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JACKPOT TAX AVOIDANCE:
HOW ONE LOTTERY COMPANY HIDES ITS BILLIONS

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DURBAN, South Africa—In line at a downtown convenience store, Helen Dlamini waits to pay for 10 slices of house-brand baloney and a half-liter of milk. It's a waste of money to buy just half a liter, but she doesn't have an icebox. Her employer gave her a mini fridge, but it broke and Dlamini now uses the appliance as a cupboard. A domestic laborer, she earns about 3,900 Rand ($300) per month.

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Dlamini reaches the register and begins counting out coins from her worn pocketbook. A R10 bill is visible inside its beaten pleather. That money, she says, belongs to "u-lotto."

She has never won any money playing the South African lottery, but she calls the game her one shot at a "free ride." In exchange for a small amount of cash—R5 per ticket—players can indefinitely chase their get-rich-quick fantasies.

Like Dlamini, a majority of South African lottery players are poor. In 2010, nearly three-quarters of them earned less than R5,000 a month, and of those, 33 percent earned about R1,000 a month or less, according to a study of lottery participants conducted by the University of South Africa. More than 70 percent of players surveyed reported forgoing purchases of household necessities in order to have lotto money.

The research mirrors studies from the United States and Europe that suggest lotteries can amount to a regressive tax. In the U.S., where lottery tickets are heavily taxed, state-run lottery revenues often exceed corporate income taxes. In South Africa, the poor are sold on "a dream" that, in the words of the National Gambling Board, which oversees the country's gambling industry, is "consciously and perhaps irresponsibly manipulated" by the national lottery's aggressive advertising. Some of the revenue fills government coffers. But the companies involved get an arguably bigger jackpot: As of 2014, the global lottery industry was worth roughly $300 billion.

This gamble, though, may in fact be a swindle. While lotteries function essentially as a tax on poor citizens, some of the big companies that dominate the industry engage in aggressive tax avoidance to ensure they pay very little. GTech, a U.S.-based lottery titan that operates jackpots in 100 countries, has been the subject of controversies stretching back decades. Active in South Africa since 1999, it merged with another U.S. gaming giant, International Game Technology (IGT), in 2015. IGT is currently the main supplier of technology for Ithuba, the company that runs South Africa's lottery.

As part of the merger, it appears that GTech engaged in tax avoidance to slash its corporate tax rates in half and hide billions from the taxman. An exclusive analysis of public financial documents shows that the company has avoided hundreds of millions of dollars in taxes through these financial maneuvers.

GAMES OF CHANCE

Arguably the world's biggest lottery company, with annual revenues topping $6 billion, GTech, as part of its merger with IGT, used a tax avoidance technique called corporate inversion. This allowed the then-Delaware-based company and its Italian parent, GTech S.p.A., to move their legal domiciles from the United States and Italy, two countries with comparatively high corporate tax rates, to the United Kingdom, where taxes are significantly lower. Under the law, all corporate entities, including the U.S. and Italian companies, are now considered subsidiaries of their new U.K.-based parent. As part of the merger, GTech also changed its name to IGT.

Despite this on-paper move, more than half of the combined company's real economic activity remains in the United States, according to company disclosures filed with the U.S. Securities and Exchange Commission (SEC). As of 2016, about 9,500 of the company's employees worked in the United States and approximately 1,000 in Italy, compared with 813 personnel who were located around the world in countries such as South Africa.

IGT PLC, the U.K. parent, was formed as a holding company in June 2014, public records

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show. Prior to the merger, IGT PLC did not conduct any meaningful business beyond activities related to acquiring the American and Italian entities. This suggests the parent company may have been created solely to facilitate the inversion and to reshuffle earnings to lower tax jurisdictions.

The move helped slash the company's tax rates in half: The United States has a 35 percent corporate tax rate and Italy has a 31.4 percent rate. In contrast, the United Kingdom's rate is 19 percent. By 2020, the nominal tax rates in the U.K., well-known for its "light" financial touch, will decline to 17 percent.

IGT's inversion is complemented by another tax loophole: It has parked much of its earnings in "offshore" accounts. By December 2016, the last year for which financial reports are available, the company held more than $2 billion in undistributed offshore earnings. Prior to the merger, Nevada-based IGT had just $202 million offshore, indicating that the bulk of the combined company's offshore money came from GTech.

In order to shield this money from taxes, IGT has cited the challenges of calculating how much it owes. In its 2016 annual report, the company said complexities in tax laws meant estimating deferred—or still to be paid—taxes was "not practicable," as some jurisdictions levied no tax and others had more complex laws.

Through a combination of the lower national tax rates and the ability to shield offshore earnings from disclosures, GTech has avoided paying between $600 million and $700 million in taxes that would otherwise have been remitted to the U.S. and Italian governments. In 2016, IGT paid a tax rate of 18 percent.

To remain offshore in a technically legal way, the company must claim that its profits are being actively used by the business and aren't simply sitting in holding companies, passively receiving earnings. But the lack of country-by-country reporting to show where business activity takes place, in combination with the use of tax havens, enables companies to withhold monies offshore indefinitely.

One example of the company's offshore holdings is IGT subsidiary, IGT Global Services Limited. In 2013, just before the merger, the Cyprus-based company held assets of nearly $600 million while serving as a holding entity for more than a dozen subsidiaries. These subsidiaries, in countries such as India, the U.K., Colombia, and Spain, paid fees for use of IGT lottery technology and other purposes. This revenue, totaling $200 million in 2013, qualified as offshore earnings and was therefore potentially shielded from tax.

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In response to questions sent to IGT's legal counsel, Neil Abrams, spokeswoman Angela Wiczek wrote, "IGT complies with applicable laws in the U.S., U.K., and in every other jurisdiction in which we operate around the world. IGT holds over 400 gaming licenses worldwide ... and is scrutinised by gaming regulators around the world."

She said that undistributed (offshore) income belonged to former parent GTech S.p.A. and that after the merger, "Italian earnings were necessarily included" in that amount. Wiczek declined to answer other questions because she said they involved confidential information.

OLD HABITS DIE HARD

IGT is no stranger to controversy. Its practice of intra-company trade—or transactions among subsidiaries—has drawn legal scrutiny before.

In 2014, a senior employee who was responsible for evaluating the company's hardware pricing methodology formally disclosed to his supervisors that IGT was artificially inflating the costs of refurbishing parts traded within the company and its subsidiaries. Inflating costs through subsidiaries of the same parent company is a common tax avoidance trick used to reduce pre-tax profits.

The whistleblower expressed concerns that the inflated costs "could result in inaccuracies in IGT's financial statements," according to SEC documents. After filing an internal grievance on the company's hotline in August 2014 and notifying the SEC the following day, the whistleblower was removed from a project involving costs savings analysis and fired shortly thereafter.

SEC records show that the whistleblower—whose name was not disclosed in SEC filings for his protection—had been repeatedly assessed by IGT as a top-performing employee with vice-president-level potential. At the time of his firing, he had been scheduled to receive a special retention bonus.

An internal investigation by IGT found that the accounting model used was appropriate, "and did not cause its reported financial statements to be distorted because IGT had a process to reconcile" estimated costs with actual costs.

The SEC did not rule on the alleged intra-company transfer mispricing. But a 2016 SEC judgement held that IGT had unlawfully fired the whistleblower and ordered the company to pay a $500,000 fine. It was the first time the SEC had focused on retaliation against a whistleblower as a standalone issue.

Years earlier, in 2004, GTech shareholders brought a class-action suit against the company in U.S. court for concealing technological glitches in the software they said had cost U.K. partner company Camelot its license to operate in that country. Instead of disclosing the situation to its investors, the company boasted about booming revenue, the plaintiffs said. The case resulted in a settlement of more than $10 million.

The scandal followed other alleged misdeeds that extended to GTech's co-founder, Guy Snowden. In 1998, Snowden was forced to resign after losing a libel case brought against him by Virgin founder Richard Branson. Branson had accused Snowden of attempting to bribe him into withdrawing Virgin's bid for the U.K.'s lottery license. When Snowden denied the claim, Branson then accused the GTech co-founder of libel for calling him a liar.

But one scandal is particularly instructive. In 2014, the year before GTech's merger with IGT was completed, the former agreed to pay a penalty of more than $40 million to the Italian authorities. The fine had been levied over charges of alleged tax evasion and price manipulation in intra-company trade that occurred during a previous merger in 2006, between GTech and its buyer, Italy-based Lottomatica.

In a press release, GTech said it had agreed to the fine because of "the lengthy legal process to resolve such controversies, the related costs that further disputes would create, and the uncertainty of their outcomes." Resolving the case appeared central to the 2015 merger's success.

MISSING PROFITS

Corporate inversions are a paperwork game: Little changes about a company's operations in practice. But the process creates an anti-competitive economy where big companies are uniquely advantaged to shift their profit to low-tax jurisdictions and escape taxation. The arrangement bleeds governments of revenue and hurts smaller businesses that cannot move their profits abroad.

There are no easy fixes. Donald Trump's administration has proposed a territorial tax system where domestic corporations pay U.S.

tax only on domestic income. In recent years more countries have adopted this approach, which some economists argue would slow the diversion of profits abroad and generate growth within the United States. But a territorial tax system would still incentivize companies to artificially move earnings to offshore or lower tax jurisdictions.

Currently, American companies hold an estimated $2.6 trillion in profits overseas.

The Trump administration is also seeking to cut corporate tax rates, which it argues would lure undistributed offshore earnings back to the U.S. and dissuade companies from inverting. But studies suggest this won't have the desired effect because corporations will continue "jurisdiction shopping" for strategically placed subsidiaries. Lowering corporate taxes has "the effect of reducing tax rates on the wealthy and increasing tax rates on the poor," said the Tax Justice Network, a London-based advocacy that fights tax evasion.

Banning the use of tax havens would be politically difficult, meanwhile, as their protectors are often dominant economies such as the U.K., whose overseas territories include the British Virgin Islands, the Cayman Islands, and Bermuda. The United States territory of Puerto Rico and the state of Delaware, where GTech was previously incorporated, are considered tax havens.

Perhaps the biggest enabler of inversions is the opacity surrounding corporate dealings. Companies are not required to report country-by-country data on their revenues, management, labor, markets, or asset performance. Under current laws established by the International Accounting Standards Board, companies must only disclose minimal information that is aggregated or project level. This allows businesses to shield the value of trade or services between subsidiaries of the same parent company.

The Organization for Economic Cooperation and Development (OECD) has proposed a so-called "base erosion and profit shifting" initiative to curb tax avoidance. But this scheme would require multinationals to file disaggregated information only in the country where the parent company is based. Little information on subsidiaries would be shared and the data wouldn't be collated and analyzed. This would continue to leave many governments and citizens in the dark.

Unless companies are required to disclose disaggregated data—which they already assemble for internal auditing purposes and furnish to shareholders—revenue agencies will have to run twice as fast simply to stay in place.

"ROUND AND ROUND"

As companies like IGT make use of tax havens, a shrinking share of their taxes goes to the countries where they operate. Last year, IGT paid only $20 million in taxes to countries outside the United States, such as South Africa. It meanwhile deferred $148 million in taxes that year through its financial games. But the source of the company's revenue—customers, most of them poor, buying lotto tickets in the hope of beating infinitesimal odds—shows no sign of shrinking.

> **CORPORATE INVERSIONS ARE A PAPERWORK GAME: LITTLE CHANGES ABOUT A COMPANY'S OPERATIONS IN PRACTICE.**

In Durban, Imtiaz, a shopkeeper at a local mini-grocery store, says lottery players like Dlamini keep returning. He estimates that at least half of the domestic workers in the area buy tickets when they visit his shop. "Like the carousel rides, they get a ring, and the whole thing keeps going," he says, shrugging his shoulders. "Round and round."

Imtiaz keeps the bright yellow lotto box beside the cash register, visible to anyone who makes a purchase. On this day, it draws the attention of a customer buying a liter of Coke and a Lunch Bar, a South African chocolate. The woman starts searching the pockets of her pink overalls for money. She comes up short.

Imtiaz gives the woman a wan smile and tells her not to worry. There is always next time, he says. ●

Jeff Kelly Lowenstein, an assistant professor of Multimedia Journalism at Grand Valley State University, contributed reporting to this project.

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