

Testimony before the House Committee on Ways and Means
Hearing on
“Interaction of Tax and Financial Accounting on Tax Reform”

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Chairman Camp, Ranking Member Levin, and distinguished members on the Committee, thank you for the opportunity to testify today on corporate tax reform and the interaction of tax and financial accounting.

I am the National Director of Ernst & Young LLP’s Quantitative Economics and Statistics practice. I was an economist at the U.S. Treasury’s Office of Tax Analysis from 1980 to 1990, during Treasury’s development of the 1984 tax reform proposal, the President’s 1985 tax reform proposal, and the enactment of the Tax Reform Act of 1986. I was the Director and Chief Economist of the Office of Tax Analysis between 1986 and 1990. Since 1990, I have worked on business tax policy issues at the federal, state and global level for both private and public sector clients.

I testified on corporate tax reform before the Ways and Means Select Revenue Measures Subcommittee in 2006, where I commented on the important effects of financial accounting on a variety of tax policy issues. Although I am not an accountant, I noted the importance of financial accounting rules when many corporate executives evaluate alternative tax reform proposals. Financial accounting considerations are one of the reasons why many economists view the effects of tax reforms differently than the business community. This has also led me to ask whether most current economic models might understate the potential benefits of a lower US corporate income tax rate.

Given the breadth of the topic of corporate tax reform, I will restrict my comments to the reasons why many corporations prefer a lower corporate tax rate to more targeted tax reductions. I will use the example of accelerated tax depreciation. Its repeal was proposed in combination with lowering the corporate tax rate by President Obama’s Fiscal Commission (Simpson-Bowles) and in Senator Wyden and Coats’ tax reform legislation. Moving toward economic depreciation has been used by many other countries to help partially finance their reduction in corporate tax rates.²

In 2005, President Bush’s Advisory Panel on Federal Tax Reform outlined a Growth and Investment Tax Plan for a business cash-flow tax—essentially an expensing proposal that

¹ Principal, Ernst & Young LLP. The views expressed in this testimony are my own, and do not necessarily reflect the views of Ernst & Young LLP or its clients.

² Michael P. Devereux, “Developments in the Taxation of Corporate Profit in the OECD Since 1965,” Oxford University Centre for Business Taxation, WP 07/04, December 2006. Nine of the 15 OECD countries studied that reduced their corporate tax rate between 1982 and 2004 also broadened their tax base by reducing the amount of accelerated depreciation.

allows for a first-year 100% write-off of capital investment.³ One might have expected that this plan—which many economists claim results in a zero effective tax rate for new capital investment—would have received strong support from the business community, but it did not.

Why the tepid response from the corporate community? Several years ago, the Tax Council Policy Institute asked multinational corporations to rank a range of alternative tax reform options. According to the survey, the clear favorite was lowering the corporate tax rate to 25 percent compared to other incremental or fundamental tax reforms.⁴

With economists and the business community differing in their response to the 2005 Advisory Panel's expensing option, many observers wonder why the disconnect. Here are seven reasons why many corporations may prefer a lower corporate tax rate to accelerated tax depreciation or other targeted tax incentives.

1. A lower corporate tax rate would lower corporations' financial statement effective tax rate and increase book net income for most corporations. Accelerated depreciation offers only a timing benefit, and doesn't reduce corporations' financial statement effective tax rate or increase reported book profits.

Most economists don't think reported book effective tax rates matter. Investors are assumed to be savvy enough to see that accelerated depreciation reduces current tax liability, which lowers the present value of current and future taxes, and thus increases the value of the firm. Timing of taxes matters and for a growing firm accelerated depreciation can offer lower taxes long into the future and for cash-constrained firms accelerated depreciation can provide important cash-flow benefits. Accelerated depreciation provides benefits similar to an unsecured zero-interest rate loan from the government.⁵ At today's historically low interest rates, the value of accelerated depreciation is relatively modest for corporations with access to the capital markets.

Many corporate tax executives focus on their cash tax liabilities and the net present value or internal rate of return when evaluating individual projects⁶, but many also factor in their reported financial statement effective tax rates and reported book earnings.⁷ Temporary book-tax differences, such as accelerated depreciation, do not affect the total

³ The President's Advisory Panel on Federal Tax Reform, Simple, Fair & Pro-Growth: Proposals to Fix America's Tax System, November 2005.

⁴ Tax Council Policy Institute, The U.S. International Tax Regime: Confronting the challenge of the Evolving Global Marketplace, February 10-11, 2005, Final Report, p. 90.

⁵ Tom Neubig, "Expensed Intangibles Have a Zero Effective Tax Rate...NOT!," *Tax Notes*, September 10, 2007

⁶ John Graham and Campbell Harvey, "How Do CFOs Make Capital Budgeting and Capital Structure Decisions," *Journal of Applied Corporate Finance*, Vol.15, No. 1, Spring 2002.

⁷ John R. Graham, Michelle Hanlon, and Terry Shevlin, "Real Effects of Accounting Rules: Evidence from Multinational Firms' Investment Location and Profit Repatriation Decisions," *Journal of Accounting Research*, Vol. 49, No. 1, March 2011.

financial statement effective tax rate, which is based on total tax expense (both current and deferred). Accelerated depreciation in the initial years reduces current tax expense while increasing deferred tax expense, but the total tax expense remains unchanged.

Thus, many corporate tax executives value permanent book-tax differences higher than temporary book-tax differences. They also value the permanent benefit of a lower corporate tax rate more than a temporary, cash-flow benefit.⁸ Reducing the corporate tax rate would immediately lower corporations' financial statement effective tax rates, thereby increasing their reported after-tax book profits.

A lower corporate marginal tax rate would also immediately reduce corporations' deferred book tax liabilities and assets—a welcome development for companies reporting deferred tax liabilities. In their 2010 financial statements, 31 of the top 50 US public corporations were in a net deferred tax liability position (19 were in a net deferred tax asset position).⁹ The 50 companies' total deferred tax liabilities were \$465 billion, compared to net deferred tax assets of \$396 billion (after valuation allowance). Accelerated depreciation accounted for almost half of the total deferred tax liabilities of the top 50 public companies.¹⁰

Corporations with a net US deferred tax liability position would have a double benefit from a lower US corporate tax rate: 1) a reduction in their financial statement effective tax rate on current earnings, plus 2) a reduction in their net deferred tax liability, both of which would result in higher reported book earnings. Many corporations with a deferred tax asset would favor a permanent lower future corporate tax rate on their future profits, even if there was a one-time adverse financial accounting effect in the year of enactment.

When Ohio enacted legislation phasing down its corporate income tax rate on June 30, 2005, a number of public corporations reported higher profits due to the future tax rate reductions in their 2005 second quarter financial results. Several of the top 50 US companies reported a reduction in their deferred tax assets due to the reduction in the United Kingdom corporate tax rate from 28% to 26% enacted in 2010.

⁸ Jesse Edgerton, "Investment, Accounting and the Saliency of the Corporate Income Tax," Federal Reserve Board of Governors Finance and Economics Discussion Series Staff working paper 2011-20. Edgerton finds that investment tax credits, which affect accounting profits, had more effect on investment than accelerated depreciation, which does not affect accounting profits.

⁹ Tom Neubig, Chester Abell and Morgan Cox, "DTAs, DTLs and Corporate Tax Rate Reduction," Tax Notes, July 25, 2011.

¹⁰ The 2010 findings are consistent with those of James M. Poterba, Nirupama S. Rao and Jeri K. Seidman, "Deferred Tax Positions and Incentives for Corporate Behavior Around Corporate Tax Changes," National Tax Journal, March 2011, 64 (1), pp. 27-58. They found that a sample of large corporations were in an overall net deferred tax liability (DTL) position every year from 1993 to 2004, a majority of the firms were in a net DTL position, and accelerated depreciation was the largest DTL.

2. A lower corporate tax rate would reduce the tax distortion on many margins of tax decision making, while accelerated depreciation or expensing reduces the tax distortion on only two margins.

Accelerated depreciation or expensing lowers the tax wedge on tangible capital investments, which can result in higher capital investment and higher wages for American workers. Expensing would also eliminate the wedge between some intangible assets that are expensed and other assets that are depreciated or amortized. Alternatively, with the same level of revenue, a lower corporate tax rate could lower the tax wedge and tax distortion across many different margins of business investment decisions.

A lower corporate tax rate would lower the tax wedge on tangible capital investments. In addition, a lower corporate tax rate would:

- Reduce the tax distortion between corporate capital, which is subject to tax at both the corporate and shareholder levels, and non-corporate capital, which is taxed once at the owners' individual income tax rate;
- Reduce the tax distortion between corporate debt, where interest is deductible, and corporate equity investment, where dividends and retained earnings are not deductible;
- Reduce taxable income shifting across jurisdictions due to the high US statutory tax rate relative to other countries' lower tax rates;
- Reduce the lock-in effect on corporate capital gain realizations and lock-out effect on repatriation of Controlled Foreign Corporations' foreign source earnings;
- Reduce the tax on corporate entrepreneurship and innovation; and
- Encourage foreign capital investment and economic activity in the United States.

A number of reports state that a territorial system of international taxation could put increased pressure on transfer pricing.¹¹ Transfer pricing and other tax arbitrage issues are important when marginal tax rates differ significantly across countries or types of activity.

After Japan's new legislation lowers its top corporate tax rate to 38.0% on April 1, 2012, the United States will have the highest top statutory corporate tax rate among the 50 largest economies, at 39.1%, including the average state income tax rate. The average top corporate tax rate for the other top 30 world economies, weighted by their Gross Domestic Product, is 29.5% in 2012. Our top 30 major trading partners' average corporate tax rate is 27.5%, weighted by total exports and imports. The average corporate tax rate in the top 30 economies where there is the most US foreign direct investment is 22.4%.

¹¹ 2005 President's Advisory Panel, p. 242. The President's Economic Recovery Advisory Board (PERAB), The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation, August 2010, p. 89-90.

These corporate tax rate differentials affect both taxable income shifting as well as the location of real economic activity and investment decisions.¹²

3. Permanent expensing of capital investment is unlikely to occur without a counterbalancing loss of interest deductibility. A lower corporate marginal tax rate could occur with continued interest deductibility.

A number of reports emphasize the necessity of combining permanent¹³ expensing with repeal of interest deductibility to prevent negative economic effective tax rates. “Allowing both expensing of new investments and an interest deduction would result in a net tax subsidy to new investment. Projects that would not be economical in a no-tax world might become viable just because of the tax subsidy. This would result in economic distortions and adversely impact economic activity.”¹⁴

In 1982, Congress scaled back accelerated depreciation as part of its deficit reduction efforts due to what were considered excessive tax benefits from combining an investment tax credit with both accelerated depreciation and interest deductibility. There were concerns about wasteful tax-driven investment expenditures, tax arbitrage and large revenue losses. The 1982 Tax Act was one of the key starting points for the 1986 Tax Reform process. The base broadening in 1982 enabled the lower individual income tax rate brackets to continue to be indexed for inflation while also reducing the deficit. It was clearly a trade-off between base-broadening versus lower tax rates, that was repeated in the 1984 Act as well as the 1986 Tax Reform Act, which further scaled back accelerated depreciation to the current Modified Accelerated Cost Recovery System and repealed the investment tax credit.

When comparing expensing versus a lower corporate tax rate, a more meaningful comparison would be permanent expensing without interest deductions versus a lower corporate tax rate with interest deductions. In that comparison, expensing would only help a small fraction of corporate investment: equity-financed tangible investments.

4. Corporations invest to earn above-normal returns, not just the “normal” or risk-free return. A lower corporate tax rate applies to the entire return to capital, while accelerated depreciation or expensing reduces the tax rate on only the risk-free return.

Economists distinguish between four different returns to investors:

- 1) a “normal” or risk-free return for deferring consumption, or a “return to waiting”;
- 2) an expected risk premium;

¹² Robert Carroll and Thomas Neubig, The Economic Benefits of Reducing the US Corporate Income Tax Rate, Ernst & Young LLP report, September 2011.

¹³ The combination of interest expense deductions with permanent expensing would cause greater economic distortions than with temporary investment tax incentives.

¹⁴ 2005 President’s Advisory Panel, p. 164. 2010 PERAB report, p. 71 and 73.

- 3) a return due to entrepreneurial skill, a unique idea, a patent or other specific factors; and
- 4) an unexpected return from good or bad luck where the actual return differs from the expected return.¹⁵

The 2005 Advisory Panel report stated “Removing the tax on the first component, the return to waiting, is the key to removing taxes from influencing savings and investment decisions.”¹⁶ Academic economists argue that in competitive markets businesses can only earn the “normal” or risk-free return to capital on their last (marginal) dollar of investment. They argue that anything earned above the risk-free return, the so-called “super-normal” return or “rent”, has no economic effects, even if taxed at high tax rates. An important caveat is that taxes on super-normal returns can affect the location of investment in a global economy. Companies don’t invest just to earn a risk-free return; they expect to earn returns to justify their risk-taking, specialized factors and competitive positioning.

Economic proponents of expensing point out that under a business cash flow tax profits above the risk-free return would be taxed. They argue that taxing “rents” is equivalent to a lump-sum tax. My colleague, Bob Cline, and I did an analysis of an Australian proposal for a 40% “super profits” tax on the mining industry.¹⁷ It included a new 40% cash-flow tax, with expensing of new capital investment, in addition to the Australian 30% corporate income tax. A report prepared for the government argued that since super profits have no economic effects and since minerals aren’t mobile, there would be no adverse economic effects. We pointed out that capital investment and the engineers are globally mobile, mineral extraction can be deferred until a future date, and companies care about their total tax burden, even on so-called “super profits”, so adverse short-term, medium-term and long-term effects should be expected. The Australian super profits tax proposal was eventually scaled back significantly.

While many economists focus on the “marginal” investment, e.g., the last laptop computer purchased, companies make investments that are large, discrete, finite, risky, and also include substantial entrepreneurial and innovative efforts. When entering a market or expanding existing operations, companies look at their total after-tax return. While a company might earn a risk-free return from the time-value of money from accelerating depreciation deductions, companies invest to earn significantly higher returns on their total investment. A lower corporate tax rate would reduce the tax on all corporate income—both the normal risk-free return income as well as the return to risk-taking, entrepreneurial skill and innovation.

¹⁵ William M. Gentry and R. Glenn Hubbard, “Distributional Implications of Introducing a Broad-Based Consumption Tax,” National Bureau of Economic Research Working Paper 5832, November 1996.

¹⁶ 2005 Advisory Panel, p. 150.

¹⁷ Thomas S. Neubig and Robert J. Cline, A critique of the economic theory and modeling underlying the Australian resource super profits tax proposal, Ernst & Young report, June 2010.

5. A lower corporate tax rate applies to all types of future income, while targeted incentives generally lower the cost of certain inputs.

Proposals for expensing would lower the economic effective tax rate for depreciable property, land and inventories. But, recent studies report that business investment in intangibles—research and development, copyrights, computerized databases, development of improved organization structures, and brand equity—is now as large as the spending on tangible capital.¹⁸ Many of these intangible assets have high rates of return, well in excess of a “normal”, risk-free rate of return, and in many cases can be developed in alternative locations within a global organization.

The current tax rules require the amortization of many intangible assets, but in some cases allow the equivalent of expensing through the deduction of wages in the creation of certain self-constructed intangible assets. In the case of certain intangible assets, such as advertising and research and development, expensing is allowed due to the lack of good information about the depreciable life and depreciation pattern of the intangible asset and the administrative issues that would otherwise be involved.

Expensing would benefit depreciable and capitalized investments, but would provide no incremental benefit to many intangible assets that are currently expensed. A lower corporate marginal tax rate, on the other hand, would benefit income from all tangible and intangible investments. Several European countries, most recently the United Kingdom, are moving to a lower corporate tax rate on certain types of intangible income (so-called patent box or intellectual property regimes), reflecting the power of a lower corporate tax rate on future income, even when those countries have other incentives, such as R&D tax credits or super-deductions, to lower the cost of the inputs.

6. Many companies would not receive the full benefit of expensing, and many have not used bonus depreciation.

Many companies would not benefit from the full effect of expensing, because expensing would create or add to tax losses for many companies. Unless the government provided immediate cash refunds, these companies would only realize a fraction of the potential benefits that expensing might offer.

Two recent studies by US Treasury Department economists report that between 2002 and 2009 many companies did not take advantage of the temporary bonus depreciation rules.¹⁹ Only 50% to 60% of C and S corporations used bonus depreciation for eligible investments, while only 30% to 40% of partnerships and sole proprietorships used bonus

¹⁸ Carol Corrado, Charles Hulten, and Daniel Sichel, “Intangible Capital and US Economic Growth,” *The Review of Income and Wealth*, 2009, 55:3, pp. 661-685.

¹⁹ John Kitchen and Matthew Knittel, “Business Use of Special Provisions for Accelerated Depreciation: Section 179 Expensing and Bonus Depreciation, 2002-2009,” mimeo, November 2011. Matthew Knittel, “Corporate Response to Accelerated Tax Depreciation: Bonus Depreciation for Tax Years 2002-2004,” US Department of the Treasury, Office of Tax Analysis Working Paper 98, May 2007.

depreciation for eligible investments. The use of Section 179 expensing ranged from 60% to 80%.

The study notes that many firms are in a tax net operating loss position or have loss carryforwards, which reduce the cash-flow tax benefits of bonus depreciation and expensing. In addition, 31 of the 47 states that impose a corporate income did not fully conform to the federal bonus depreciation provisions in 2010, which increased companies' compliance costs and reduced the total tax benefit. The study notes that while accelerated depreciation in theory reduces the cost of investment, "in practice various factors limit the use of bonus depreciation and its relative value".

7. A lower corporate tax rate reduces the value of financial statement deferred tax assets and liabilities. Expensing leaves large deferred tax liabilities that could be increased by future tax increases.

Economists' assertion that expensing creates a zero effective tax rate on the risk-free return only holds if tax rates remain unchanged over the life of the investment. If tax rates increase in the future, then the effective tax rate would be higher. If tax rates decreased in the future, then the economists' effective tax rate would fall below zero.

Expensing would create large deferred tax liabilities. Some economists might argue that these could later be taxed at higher rates without adverse economic effects since the investments had already been made. This is the same argument that many economists use for estimating the future economic benefits of moving to a consumption tax (either a value-added tax or business cash flow tax), since the shift can be financed by imposing taxes on old capital (existing investments), which they argue has no adverse economic effects.

Some economists argue against a reduction in the corporate tax rate since it would provide a "windfall" to "old capital". Accelerated depreciation has been cited as providing a bigger "bang-for-the-buck" than a lower corporate tax rate.²⁰ Instead, some economists propose focusing any favorable tax rules on "new" investment. Of course, most "new" investment is actually replacing depreciating "old" investment, rather than increasing the total capital stock. Attempting to limit favorable tax treatment to "incremental new" activity (e.g., R&D tax credit, new jobs tax credit) involves significant complexity, unintended consequences, and limited incentive effects. Business executives don't distinguish between "new" and "old" capital. Policy analysts haven't distinguished between "new" and "old" "human capital" when payroll or income tax rates are changed.

Lowering corporate income taxes will be beneficial to companies that have made "old" investments in the United States which are contributing to today's US jobs, as well as to

²⁰ U.S. Treasury Department, Office of Tax Policy, Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century, December 2007, p. 50. Treasury states that the United States has relatively generous depreciation allowances for equipment. "In the OECD, only Greece and Italy have more generous depreciation allowances." p. 9.

those same companies making future replacement and incremental new investments in the United States.

Conclusion

Financial statement accounting is one of several factors that influence business decision making, and is often not taken into account in some economists' proposals for tax reform and their modeling. The positive effects of a lower corporate income tax rate compared to the negative effects of corporate base broadening will be underestimated without understanding these other effects. These other effects include tax risk and uncertainty²¹, compliance burdens, and other non-income taxes that affect business decisions.

Fortunately, the tax accounting academic community is starting to weigh in on tax policy and the effects of financial accounting on business investment decisions. I know from my days at the Treasury Department how much potential damage a solo tax policy economist can do, without the benefit of working with good tax lawyers and knowledgeable industry and business executives. We need to add the benefit of tax accountants and even behavioral economists to fully capture the effect of the different types of incentives and responses to changes in tax policy.

These seven reasons help explain why many corporate executives have not stood up with many economists to support permanent expensing and business cash-flow tax proposals. It is why many corporations, but not all, would prefer a permanently lower corporate tax rate over accelerated depreciation. If accelerated depreciation were changed, it would be important for the US tax depreciation rules to be updated to reflect the economic realities of the 21st century.²²

Most of the corporate tax community would prefer to see the United States join other countries in significantly lowering its corporate income tax rate. How a lower corporate tax rate would be financed matters, but I hope that future modeling of US corporate tax reforms will take into account more of the benefits of a lower corporate tax rate.

That concludes my testimony. I would be happy to answer any questions about my testimony.

²¹ Ernst & Young, Tax risk and controversy survey: A new era of global risk and uncertainty, 2011.

²² Testimony of Thomas S. Neubig before the Senate Committee on Finance Subcommittee on Long-Term Growth and Debt Reduction, "Updating Depreciable Lives: Is There Salvage Value in the Current System?", July 21, 2005.