

Issues in Corporate Tax Policy
For presentation at the House Ways and Means Committee Retreat
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1. Depreciation
 2. The Corporate AMT
 3. Corporate Accounting Issues
 4. Small Business Taxation and Entrepreneurship
 5. Future Issues
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1. Depreciation

- a. What are the principles behind depreciation
 - i. Neutrality
 - ii. Efficiency
 - iii. Equity

- b. Key issues:
 - i. How do tax lives compare to economic lives?
 - ii. Is equipment tax-disadvantaged?
 - iii. How significant are any distortions?

2. The Corporate AMT

- a. Role and significance of AMT has declined over time.

1987	\$3.35 billion (3.5% of tax after credits)
1990	\$8.10 billion (8.4% of tax after credits)
1998	\$3.32 billion (1.8% of tax after credits)

- b. Key issue: Should there be an AMT ?
 - i. Equity
 - ii. Efficiency
 - iii. No AMT or not this AMT?
 - iv. Do we measure corporate income properly?

3. Corporate Accounting Issues

a. Objectives of financial reporting

To provide information useful to investors and creditors in making investment and other decisions about firms.

b. Regulators and tax authorities are different from other external users

... although both taxing authorities and rate-making bodies often use the information in financial statements for their purposes, both have the statutory authority to require the specific information they need to fulfill their functions and do not need to rely on information provided to other groups. (Financial Accounting Standards Board, Statement of Accounting Concepts No. 1, Paragraph 26)

c. How can Tax Income differ from Financial (Book) Income?

- i. *Temporary differences* - caused by recognizing the same amount of income or expense over different periods
- ii. *Permanent differences* - caused by differences in scope

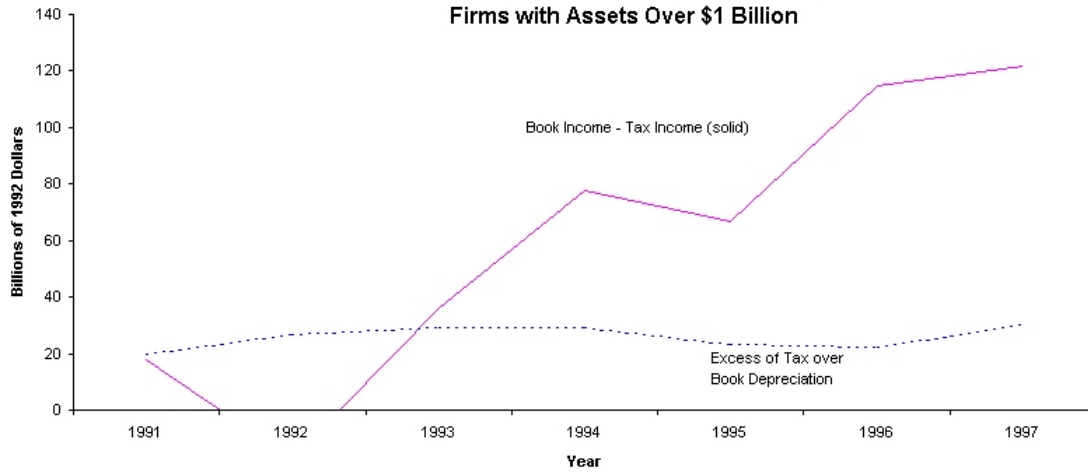
Transactions that	
increase book income relative to tax	increase tax income relative to book
Prior period prepayments	Prepayments received (such advanced rent or prepaid interest)
Tax exempt interest (permanent difference)	Book depreciation in excess of tax depreciation
Tax depreciation in excess of book depreciation	Travel and entertainment expenses in excess of deductible amounts
Compensation related to the exercise of non-qualified stock options (permanent, with tax payments made by individuals)	Reserves for warranty expenses

Differences in the amounts capitalized under each system contribute to current and later differences in the amount of income reported under each system.

d. How significant are the differences?

The recent growth in book-tax differences may be a return to historical levels rather than a recent development. The following two graphs, one from Treasury testimony, the other based upon my calculations, compare data from the 1970s to the 1990s.

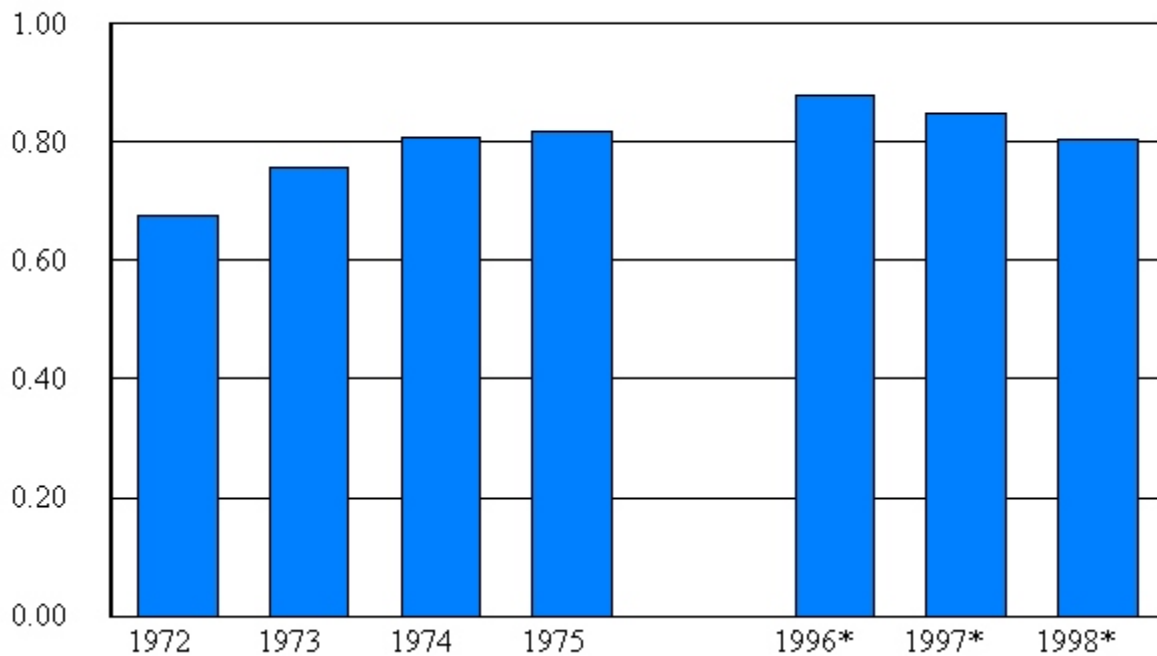
Figure 2.
The Difference Between Book and Tax Corporate Income
Firms with Assets Over \$1 Billion



Book Income = After-tax book income from Schedule M-1 + Federal taxes - tax exempt interest
 Tax Income = Total Receipts - Total Deductions
 Corporations excluding S corporations, RICs, REITs, and Foreign Corporations
 Source: Internal Revenue Service, Statistics of Income

Source: U.S. Treasury, testimony of Jonathan Talisman before the Senate Finance Committee, March 8, 2000.

Ratio of Tax Net Income to Pretax Book Income



Author's calculations. Periods may not be strictly comparable due to differences in the sample of firms.

4. Small Business Taxation and Entrepreneurship

- a. What is small?
- b. Are small firms tax-disadvantaged?
- c. Should small firms be given special advantages?
 - i. Are capital markets inefficient?
 - ii. Do small businesses produce external benefits?

5. Future Corporate Issues

- a. Financial innovations and aggressive tax-minimizing strategies
Distinctions between debt and equity are increasingly difficult to make, especially given innovations in financial instruments. Many tax minimization strategies (tax shelters) are facilitated by otherwise economically justifiable financial instruments. Further, there appears to be increasing emphasis on after-tax performance within firms, increasing the incentives of managers to reduce taxes.
- b. Broader integration and simplification for small firms
In an ALI Reporters' Study Yin and Shakow (1999) have proposed dramatic revisions to subchapters K and S. Their proposals would both simplify and extend pass-through rules.
- c. A fundamental reexamination of the corporate income tax
There are strong economic arguments for the integration of corporate and individual taxes. By itself, however, integration will not solve problems outlined here as a determination of taxable corporate income must still be made.

Related readings:

Corporate Accounting and Book-Tax Measurement Issues

Mackie, J.B., III, "The Comeback of the Corporate Income Tax," in *Proceedings of the Ninety-Second Annual Conference*, (Columbus: National Tax Association - Tax Institute of America, 2000), pp. 93-102..

Manzon, Gil. B., and George A. Plesko, "The Relation Between Financial and Tax Reporting Measures of Income," forthcoming, *Tax Law Review*, 2002.

Plesko, George A., "Book-tax Differences and the Measurement of Corporate Income," *Proceedings of the Ninety-Second Annual Conference*, (Columbus: National Tax Association - Tax Institute of America, 2000), pp. 171 - 176.

-----, "Evidence and Theory on Corporate Tax Shelters," *Proceedings of the Ninety-Second Annual Conference*, (Columbus: National Tax Association - Tax Institute of America, 2000), pp. 367 - 371.

-----, "An Evaluation of Alternative Measures of Corporate Tax Rates" working paper, MIT.

Small Business Taxation

Holtz-Eakin, Douglas, "Should Small Businesses be Tax-favored?" *National Tax Journal*, Vol. 48, No. 3, (September 1995), pp. 387 - 395.

Plesko, George A., "'Gimme Shelter:' Closely-Held Corporations Since the Tax Reform Act of 1986," *National Tax Journal*, Vol. 48, No. 3, (September 1995), pp. 409 - 416.

Yin, George K. and David J. Shakow (1999) American Law Institute, Federal Income Tax Project: Taxation of Private Business Enterprises – Reporters' Study. Summarized in volume 3 of JCT's "Study Of The Overall State Of The Federal Tax System And Recommendations For Simplification"

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