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## Corporate Tax Reform: Listening to Corporate America

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# Corporate Tax Reform: Listening to Corporate America

Christopher H. Hanna\*

I. INTRODUCTION .....	284
II. BACKGROUND ON FINANCIAL INCOME .....	286
<i>A. General Principles</i> .....	286
<i>B. The Focus of Corporate Management</i> .....	289
III. VARIOUS TYPES OF CORPORATE TAX PREFERENCES .....	292
<i>A. Expensing and Accelerated Depreciation</i> .....	293
<i>B. Deductions with No Economic Outlay</i> .....	294
<i>C. Exclusions from Gross Income</i> .....	295
<i>D. Tax Credits</i> .....	296
<i>E. Deferral of Income</i> .....	298
IV. THE EFFECTIVENESS OF CORPORATE TAX PREFERENCES .....	303
<i>A. In General</i> .....	303
<i>B. Accelerated Depreciation, Manufacturing Deduction and Research Credit</i> ....	304
<i>C. Tax-Exempt Interest</i> .....	308
<i>D. Deferral of Income and APB 23</i> .....	308
V. CORPORATE TAX RATE CUT .....	309
VI. GENERAL REFLECTIONS ON VARIOUS TYPES OF CORPORATE TAX PREFERENCES .....	314
<i>A. In General</i> .....	314
<i>B. Permanent Differences Versus a Corporate Tax Rate Cut</i> .....	314
<i>C. Differences Among Permanent Differences</i> .....	316
<i>D. The Importance of Temporary Differences</i> .....	319
VII. PRINCIPLES FOR REFORM OF CORPORATE TAX PREFERENCES .....	322

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## VIII. CONCLUSION..... 324

## I. INTRODUCTION

On a typical hot and humid Washington summer day in 2004, representatives from a handful of America's leading manufacturing companies trekked to the Longworth House Office Building on Capitol Hill. On the second floor, the tax staffs of the Ways and Means Committee of the United States House of Representatives were hard at work on a huge tax bill that many in the business community believed was on the brink of enactment. The representatives walked the famed halls of the Longworth building, forever known as Gucci Gulch,<sup>1</sup> for a scheduled meeting with the tax staffs with one goal in mind: to try and prevent Congress from enacting a corporate tax rate cut for American manufacturing companies. The representatives knew that almost all public corporations in the United States desired a corporate tax rate cut. In fact, it was probably the single most desired tax item of Corporate America. However, the representatives also knew that of critical importance to public corporations were their quarterly (and annual) income statements. A corporate tax rate cut would cause a small group of manufacturing companies, on behalf of which the representatives were lobbying, to take an immediate charge (or "hit") to earnings—thereby reporting lower quarterly net income and lower earnings per share (EPS).<sup>2</sup> So even though a rate cut would benefit these manufacturing companies in future years, a current charge to earnings was unacceptable to this small but influential group of manufacturing companies.<sup>3</sup>

The representatives of the manufacturing companies asked the tax staffs to enact a tax benefit for American manufacturing companies in the form of a new deduction rather than a corporate tax rate cut, in the same manner that the Finance Committee of the United States Senate did in its tax bill.<sup>4</sup> And if the Ways and Means Committee consented to the tax benefit in the form of a deduction, the representatives requested that the deduction not look like a tax rate cut. If the manufacturing deduction looked too much like a rate cut, the Financial Accounting Standards Board (FASB) would likely treat it as such for Generally Accepted Accounting Principles (GAAP), and the companies would still have to reduce earnings and EPS. The tax staffs understood the request and conveyed it to the leading members of the Ways and Means Committee. In October 2004, the leading members of the Ways and Means Committee and the Senate Finance Committee

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1. JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH 4 (1987) ("Gucci Gulch" refers to the Capitol corridors where the lobbyists, wearing their expensive suits and shiny Italian shoes, mingle with the members of the tax-writing committees.).

2. As explained in detail below, these manufacturing companies were in a net deferred tax asset position. A corporate tax rate cut would require these companies to revalue their net deferred tax assets, resulting in a decrease in net income. In contrast, companies in a net deferred tax liability position stood to benefit immediately from a corporate tax rate cut. *See infra* Part V.

3. *See, e.g.,* Lillian F. Mills, *Five Things Economists and Lawyers Can Learn from Accountants: An Illustration Using the Domestic Production Activities Deduction*, 59 NAT'L TAX J. 585, 592 (2006) ("To recap, publicly traded corporations care about book income and are likely to lobby to avoid losses and increase income. Because rate changes affect deferred tax assets and liabilities, rate changes affect corporate income immediately.").

4. Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong., § 102 (2003).

convened. As part of their conference agreement, the Ways and Means Committee members agreed to the Senate Finance Committee's approach: enactment of a new manufacturing deduction, rather than a tax rate cut, coupled with a number of requirements that must be met in an attempt to avoid having the deduction viewed as a tax rate cut by FASB.

On October 22, 2004, President George W. Bush signed the American Jobs Creation Act of 2004 into law.<sup>5</sup> One of the centerpieces of the legislation was the new deduction designed specifically to benefit American manufacturing companies.<sup>6</sup> At that point, the representatives of the manufacturing companies had achieved half of their objective. Almost two months later, on December 21, 2004, they achieved the second half of their objective. FASB issued a staff position in which the FASB staff commented that the manufacturing deduction should not be treated as a tax rate cut, but rather as a special deduction for GAAP purposes.<sup>7</sup>

In the last few years, academics, practitioners, and government officials have engaged in serious discussions about reforming the U.S. corporate income tax system.<sup>8</sup> Some, if not much, of the discussion has focused on maintaining the competitiveness of U.S. corporations in a global economy.<sup>9</sup> As a result, some have argued that the United States needs to reduce its top corporate tax rate from 35%, which is currently among the highest of the 30 Organization for Economic Cooperation and Development (OECD) countries, to a rate around 30% or even lower.<sup>10</sup> Others have maintained that the United States needs to enact specific or targeted tax incentives, such as expensing of all equipment purchases.<sup>11</sup> In discussing reform of the U.S. corporate income tax system,

5. American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004).

6. § 102(a) (creating a new code section, I.R.C. § 199).

7. FASB Staff Position, No. FAS 109-1, Application of FASB Statement No. 109, *Accounting for Income Taxes*, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 (Dec. 21, 2004).

8. See, e.g., Michael J. Graetz, Professor of Law, Yale Law School, Address Before the Senate Finance Committee on Fundamental Tax Reform (Apr. 15, 2008); Edward D. Kleinbard, *The Business Enterprise Income Tax: A Prospectus*, 106 TAX NOTES 97 (2005); Alvin C. Warren, *The Business Enterprise Income Tax: A First Appraisal*, 118 TAX NOTES 921 (2008); OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY (2007) [hereinafter TREASURY COMPETITIVENESS STUDY]; PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (2005) [hereinafter PRESIDENT'S ADVISORY PANEL REPORT].

9. See, e.g., TREASURY COMPETITIVENESS STUDY, *supra* note 8, at 1-2; U.S. DEP'T OF THE TREASURY, TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS 1 (2007) [hereinafter TREASURY CONFERENCE PAPER].

10. See, e.g., Graetz, *supra* note 8, at 23 (proposing a 15-20% corporate income tax rate); TREASURY COMPETITIVENESS STUDY, *supra* note 8, at 44 (suggesting a 28% corporate income tax rate, or a 31% corporate income tax rate if coupled with accelerated depreciation); Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong., § 3001 (2007) (proposing a 30.5% corporate income tax rate); Made in the USA Tax Act, S. 3162, 110th Cong. (2009) (proposing a 28% corporate income tax rate); Michael Joe, *Obama Willing to Reduce Corporate Rate in Exchange for Closing 'Loopholes'*, 122 TAX NOTES 1308 (2009); Peter R. Merrill, *Competitive Tax Rates for U.S. Companies: How Low to Go?*, 122 TAX NOTES 1009 (2009) (proposing a corporate income tax rate between 21% and 25.5%).

11. See, e.g., TREASURY COMPETITIVENESS STUDY, *supra* note 8, at 47-50; PRESIDENT'S ADVISORY PANEL REPORT, *supra* note 8, ch. 7; Warren, *supra* note 8, at 927-28 (suggesting expensing rather than a cost of capital allowance); Heidi Glenn, *Business Leaders Would Give Up Tax Breaks for Lower Rates*, 116 TAX NOTES 324,

one aspect of reform seems to be consistently overlooked, ignored, or marginalized: the impact reform will have on the financial statements of the Fortune 500 (public) companies and other public corporations, which I focus on and refer to as "Corporate America." In Corporate America, the overwhelming emphasis is on a corporation's net income, earnings per share (EPS), and effective tax rate.<sup>12</sup> The different types of corporate tax reform may have a significantly different impact on these three financial indicators. Consequently, because of Corporate America's focus on net income, EPS, and the effective tax rate, the effectiveness of the various types of corporate tax reform may be greatly impacted by the form. For example, if economists agree that a directed tax preference is needed to stimulate economic expansion, the form of the tax preference and its impact on Corporate America's financial statements may significantly affect the effectiveness of the tax preference. Or, if economists agree that a directed tax preference is needed to stimulate research and development activities, whether the preference is enacted in the form of a deduction or credit may impact the effectiveness of the tax preference.

Part II of this Article will provide some background regarding financial accounting income and taxable income and explore some of the differences between the two types of income. In addition, some background will be provided on financial statements issued by public corporations and the importance of various components of the financial statements.

Part III of this Article will discuss the major categories of corporate tax preferences and the impact these preferences have on the financial statements of Corporate America. Part IV will discuss the effectiveness of the major corporate tax preferences. Part V of this Article will discuss the advantages and disadvantages to Corporate America of a corporate tax rate cut. Part VI of the Article will include some observations on permanent differences, temporary differences, and a corporate tax rate cut. Finally, Part VII of this Article will include some principles for corporate tax reform.

## II. BACKGROUND ON FINANCIAL INCOME

### *A. General Principles*

A public corporation is required to compute its income for financial accounting purposes each year in accordance with GAAP. The resulting income figure is generally referred to as pretax financial income.<sup>13</sup> The corporation will also compute its income tax expense for the year, which is subtracted from pretax financial income, resulting in the corporation's net income.<sup>14</sup> In addition, a corporation's income is generally subject to taxation by federal, most state, and several local taxing authorities. As a result, a corporation must also compute its income for tax purposes in accordance with the

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326 (2007) (finding that economists "favor increased expensing and accelerated depreciation" as part of corporate tax reform).

12. See *infra* Part II.

13. Pretax financial income is sometimes referred to as pretax book income (PTBI), income before taxes (or earnings before taxes), income for financial reporting purposes, or income for book purposes. See DONALD E. KIESO ET AL., *INTERMEDIATE ACCOUNTING* 964 (12th ed. 2006).

14. For purposes of this Article, a corporation's net income is equal to its pretax financial income less its income tax expense.

applicable tax statutes and regulations of these various jurisdictions. The resulting income figure is referred to as taxable income.<sup>15</sup> In almost all cases, a corporation's taxable income will differ from its pretax financial income. In fact, the determinations of taxable income for these various jurisdictions almost always differ from each other and also from pretax financial income. These differences primarily reflect the different objectives behind the various taxing authorities and the accounting rules.<sup>16</sup>

The tax rules are designed to provide equitable and efficient determination of tax liability and subsequent collection of revenue and also to provide incentives for corporations and individuals to engage in a particular activity based upon the priorities and revenue needs of the various taxing authorities.<sup>17</sup> The financial accounting rules are designed to paint a picture of the corporation's operations that is consistent in its measurement on both an annual basis and across entities such that creditors, shareholders, management, and any other properly interested persons can evaluate the absolute and relative performance of the corporation.<sup>18</sup> The Financial Accounting Standards Board (FASB) has written:

The objectives begin with a broad focus on information that is useful in investment and credit decisions; then narrow that focus to investors' and creditors' primary interest in the prospects of receiving cash from their investments in or loans to business enterprises and the relation of those prospects to the enterprise's prospects; and finally focus on information about an enterprise's economic resources, the claims to those resources, and changes in them, including measures of the enterprise's performance, that is useful in assessing the enterprise's cash flow prospects.<sup>19</sup>

While the rules for determining pretax financial income are fairly rigorous and are based upon underlying economic assumptions and principles, the various taxing authorities have promulgated laws and regulations for determining taxable income that do not necessarily follow rules grounded on the economic theories of financial reporting, but rather may be based on political, social, or economic objectives.<sup>20</sup> In addition, the difference between a corporation's taxable income and its pretax financial income may be

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15. I.R.C. §§ 11, 63(a) (1986).

16. See *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 542 (1979) ("The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc.").

17. See, e.g., Michelle Hanlon, *What Can We Infer About a Firm's Taxable Income from Its Financial Statements?*, 56 NAT'L TAX J. 831, 833 (2003) (explaining that the Internal Revenue Code seeks to collect revenue efficiently and equitably and to incentivize particular firm activities); MYRON S. SCHOLES ET AL., *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* ch. 2.2 (3d ed. 2005) (stating that broad legal restrictions in tax laws allow tax authority to determine if taxpayer transactions are explained by a valid business purpose); Gil B. Manzoni, Jr. & George A. Plesko, *The Relation Between Financial and Tax Reporting Measures of Income*, 55 TAX L. REV. 175, 180 (2002) (noting that the Code's objective is to provide a fair and functional assessment of tax payment and collection).

18. CHRISTOPHER H. HANNA ET AL., *CORPORATE INCOME TAX ACCOUNTING: 2009 EDITION* 2.01 (2008).

19. OBJECTIVES OF FIN. REPORTING BY BUS. ENTERS., Statement of Fin. Accounting Concepts No. 1, §§ 32–33 (Fin. Accounting Standards Bd. 1978).

20. See HANNA ET AL., *supra* note 18, at 2.01.

due to the corporation's tax planning strategies, resulting in lower taxable income relative to pretax financial income.<sup>21</sup>

Numerous items create differences between taxable income and pretax financial income.<sup>22</sup> Some of these differences are permanent differences and others are temporary differences (sometimes referred to as timing differences).<sup>23</sup> Permanent differences are (i) items that enter into pretax financial income but *never* into taxable income, or (ii) items that enter into taxable income but *never* into pretax financial income.<sup>24</sup> As a result, these items create a difference between pretax financial income and taxable income that will not reverse over time, i.e., they are permanent differences. FASB has not specifically defined permanent differences; however, FASB has written, "Some events do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. In the United States, for example, interest earned on certain municipal obligations is not taxable and fines are not deductible."<sup>25</sup>

Temporary differences are generally (i) items that enter into pretax financial income earlier than when the item enters into taxable income, or (ii) items that enter into taxable income earlier than when the item enters into pretax financial income.<sup>26</sup> As a result, pretax financial income is different from taxable income in the year in which the temporary difference arises. In subsequent years, when the item giving rise to the temporary difference reverses, an offsetting difference is created between pretax financial income and taxable income.<sup>27</sup> As a result, these items create a difference between taxable income and pretax financial income that will reverse over time, i.e., they are temporary

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21. See Hanlon, *supra* note 17, at 833 (explaining that firms lower taxable income relative to book income through tax planning methods, "legal or otherwise").

22. See, e.g., KIESO, *supra* note 13, at 973.

23. *Id.*

24. *Id.* at 975.

25. ACCOUNTING FOR INCOME TAXES, Statement of Fin. Accounting Standards No. 109, n.3 (Fin. Accounting Standards Bd. 1992) [hereinafter ACCOUNTING FOR INCOME TAXES No. 109]. FASB has utilized the term "permanent difference" by writing "nontaxable or nondeductible differences between financial statements and tax returns (sometimes referred to as permanent differences)." ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES—AN INTERPRETATION OF FASB STATEMENT NO. 109, Fin. Accounting Standards Interpretation No. 48, § B11 (Fin. Accounting Standards Bd. 2006). The Accounting Principles Board, which was the predecessor to FASB, had defined permanent differences as "[d]ifferences between taxable income and pretax accounting income arising from transactions that, under applicable tax laws and regulations, will not be offset by corresponding differences or 'turn around' in other periods." ACCOUNTING FOR INCOME TAXES, APB Opinion No. 11, § 13.f (Accounting Principles Bd. 1967) [hereinafter ACCOUNTING FOR INCOME TAXES No. 11].

26. ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, §§ 10–13.

27. The Financial Accounting Standards Board has defined a temporary difference as occurring when the tax basis of an asset or liability differs from its financial reporting basis (i.e., book basis). ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, app. E. If a corporation's tax basis in an asset is greater than its book basis in the asset, a deductible temporary difference is created, resulting in a deferred tax asset. If a corporation's tax basis in an asset is less than its book basis in the asset, a taxable temporary difference is created resulting in a deferred tax liability. *Id.*

In 1967, the Accounting Principles Board issued Opinion No. 11, entitled *Accounting for Income Taxes*. ACCOUNTING FOR INCOME TAXES No. 11, *supra* note 25, ¶ 13.e. In the opinion, the APB defined timing differences as "[d]ifferences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Timing differences originate in one period and reverse or 'turn around' in one or more subsequent periods." *Id.* Although APB 11 has been superseded by FAS 109, some practitioners still use the term "timing difference" in describing a "temporary difference."

differences.

### *B. The Focus of Corporate Management*

Before discussing corporate tax preferences in detail, it may be helpful to summarize the financial indicators that are critical to corporate management. The following is the first two paragraphs of a December 18, 2008 Associated Press business news story on Nike Corporation:

Shoe and apparel company Nike Inc. said Wednesday that, despite weak domestic sales, its profit grew 9% in the second quarter on strong sales overseas.

The Beaverton, Ore.-based company reported its net income rose to \$391 million, or 80 cents per share, compared with net income of \$359.4 million, or 71 cents per share, in the same quarter last year.<sup>28</sup>

As a general proposition, which is supported by the Nike news story, corporate management (and the business community) is extremely focused on the income statement, often called the statement of income or statement of earnings. In business parlance, it is usually referred to as the P & L statement (i.e., profit and loss statement). The income statement is the “report that measures the success of a corporation’s operations for a given period of time.”<sup>29</sup> In looking at the income statement, several key items stand out. First, net income is viewed as the primary indicator of the performance of corporate management.<sup>30</sup> In the Nike news story, the AP reported that Nike’s net income for the second quarter was \$391 million and compared that figure to Nike’s net income in the same period a year earlier. In many cases, the board of directors of a public corporation will focus on the net income of the corporation in evaluating the performance of corporate management.<sup>31</sup> Investors and analysts will also look at a company’s net income (and pretax financial income) in evaluating the company’s performance.<sup>32</sup>

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28. *Nike Shares Rise on Strong 2Q Sales Overseas*, ASSOCIATED PRESS, Dec. 17, 2008, available at <http://abcnews.go.com/Business/wireStory?id=6483186>.

29. KIESO, *supra* note 13, at 126.

30. *Id.* at 127 (“So far, our discussion has highlighted the importance of information in the income statement for investment and credit decisions, including the evaluation of the company and its managers.”); *id.* at 144 (“A company customarily sums up the results of its operations in one important figure: net income.”); BARRY J. EPSTEIN ET AL., WILEY GAAP 2007: INTERPRETATION AND APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES 64 (2006) (“In financial reporting, performance is primarily measured by net income and its components, which are provided in the income statement.”).

31. Corporate management’s compensation may be based, in part, on the corporation’s net income or a subset or variation of net income, such as operating income or earnings before interest, taxes, depreciation, and amortization, generally referred to as EBITDA. *See infra* note 32.

32. A subset of pretax financial income is operating income, sometimes referred to as income from continuing operations. Operating income differs from pretax financial income in that the latter figure includes several additional items, such as discontinued operations and extraordinary items. *See KIESO, supra* note 13, at 134–44. Analysts will many times focus on EBITDA. *See supra* note 31. EBITDA is closely related to operating income. Another item on the income statement that is critical is revenues. Corporate management will, in almost all cases, focus on increasing revenues from period to period. In this Article, the difference among pretax financial income, operating income and EBITDA, and the importance of growth in revenues are not particularly relevant in analyzing corporate tax preferences, and as a result, will not be discussed in great detail.



Corporate management desires a sufficient amount of net income each quarter to enable the company to meet or exceed the expectations of Wall Street so that the market price of the stock will increase.<sup>33</sup> One effect of an increasing stock price is to increase the value, if any, of management's stock options.<sup>34</sup> Generally, corporations prefer, if possible, to show steady growth in net income rather than wild swings from period to period.<sup>35</sup> Attempting to smooth out a corporation's net income from period to period is referred to as "earnings management."<sup>36</sup>

While corporate management focuses on net income, the financial world generally focuses intently on a corporation's EPS.<sup>37</sup> EPS is considered to be the most significant business indicator in the financial world.<sup>38</sup> In the Nike news story, the AP reported that Nike's EPS was 80 cents per share and compared that figure to Nike's performance a year earlier, when it reported 71 cents per share. A corporation's EPS is equal to its net income or operating income available to common shareholders (less dividends on preferred stock) divided by the weighted average number of common shares of its stock outstanding.<sup>39</sup> Because EPS is calculated using the corporation's net income (and operating income), both EPS and net income are directly related (i.e., a higher net income will lead to a higher EPS). A corporation must disclose its EPS on the face of its income statement.<sup>40</sup>

A public corporation must also disclose its effective tax rate reconciliation in the

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33. Under the Securities Exchange Act of 1934, public companies, usually referred to as reporting companies, must file a quarterly report on Form 10-Q for each of the first three quarters of the company's fiscal year. 17 C.F.R. § 249.308a(a) (2009). The Form 10-Q will contain the company's financial statement showing the company's financial results for the quarter. *Id.* A public company must also file an annual report on Form 10-K. § 249.310(a). The Form 10-K will contain complete audited financial statements. § 240.13a-1. Most reporting companies do not file a Form 10-Q for their last fiscal quarter but include the last fiscal quarter's financial results in the Form 10-K. *See* § 249.308a(a).

34. *See* KIESO, *supra* note 13, at 127–28. A higher share price may also lead to job preservation for corporate management. A higher share price means that it is less likely that the company will be a takeover target, and, in fact, the company may use its shares to acquire weaker rivals.

35. *See, e.g.*, STAFF OF THE JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO CORPORATE TAX REFORM: ISSUES OF CONFORMING BOOK AND TAX INCOME AND CAPITAL COST RECOVERY, 17–18 (2006) [hereinafter JCT BOOK-TAX REPORT], available at <http://www.jct.gov/x-16-06.pdf>.

36. *See, e.g.*, KIESO, *supra* note 13, at 128 (earnings management is "often defined as the planned timing of revenues, expenses, gains and losses to smooth out bumps in earnings"); HANNA ET AL., *supra* note 18, at 4.08 (discussing utilization of a charitable foundation to achieve earnings management).

37. Analysts may also focus on other financial indicators, such as EBITDA. *See supra* note 32.

38. *See, e.g.*, KIESO, *supra* note 13, at 144 ("However, the financial world has widely accepted an even more distilled and compact figure [than net income] as the most significant business indicator—earnings per share (EPS)."); EPSTEIN ET AL., *supra* note 30, at 926 ("Earnings per share (EPS) is an indicator widely used by both actual and prospective investors to gauge the profitability of a corporation."); *The Foundation of International Tax Reform: Worldwide, Territorial, and Something in Between: Hearing Before the S. Comm. on Finance*, 110th Cong. 5 (2008) (statement of Robert H. Dilworth, Partner, McDermott Will & Emery LLP, Washington, D.C.) ("The main goal of a U.S. MNC's tax management in seeking tax reduction is more likely to be based on improved financial statement presentation of earnings per share rather than reducing the actual cost of capital by a few basis points."), available at <http://finance.senate.gov/sitepages/hearing062608.htm>.

39. EARNINGS PER SHARE, Statement of Fin. Accounting Standards No. 128, ¶¶ 8–10 (Fin. Accounting Standards Bd. 1997) (basic earnings per share). A corporation computes its basic EPS using both net income and operating income resulting in two EPS figures. *Id.* ¶ 9.

40. *Id.* ¶ 36.

footnotes to its financial statements filed as part of Form 10-K.<sup>41</sup> This disclosure is referred to as the “tax footnote.” Generally, a public corporation desires that its effective tax rate be comparable to or lower than the industry average.<sup>42</sup> More specifically, a corporation wants a lower effective tax rate than its main competitors.<sup>43</sup> In addition, a public corporation desires to sustain a low effective tax rate (“sustainability of ETR”).<sup>44</sup>

The effective tax rate is computed by dividing the corporation’s income tax expense attributable to operating income by its operating income (sometimes referred to as “income from continuing operations”).<sup>45</sup> The income tax expense includes current tax expense and deferred tax expense.<sup>46</sup> The deferred tax expense is computed based on a corporation’s temporary differences.<sup>47</sup> Because the tax effects of the temporary differences comprise deferred tax expense, a corporation’s effective tax rate is not affected by temporary differences (unless a rate change takes place).<sup>48</sup>

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41. ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, ¶ 47. FASB requires that a public enterprise disclose a reconciliation of “(a) the reported amount of income tax expense attributable to continuing operations for the year to (b) the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations.” *Id.* In computing and disclosing this reconciliation, a public enterprise may use actual dollar amounts or percentages. *Id.* A public enterprise will also disclose its estimated effective tax rate as part of the Form 10-Q, which is filed quarterly with the SEC. ACCOUNTING FOR INCOME TAXES IN INTERIM PERIODS, Interpretation No. 18 (Fin. Accounting Standards Bd. 1977); INTERIM FINANCIAL REPORTING, APB Opinion No. 28 (Accounting Principles Bd. 1973).

42. A public corporation may often be more concerned about its income tax expense as reported on the income statement than the actual taxes it pays. The reason, of course, is that income tax expense is the tax figure used in determining a corporation’s effective tax rate (as well as net income and EPS). See Tom Neubig, *Where’s the Applause? Why Most Corporations Prefer a Lower Rate*, 111 TAX NOTES 483, 483 (2006) (“While most economists believe that book corporate tax rates [effective tax rates] shouldn’t matter (because investors should pierce the corporate veil), many corporate tax directors and officers do believe that book corporate tax rates matter to their investors—and also affect their own performance criteria.”).

43. See Roger D. Wheeler et al., *Session 7: Opportunities and Obstacles in Designing a U.S. Business Tax System for 2010 and Beyond*, 86 TAXES 115, 120 (2008) (providing the following from Roger D. Wheeler: “I used to be a corporate tax executive, and, you know, statutory rates, we had them, but I never focused on statutory rates very much. It was always the effective rates. That is sort of how you earned your stripes, you focused on that, you tried to do better than somebody else and getting your effective rate lower”).

44. In a survey of corporate tax executives, management of the effective tax rate was listed as the top business tax concern in 2009. MILLER & CHEVALIER, TAX POLICY FORECAST SURVEY 1 (2009), available at <http://www.millerchevalier.com/Publications/MillerChevalierPublications?find=4927>.

45. ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, ¶ 47. Operating income is a subset of pretax financial income. *Id.*

46. *Id.* ¶ 16 (“Total income tax expense or benefit for the year is the sum of deferred tax expense or benefit and income taxes currently payable or refundable.”); *Id.* ¶ 45 (two significant components of income tax expense attributable to continuing operations for the year are current tax expense (or benefit) and deferred tax expense (or benefit)).

47. *Id.* ¶ 16 (“Deferred tax expense or benefit is the change during the year in an enterprise’s deferred tax liabilities and assets.”).

48. See Christopher H. Hanna, *The Real Value of Tax Deferral*, 61 FLA. L. REV. 203, 236 (2009) (explaining why temporary differences are unimportant to Corporate America).

### III. VARIOUS TYPES OF CORPORATE TAX PREFERENCES

Congress may enact corporate tax preferences in a number of different forms. The Treasury Department, in its 2007 report on business taxation and global competitiveness, provided a table listing the major corporate tax preferences.<sup>49</sup>

<b>Corporate Tax Preferences</b>	<b>Projected Revenue Costs, FY 2008–2017 (in \$ billions)</b>
Expensing and accelerated depreciation provisions	\$410
Deduction for U.S. production activities	\$210
Exclusion of interest on state and local bonds	\$135
Research and experimentation (R & E) credit	\$132
Deferral of income from controlled foreign corporations	\$120
Low income housing credit	\$55
Exclusion of interest on life insurance savings	\$30
Inventory property sales source rules exception	\$29
Deductibility of charitable contributions	\$28
Special ESOP rules	\$23
Exemption of credit union income	\$19
New technology credit	\$8
Special Blue Cross/Blue Shield deduction	\$8
Excess of percentage over cost depletion, fuels	\$7
Other corporate tax preferences	\$27
<b>Total</b>	<b>\$1,241</b>

As shown in the chart, the first five corporate tax preferences comprise over 80% of the total corporate tax preferences (measured in dollars). In addition, the fifth item on the list, deferral of income from controlled foreign corporations, is more than twice as expensive as the sixth item on the list, the low income housing credit. As a result, in discussing the various corporate tax preferences, the focus will be on the first five items in the chart.

Generally, the various corporate tax preferences fall into one of five categories as illustrated by the five largest corporate tax preferences in the Treasury study table: (1) expensing and accelerated depreciation; (2) deductions with no economic outlay; (3) exclusions from gross income; (4) tax credits; and (5) deferral of income.<sup>50</sup> For many years, economists have debated the effectiveness of different types of corporate tax preferences.<sup>51</sup> For example, does accelerated depreciation for equipment stimulate the

49. TREASURY CONFERENCE PAPER, *supra* note 9, at 11. In its competitiveness study, Treasury issued a table listing the major corporate tax preferences and the revenue associated with eliminating the preferences for both corporations and flow-through businesses, such as partnerships, S corporations, and sole proprietorships. See TREASURY COMPETITIVENESS STUDY, *supra* note 8, at 47–48.

50. *Id.* at 47.

51. See, e.g., JANE G. GRAVELLE, THE ECONOMIC EFFECTS OF TAXING CAPITAL INCOME 95–121 (1994)

purchase of equipment by businesses? If so, is it a more effective investment subsidy than an investment tax credit? The financial statement impact of the various types of corporate tax preferences seems to have attracted little attention among academics and policy makers (but not Corporate America). In this part of the Article, the financial statement effects of the five general categories of corporate tax preferences are analyzed utilizing an example for each category.

### *A. Expensing and Accelerated Depreciation*

In the Treasury study, the leading corporate tax preference was expensing and accelerated depreciation.<sup>52</sup> There are many areas of the tax laws permitting expensing and accelerated depreciation that are viewed as corporate tax preferences.<sup>53</sup> One important area involves the purchase of equipment and other tangible personal property for use in business.

In 1981, Congress enacted the Accelerated Cost Recovery System (ACRS), which has been modified over the years.<sup>54</sup> Under ACRS, Corporate America may recover the cost of most depreciable tangible assets utilizing accelerated depreciation with recovery periods that are, in many cases, shorter than the useful lives of the properties. In 2002, Congress enacted a 30% bonus depreciation provision for certain tangible property acquired and placed in service after September 10, 2001, and before September 11, 2004.<sup>55</sup> The following year, Congress increased the bonus depreciation percentage to 50% for property acquired and placed in service after May 5, 2003, and before January 1, 2005.<sup>56</sup> More recently, as part of the Economic Stimulus Act of 2008, Congress resurrected the 50% bonus depreciation for certain tangible property acquired and placed in service in 2008.<sup>57</sup> The bonus depreciation is limited to property that has a recovery period of 20 years or less, computer software, water utility property, and qualified leasehold improvement property.<sup>58</sup> The combination of the 50% bonus depreciation and ACRS produces a very quick write-off for many depreciable assets.

*Example 1.* A corporation acquires and places in service on January 1, 2008 equipment costing \$1 million. The equipment is five-year property. Under the bonus depreciation provision, the corporation's depreciation deduction in 2008 is \$500,000 (\$1 million times 50%). The corporation is also entitled to regular depreciation of \$100,000 (\$500,000 times 40% times one-half). The corporation's total depreciation deduction with respect to the equipment in 2008 is \$600,000. As a result, 60% of the cost of the asset is

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[hereinafter GRAVELLE, CAPITAL INCOME]; Jane G. Gravelle, *Using Business Tax Cuts to Stimulate the Economy*, in TAX CUTS: ISSUES AND ANALYSES 63–74 (James S. Larson ed. 2003) [hereinafter Gravelle, *Business Tax Cuts*]; CONGRESSIONAL RESEARCH OFFICE, TAX EXPENDITURES: COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS (2008) (selected bibliography) [hereinafter CRO REPORT].

52. TREASURY CONFERENCE PAPER, *supra* note 9, at 11.

53. See CRO REPORT, *supra* note 51.

54. I.R.C. § 168.

55. Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, §101(a), 116 Stat. 22 (2002).

56. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 201(a), 117 Stat. 752 (2003).

57. Economic Stimulus Act of 2008, Pub. L. No. 110-185, § 103, 122 Stat. 613 (2008). Congress has extended the 50% bonus depreciation for one additional year. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1201, 123 Stat. 115 (2009).

58. I.R.C. § 168(k)(2).

expensed in the first year.

If the corporation utilizes the straight-line method of depreciation with a recovery period of five years for financial accounting purposes, the depreciation expense for accounting purposes is \$200,000 (\$1 million divided by five years) for 2008. In 2008, a temporary difference of \$400,000 (\$600,000 depreciation deduction less \$200,000 depreciation expense) is created between taxable income and pretax financial income. This temporary difference will reverse in future years as depreciation expense for financial accounting purposes becomes greater than depreciation deductions for tax purposes.

As Example 1 illustrates, a deduction, such as accelerated depreciation and the 50% bonus depreciation, merely creates a temporary difference between taxable income and pretax financial income. This temporary difference will reverse in subsequent years. Such temporary differences are not highly prized by Corporate America because they do not result in higher net income or higher EPS and do not lower a corporation's effective tax rate.<sup>59</sup> They only result in a temporary increase in cash, which, while certainly not insignificant, is not considered to be of overwhelming importance to Corporate America.<sup>60</sup>

### *B. Deductions with No Economic Outlay*

Some deductions create a permanent difference between taxable income and pretax financial income. Generally, these deductions have no economic outlay associated with them. For example, as part of the American Jobs Creation Act of 2004, Congress enacted a tax deduction for qualified production activities.<sup>61</sup> The deduction, generally referred to as the manufacturing deduction, when fully phased-in, is equal to nine percent of the lesser of: (a) qualified production activities income; or (b) taxable income (after the deduction for the utilization of any net operating loss carryforwards).<sup>62</sup> In addition, the deduction is limited to 50% of the W-2 wages paid by the taxpayer.<sup>63</sup> On Treasury's list of corporate tax preferences, the manufacturing deduction is the second item listed with a price tag of \$210 billion over ten years.<sup>64</sup> The manufacturing deduction creates a permanent difference between taxable income and pretax financial income because there is no counterpart to the deduction under the financial accounting rules.

*Example 2.* A corporation has taxable income for the year 2008 (excluding the qualified production activities deduction) of \$22,000. Its qualified production activities income for the year 2008 is \$40,000, and its W-2 wages for 2008 are \$12,000. The statutory income tax rate is 35%. The corporation's qualified production activities deduction for 2008 is computed as six percent of the lesser of: (1) \$40,000 (qualified

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59. See, e.g., Neubig, *supra* note 42, at 483 (explaining why public corporations prefer a rate cut to expensing of capital investments).

60. See *infra* Part VI.D (discussing the importance of temporary differences).

61. I.R.C. § 199.

62. § 199(a). The deduction is phased-in beginning in 2005. For taxable years beginning in 2005 and 2006, the deduction is three percent of the lesser of (a) qualified production activities income or (b) taxable income. In 2007, 2008, and 2009, the percentage is increased to six percent. For taxable years beginning in 2010, the deduction is fully phased-in at nine percent. I.R.C. § 199(a)(2).

63. § 199(b).

64. TREASURY CONFERENCE PAPER, *supra* note 9, at 11.

production activities income); or (2) \$22,000 (taxable income). This is equal to \$1320, which is limited to 50% of the corporation's W-2 wages for 2008. The corporation's deduction of \$1320 creates a permanent difference between taxable income and pretax financial income.

A deduction, such as the manufacturing deduction, that creates a permanent difference between taxable income and pretax financial income is, as a general rule, highly prized by Corporate America. It results in higher net income, higher EPS, and a lower effective tax rate.

*Example 3.* Intel had the following tax rate reconciliation in its 2008 Annual Report (note 23):<sup>65</sup>

Note 23: Taxes

The difference between the tax provisions at the statutory federal income tax rate and the tax provision as a percentage of income before income taxes was as follows:

	2008	2007	2006
Statutory federal income tax rate	35.0%	35.0%	35.0%
<i>Increase (reduction) in rate resulting from:</i>			
Non-U.S. income taxed at different rates	(4.2)	(4.7)	(4.3)
Settlements	(0.5)	(5.3)	—
Research and development tax credits	(1.4)	(1.3)	(0.8)
Domestic manufacturing deduction benefit	(1.7)	(1.1)	(0.9)
Deferred tax asset valuation allowance— Unrealized losses	3.4	—	—
Export sales benefit	—	—	(2.1)
Other	0.5	1.3	1.7
Income tax rate	31.1%	23.9%	28.6%

As shown in the effective tax rate reconciliation table, the manufacturing deduction lowered Intel's effective tax rate in years 2006 through 2008 by approximately 0.9%, 1.1%, and 1.7%, respectively.

### C. Exclusions from Gross Income

Congress may enact a tax preference in the form of an exclusion from gross income. One of the most common examples is the exclusion for interest received on state and local bonds.<sup>66</sup> On Treasury's list of corporate tax preferences, the exclusion for state and local bond interest is the third largest corporate tax preference item.<sup>67</sup> In 1913, Congress enacted the exemption for interest income on state and local bonds based on the idea that taxing such income "would impose an unconstitutional burden on the borrowing power of state and local governments."<sup>68</sup> Although the constitutional concern is no longer an

65. INTEL 2008 ANNUAL REPORT (2008), available at <http://www.intel.com/intelAR2008/financial/statements/note23/index.html#n23> (last visited Sept. 1, 2009).

66. I.R.C. § 103(a).

67. TREASURY CONFERENCE PAPER, *supra* note 9, at 11.

68. See BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶

issue,<sup>69</sup> Congress has retained the exclusion as a revenue sharing arrangement with the state and local governments. Allowing the exclusion permits the state and local governments to borrow at lower interest rates than taxable bonds of similar quality.

*Example 4.* A corporation owns some state and local bonds. It receives \$50,000 of interest on the bonds in 2009. Under the tax code, interest on state and local bonds is excluded from gross income and therefore never enters into the computation of taxable income.<sup>70</sup> However, such interest enters into the computation of pretax financial income. As a result, a difference of \$50,000 is created in 2009 between taxable income and pretax financial income. This difference is permanent—it will not reverse over time.

The exclusion for interest on state and local bonds creates a permanent difference between taxable income and pretax financial income. It increases a corporation's net income and EPS while also lowering the corporation's effective tax rate.

*Example 5.* Best Buy had the following tax rate reconciliation in its 2008 Annual Report (note 8):<sup>71</sup>

Note 8: Income Taxes

The following is a reconciliation of the federal statutory income tax rate to income tax expense in fiscal 2008, 2007, and 2006:

	2008	2007	2006
Federal income tax at the statutory rate	\$780	\$747	\$603
State income taxes, net of federal benefit	67	38	34
Benefit from foreign operations	(25)	(36)	(37)
Non-taxable interest income	(17)	(34)	(28)
Other	10	37	9
Income tax expense	\$815	\$752	\$581
Effective income tax rate	36.6%	35.3%	33.7%

In Best Buy's effective tax rate reconciliation, it listed "non-taxable interest income," which is a permanent difference. It lowered Best Buy's effective tax rate in years 2006 through 2008 by \$28, \$34, and \$17, respectively.

#### D. Tax Credits

Congress may enact a tax preference in the form of a tax credit. In 1981, Congress enacted a research credit because it believed that "a substantial tax credit for incremental research and experimental expenditures [would] overcome the resistance of many businesses to the significant cost of staffing, supplies and certain computer charges which must be incurred in initialing or expanding research programs."<sup>72</sup> The credit is the fourth

15.1.1 (1999).

69. *South Carolina v. Baker*, 485 U.S. 505, 526–27 (1988) (stating that Congress may tax interest on state and local obligations).

70. I.R.C. § 103(a). In certain cases, interest on state and local bonds may be subject to tax under the alternative minimum tax. § 57(a)(5) (treating interest on specified private activity bonds as a tax preference).

71. BEST BUY 2008 ANNUAL REPORT (2008), available at [http://media.corporate-ir.net/media\\_files/IROL/83/83192/08AR/assets/shared/BestBuy\\_Fiscal08\\_Annual\\_Report.pdf](http://media.corporate-ir.net/media_files/IROL/83/83192/08AR/assets/shared/BestBuy_Fiscal08_Annual_Report.pdf).

72. H.R. REP. NO. 201, at 111 (1981).

most expensive corporate tax preference in the Treasury study.<sup>73</sup> Congress has never made the credit a permanent part of the tax laws but rather has renewed the credit continuously since 1981. Currently, the credit will expire on December 31, 2009.<sup>74</sup>

The amount of the research credit is equal to 20% of the excess of the qualified research expenses for the taxable year over the base amount.<sup>75</sup> “Qualified research” is defined as research with respect to which the

expenditures may be treated as expenses under section 174, which is undertaken for the purpose of discovering information which is technological in nature, and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitutes elements of a process of experimentation for a particular purpose<sup>76</sup>

(i.e., a new or improved function, performance, or reliability or quality). “Qualified research expenses” is the sum of in-house research expenses and contract research expenses.<sup>77</sup> The base amount is the greater of: the fixed base percentage times the average annual gross receipts for the preceding four taxable years, or 50% of the qualified research expenses for the year.<sup>78</sup> As a result, the maximum credit is 10% of qualified research expenses (20% of the excess of qualified research expenses over 50% thereof).<sup>79</sup>

A taxpayer may not deduct or capitalize research costs to the extent of the research credit allowed to the taxpayer.<sup>80</sup> For example, if a corporation has \$10,000 of qualified research expenses and is allowed a research credit of \$1000, then it may only deduct \$9000 of research costs. Alternatively, a taxpayer may elect to preserve its deduction by reducing its research credit by the amount of the credit multiplied by the maximum corporate tax rate of 35%.<sup>81</sup> Therefore, if the corporation has \$10,000 of qualified research expenses and is allowed a research credit of \$1000, it may elect to reduce its credit to \$650 (\$1000 less (\$1000 times 35%)) and thereby deduct the entire \$10,000 of research costs.

*Example 6.* A corporation has \$1 million of qualified research expenses and is allowed a research credit of \$100,000. The corporation elects to reduce the credit by \$35,000 (\$100,000 times 35%) so that its research credit is only \$65,000 for the year. As a result of the election, the corporation is allowed to deduct the entire \$1 million of qualified research expenses. The corporation will also expense the \$1 million of qualified

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73. TREASURY CONFERENCE PAPER, *supra* note 9, at 11.

74. I.R.C. § 41(h)(1). The Obama Administration has proposed making the research credit a permanent part of the tax laws. See U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 15 (2009), available at <http://www.ustreas.gov/offices/tax-policy/library/grmbk09.pdf>.

75. § 41(a)(1).

76. § 41(d)(1), (d)(3).

77. § 41(b)(1)–(3).

78. § 41(c).

79. See BITTKER & LOKKEN, *supra* note 68, ¶ 27.4.2.

80. § 280C(c)(1)–(2).

81. § 280C(c)(3). Most taxpayers that claim the research credit make the reduced research credit election. See Amy S. Elliott, *Proposed Regs Solidify Research Credit Election Mechanics*, 124 TAX NOTES 222 (2009).



research expenses for financial accounting purposes. The research credit of \$65,000 is a permanent difference.

For financial accounting purposes, a corporation expenses its research and development costs as they are incurred.<sup>82</sup> As a result, the research credit is a permanent difference because it is an item provided for in the tax laws with no counterpart in the financial accounting rules. As a permanent difference, the research credit results in higher net income, higher EPS, and a lower effective tax rate.

*Example 7.* Hewlett Packard had the following tax rate reconciliation in its 2008 Annual Report:<sup>83</sup>

Note 13: Taxes on Earnings (Continued)

The differences between the U.S. federal statutory income tax rate and HP's effective tax rate were as follows for the following fiscal years ended October 31:

	2008	2007	2006
U.S. federal statutory income tax rate	35.0%	35.0%	35.0%
State income taxes, net of federal benefit	1.3	0.5	(0.1)
Lower rates in other jurisdictions, net	(16.9)	(13.2)	(11.9)
Research and development credit	(0.4)	(0.6)	(0.2)
Valuation allowance	—	(1.7)	(1.0)
U.S. federal tax audit settlement	—	—	(7.9)
Accrued taxes due to post-acquisition integration	2.0	—	—
Other, net	(0.5)	0.8	(0.1)
	20.5%	20.8%	13.8%

As demonstrated in the table, the research credit lowered Hewlett Packard's effective tax rate in years 2006 through 2008 by 0.2%, 0.6%, and 0.4%, respectively.

### *E. Deferral of Income*

A number of provisions in the tax laws permit the deferral of taxes on income.<sup>84</sup> In Corporate America, the term "deferral" generally refers to the deferral of taxes on income earned by a foreign subsidiary. It is the fifth most expensive item of corporate tax preference.<sup>85</sup> If a U.S. corporation wants to conduct business abroad, in many cases it will form a corporation in the foreign country in which the business is to be conducted. The income of the foreign corporation is not subject to United States taxation unless the foreign corporation earned part or all of that income in the United States.<sup>86</sup> Assuming

82. ACCOUNTING FOR RESEARCH AND DEVELOPMENT COSTS, Statement of Financial Accounting Standards No. 2, § 15 (Fin. Accounting Standards Bd. 1974).

83. HEWLETT PACKARD 2008 ANNUAL REPORT (2008), available at [http://media.corporate-ir.net/media\\_files/irol/71/71087/HewlettPackard\\_2008\\_AR.pdf](http://media.corporate-ir.net/media_files/irol/71/71087/HewlettPackard_2008_AR.pdf).

84. See generally CHRISTOPHER H. HANNA, COMPARATIVE INCOME TAX DEFERRAL: THE UNITED STATES AND JAPAN (2000) (discussing a number of deferral provisions in the United States income tax system).

85. TREASURY CONFERENCE PAPER, *supra* note 9, at 11.

86. I.R.C. § 11(d) (providing that foreign corporations are taxed by the U.S. as provided in section 882,

that it did not, the income of the foreign corporation will not be taxed by the United States until the foreign corporation repatriates the income, typically by way of dividends, to its U.S. parent corporation.<sup>87</sup> When the foreign subsidiary does so, the U.S. will tax the U.S. parent on the dividends it receives from its foreign subsidiary at the time the U.S. parent receives the dividends. In addition, the U.S. parent will be entitled to credit the foreign taxes paid by its foreign subsidiary against the U.S. taxes that arise as a result of the repatriation.<sup>88</sup>

Because the income of the foreign subsidiary is not taxed to the U.S. parent until the income is repatriated, the U.S. parent defers paying U.S. income taxes on the income of its foreign subsidiary. The deferral period could last for many years—until repatriation or the sale or other disposition of the stock of the foreign subsidiary. This deferral is viewed as a tremendous tax advantage to the U.S. parent. Congress has enacted a number of anti-deferral regimes, which primarily target passive, mobile types of income.<sup>89</sup> If an anti-deferral regime is applicable, then generally the income of the foreign subsidiary will flow-through to the U.S. parent.<sup>90</sup> Some commentators have recommended that a pass-through regime be enacted such that all income of a foreign subsidiary will flow-through to the U.S. parent—not just the passive, mobile types of income.<sup>91</sup> It is unlikely, however, that such a pass-through regime will be enacted in the near future with respect to income of foreign subsidiaries.<sup>92</sup>

Public corporations view the tax deferral of income of foreign subsidiaries as extremely important, but not solely for the time value of money benefits. Under the financial accounting rules, if a corporation owns 20% or more of another corporation (whether domestic or foreign), then the investor corporation is treated as having

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which generally taxes only the U.S. source income of foreign corporations).

87. § 61(a) (gross income includes dividend income).

88. § 78 (gross-up of the dividend to include the foreign income taxes); § 902 (indirect foreign tax credit).

89. See §§ 951–65 (targeting subpart F income); §§ 1291–98 (passive foreign investment company rules targeting offshore mutual funds); §§ 541–47 (personal holding company rules); §§ 531–37 (accumulated earnings tax). Congress recently repealed, as part of the American Jobs Creation Act of 2004, two other taxing regimes targeting passive types of income of foreign corporations: I.R.C. §§ 551–58 dealt with foreign personal holding companies. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 413. Sections 1246–47 deal with foreign investment companies. § 413(a)(2)–(3).

90. See, e.g., I.R.C. § 951 (subpart F income flows-through to the U.S. shareholder); § 1293 (income of qualified electing fund flows through to U.S. person).

91. See, e.g., Robert J. Peroni et al., *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999) (discussing curtailing deferral of U.S. income tax on foreign source income); J. Clifton Fleming Jr. & Robert J. Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 109 TAX NOTES 1557 (2005) (analyzing U.S. exemption system proposals); Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 TAXES 1042 (1996) (reviewing anti-deferral rules).

92. See, e.g., PRESIDENT'S ADVISORY PANEL REPORT, *supra* note 8 (proposing fixes to the U.S. tax system); STAFF OF JOINT COMM. ON TAXATION, *OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES* (2005) (presenting improvements for tax compliance and reforming tax expenditures). In 2005, both the President's Advisory Panel and the Staff of the Joint Committee on Taxation proposed a territorial (or exemption) system for active business income earned abroad through branches and foreign subsidiaries. See Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike)*, 59 SMU L. REV. 751 (2006) (analyzing the recommendations of the Advisory Panel). But see *infra* note 147 (Obama Administration's proposed changes to U.S. international tax rules).

“significant influence” over the investee corporation.<sup>93</sup> The investor corporation will account for its investment in the investee corporation under the equity method of accounting, which treats the income of the investee corporation as flowing-through to the investor corporation.<sup>94</sup>

If the investor corporation owns more than 50% of the investee corporation, then the investor corporation is referred to as the parent corporation and the investee corporation is referred to as the subsidiary corporation.<sup>95</sup> The U.S. parent will generally file consolidated financial statements with respect to its foreign subsidiary.<sup>96</sup> This means that the income of the foreign subsidiary will be consolidated with the income of the U.S. parent. In computing the U.S. parent’s book basis in its foreign subsidiary stock, the income of the foreign subsidiary flows through to the U.S. parent under the equity method for financial accounting purposes.<sup>97</sup> As a result, for financial accounting purposes, the U.S. parent will increase its basis in the stock of the foreign subsidiary.<sup>98</sup> For tax purposes, however, the income of the foreign subsidiary will not flow through to the U.S. parent (assuming one of the anti-deferral regimes is not applicable), and the U.S. parent’s basis in its foreign subsidiary will remain unchanged. As a result, the U.S. parent’s book basis in its foreign subsidiary will be greater than its tax basis by the amount of income flowing through to the U.S. parent. Generally, under the financial accounting rules, the excess of book basis over tax basis in an asset is a temporary difference leading to the recording of a deferred tax liability with a corresponding increase to deferred tax expense.<sup>99</sup>

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93. See THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, APB Opinion No. 18, ¶ 17 (Accounting Principles Bd. 1971); CRITERIA FOR APPLYING THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, Statement of Fin. Accounting Standards No. 35 (Fin. Accounting Standards Bd. 1981) (clarifying criteria for applying the equity method of accounting for investments in common stock).

94. THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, ¶ 10, *supra* note 93.

95. See, e.g., CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES, Statement of Financial Accounting Standards No. 94 ¶¶ 1, 2, 13 (Fin. Accounting Standards Bd. 1982) (requiring consolidation of majority-owned subsidiaries); CONSOLIDATED FINANCIAL STATEMENTS, Accounting Research Bulletin No. 51, ¶¶ 2-3 (Comm. on Accounting Procedure 1959); CONSOLIDATION OF VARIABLE INTEREST ENTITIES, Statement of Fin. Accounting Standards Interpretation No. 46(R) (Fin. Accounting Standards Bd. 2003) (addressing consolidation of business enterprises). For tax purposes, only if the investor corporation owns 80% or more of the investee corporation is the investor corporation referred to as the parent corporation and the investee corporation as the subsidiary corporation. See, e.g., I.R.C. §§ 332, 337, 1504.

96. See, e.g., ACCOUNTING FOR THE IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS, Statement of Fin. Accounting Standards No. 144, ¶¶ 2, B119 (Fin. Accounting Standards Bd. 2001) (addressing financial accounting and reporting relating to long-lived assets); CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES, *supra* note 95 (requiring consolidation of majority-owned subsidiaries).

97. Under the equity method, the income will flow through the foreign subsidiary to its U.S. parent. THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, *supra* note 93, ¶ 10. In essence, the income of the foreign subsidiary is aggregated with the income of its U.S. parent. If the U.S. parent and foreign subsidiary file consolidated financial statements, the income of the foreign subsidiary is aggregated with the income of its U.S. parent. Both the equity method and consolidation, in essence, aggregate the income of the foreign subsidiary with its U.S. parent. As a result, the equity method is sometimes referred to as “single line consolidation.” See EPSTEIN ET AL., *supra* note 30, at 475.

98. THE EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS IN COMMON STOCK, *supra* note 93, ¶ 10 (“An investor adjusts the carrying amount of an investment for its share of the earnings or losses of the investee subsequent to the date of investment . . .”).

99. ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, §§ 32, 33 & app. E (stating that book basis

FASB has provided an exception to the recording of a deferred tax liability with respect to the excess of book basis over tax basis in the stock of a foreign subsidiary if there is a showing of sufficient evidence that the foreign subsidiary has invested or will invest its undistributed earnings indefinitely (i.e., the investment is essentially permanent in duration).<sup>100</sup> This exception to the recording of a deferred tax liability is referred to as the APB 23 provision, named after Opinion No. 23 issued by the Accounting Principles Board in 1972.<sup>101</sup>

To illustrate the financial accounting advantage of APB 23, assume a U.S. parent owns 100% of the stock of a foreign subsidiary. The U.S. parent's basis in the stock of the foreign subsidiary is \$1 million for book and tax purposes. The U.S. parent has pretax financial income of \$40 million in 2007, and the foreign subsidiary has pretax financial income of \$20 million in 2007. Assume the U.S. parent is subject to a 35% U.S. tax rate, and the foreign subsidiary is located and operating in a no-tax jurisdiction. Under the consolidation/equity method, the U.S. parent will include the foreign subsidiary's pretax financial income in its consolidated income, thereby increasing pretax financial income to \$60 million for 2007. If the U.S. parent was required to record a deferred tax liability for the excess of its book basis over its tax basis in the stock of its foreign subsidiary, then the U.S. parent would record a \$7 million deferred tax liability (\$20 million times 35%) and an increase to deferred tax expense of \$7 million. This would reduce the consolidated net income from \$46 million (\$40 million of income less \$14 million in taxes plus \$20 million income from the foreign subsidiary) to \$39 million. In business terms, the U.S. parent takes a charge (or hit) to earnings of \$7 million as a result of recording the deferred tax liability.

If the U.S. parent can show that the foreign subsidiary has invested or will invest the undistributed earnings indefinitely, then the U.S. parent may utilize APB 23 to avoid recording a \$7 million deferred tax liability, and thereby avoid a \$7 million increase to deferred tax expense (i.e., the charge to earnings).<sup>102</sup> As a result, the consolidated net income will remain at \$46 million. The following table shows the consolidated net income if the U.S. parent utilizes APB 23 and compares it if the U.S. parent is unable to utilize APB 23:

	Consolidated Income Statement (APB 23 Used)	Consolidated Income Statement (APB 23 Not Used)
Pretax Financial Income	\$60,000,000	\$60,000,000
Current Tax Expense	\$14,000,000	\$14,000,000
Deferred Tax Expense	\$0	\$7,000,000
Net Income	\$46,000,000	\$39,000,000

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over tax basis in an asset is a taxable temporary difference).

100. *Id.* §§ 31(a), 288(f); ACCOUNTING FOR INCOME TAXES—SPECIAL AREAS, APB Opinion No. 23, ¶ 12 (Accounting Principles Bd. 1972) (“The presumption that all undistributed earnings will be transferred to the parent company may be overcome, and no income taxes should be accrued by the parent company, if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation.”).

101. ACCOUNTING FOR INCOME TAXES—SPECIAL AREAS, *supra* note 100.

102. *Id.* ¶ 12.

By utilizing APB 23, the consolidated net income is \$7 million higher than it would be in the absence of APB 23. This will lead to an increase in EPS. In addition, the effective tax rate is lowered as a result of utilizing APB 23. In the example, the effective tax rate utilizing APB 23 is equal to 23.33% (\$14 million income tax expense divided by \$60 million operating income).<sup>103</sup> If APB 23 is not applicable, the effective tax rate is equal to 35% (\$21 million income tax expense divided by \$60 million operating income). What APB 23 does, in essence, is convert a temporary difference into a permanent difference; the permanent difference in turn increases the consolidated net income, increases EPS and decreases the effective tax rate. As a result, Corporate America greatly values APB 23.

In the tax law community, scholars have discussed the benefits of tax deferral with respect to income of foreign subsidiaries. But just as important as the tax laws are the financial accounting rules treating the income of the foreign subsidiary as a permanent difference. If FASB was to repeal APB 23, thereby requiring the U.S. parent to record a deferred tax liability for the excess of its book basis over its tax basis in the stock of the foreign subsidiary, then it would be interesting to see if the U.S. parent would continue to greatly value the tax deferral benefit of delaying repatriation of the income of foreign subsidiaries.<sup>104</sup> The U.S. parent would have already taken a charge to earnings for the U.S. tax on the income of the foreign subsidiary prior to repatriation if APB 23 was repealed. It is possible the U.S. parent would be much more inclined to repatriate the earnings of the foreign subsidiary, finding much less need to keep the income offshore once it had already taken a charge on the income statement for the U.S. taxes that would be owed on repatriation.<sup>105</sup>

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103. In the example, operating income is assumed to equal pretax financial income.

104. If FASB was to repeal APB 23, a number of practical problems may arise in calculating the deferred tax liability (and deferred tax asset) for the excess of the U.S. parent's book basis over its tax basis in the stock of the foreign subsidiary. FASB noted that the "hypothetical nature of the calculations introduces significant implementation issues and other complexities that occur less frequently in calculations of a deferred tax liability for an *expected* remittance of earnings from a foreign entity." ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, § 173. In addition, the U.S. parent would have to calculate the foreign tax credit consequences of a hypothetical remittance of earnings from a foreign subsidiary, which would involve currency exchange rates, in determining the recording of a deferred tax asset. *Id.* § 174.

105. Of course, by not repatriating the earnings of the foreign subsidiary, the U.S. parent avoids paying U.S. income taxes on the earnings, thereby enhancing its cash flow. As part of the American Jobs Creation Act of 2004, Congress enacted a temporary provision permitting U.S. corporations to repatriate the earnings of their foreign subsidiaries with an 85% dividends received deduction. I.R.C. § 965. U.S. corporations repatriated billions of earnings of foreign subsidiaries utilizing the temporary 85% dividends received deduction. See Melissa Redmiles, *The One-Time Received Dividend Deduction*, 27 SOI BULLETIN 102, 103 (2008). Approximately 840 mostly large corporations repatriated nearly \$362 billion from their controlled foreign corporations (CFCs) and deducted about \$265 billion of these dividends from their taxable incomes between tax years 2004 and 2006 due to the one-time dividend received deduction enacted in the American Jobs Creation Act of 2004. *Id.* It is hard to know whether the repatriation was due to the lower U.S. income taxes owed on the repatriated earnings, the lower charge to earnings on the income statement as a result of the lower taxes, or a combination of the two.

*Example 8.* Microsoft had the following tax rate reconciliation in note 11 of its 2008 Annual Report:<sup>106</sup>

Note 11: Income Taxes

	2008	2007	2006
Federal statutory rate	35.0%	35.0%	35.0%
<i>Effect of:</i>			
Foreign earnings taxed at lower rates benefit	(7.0)%	(5.1)%	(4.6)%
Examination settlements	(5.8)%	—	(0.6)%
European Commission fine	2.1%	—	0.7%
Other reconciling items	1.5%	0.1%	0.5%
Effective rate	25.8%	30.0%	31.0%

In general, other reconciling items consist of interest, U.S. state income taxes, domestic production deductions, and research credits. In fiscal years 2008 and 2006, there were no individually significant other reconciling items. Other reconciling items in fiscal year 2007 included the impact of a \$195 million reduction resulting from various changes in tax positions taken in prior periods, related primarily to favorable developments in an IRS position and multiple foreign audit assessments.

As a result of utilizing APB 23, Microsoft lowered its effective tax rate in years 2006 through 2008 by 4.6%, 5.1%, and 7.0%, respectively.<sup>107</sup> Unlike many other permanent differences, such as the manufacturing deduction, research credit, and tax-exempt interest income, the permanent difference created as a result of APB 23 may significantly lower a corporation's effective tax rate, as illustrated by Microsoft in Example 8.

#### IV. THE EFFECTIVENESS OF CORPORATE TAX PREFERENCES

##### *A. In General*

Congress has enacted a number of corporate tax preferences in the tax laws, and it will continue to do so in the future. But how important are these tax preferences to Corporate America? More specifically, is Congress simply giving money away to Corporate America in the form of tax preferences that Corporate America does not value? On January 17, 2001, at his confirmation hearing before the U.S. Senate Finance Committee, Treasury Secretary Nominee Paul O'Neill, who was the former chairman and CEO of Alcoa, Inc., responded to a question regarding "what areas of the tax code do you

106. MICROSOFT 2008 ANNUAL REPORT, n.11 (2008), available at [http://www.microsoft.com/msft/reports/ar08/10k\\_fr\\_not\\_10.html](http://www.microsoft.com/msft/reports/ar08/10k_fr_not_10.html).

107. APB 23 has been referred to as a "rich company's benefit," meaning that well-to-do companies can keep money offshore (utilizing APB 23) while at the same time issuing debt in the United States at low interest rates. For example, in May 2009, Microsoft, for the first time in its history, sold \$3.75 billion in bonds to investors at interest rates only slightly higher than U.S. government debt. As illustrated in Example 8, Microsoft also utilizes APB 23 to lower its effective tax rate. See Nick Wingfield & Romy Varghese, *Cash-Rich Microsoft Sells Its First Bonds*, WALL ST. J., May 12, 2009, at B1.

think would best encourage more business investment.”<sup>108</sup> He replied:

[L]et me answer you this way. I guess I will be a maverick for the moment and tell you what I think about this. I never made an investment decision based on the tax code. If I didn't think I knew how I was going to cover the cost of capital with an investment, whatever the effective tax rate was, I took that into consideration. And, frankly, with investments—not everyone is like this—but if you make an investment for 20 years and you don't know pretty well how that investment is going to pay for the cost of capital, assuming the status quo and the—with the tax system, then you're not a businessman, you're a gambler. You know, maybe I should say more directly to you, if you're giving money away, I'll take it, you know. If you want to give me inducements for something I'm going to do anyway, I'll take it. But good business people don't do things because of inducements. They do it because they can see that they're going to be able to earn the cost of capital out of their own intelligence and organization of resources.<sup>109</sup>

Clearly, the most important aspect of corporate tax preferences is whether they are achieving their intended purposes. How the corporate tax preferences are reported on the financial statements, however, may have an important impact on the effectiveness of the preference. In general, to maximize the effectiveness of a corporate tax preference, it appears it should take the form of a permanent difference rather than a temporary difference.

*B. Accelerated Depreciation, Manufacturing Deduction and Research Credit*

Economists have debated for years whether accelerated depreciation is an effective economic stimulus. In much of the early literature, economists generally concluded that accelerated depreciation provided a low “bang for the buck.”<sup>110</sup> This was generally defined as whether the investment stimulated by the subsidy is larger than the revenue loss.<sup>111</sup> In 2002, Congress enacted bonus depreciation in the form of an immediate 30% write-off of the cost of equipment.<sup>112</sup> The following year, Congress increased the percentage to 50%.<sup>113</sup> Several studies found that the bonus depreciation provisions in 2002 and 2003 had “only a very limited impact on investment spending.”<sup>114</sup> For

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108. *Hearing of the Senate Finance Committee, Nomination of Treasury Secretary*, 107th Congress (2001).

109. *Id.* See also *The Foundation of International Tax Reform: Worldwide, Territorial, and Something in Between: Hearing Before the S. Comm. on Finance*, 110th Cong. 5 (2008) (statement of Robert H. Dilworth, Partner, McDermott Will & Emery LLP, Washington, D.C.) (“I have never actually met a businessman (or even a tax executive) who was actually involved in decision-making about the tax issues of where to locate a business (that actually employed people) who would agree that his MNC employer acted to invest somewhere because of an interest-free loan of residual U.S. corporate tax if the company invested in a foreign country rather than the United States. Businesses follow customers, efficient delivery of materials and productive work forces to such an extent that tax incentives are often just an afterthought.”).

110. See GRAVELLE, *CAPITAL INCOME*, *supra* note 51, at 118–20 (summarizing the economic literature on investment incentives as countercyclical devices from the 1960s until the early 1990s).

111. *Id.* at 118.

112. Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 101(a) (2002).

113. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 201 (2003).

114. See, e.g., Darrel S. Cohen & Jason Cummins, *A Retrospective Evaluation of the Effects of Temporary*

example, one study found that it increased output by only 0.1% to 0.2% and increased employment by only 100,000 to 200,000 jobs.<sup>115</sup> A number of reasons were advanced as to why the bonus depreciation provisions had such limited impact, including: (1) expectations that the provisions would be extended; (2) circumstances that were unique to business conditions in 2002 and 2003; and (3) investment projects planning lags, often extending well beyond one year.<sup>116</sup>

In December 2008, the Congressional Research Office (CRO) prepared a report for the United States Senate Committee on the Budget.<sup>117</sup> In its report, the CRO wrote the following as part of its assessment of accelerated depreciation for equipment:

Evidence suggests that the rate of economic decline of equipment is much slower than the rates allowed under current law, and this provision causes a lower effective tax rate on such investments than would otherwise be the case. The effect of these benefits on investment in equipment is uncertain, although more studies find equipment somewhat responsive to tax changes than they do structures. Equipment did not, however, appear to be very responsive to the temporary expensing provisions adopted in 2002 and expanded in 2003.<sup>118</sup>

The CRO concluded that because of accelerated depreciation, equipment tends to be favored relative to other assets.<sup>119</sup> As a result, the tax system causes a misallocation of capital.<sup>120</sup>

One reason that may partially explain the limited impact on investment spending of bonus depreciation and accelerated depreciation for public companies is the financial statement impact. Bonus depreciation and accelerated depreciation create temporary differences.<sup>121</sup> Neither provides an immediate income statement benefit. As a result, from a financial accounting standpoint, bonus depreciation and accelerated depreciation may have very little impact on a public company's investment spending because they do not increase the company's net income or EPS and do not lower the company's effective tax rate.

The investment tax credit has been suggested by economists as a possible investment subsidy alternative to accelerated depreciation.<sup>122</sup> Congress first enacted an investment tax credit in 1962.<sup>123</sup> The regular investment tax credit has gone in and out of

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*Partial Expensing*, (Fed. Reserve Bd., Finance and Economics Discussion Series Working Paper No. 2006-19, 2006); Christopher House & Matthew Shapiro, *Temporary Investment Tax Incentives: Theory with Evidence from Bonus Depreciation* (NBER Working Paper No. 12514, 2006).

115. See House & Shapiro, *supra* note 114, at 34.

116. See *Options for Responding to Short-Term Economic Weakness: Hearing Before the Senate Comm. on Finance* 110th Cong. 15 (2008) (statement of Peter R. Orszag, Director Congressional Budget Office).

117. CRO REPORT, *supra* note 51.

118. *Id.* at 420.

119. *Id.*

120. *Id.*

121. See *supra* Part III.A.

122. See, e.g., Gravelle, *Business Tax Cuts*, *supra* note 51, at 72 ("If such subsidies are used, however, the most effective short run policy is probably a temporary investment credit."); Jesse Edgerton, Investment, Accounting, and the Salience of the Corporate Income Tax 1 (Oct. 7, 2009) (unpublished manuscript, available at <http://www.mit.edu/~edge/bookTax.pdf>) ("Investment tax credits, which do affect accounting profits, have more impact on investment than accelerated depreciation, which does not.").

123. Revenue Act of 1962, Pub. L. No. 87-834, § 2; 76 Stat. 960, 962-63 (1962).



the Code over the years, finally being repealed as part of the Tax Reform Act of 1986.<sup>124</sup> For public companies, it is possible that the investment tax credit is a better economic stimulus than expensing and accelerated depreciation. The reason again involves financial accounting. The investment tax credit is a permanent difference. As a result, it provides a benefit on the income statement by increasing net income, increasing EPS, and lowering the effective tax rate. The Joint Committee on Taxation has noted the financial statement benefit of the investment tax credit versus expensing and accelerated depreciation: "In contrast to the straight-line depreciation, accelerated depreciation, and expensing methods of cost recovery, an investment tax credit reduces the total cash taxes paid over the life of an asset as well as the total tax expense and effective tax rate reported on the financial statements."<sup>125</sup>

Looking at the history of the investment tax credit may help determine if companies valued the credit. When Congress first enacted the investment tax credit in 1962, there was a financial accounting issue as to when to account for the credit on the income statement. In other words, could the company fully utilize the credit in the year the property was placed in service, or did the company have to amortize the credit over the life of the property? In 1962, the APB issued Opinion No. 2, which required that the credit be recognized over the life of the asset.<sup>126</sup> This method was referred to as the deferral method. In adopting the deferral method, the APB recognized that the benefit of the credit took place as the asset was used in business and not through the act of acquiring the asset.

*Example 9.* A company purchases \$800,000 of equipment that qualifies for a 10% investment tax credit, resulting in a credit of \$80,000. The useful life of the equipment is ten years. Under the deferral method, the company will recognize the benefit of the investment tax credit on its income statement over the useful life of the equipment, which is \$8000 per year (\$80,000 divided by 10 years).

A number of companies were not pleased with Opinion No. 2's requirement that the investment tax credit be amortized over the useful life of the asset.<sup>127</sup> As a result, in 1964, the APB, at the encouragement of the SEC, issued Opinion No. 4, which specified a preference for the deferral method but permitted companies to utilize a flow-through method, in which companies would immediately receive an income statement benefit for the full amount of the investment tax credit.<sup>128</sup>

*Example 10.* Same facts as Example 9, except the company utilizes the flow-through method for the investment tax credit. Under such method, the company will recognize the full amount of the credit (\$80,000) in year one.

As a result of Opinion No. 4, the investment tax credit was a permanent difference that resulted in an immediate income statement benefit for the full amount of the credit in the year the asset was placed in service. Corporate America's displeasure with Opinion No. 2 lends some support to the importance of an immediate income statement benefit.

Focusing solely on financial statement benefits, it should not be surprising if the

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124. Tax Reform Act of 1986, Pub. L. No. 99-514, § 211(a); 100 Stat. 2085, 2166-70 (1986) (repealing the regular investment tax credit).

125. See JCT BOOK-TAX REPORT, *supra* note 35, at 31.

126. ACCOUNTING FOR THE INVESTMENT CREDIT, APB Opinion No. 2 (Accounting Principles Bd. 1962).

127. See LANNY G. CHASTEEN ET AL., INTERMEDIATE ACCOUNTING 502 (2d ed. 1987).

128. ACCOUNTING FOR THE INVESTMENT CREDIT, APB Opinion No. 4 (Accounting Principles Bd. 1964).

investment tax credit provides a slightly better economic stimulus to Corporate America than accelerated depreciation. However, similar to accelerated depreciation, the investment tax credit has not been viewed by most economists as a successful investment incentive.<sup>129</sup> From a financial accounting standpoint, one reason for the lack of success of the investment tax credit may be that, in many cases, it has a minimal impact on net income, EPS, and the effective tax rate.

The manufacturing deduction is a relatively new corporate tax preference, having been enacted in 2004. It is a permanent difference and would seem to be prized by Corporate America. But it provides such a small benefit on the income statement of many public corporations that it may not be all that important.<sup>130</sup> As a result, it should not be surprising if Corporate America is willing to surrender the manufacturing deduction in exchange for even a modest corporate tax rate cut. In addition, Corporate America may be willing to surrender the manufacturing deduction for a corporate tax rate cut because of the complexity of the deduction.<sup>131</sup> The deduction is based in part on a deduction that Canada had enacted as part of its tax system.<sup>132</sup> Canada later repealed its manufacturing deduction because of the administrative complexity associated with it.<sup>133</sup>

Early in its history, the research credit was generally thought to be cost-effective.<sup>134</sup> For example, the CRO has noted that evidence from the 1980s indicates that a one dollar decline in the after-tax cost of research and development was associated with an increase in research and development of one to two dollars, suggesting a relatively high price elasticity for research and development spending in the 1.0 to 2.0 range.<sup>135</sup> Other studies have, however, questioned the cost-effectiveness of the research credit, suggesting that the price elasticity for the research credit may only be in the range of 0.2 to 0.5.<sup>136</sup> These studies indicate instead that research and development spending is relatively price inelastic, and that a 10% tax credit would increase aggregate research spending by only about 2% to 5%.<sup>137</sup> A number of criticisms have been leveled against the credit, including: (1) a credit may not be the most efficient way to increase investment in

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129. See, e.g., Alan J. Auerbach & Kevin A. Hassett, *Tax Policy and Business Fixed Investment*, 47 J. PUB. ECON. 141 (1992); MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION* 346 (6th ed. 2009); Gravelle, *Business Tax Cuts*, *supra* note 51, at 67.

130. Of course, the impact on the income statement will be greater as the amount of the deduction increases until it is fully phased-in. I.R.C. § 199(a)(2) (2006). For taxable years beginning in 2005 and 2006, the deduction is three percent of the lesser of (a) qualified production activities income or (b) taxable income. *Id.* In 2007, 2008, and 2009, the percentage is increased to 6%. For taxable years beginning in 2010, the deduction is fully phased-in at 9%. *Id.*

131. CRO REPORT, *supra* note 51, at 88.

132. *Id.*

133. *Id.*

134. See, e.g., GARY GUENTHER, CONGR. BUDGET OFFICE, *RESEARCH TAX CREDIT: CURRENT STATUS, LEGISLATIVE PROPOSALS IN THE 109TH CONGRESS, AND POLICY ISSUES* 15 (2006); CRO REPORT, *supra* note 51, at 88. The effectiveness of the research credit has also been measured by the social benefit from any added research and development as a result of the credit less the social cost of that research and development. See GUENTHER, *supra*, at 13.

135. CRO REPORT, *supra* note 51, at 88.

136. See STAFF OF THE JOINT COMM. ON TAXATION, *DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2006 BUDGET PROPOSAL* 306-09 (2005) (discussing the responsiveness of research spending to the tax credit).

137. *Id.*

research and development; (2) the credit lacks a clear definition of research and development; (3) the incentive effect of the credit may not be sufficient to increase research and development to levels commensurate with its purported social benefits; (4) the credit mostly subsidizes research that would have been done in the absence of the credit; and (5) the temporary nature of the credit may deter some research and development investment.<sup>138</sup>

Although the research credit is a permanent difference, it usually only lowers a corporation's effective tax rate by a small percentage. For example, Hewlett Packard showed a reduction in its effective tax rates due to the research credit in years 2006 through 2008 of only 0.2%, 0.6%, and 0.4%, respectively.<sup>139</sup> Similarly, Pfizer showed a reduction in its effective tax rates due to the research credit in years 2004 through 2006 of only 0.5%, 0.8%, and 0.6%, respectively.<sup>140</sup> Microsoft did not even show the research credit as a separate line item in its effective tax reconciliation for years 2006 through 2008.<sup>141</sup> As a result, it should not be surprising if Corporate America is willing to surrender the research credit in exchange for even a modest corporate tax rate cut.<sup>142</sup>

### C. Tax-Exempt Interest

The exclusion for tax-exempt interest was enacted by Congress in 1913. Congress has retained the exclusion as a revenue sharing arrangement with the state and local governments. More specifically, the justification of the exclusion is that it provides a subsidy to state and local governments in the form of lower borrowing costs.<sup>143</sup> As a result, the effectiveness of the exclusion on Corporate America is not really relevant in the same manner as other corporate tax preferences such as accelerated depreciation and the research credit.<sup>144</sup>

### D. Deferral of Income and APB 23

The deferral of income coupled with APB 23 produces a significant financial statement benefit for Corporate America. In fact, for many—if not most—public companies in the United States, the deferral of income and APB 23 may be the largest and most important permanent difference. There has been a lot of discussion among

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138. CRO REPORT, *supra* note 51, at 88; *see also* GUENTHER, *supra* note 134, at 17–27 (discussing “policy issues raised by the current research tax credit”).

139. *See* HEWLETT PACKARD CO. 2007 ANNUAL REPORT 118 (2007), *available at* [http://media.corporate-ir.net/media\\_files/irol/71/71087/AR2007/index.html](http://media.corporate-ir.net/media_files/irol/71/71087/AR2007/index.html).

140. *See* PFIZER INC. 2006 FINANCIAL REPORT 48 (2006), *available at* [http://www.pfizer.com/investors/financial\\_reports/financial\\_report\\_2006.jsp](http://www.pfizer.com/investors/financial_reports/financial_report_2006.jsp).

141. MICROSOFT CORP. ANNUAL REPORT 2008 (2008), *available at* [http://www.microsoft.com/msft/reports/ar08/downloads/MS\\_2008\\_AR.docx](http://www.microsoft.com/msft/reports/ar08/downloads/MS_2008_AR.docx).

142. *See Our Business Tax System: Objectives, Deficiencies, and Options for Reform: Hearing Before the Sen. Comm. on Finance* 109th Cong. (2006) (statement of David L. Bernard, International President, Tax Executives Institute, Inc.) [hereinafter Bernard Testimony] (arguing for a simpler tax system with a broader base and lower rate).

143. *See* GRAETZ & SCHENK, *supra* note 129, at 227.

144. Although tax-exempt interest is a permanent difference, which is generally favored by Corporate America, it has a drawback. The generally lower interest rate on tax-exempt bonds relative to taxable bonds creates less pretax financial income (i.e., above the line income) than the higher interest rate on taxable bonds, which is an unfavorable result.

academics, practitioners, and government officials as to whether Congress should retain deferral of income of foreign subsidiaries, adopt a territorial exemption system, or adopt a flow-through system.<sup>145</sup>

If Congress retains deferral, as under the current tax system, then Corporate America will continue to greatly value the permanent difference created as a result of APB 23. If Congress moves towards a territorial exemption system, then APB 23's significance will be greatly reduced because no U.S. income tax expense would be recorded for income of a foreign subsidiary, whether permanently reinvested or not. In other words, under the current tax system, APB 23 in essence creates a territorial system on the U.S. parent's consolidated financial statements.<sup>146</sup> If Congress moves towards a flow-through system by eliminating deferral, then APB 23's significance would again be greatly reduced, because the U.S. income tax expense of the income of a foreign subsidiary would have to be recorded on a current basis.

Thus, if Congress continues to permit deferral of taxes on the income of foreign subsidiaries,<sup>147</sup> Corporate America will continue to fight hard to retain APB 23 because it creates a permanent difference. In addition, Corporate America may strongly oppose a flow-through system of taxing income of foreign subsidiaries, one reason being the adverse financial statement results of such a system (as well as the increase in current U.S. income tax).

#### V. CORPORATE TAX RATE CUT

The United States has a progressive corporate tax rate system, with four statutory tax rates: 15%, 25%, 34%, and 35%.<sup>148</sup> The highest statutory tax rate of 35% begins when a corporation's taxable income exceeds \$10 million.<sup>149</sup> Many public corporations have taxable incomes well in excess of \$10 million and are therefore subject to the 35% corporate tax rate.<sup>150</sup>

For a number of years, Corporate America has asked the Administration and Congress to reduce the top corporate tax rate from 35% to closer to 30% or even lower.<sup>151</sup> Corporate America has noted that the United States has the second highest corporate tax rate of the 30 OECD countries, with only Japan being higher.<sup>152</sup> In October

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145. See generally *supra* notes 91–92.

146. Unlike a territorial system, however, cash flow is restricted under APB 23.

147. The Obama Administration has proposed a number of changes to the U.S. international tax rules that would impact the deferral of income of foreign subsidiaries. See DEPT. OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 28–39 (2009).

148. I.R.C. § 11(b) (2006).

149. In addition to the four statutory corporate tax rates, there are two additional corporate tax rates that are not specifically provided for in the statutory rate structure. The rate advantages of the 15% and 25% brackets are phased out by a 5% surtax on a corporation's taxable income between \$100,000 and \$335,000. The rate advantage of the 34% bracket is phased out by a 3% surtax on a corporation's taxable income between \$15 million and \$18,333,333. *Id.* § 11(b)(1).

150. A corporation with taxable income exceeding \$18,333,333 is subject to a flat 35% corporate tax rate. § 11(b).

151. See, e.g., Glenn, *supra* note 11, at 324–36 (discussing corporate desire to reduce breaks in exchange for a simpler system based on lower rates); see generally Joann M. Weiner, *U.S. Corporate Tax Reform: All Talk, No Action*, 116 TAX NOTES 716 (2007).

152. OECD TAX DATABASE, tbl. II.1, available at [www.oecd.org/ctp/taxdatabase](http://www.oecd.org/ctp/taxdatabase); TREASURY

2007, Rep. Charles Rangel, chairman of the Ways and Means Committee, released his tax reform bill in which the top corporate tax rate would be reduced from 35% to 30.5%.<sup>153</sup> As a trade-off for a lower top corporate tax rate, Rep. Rangel proposed eliminating a number of corporate tax preferences, including the manufacturing deduction.<sup>154</sup> The Treasury Department, in its 2007 report on approaches to improving business competitiveness, suggested that a 28% corporate tax rate was possible by eliminating a broad range of corporate tax preferences.<sup>155</sup>

A reduction in the top corporate tax rate may have an immediate impact on a corporation's net income. To understand this immediate impact, it is important to know what position the corporation is in regarding its deferred taxes.<sup>156</sup> A corporation will record a deferred tax asset on its balance sheet if it has, in essence, *prepaid* taxes with respect to one or more transactions.<sup>157</sup> For example, if a corporation receives an advance payment for services to be rendered in the future, it will, as a general rule, include the advance payment in gross income for tax purposes upon receipt.<sup>158</sup> For financial accounting purposes, however, the advance payment will be included in revenue over time as the services are rendered.<sup>159</sup> As a result, when viewed from the financial accounting perspective, taxes paid upon receipt of the advance payment are, in essence, prepaid. The corporation therefore records a deferred tax asset reflecting the prepayment of the taxes on the advance payment for services. The deferred tax asset is equal to the advance payment multiplied by the applicable tax rate.<sup>160</sup>

One of the most common reasons for a corporation to record a deferred tax asset on its financial statements relates to employee benefit obligations.<sup>161</sup> Prior to the early 1990s, the prevalent practice among companies was to account for welfare benefits under a pay-as-you-go (i.e., cash) basis, which is how such benefits are accounted for under the tax laws.<sup>162</sup> As a result, a company would record as an expense on its income statement for its welfare benefits at the same time it recorded a deduction for tax purposes, i.e., at the time of payment. Therefore, no deferred tax asset would arise. Since the early 1990s, however, under the financial accounting rules, a company must account for health care

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COMPETITIVENESS STUDY, *supra* note 8, at 7.

153. Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. § 3001 (2007).

154. *Id.* at § 3101.

155. TREASURY COMPETITIVENESS STUDY, *supra* note 8, at 44.

156. Deferred taxes refer to both deferred tax assets and deferred tax liabilities.

157. ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, ¶ 11 (b), (c).

158. *See, e.g.,* Auto. Club of Mich. v. Comm'r, 353 U.S. 180 (1957); Am. Auto. Ass'n v. United States, 367 U.S. 687 (1961); Schlude v. Comm'r, 372 U.S. 128 (1963).

159. ELEMENTS OF FINANCIAL STATEMENTS, Statement of Fin. Accounting Concepts No. 6, ¶ 197 (Fin. Accounting Standards Bd. 1985).

160. ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, ¶ 18.

161. *See* James M. Poterba et al., New Evidence on the Sources, Importance, and Potential Consequences of Temporary Differences (Feb. 1, 2007) (unpublished manuscript, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=962750](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=962750)). In 2004, 27 firms in a sample of 78 large public corporations reported net deferred tax assets, and 51 firms reported net deferred tax liabilities. *Id.* The largest components of deferred tax assets for sample firms were Loss and Credit Carryforwards and Employment and Post-Employment Benefits. *Id.* The largest component of deferred tax liabilities was Property, Plant & Equipment. *Id.* Total deferred tax assets for sample firms with net deferred tax assets in 2004 was \$65.4 billion, while total deferred tax liabilities for sample firms with net deferred tax liabilities was \$226.6 billion. *Id.*

162. *See* KIESO, *supra* note 13, at 1057.

and other welfare benefits on an accrual basis.<sup>163</sup> Therefore, a company will record an expense for welfare benefits prior to deducting the welfare benefits for tax purposes. This will lead to the recording of a deferred tax asset.<sup>164</sup>

A second and even more common reason a company will record a deferred tax asset relates to net operating loss carryforwards.<sup>165</sup> As a general rule, net operating losses may be carried back two years and carried forward 20 years.<sup>166</sup> With the economic downturn beginning in 2008, it is possible, if not likely, that many more public companies will record a deferred tax asset for net operating loss carryforwards. The last economic downturn in 2001 resulted in a significant increase in 2002 in the net deferred tax assets of large public corporations.<sup>167</sup> The increase, however, was short-lived. In 2003, the net deferred tax assets of large public corporations had returned to the 2001 level.<sup>168</sup>

A corporation will record a deferred tax liability on its balance sheet if it has, in essence, *deferred* paying taxes on one or more transactions.<sup>169</sup> For example, assume a corporation sells equipment and reports the gain for tax purposes under the installment method of accounting.<sup>170</sup> As a result, part or all of the tax due on the gain will be paid in later years when payments are received on the installment obligation. For financial accounting purposes, however, a corporation as a general rule is not permitted to report gain using the installment method.<sup>171</sup> Therefore, the corporation will report the gain in the year of sale for financial accounting purposes; however, taxes will be paid on the gain in a later year. As a result, when viewed from the financial accounting perspective, taxes paid on the sale of the equipment are, in essence, deferred. The deferred tax liability is equal to the gain not yet included in gross income multiplied by the applicable tax rate.<sup>172</sup>

One of the most common reasons that a corporation will record a deferred tax liability on its balance sheet relates to accelerated depreciation of equipment.<sup>173</sup> Many times, a corporation will utilize accelerated depreciation for tax purposes but straight-line

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163. EMPLOYERS' ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS, Statement of Fin. Accounting Standards No. 106 (Fin. Accounting Standards Bd. 1990).

164. When FAS 106 first became effective, a number of companies recorded large charges for employee benefit obligations. For example, IBM recorded a \$2.3 billion charge, and General Electric recorded a \$2.7 billion charge. See KIESO, *supra* note 13, at 1057.

165. See Poterba et al., *supra* note 161.

166. I.R.C. § 172(b)(1)(A).

167. See Poterba et al., *supra* note 161. In 2001, 33 firms in a sample of 78 large public corporations reported net deferred tax assets, and 45 firms reported net deferred tax liabilities. *Id.* The net deferred tax assets of the 33 firms totaled \$69.1 billion, and the net deferred tax liabilities of the 45 firms totaled \$181.6 billion. *Id.* In 2002, 33 firms again reported net deferred tax assets, and 45 firms reported net deferred tax liabilities. *Id.* The net deferred tax assets of the 33 firms increased to \$94.1 billion, and the net deferred tax liabilities increased slightly to \$186.9 billion. *Id.* By 2003, however, only 29 firms reported net deferred tax assets totaling \$68.4 billion, and 49 firms reported net deferred tax liabilities totaling \$226.9 billion. Poterba et al., *supra* note 161.

168. *Id.*

169. ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, ¶ 11(a), (d).

170. I.R.C. § 453 (defining the installment method).

171. See OMNIBUS OPINION, APB Opinion No. 10, § 12 (Accounting Principles Bd. 1966) (except in special circumstances, "the installment method of recognizing revenue is not acceptable").

172. ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, ¶ 18.

173. See Poterba et al., *supra* note 161, at 14.

depreciation for financial accounting purposes. As a result, tax depreciation will be greater than financial accounting depreciation in the early years of the depreciable asset. The corporation will record a deferred tax liability reflecting the difference between the corporation's tax basis in its depreciable asset and its financial accounting basis in the same asset. The deferred tax liability reflects the fact that the corporation is deferring paying taxes to the U.S. government as a result of using accelerated depreciation for tax purposes.

Most public corporations are in a net deferred tax liability position, meaning that their deferred tax liabilities exceed their deferred tax assets.<sup>174</sup> Under the relevant financial accounting rules, if Congress changes the top corporate tax rate, corporations must adjust their deferred tax liabilities and deferred tax assets.<sup>175</sup> The effect is included in income from continuing operations for the period that includes the enactment date of the tax laws or rates.<sup>176</sup> This means that the adjustment will impact a corporation's net income, EPS, and effective tax rate. If, for example, a corporation has a deferred tax liability of \$35,000 (\$100,000 temporary difference times 35% applicable tax rate) and Congress increases the top tax rate from 35% to 40%, then the corporation must increase its deferred tax liability to \$40,000 and increase its deferred tax expense by \$5000 for the period that includes the enactment date. The net effect is to increase income tax expense by \$5000, thereby decreasing net income by a corresponding amount. As a result, when Congress increases the top corporate tax rate, corporations are forced to take a charge (or "hit") to earnings if they have net deferred tax liabilities.

When Congress last increased the top corporate tax rate (from 34% to 35%) as part of the Omnibus Budget Reconciliation Act of 1993, it did so retroactively to January 1, 1993.<sup>177</sup> An issue arose as to whether the tax effect of a retroactive change in tax rates should be measured utilizing temporary differences on the enactment date of August 10, 1993, or on the effective date of January 1, 1993. A FASB Task Force concluded that the tax effect of a retroactive change in tax rates should be measured using temporary differences and currently taxable income on the enactment date of August 10, 1993, with the cumulative tax effect included in income from continuing operations.<sup>178</sup>

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174. *See id.*, at 2-3 (reporting study indicating large proportion of firms are in a net deferred tax liability position). With the current economic downturn in 2008-09, it is possible that some or even many public corporations that were previously in a net deferred tax liability position will, as a result of recording a large deferred tax asset for a net operating loss carryforward, be in a net deferred tax asset position.

175. ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, § 27.

176. *Id.*

177. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13221(a) (1993).

178. EFFECT OF A RETROACTIVE CHANGE IN ENACTED TAX RATES THAT IS INCLUDED IN INCOME FROM CONTINUING OPERATIONS, Issue No. 93-13 (Fin. Accounting Standards Bd. Task Force). Apparently, analysts reacted to the increase in earnings due to the tax rate adjustment in the same way they reacted to the other components of earnings (i.e., analysts did not disaggregate the earnings). *See* Kevin C. W. Chen & Michael P. Schoderbek, *The 1993 Tax Rate Increase and Deferred Tax Adjustments: A Test of Functional Fixation*, 38 J. ACCT. RESEARCH 23-44 (2000) (reporting study of analysts' reactions to the 1993 tax increase).

*Example 11.* Ford Motor Company had the following tax rate reconciliation in its 1995 Annual Report (note 6):<sup>179</sup>

A reconciliation of the provision of income taxes compared with the amounts at the U.S. statutory tax rate is shown below (in millions):

	1995	1994	1993
Tax provision at U.S. statutory rate of 35%	\$2400	\$2981	\$1357
<i>Effect of:</i>			
Foreign taxes over U.S. tax rate	100	68	219
State and local income taxes	71	158	118
Rate adjustments on U.S. and foreign deferred taxes	—	—	(199)
Income not subject to tax or subject to tax at reduced rates	(47)	(62)	(70)
Other	(145)	184	(75)
Provision of income taxes	\$2379	\$3329	\$1350
Effective tax rate	34.7%	39.1%	34.8%

One of the items listed as part of Ford's tax rate reconciliation is a rate adjustment of (199) in 1993. This reflects the increase in the top corporate tax rate from 34% to 35%. Ford had a negative adjustment of \$199, which means that Ford was in a net deferred tax asset position. It increased its net deferred tax assets with a corresponding decrease to income tax expense. As a result, even though the top corporate tax rate increased by one percentage point, Ford's rate adjustment lowered its effective tax rate by \$199.

If Congress reduces the top corporate tax rate from 35% to, for example, 30%, it will have several consequences on the income statement for Corporate America.<sup>180</sup> First, corporations that are in a net deferred tax liability position will reduce their net deferred tax liabilities.<sup>181</sup> The reduction will increase the corporation's income from continuing operations.<sup>182</sup> As a result, the corporation will show higher net income and EPS for the period in which the corporate tax rate is reduced, and the corporation's effective tax rate will be lowered. Second, for future periods, the corporation will show a lower amount of tax expense as a result of the lower corporate tax rate. This results in higher net income and EPS each year as well as a lower effective tax rate. As a result, corporations in a net deferred tax liability position receive both an immediate income statement benefit and a future income statement benefit.

Corporations that are in a net deferred tax asset position will take an immediate charge on the income statement if Congress enacts a corporate tax rate cut.<sup>183</sup> The reason is that the corporations will be forced to reduce their deferred tax assets with a

179. Ford Motor Co., Annual Report (Form 10-K405) (1996), available at <http://www.secinfo.com/d1533.98.htm#1stPage>.

180. See Poterba et al., *supra* note 161, at 18–20 (describing the consequences as a “revaluation effect” and “direct effect”).

181. ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, §27.

182. *Id.*

183. See *supra* Part I (describing how the manufacturing companies that lobbied the tax staffs of the Ways and Means Committee in 2004 were in a net deferred tax asset position).



corresponding increase to income tax expense.<sup>184</sup> The increase to income tax expense will reduce the corporation's net income and EPS and will also increase the corporation's effective tax rate for the period in which the tax rate cut is enacted. For future periods, however, a corporate tax rate cut will benefit corporations that are in a net deferred tax asset position.

## VI. GENERAL REFLECTIONS ON VARIOUS TYPES OF CORPORATE TAX PREFERENCES

### *A. In General*

As demonstrated, the five leading corporate tax preferences can be grouped into five separate categories for tax purposes.<sup>185</sup> From a financial accounting standpoint, however, almost all, if not all, corporate tax preferences can be placed into one of three categories. The first category is permanent differences. This category would include such corporate tax preferences as the manufacturing deduction, the research and development credit, tax-exempt interest, and deferral of income of foreign subsidiaries. The second category is temporary differences. This would include such corporate tax preferences as expensing and accelerated depreciation. The third category is a corporate tax rate cut, which would include an actual tax rate cut and deductions that are treated as a rate cut. Of the three categories, which are the most important to Corporate America? If Corporate America is focused on net income, EPS, and the effective tax rate, then it will desire tax preferences in the form of either permanent differences or a corporate tax rate cut. Only items in these two categories increase net income and EPS and lower the effective tax rate. Temporary differences, such as expensing and accelerated depreciation, do not have an immediate impact on net income, EPS, or the effective tax rate. Rather, temporary differences provide a temporary cash flow benefit, which is not generally considered to be of overwhelming importance to a company unless it is in a cash flow crisis.<sup>186</sup>

### *B. Permanent Differences Versus a Corporate Tax Rate Cut*

If Corporate America prefers tax preferences in the form of either permanent differences or a tax rate cut, is one preferable to the other? In certain cases, permanent differences and a tax rate cut may have an identical effect. For example, assume a manufacturing company has \$100,000 of taxable income that is taxed at 35%. If Congress provides a nine percent deduction of the manufacturer's taxable income, then the deduction is equivalent to a 31.85% tax rate for the manufacturer. If financial accounting income is also \$100,000, then the following effective tax rate reconciliation table demonstrates the identical results of a permanent difference and a corporate tax rate cut.

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184. ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, § 27.

185. *See supra* Part III.

186. *See* Neubig, *supra* note 42, at 483 (observing that the proposed option of expensing of capital investments resulted in the "proverbial sound of 'one hand clapping'" from Corporate America).

	Permanent difference	Corporate tax rate cut
Federal income tax at the statutory rate	\$35,000	\$31,850
Manufacturing deduction	(3150)	—
Income tax expense	\$31,850	\$31,850
Effective income tax rate	31.85%	31.85%

Unlike a permanent difference, a corporate tax rate cut will have an immediate impact on a corporation with deferred taxes.<sup>187</sup> If a corporation is in a net deferred tax liability position, as most corporations are, a corporate tax rate cut will provide an immediate boost to the corporation's net income by lowering its net deferred tax liabilities with a corresponding decrease to income tax expense.<sup>188</sup> This will increase the corporation's net income and EPS and lower the corporation's effective tax rate.

In contrast, a permanent difference will not have an immediate impact on a corporation with deferred taxes. If the manufacturing deduction is treated as a permanent difference for financial accounting purposes, then a corporation's deferred tax liability is not reduced. If, however, part or all of the temporary difference giving rise to the deferred tax liability reverses the next year, it will lower deferred tax expense the next year at the statutory tax rate of 35%. As a result, a permanent difference may lower deferred tax expense in a future year(s) and thereby decrease a corporation's effective tax rate in a future year(s).

One major difference between a permanent difference and a corporate tax rate cut is that the latter generally applies to all corporations. For example, Representative Rangel, in his tax bill, has proposed to reduce the top corporate tax rate from 35% to 30.5%.<sup>189</sup> This will obviously affect all corporations currently subject to the top corporate tax rate. The Treasury Department has suggested that a 28% corporate tax rate may be possible by eliminating a broad range of corporate tax preferences.<sup>190</sup>

It is possible to differentiate among corporations so as to provide a *targeted* corporate tax rate cut. In 2004, the House Ways and Means Committee, in its bill, the American Jobs Creation Act of 2004, proposed that the corporate tax rate applicable to qualified production activities income not exceed 32% (34% for taxable years beginning before 2007).<sup>191</sup> The committee was attempting to provide a tax rate cut for domestic manufacturers.<sup>192</sup> As part of the Conference Agreement, the House dropped its proposal for a targeted corporate tax rate cut and agreed to the Senate Finance Committee's

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187. See *supra* Part V (discussing the effect of a corporate tax rate cut and the effect it would have on a corporation's net income).

188. *Id.*

189. See Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong., § 3001 (2007).

190. See TREASURY COMPETITIVENESS STUDY, *supra* note 8, at 47 (noting that repealing certain provisions would reduce top business tax rate to 28%).

191. American Jobs Creation Act of 2004, H.R. 4520, 110th Cong., § 102(a) (2004).

192. Congress' interest in providing a tax benefit to U.S. manufacturers was in response to the World Trade Organization's decision that the Extraterritorial Income (ETI) regime in the tax code was a prohibited export subsidy. See STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 170 (2005) ("Consequently, the Congress believed that it was appropriate and necessary to replace the ETI regime with new provisions that reduce the tax burden on domestic manufacturers, including small businesses engaged in manufacturing.").

proposal for a manufacturing deduction, which was then enacted as part of the American Jobs Creation Act of 2004.<sup>193</sup> If Congress desires to provide a *targeted* corporate tax preference, it may be easier to do so with a permanent difference than with a corporate tax rate cut.<sup>194</sup>

Corporate tax preferences that give rise to permanent differences under the financial accounting rules can, as a general rule, be easily tailored by Congress to apply to corporations operating in a specific industry or to specific activities of certain corporations. For example, the research credit is particularly beneficial to corporations that spend increasingly large amounts on research. If Congress were to resurrect the investment tax credit, which is a permanent difference, it could tailor the credit to property newly placed in service or to particular types of property or investments.<sup>195</sup>

Generally, Corporate America prefers a corporate tax rate cut versus a permanent difference even if they have identical effects on net income, EPS, and the effective tax rate. For example, David L. Bernard, International President of Tax Executives Institute (TEI), in testimony before the Senate Finance Committee on September 20, 2006, requested that Congress lower the top corporate tax rate from 35% to a rate more in line with the rest of the world.<sup>196</sup> Mr. Bernard indicated that Corporate America would prefer a lower corporate tax rate versus a research credit, which is a permanent difference, “to reduce complexity, ease tax administration, and minimize the government’s role in picking ‘winners’ and ‘losers.’”<sup>197</sup>

In addition, a corporate tax rate cut produces “clean earnings” for analysts. That is, analysts generally remove one-time items and unpredictable items from earnings.<sup>198</sup> Rate cuts do not require these adjustments. On the other hand, some public companies may prefer particular types of permanent differences if the company in question qualifies for the permanent difference and its major competitors do not. If, for example, General Motors benefitted from a permanent difference and Ford Motor Company did not, then General Motors might prefer the permanent difference to an equivalent corporate tax rate cut.

### *C. Differences Among Permanent Differences*

Many permanent differences, in isolation, have a small impact on a corporation’s effective tax rate. For example, the research credit is a permanent difference and the fourth most expensive corporate tax preference listed in the 2007 Treasury study.<sup>199</sup> However, for many corporations, the research credit lowers the effective tax rate by less

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193. See American Jobs Creation Act of 2004, H.R. 4520, 108th Cong. § 102 (2004).

194. The manufacturing deduction, however, which is a permanent difference, has proven to be quite difficult to apply in practice. For example, in Notice 2005-14, the IRS listed a number of unresolved issues related to the manufacturing deduction and requested comments from taxpayers. Notice 2005-14, § 6, 2005-1 C.B. 498.

195. See GRAETZ & SCHENK, *supra* note 129, at 346.

196. See Bernard Testimony, *supra* note 142 (arguing that the current tax rate puts American companies at a disadvantage).

197. *Id.*

198. The research credit would be an example of an unpredictable item because the amount of the credit may vary from year to year, and it is not completely certain that Congress will continue to extend it.

199. See *supra* Part III.D.

than one percentage point. Utilizing Pfizer as an example, which is the world's largest pharmaceutical company, Pfizer's effective tax rate was lowered by the research credit in years 2004 through 2006 by only 0.6%, 0.8%, and 0.5%, respectively.<sup>200</sup>

The minimal impact that the research credit has for many corporations may be one reason why Mr. Bernard would prefer a corporate tax rate cut as opposed to the research credit.<sup>201</sup> The manufacturing deduction, which is another permanent difference and the second most expensive corporate tax preference, similarly may have a small impact on a corporation's effective tax rate.<sup>202</sup> For example, Intel's effective tax rate was lowered by the manufacturing deduction in years 2006 through 2008 by 0.9%, 1.1%, and 1.7%, respectively.<sup>203</sup> Microsoft does not even provide a separate line item for the manufacturing deduction, but rather aggregates it with other small reconciling items as part of its effective tax rate reconciliation.<sup>204</sup>

In contrast to most permanent differences, one permanent difference provides a large benefit to many corporations' effective tax rates: the deferral of income of foreign subsidiaries coupled with APB 23. For example, in the case of Pfizer, the deferral of income of foreign subsidiaries reduced its effective tax rates in years 2004 through 2006 by 19%, 20.6%, and 15.7%, respectively.<sup>205</sup> In Microsoft's case, the deferral of income of foreign subsidiaries reduced its effective tax rates in years 2006 through 2008 by 4.6%, 5.1%, and 7.0%, respectively.<sup>206</sup> As a result, many corporations greatly value the deferral of income of foreign subsidiaries (and APB 23). In addition, foreign corporations that are located in territorial jurisdictions may be reporting income of their foreign subsidiaries in a similar (if not identical) manner to the results provided by APB 23. U.S. corporations utilizing APB 23 therefore achieve, in a sense, a level playing field with those foreign corporations with respect to their financial statements.

Although permanent differences are greatly valued by Corporate America, not all permanent differences are created equal, even if they have a comparable effect on a corporation's effective tax rate. For example, the deferral of income of foreign subsidiaries coupled with APB 23 is not really a permanent difference. It is more accurately described as an indefinite difference. Generally, under GAAP, the U.S. parent corporation includes the income of its foreign subsidiary as part of its consolidated income, but does not take a charge to income tax expense for the estimated U.S. income taxes owed on the foreign subsidiary's income if an APB 23 representation is made.<sup>207</sup> As a result, the consolidated net income is increased, as is EPS, and the effective tax rate is lowered.<sup>208</sup> Unlike other permanent differences, however, the permanent difference

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200. PFIZER INC. 2006 FINANCIAL REPORT 48 (2006), available at <http://media.pfizer.com/files/annualreport/2006/financial/financial2006.pdf>.

201. See *supra* Part IV.B (arguing that corporate tax rate cuts apply to and benefit all corporations while the research credit does not).

202. Of course, the impact will be greater when the manufacturing deduction becomes fully phased in beginning in 2010. I.R.C. § 199(a)(2).

203. INTEL 2008 ANNUAL REPORT (2008), available at [http://www.intc.com/intelAR2008/common/pdfs/Intel\\_2008\\_Annual\\_Report.pdf](http://www.intc.com/intelAR2008/common/pdfs/Intel_2008_Annual_Report.pdf).

204. MICROSOFT CORP. ANNUAL REPORT 2008, *supra* note 141.

205. PFIZER INC. 2006 FINANCIAL REPORT, *supra* note 200.

206. MICROSOFT CORP. ANNUAL REPORT 2008, *supra* note 141.

207. ACCOUNTING FOR INCOME TAXES—SPECIAL AREAS, *supra* note 100, ¶ 12.

208. See *supra* Part III.E.

created by APB 23, may come to an end, creating very adverse results on the consolidated income statement.

More specifically, APB 23 creates a permanent difference that will end when the U.S. parent no longer represents that the foreign subsidiary has invested or will invest its undistributed earnings indefinitely. It is possible that a major reason why U.S. companies do not repatriate earnings from foreign subsidiaries involves the adverse financial accounting consequences of repatriation and not solely the U.S. taxes that will be owed on the repatriated funds.<sup>209</sup>

*Example 12.* Pfizer had the following tax rate reconciliation in its 2006 Annual Report:<sup>210</sup>

Note 7: Taxes on Income

B. Tax Rate Reconciliation

Reconciliation of the U.S. statutory income tax rate to our effective tax rate for continuing operations before the cumulative effect of a change in accounting principles follows:

	2006	2005	2004
U.S. statutory income tax rate	35.0%	35.0%	35.0%
Earnings taxed at other than U.S. statutory rate	(15.7)	(20.6)	(19.0)
Resolution of certain tax positions	(3.4)	(5.4)	—
Tax legislation impact	(1.7)	—	—
U.S. research tax credit	(0.5)	(0.8)	(0.6)
Repatriation of foreign earnings	(1.0)	15.4	—
Acquired IPR&D	2.2	5.4	2.8
All other, net	0.4	0.4	0.2
Effective tax rate for income from continuing operations before cumulative effect of a change in accounting principles	15.3%	29.4%	18.4%

In 2005, Pfizer's repatriation of \$37 billion in foreign earnings resulted in a 15.4% increase in Pfizer's effective tax rate.

As part of the American Jobs Creation Act of 2004, Congress enacted a special one-time dividends received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer ("repatriation provision").<sup>211</sup> The deduction was equal to 85% of certain foreign earnings that were repatriated in either a corporation's last taxable year that began before the enactment date of October 22, 2004, or the corporation's first taxable year that began during the one-year period beginning on the date of enactment.<sup>212</sup> A number of U.S. corporations utilized the one-time dividends received deduction, resulting in almost \$362

209. Several reviewers of this Article have suggested that Corporate America is more interested in the income tax expense reported on the income statement than the actual taxes paid to the U.S. government.

210. PFIZER INC. 2006 FINANCIAL REPORT, *supra* note 200, at 48.

211. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 422(a), 118 Stat. 1418, 1514–19 (2005).

212. I.R.C. § 965 (a), (f).

billion of funds being repatriated.<sup>213</sup> U.S. corporations that repatriated funds pursuant to the one-time dividends received deduction were effectively taxed at only 5.25%, rather than 35%, of the repatriated funds, and equally as important, were subject to a much smaller increase in their effective tax rates. Without the repatriation provision, U.S. corporations may have been subject to a huge increase in their effective tax rate. For example, Pfizer's effective tax rate was increased by 15.4% in 2005 as a result of repatriating \$37 billion in foreign earnings.<sup>214</sup> The increase in Pfizer's effective tax rate may have been significantly larger in the absence of the one-time dividends received deduction (assuming Pfizer would have still repatriated its foreign earnings for which it had made an APB 23 representation).

#### *D. The Importance of Temporary Differences*

While Corporate America prizes permanent differences much more than temporary differences, temporary differences are still relevant. A temporary difference may increase a company's cash flow.<sup>215</sup> The statement that "[h]appiness is a positive cash flow" is certainly true.<sup>216</sup> For small and new companies, cash flow is considered to be the single most important element for survival.<sup>217</sup> For public companies, corporate management focuses on the income statement while also controlling the company's cash flow. Investors also focus on the income statement, but may look at a company's cash flow in assessing the company's liquidity, financial flexibility, and overall performance.<sup>218</sup>

Increasing cash flow may help a company in several ways. Famed investor Warren Buffet, the chairman of Berkshire Hathaway, Inc., has noted the time value of money benefits for temporary differences (which create deferred tax liabilities):

Besides, Berkshire has access to two low-cost, non-perilous sources of leverage that allow us to safely own far more assets than our equity capital alone would permit: deferred taxes and "float," the funds of others that our insurance business holds because it receives premiums before needing to pay out losses. Both of these funding sources have grown rapidly and now total about \$69 billion.

Better yet, this funding to date has often been cost-free. Deferred tax liabilities bear no interest. And as long as we can break even in our insurance underwriting the cost of the float developed from that operation is zero. Neither item, of course, is equity; these are real liabilities. But they are liabilities without covenants or due dates attached to them. In effect, they give us the

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213. See Redmiles, *supra* note 105, at 103 (stating that approximately 840 mostly large corporations repatriated nearly \$362 billion from their controlled foreign corporations (CFCs) and deducted about \$265 billion of these dividends from their taxable incomes between tax years 2004 and 2006 due to the one-time dividends received deduction enacted in the American Jobs Creation Act of 2004).

214. PFIZER INC. 2006 FINANCIAL REPORT, *supra* note 200, at 48.

215. In 1970, the SEC required that companies registered with the SEC include a funds flow statement, which is the predecessor to the cash flow statement, in their annual SEC filings. See LANNY G. CHASTEEN ET AL., INTERMEDIATE ACCOUNTING 1063 (2d ed. 1987).

216. See KIESO, *supra* note 13, at 195.

217. See *id.*

218. See *id.* at 191.

benefit of debt—an ability to have more assets working for us—but saddle us with none of its drawbacks.<sup>219</sup>

Another way that increasing cash flow can help is by paying down debt. Debt reduction has several advantages. For instance, many companies believe that “removing debt enhances the quality of the balance sheet” and thereby permits obtaining credit more readily at a lower cost.<sup>220</sup> In addition, loan covenants typically limit the amount of debt a company may have.<sup>221</sup> Deferred tax liabilities are not typically treated as debt for this purpose, thereby giving, as Buffet notes, some of the advantages of debt without the drawbacks. Finally, debt reduction decreases the “debt to total assets ratio.” The ratio is calculated as total debt (both current and long-term liabilities) divided by total assets.<sup>222</sup> The higher a corporation’s debt to total assets ratio, the greater the risk that the corporation may be unable to meet its obligations as they mature.<sup>223</sup>

A reduction in interest expense also has several advantages. First, it increases net income for the year, which, in itself, is a valuable benefit for the company. Moreover, it is above the income tax expense line on the income statement, meaning that it increases pretax financial income for the year, which is an even greater benefit for a company than simply increasing net income.<sup>224</sup> Second, a reduction in interest expense also increases the “times interest earned ratio.” This ratio is determined by dividing the sum of pretax financial income and interest expense by interest expense.<sup>225</sup> The higher a corporation’s times interest earned ratio is, the greater the probability that the corporation can meet its interest payments as they come due.<sup>226</sup> Long-term creditors and stockholders may use the times interest earned ratio to help determine the long-run solvency of a corporation.<sup>227</sup>

*Example 13.* In its 2005 Annual Report, Best Buy reported total liabilities of \$5.845 billion, total assets of \$10.294 billion, interest expense of \$44 million, income tax expense of \$509 million, and net income of \$984 million.<sup>228</sup> Best Buy’s debt to total assets ratio is \$5.845 billion divided by \$10.294 billion, equaling 56.8%. This is considered a relatively high debt to total assets ratio.<sup>229</sup> Best Buy’s times interest earned ratio is \$1.537 billion (\$984 million of net income plus \$44 million of interest expense plus \$509 million of income tax expense) divided by \$44 million, equaling 35 times. Best Buy’s interest coverage of 35 times indicates that it can easily meet its interest payments

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219. BERKSHIRE HATHAWAY, INC. 2006 ANNUAL REPORT (2006), available at <http://www.berkshirehathaway.com/2006ar/2006ar.pdf>.

220. See KIESO, *supra* note 13, at 692.

221. *Id.*

222. *Id.* at 695.

223. *Id.*

224. The reduction in interest expense should increase pretax financial income by a greater amount than the increase in net income because of the dilution by income tax expense. For example, using a 35% tax rate, a reduction in interest expense of \$100 will increase pretax financial income by \$100, but will only increase net income by \$65.

225. See KIESO, *supra* note 13, at 695.

226. *Id.* at 695–96.

227. *Id.*

228. BEST BUY 2005 ANNUAL REPORT (2005), available at [http://media.corporate-ir.net/media\\_files/IROL/83/83192/reports/BestBuyAR05.pdf](http://media.corporate-ir.net/media_files/IROL/83/83192/reports/BestBuyAR05.pdf).

229. See KIESO, *supra* note 13, at 696.

when they come due.<sup>230</sup>

Rather than paying down debt, a company may use an increase in cash in its business operations to increase its pretax financial income (and therefore net income) in future years.<sup>231</sup> Increasing its pretax financial income will also increase the company's EPS. As a result, temporary differences may not have an immediate impact on net income or EPS, but may have a future impact by paying down debt or increasing income from business or investment operations.<sup>232</sup>

It should be noted that not all temporary differences are created equal. For example, some temporary differences may reverse quite quickly—in, say, one or two years. Other temporary differences may not reverse for many years. The longer the time frame involved, the greater the cash flow benefit the corporation receives. As a result, temporary differences of a long duration are generally more highly prized than those that last a short time.

In some cases, temporary differences that reverse in a relatively short time period may actually create a deferral period of an indefinite nature. For example, if a company purchases equipment in which it utilizes accelerated depreciation for tax purposes and straight-line depreciation for financial accounting purposes, it will recognize a deferred tax liability in depreciating the equipment. The amount of the deferred tax liability will start to decrease as financial accounting depreciation begins to exceed tax depreciation, which may occur in just a few years. If, however, the company continues to purchase equipment, a new deferred tax liability will be created with respect to the new equipment that can be viewed as, in essence, replacing the old deferred tax liability. When viewed in the aggregate, the total deferred tax liability may not change very much from year to year. As a result, the company is achieving an indefinite deferral of taxes through temporary differences.<sup>233</sup>

Some public companies are strapped for cash and, as a result, it appears that temporary differences may be quite valuable to these companies. Temporary differences, as a general rule, provide a temporary increase in cash, which could be important to these companies. But many of these companies may have net operating losses that they are carrying forward.<sup>234</sup> For those companies, temporary differences, such as expensing or

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230. *Id.*

231. Generally, a company will utilize an increase in cash in its business operations if it can earn at least the weighted average cost of capital.

232. The cash flow and balance sheet benefits of temporary differences may be valuable to a corporation that is the target of a takeover or a corporation that is putting itself up for sale.

233. FASB has recognized the indefinite deferral aspect of deferred tax liabilities with respect to items such as depreciation on equipment. ACCOUNTING FOR INCOME TAXES No. 109, *supra* note 25, ¶¶ 203–05. In deciding what approach to adopt with respect to deferred taxes, FASB considered what is known as the “partial recognition of deferred taxes.” *Id.* Under this approach, a deferred tax liability is not recognized if the cumulative amount of temporary differences for a particular recurring item, such as depreciation, does not reverse in future years because new originating differences offset reversing differences. *Id.* FASB rejected such an approach noting that “the deferred tax consequences of a depreciation difference for a particular depreciable asset ordinarily will result in a sacrifice [reverse resulting in taxes owed] in future years.” *Id.* ¶ 205.

234. Companies that do not generate positive cash flow generally do not have income for financial accounting purposes. Therefore, if a company's financial accounting income is meager or negative, then the company generally has net operating losses. A big part of the reason is that tax depreciation is faster than book depreciation, and many expenditures that can be currently deducted for tax purposes must be capitalized for financial accounting purposes. However, companies that are funded by venture capital (e.g., the biotech



accelerated depreciation, will provide no cash flow benefit.<sup>235</sup>

Because of the importance of the income statement to corporate management, if a permanent difference and a temporary difference both create an equal net present value of future cash flows, corporate management will favor the permanent difference over the temporary difference because of its positive impact on net income, EPS, and effective tax rate.<sup>236</sup> In fact, corporate management may even sacrifice net present value of future cash flows in exchange for a net income, EPS, and effective tax rate benefit.

## VII. PRINCIPLES FOR REFORM OF CORPORATE TAX PREFERENCES

Based on the lack of effectiveness of most, if not nearly all, corporate tax preferences coupled with Corporate America's desire for a corporate tax rate cut, two broad propositions can be suggested. First, public corporations should have a broad tax base (with minimal corporate tax preferences) coupled with a low corporate tax rate. Second, corporate tax preferences that are enacted for Corporate America should be in the form of permanent differences to achieve maximum effectiveness with respect to Congress's underlying goal for the preference.<sup>237</sup>

Corporate America has requested for a number of years that Congress reduce the top corporate tax rate from 35% to 30% or even lower.<sup>238</sup> Some economists have resisted supporting a corporate tax rate reduction, noting that such a corporate tax rate cut provides an even lower bang for the buck than accelerated depreciation or investment tax credits.<sup>239</sup> The reason is that accelerated depreciation or investment tax credits do not reduce taxes on the flow of income to existing capital assets.<sup>240</sup> In contrast, a corporate tax rate cut provides a windfall to old investment.<sup>241</sup>

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industry) may be sitting on hundreds of millions of dollars but have book losses. For these companies, their payday happens when they develop a successful product and are then acquired by a big pharmaceutical company. The big tax planning in these corporate acquisitions is the section 382 limitation on the transfer of net operating losses. I.R.C. § 382.

235. If the temporary difference creates or increases a net operating loss that can be carried back, then an immediate cash flow benefit may result.

236. See Kenneth Gideon et al., *Alternatives for Trxation of Domestic Business Income*, 86 TAXES 61, 68 (2008) (quoting statement of Stuart D. Goldstein, Vice President, Taxes, Lockheed Martin Corporation: "Even if the benefits were the same [expensing versus corporate tax rate reduction], CFOs would favor rate reduction which has an immediate impact on earnings, whereas expensing produces a cash benefit but no reduction in the effective tax rate."); Mills, *supra* note 3, at 586 ("In setting tax policy, economists might think that managers of corporations will view alternatives as equivalent if they provide equal present values of after-tax cash flows. Legislators can construct an investment incentive through a statutory rate cut, a credit, a permanent deduction, or an accelerated deduction, and write the law to make any of those structures economically equivalent. However, because different structures have different effects on reported book income, corporations may lobby in favor of one alternative over another."). Cf. JCT BOOK-TAX REPORT, *supra* note 35, at 28-33 (noting how the investment tax credit, in contrast to expensing or accelerated depreciation, lowers a corporation's effective tax rate but then focuses on net present value of cash flows in determining what is desirable to taxpayers).

237. See David I. Walker, *Financial Accounting and Corporate Behavior*, 64 WASH. & LEE L. REV. 927 (2007) (discussing the power of financial accounting to shape corporate behavior).

238. See *supra* note 151 and accompanying text.

239. See Gravelle, *Business Tax Cuts*, *supra* note 51, at 68 (stating that "an investment credit (or . . . accelerated depreciation) has more 'bang for the buck' than a corporate rate cut").

240. *Id.*

241. *Id.*

Economists debated this issue during consideration of the Tax Reform Act of 1986.<sup>242</sup> As part of that act, Congress repealed the regular investment tax credit and made accelerated depreciation on equipment slightly less generous to Corporate America.<sup>243</sup> The trade-off was a reduction in the top corporate tax rate from 46% to 34%.<sup>244</sup> Economists who supported the legislation argued that “the investment [tax] credit was the cause of economic distortions and that lowering the tax rates and broadening the base would result in a more neutral tax system, and a more efficient allocation of capital.”<sup>245</sup> The critics were more focused on the savings response.<sup>246</sup> They believed that it was poor policy to exchange a subsidy that only applied to new investments for a rate cut that provided a windfall to old investments.<sup>247</sup>

From a financial accounting standpoint, it is simple to understand why Corporate America wants a corporate tax rate cut even at the expense of various corporate tax preferences. The corporate tax rate cuts that are being proposed are in the range of a 5–10% cut, reducing the top corporate tax rate from 35% to 25–30%. Even if the rate is reduced to only 30.5%, as advocated by Rep. Rangel, it would more than offset the loss of the manufacturing deduction and the research credit to much of Corporate America. Some public corporations will be opposed to a corporate tax rate cut, as evidenced by the small number of manufacturing companies that opposed a corporate tax rate cut in 2004 (which resulted in Congress enacting the manufacturing deduction).<sup>248</sup> These corporations, which are in a net deferred tax asset position, will take a one-time charge to earnings upon enactment of a corporate tax rate cut. This is a highly undesirable result; however, in the long run, these corporations may also greatly benefit from a corporate tax rate cut.

The proposition that public corporations have a broad tax base (with minimal corporate tax preferences coupled with a low corporate tax rate) may result in different tax bases for public corporations and non-public corporations. Such a proposition is not a new idea. In fact, differences already exist under existing tax laws. For example, since 1993, the deduction for compensation to the CEO and the four other highest compensated officers of a public corporation has been subject to a cap, which is inapplicable to non-public corporations.<sup>249</sup> As a result, the tax base is slightly different for public corporations versus non-public corporations.

If Congress eliminates a number of corporate tax preferences for public corporations, then the tax base for public corporations will begin to approach the base for financial accounting purposes. A number of tax law commentators have suggested such an approach (i.e., book-tax conformity) for a number of different reasons.<sup>250</sup> The

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242. See CAPITAL INCOME, *supra* note 51, at 95 (stating that a point of disagreement when considering the Tax Reform Act of 1986 was the repeal of the regular investment tax credit in exchange for corporate tax cuts).

243. Tax Reform Act of 1986, Pub. L. No. 99-514, § 211(a) (1986).

244. § 601.

245. See CAPITAL INCOME, *supra* note 51, at 95.

246. *Id.*

247. *Id.*

248. See *supra* Part I (discussing efforts of the representatives of these companies to prevent Congress from enacting a corporate tax rate cut that would cause them to take an immediate earnings hit).

249. I.R.C. § 162(m).

250. See, e.g., Hank Gutman et al., *A Closer Look at Tax Reform Options Within Fiscal Policy Constraints*, 86 TAXES 51, 56 (2008) (quoting statement of Michael J. Graetz: “I also argue, as Larry Summers mentioned

proposal coincides with this approach, but for different reasons. If Corporate America is focused on net income, EPS, and effective tax rates, then a corporate tax rate cut enhances all three financial indicators. Corporate tax preferences in the form of permanent differences also achieve such a result but, in most cases, at a very modest level, thereby possibly minimizing the effectiveness of the preference. As a result, elimination of many corporate tax preferences is entirely possible.

If Congress determines that a particular tax preference is an important part of the tax laws, then the preference should be enacted in the form of a permanent difference to achieve maximum effectiveness. A preference enacted in the form of a permanent difference will positively affect a corporation's net income and EPS with a lowering of the corporation's effective tax rate. The downside to a preference enacted as a permanent difference, when compared to a corporate tax rate cut, is generally the administrative complexity associated with the preference, the generally minimal impact the preference has on net income, EPS, and effective tax rate, and the winners and losers associated with the preference.

### VIII. CONCLUSION

Congress has provided a number of tax preferences to Corporate America as part of the Internal Revenue Code. Economists have debated for years whether these preferences achieve their intended purposes. For example, do bonus depreciation and accelerated depreciation stimulate the purchase of equipment? Does the research credit increase research and development in Corporate America? In many cases, it is doubtful whether the corporate tax preferences are achieving their intended purposes with respect to Corporate America.

Corporate America has, for years, requested that Congress provide a corporate tax rate cut. If, as proposed in this Article, Corporate America focuses overwhelmingly on net income, EPS, and the effective tax rate, then it is not surprising that a corporate tax rate cut is at the top of their list of requests.<sup>251</sup> A corporate tax rate cut increases net income and EPS and lowers a corporation's effective tax rate. It hits all three financial indicators. Some permanent differences may achieve a similar result, but will in many cases entail a lot more complexity, a lot less financial statement impact, and number of winners and losers.

As a general proposition, if Congress wants to provide a corporate tax preference to Corporate America it appears that it should be in the form of a permanent difference rather than a temporary difference to achieve maximum effectiveness. In other words, enhancing the financial statement benefit may improve the effectiveness of the corporate tax preference. In addition, a reduction in the top corporate tax rate can be substituted for

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this morning, for close conformity between book and tax accounting, which I also think is important to eliminate the tax shelter business"); George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209, 224 (2001) (suggesting combating corporate tax shelters by taxing public corporations on income reported for financial accounting purposes as adjusted by tax rules authorizing specific deviations); Glenn, *supra* note 11, at 324 (stating that Alan Greenspan urged policymakers to lower rates and broaden the base).

251. See Wheeler et al., *supra* note 43, at 120 ("The number one pick is lower rates with a broader base. . . . Thirty-seven percent of the people, in the room, had picked that, and the second was replacing just the current regime with a territorial system.").

many, if not most, corporate tax preferences (even those in the form of permanent differences) with the result being a broader tax base with lower rates. Broadening the corporate income tax base and lowering rates is a goal that most tax scholars agree with, and it would coincide with the ideal financial statement results for Corporate America.<sup>252</sup>

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252. See Martin A. Sullivan, *Corporate Tax Reform—or Else?*, 123 TAX NOTES 1396, 1397 (2009) (“Tax gurus have been kicking around the idea of restructuring the corporate tax with lower rates and a broader base for as long as the tax has existed.”).

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