnings estimates, but, I am sure the removal of the tax benefit (not paying) was part of the reason the stock remains down. Some fund managers told me they liked Champion because it improved its balance sheet between ’03 and ’05. The $63.5 million tax refund it received in ’03 certainly helped the company in its efforts to pay down debt, and improve its balance sheet.

Pool Corporation, which is based in Louisiana, was able to defer taxes in the second half of ’05, and the first half of ’06, because of legislation passed to help companies in the hurricane Katrina affected areas. It deferred $60 million in taxes during this period. You would never know that it not pay taxes during this period by just looking at its income statement, as the fact that it did not pay taxes during this period did not show up on is income statement, and only affected the cash taxes it was supposed to pay the IRS. It now has to pay $60 million in cash taxes in the third quarter.

Aaron Rents, a rent to own company, paid at an abnormally low percentage for cash taxes between ’02 and ’04 because of a tax deferral law called the “Job creation and workers assistance act of ’02. This made operating cash flow look better than reality than during this period. This law allowed for accelerated deprecation more than the normal rate to entice companies to make investments in capital equipment. This law was passed after 9 -11. Aaron Rents, which rents out furniture and appliances, was able to use the accelerated deprecation, not just on its property plant and equipment, but, for the products it rents as well, because of the nature of its business, and the fact it depreciates its rental products over 2 to 3 years. Its operating cash flow fell to negative $6.4 million in ’05, because it had to pay $51 million in taxes that it had deferred between ’02 and ’04. It now, this year is going to use the tax deferral benefit from Katrina because it has 120 offices in the hurricane Katrina affected area. Aaron Rents added almost $900 K to earnings in the recent second quarter because the state of Texas made a change to its tax code.

AMN Healthcare, a travel nurse company, has paid almost no cash taxes this year because of tax loss carry forwards it obtained when it acquired a company in the fourth quarter of last year.

The above examples show how companies can add to both earnings and cash flow using many assorted different tax gimmicks. But, at some point in time all of these cash flow and earnings additives will end, as was shown very clearly with the situation at Champion Enterprises. According to estimates, the number of lobbyists in Washington has doubled since 2000. We can see what they have been up to by looking at the tax breaks they have delivered. One thing is clear though, eventually someone is going to look at these various tax breaks that were given during a time when spending on the Iraq war has been over $300 billion by some estimates, and budget deficits have been staggering every year, over the last several years. It would behoove investors to try to figure out the point in time when these tax breaks can no longer be used by companies. That would be a good time to short a stock wouldn't it?