Issues in Corporate Tax Policy
For presentation at the House Ways and Means Committee Retreat
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George A. Plesko
Sloan School of Management, MIT

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

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


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 Yín 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**
-----, “An Evaluation of Alternative Measures of Corporate Tax Rates” working paper, MIT.

**Small Business Taxation**

**Contact information:**
George Plesko
E52-325
Sloan School of Management, MIT
50 Memorial Drive
Cambridge, MA 02142-1347
617-253-2668
gplesko@mit.edu