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## Introduction

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# INTRODUCTION

*Christopher H. Hanna\**

This issue of the SMU Law Review entitled *Time, Tax, and Money* contains a number of important articles and comments focusing on tax deferral and time value of money issues. The importance of this area cannot be overemphasized as timing and deferral issues cut across all areas of tax laws. Professor Daniel Halperin wrote a number of years ago, in his landmark time value of money article, that “[q]uestions of timing—such as the correct period for reporting income or claiming deductions—present some of the most critical and vexing issues in the design of an income tax.”<sup>1</sup> This statement seems just as timely today as it was when he wrote it in 1986.

First, in her article on implicit taxes,<sup>2</sup> Professor Charlotte Crane notes that virtually all investors will adjust the price they are willing to pay for an asset to take into account the value of the tax treatment they anticipate from holding the asset. For assets in limited supply, the value of the tax treatment of assets may therefore be capitalized into the price of the assets. This adjustment to the price of assets to account for tax effects is frequently referred to as an “implicit tax.” Although the tax policy literature has acknowledged the possibility of implicit taxes for some time, tax doctrine has failed to acknowledge this possibility. Tax doctrine, for instance, rather stubbornly insists that there is an abstract fair market value for every asset and that it is sensible to distinguish transactions in which there is a pre-tax profit from those in which there is no pre-tax profit. Tax doctrine also has a very difficult time distinguishing between the amount paid for an asset and the amount paid for the tax benefits associated with the asset. As a formal matter, the latter amount should not be included in the amount paid for the asset, and yet, as a practical matter, it cannot be distinguished from the rest of the purchase price.

Professor David Weisbach comments on Professor Crane’s article.<sup>3</sup> He makes two major comments. First, he discusses implicit taxes, expanding on some of Professor Crane’s arguments. Second, he discusses implicit taxes in the context of a pre-tax profit requirement for tax shelters.

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1. Daniel I. Halperin, *Interest in Disguise: Taxing the “Time Value of Money,”* 95 *YALE L.J.* 506 (1986).

2. Charlotte Crane, *Some Explicit Thinking About Implicit Taxes*, 52 *SMU L. REV.* 339 (1999).

3. David A. Weisbach, Comment, *Implications of Implicit Taxes*, 52 *SMU L. REV.* 373 (1999).

In the second article,<sup>4</sup> Professor Christopher Hanna attempts to clarify tax deferral by focusing on a fifty-year old model developed by Dr. Cary Brown. The model generally holds that immediately deducting the cost of an asset is equivalent to excluding from gross income the future annual return of the asset. The Cary Brown model has been discussed quite a lot in the academic literature in the last ten years. Professor Hanna argues, however, that one aspect of Dr. Brown's model has gone relatively unnoticed over the years. He discusses the "partnership" that takes place between the taxpayer and the government in a tax deferral situation. Understanding this partnership analogy removes much of the mystery surrounding tax deferral.

In his article focusing on the use of stock compensation,<sup>5</sup> Professor Calvin Johnson argues that corporations should not be using stock to compensate officers and employees. Corporate debt historically has had an after-tax, inflation-adjusted discount rate that hovers near zero. Corporate stock, however, has historically borne a very high discount rate. A high discount rate is brutal to the issuer because it is a cost to the corporation in the nature of interest. The interest-like payments, however, are not deductible. The high discount rate means that the issuer must pay out extraordinary amounts of cash to support the current value, and also the issuer is getting credit from its executives for a discounted present value that is an insubstantial fraction of the cash the issuer will eventually pay. The high discount rate also comes from causes, such as volatility of stock and distrust of management, that do not need to be imported into compensation. As a result, stock compensation is the least optimal way to pay future cash. The most plausible explanation of stock compensation is the fallacy that the future cash that will be shared with the new shareholders as dividends or redemption proceeds are free to the issuer. Employees may view the stock as recyclable paper, but the issuer's reasoning is even sillier because the issuer seems to think it is free.

In their article in the international tax arena,<sup>6</sup> Professors Robert Peroni and J. Clifton Fleming along with Stephen Shay take a serious look at ending deferral of United States income tax on foreign source income. They provide an exhaustive analysis of the deferral incentive and the history of the anti-deferral provisions in U.S. income tax laws. They propose treating foreign corporations as pass-through entities with respect to U.S. persons holding stock in such corporations, with special rules for less than 10% shareholders in a non-U.S. controlled foreign corporation. Peroni, Fleming, and Shay discuss the soundness of their proposal and why it is superior to other anti-deferral proposals. They admit that there are difficult transition rules involved with their proposal, but they believe it satis-

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4. Christopher H. Hanna, *Demystifying Tax Deferral*, 52 SMU L. REV. 383 (1999).

5. Calvin H. Johnson, *Stock Compensation: The Most Expensive Way To Pay Future Cash*, 52 SMU L. REV. 423 (1999).

6. Robert J. Peroni, J. Clifton Fleming, and Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999).

fies the optimum criteria for designing an appropriate anti-deferral regime.

Professor Reuven Avi-Yonah comments on the proposal put forth by Peroni, Fleming, and Shay.<sup>7</sup> He focuses on three issues: (1) the merits of ending deferral from an efficiency, equity, and administrative perspective; (2) the recent developments at the Organization for Economic Co-operation and Development (OECD) regarding deferral; and (3) the expansion of the passive foreign investment company (PFIC) regime to all foreign corporations as proposed by Peroni, Fleming, and Shay.

Professor Yoshihiro Masui also comments on the proposal put forth by Peroni, Fleming, and Shay.<sup>8</sup> He contrasts their proposal with the present Japanese anti-tax haven measure. In addition, he focuses on three issues: (1) compromise of criteria; (2) simplification; and (3) international repercussion.

Professor Jeff Strnad discusses the theoretically ideal tax depreciation under an accretion tax.<sup>9</sup> He notes that economic depreciation meets this ideal. In pursuing this objective, he states that if the age-price profile for surviving units is known for a particular asset and the goal is to replicate economic depreciation, then the tax depreciation schedule should be based on the age-price profile for surviving assets. This schedule should not be adjusted for retirement risk. If, however, the objective is to accelerate depreciation in a way that is neutral across assets, then the depreciation schedule must take retirement risk into account. Professor Strnad also discusses the situation when the age-price profile is uncertain, noting that replicating economic depreciation is more complex. In this latter scenario, strategic loss-taking becomes an important consideration.

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7. Reuven S. Avi-Yonah, Comment, *Comment on Peroni, Fleming and Shay "Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 531 (1999).

8. Yoshihiro Masui, Comment, *A Japanese View*, 52 SMU L. REV. 541 (1999).

9. Jeff Strnad, *Tax Depreciation and Risk*, 52 SMU L. REV. 547 (1999).



# Articles

