Georgetown University Law Center
Scholarship @ GEORGETOWN LAW

2006

Hearing on Corporate Tax Reform: Hearing Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways and Means, 109th Cong., May 9, 2006 (Statement of Professor Ronald A. Pearlman, Geo. U. L. Center)

Ronald A. Pearlman
Georgetown University Law Center

CIS-No.: 2007-H781-12

This paper can be downloaded free of charge from:
http://scholarship.law.georgetown.edu/cong/33

This open-access article is brought to you by the Georgetown Law Library. Posted with permission of the author.
Follow this and additional works at: http://scholarship.law.georgetown.edu/cong

Part of the Legislation Commons, and the Tax Law Commons

Testimony of Ronald A. Pearlman

Professor, Georgetown University Law Center

Hearing: Corporate Tax Overhaul

May 9, 2006

U.S. House Ways and Means Committee

Subcommittee on Select Revenue Measures

May 09, 2006

Mr. Chairman and Members of the Subcommittee:

My name is Ronald A. Pearlman. I am a Professor of Law at the Georgetown University Law Center, where I teach courses in Federal income taxation.

It is a great privilege to appear before the Subcommittee today. I appear on my own behalf. My comments represent my personal views and not necessarily those of Georgetown University or any other organization with whom I am associated.

I have appeared before the Subcommittee on two prior occasions to address issues relating to corporate tax reform. In 1983, as a representative of the Treasury Department, I discussed problems with the carryover of corporate net operating losses and other tax attributes, and in 1985, I discussed factors relating to the then-current wave of corporate mergers. Today, I would like to comment on two tax reform topics that, at least on the surface, appear to be quite different than the subjects of my prior testimony.

Business Tax Preferences

The first topic that I wish to address involves the recurring question whether Congress should provide tax relief to corporate taxpayers, by which I mean to include all business taxpayers regardless of their form of organization, through targeted tax preferences or by means of periodic reductions in the corporate tax rate.

My instinct, informed by 27 years of experience as a practicing tax lawyer advising clients in many different industries, and ranging in size from small closely-held businesses to large multinational corporations, and by 10 years of assorted tax- related government service, is that corporate tax rate reduction most often is preferable to the enactment of industry-specific or activity-specific tax preferences. Put another way, I think the legislative default policy should be to eliminate tax preferences and lower

corporate tax rates.

In May 1985, President Reagan transmitted to the Congress the recommendations that served as the impetus for enactment of the Tax Reform Act of 1986. The summary of President Reagan's proposals stated, "The tax system should, insofar as possible, foster economic growth by . . . allowing resources to be allocated efficiently on the basis of economic rather than tax considerations." In furtherance of this efficiency objective, the Report went onto say, "Special subsidies or preferences for specific industries or sectors should be curtailed except where there is a clear national security interest that argues to the contrary."

Why was efficiency so important to President Reagan? I think it was because he understood that by altering incentives, an industry-specific or an activity-specific tax preference will cause business taxpayers to disregard market forces -- or at least alter the influence of market competition on their decisions -- thereby adversely affecting the allocation of resources of the particular business and of the Nation.

Not only is a distortion in the business decision making process likely to impose costs on the economy, it also tilts the playing field in favor of one group of businesses over another. The financial advantage of a narrow tax preference may influence how third parties -- lenders and equity investors, for example -- evaluate competing businesses. The tax preference thereby may create an inappropriate advantage in the marketplace that discourages entrepreneurs in emerging industries or technologies who do not enjoy a comparable tax advantage from successfully competing for capital, thereby stifling U.S. economic growth.

While I admit to a bias in favor of President Reagan's approach to tax reform because of my involvement in the development of the Administration's proposals and my advocacy for their enactment before the Ways and Means Committee, I think our tax system would be much improved if the tax law today more fully reflected his philosophy. However, one does not have to accept a market efficiency analysis to question the appropriateness of

narrow business tax preferences.

We might tolerate the economic distortion resulting from a particular preference if we could be reasonably certain that it produces a sufficient quantity of the desired behavior over and above the behavior that would occur absent the existence of the preference. To the extent a tax preference provides a tax subsidy for behavior that would occur anyway, the subsidy is a waste of money that could be expended more productively on new or existing programs, to reduce the deficit, or to provide broad-based tax relief.

Unfortunately, our collective knowledge of the effectiveness of targeted tax preferences is not well developed. Recently, the Director of Strategic Issues for the Government Accountability Office was reported to have bemoaned the lack of research on the true effect of tax incentives. Supporters of a tax preference typically point to an assortment of ad hoc examples of the positive impact of the preference and to self-serving supportive assertions by executives about the incentive effect. In the absence of a body of unbiased research regarding the effectiveness of tax preferences or a negative analysis by opponents of a particular preference, Members of Congress, under the pressure of the tax legislative process, understandably tend to accept supportive information as a validation of the preference's effectiveness.

The U.S. business tax system is replete with targeted tax preferences. Some are narrowly targeted, some more broadly. However, in every case, one class of business taxpayers is preferred over another. In the aggregate, the revenue effects of these preferences are substantial. Take for example a small group of tax credits: the credit for increasing research activities, popularly known as the research and development or "R&D" tax credit (Section 41 of the Internal Revenue Code); the low-income housing credit (S. 42); the renewable electricity production credit (S. 45); and the nonconventional source fuel credit, more commonly referred to as the Section 29 credit even though the section reference is out of date (S. 45K). Assuming extension of the R&D credit, the combined projected revenue effect of these four credits for a single year (F/Y 2007) is approximately $13.7 billion, and the five-year effect is approximately $81.6 billion.

Why would it not be appropriate to compare the potential economic effects of retaining the credits or alternatively financing a reduction in the corporate tax rate with the revenues generated by repeal of the credits? I am not so naive to assume that there is any realistic chance repeal will occur. Nevertheless, supporters of existing, as well as proposed, business tax preferences should be forced to justify why the alternative of a corporate rate reduction is not in the best interests of U.S. tax and economic policy. This Subcommittee is an ideal venue for carefully considering the continuing utility of these and other tax preferences. To those who say that $13.7 billion is not sufficient revenue to effect a meaningful reduction in the corporate tax rate, I am confident that in response to the Subcommittee's request, the Staff of the Joint Committee on Taxation will provide a list of additional repeal candidates that would finance meaningful corporate tax rate reduction.

There are two occasions in the tax legislative process when advocates of existing tax preferences may realistically be pressured to justify continuation of their preferences. One arises when Congress needs to increase tax revenues to reduce the deficit or offset other tax reductions. The other is when Congress undertakes a comprehensive review of present law in connection with broad-based tax reform. In anticipation of any corporate tax reform project in the Ways and Means Committee, I encourage the Subcommittee to seek the assistance of the Joint Committee on Taxation, the Congressional Budget Office, the Congressional Research Service, and General Accountability Office, as well as academic and private sector analysts, in carefully and, might I suggest boldly, reevaluating the appropriateness of existing business tax preferences. This exercise will not, and probably should not, result in the repeal of all of them. However, with Member support, it should serve to identify those provisions that no longer can be justified and assist in improving the effectiveness of those provisions that remain in the law.

Deductibility of Business Interest

The second topic that I wish to discuss relates to the deductibility of interest expense on

debt incurred by business taxpayers to finance the purchase of capital investment, including not only real and tangible property (plant, machinery and equipment), but also intangible property, such as patents, copyrights, and know-how.

One important reason to consider the relevance of the deductibility of interest expense in the context of corporate tax reform relates to the problems under present law that result from characterization of corporate investment as debt or equity. However, I am motivated to discuss business interest expense today for a different reason, namely, because of the relationship between the deductibility of interest expense and the tax law cost recovery rules relating to debt-financed investments that I assume will be an important part of any corporate tax reform debate.

"Cost recovery" refers to mechanisms by which a business taxpayer is entitled to reduce or offset otherwise taxable income by its investment in a business asset. Depreciation is an important form of cost recovery, as is the right of a taxpayer to offset its undepreciated investment, referred to as the asset's adjusted tax basis, against the consideration the taxpayer receives on the sale or other disposition of a business asset in calculating the gain or loss on the disposition. Other provisions of the Internal Revenue Code that might not appear to be cost recovery mechanisms are best analyzed as if they were. In particular, certain business tax credits, such as the R&D credit and the low-income housing tax credit, are calculated as a percentage of a taxpayer's relevant expenditures and, therefore, afford the taxpayer an added means of recovering a portion of its investment in property associated with the tax-preferred activity.

A pure, or idealized, income tax subjects a business taxpayer to tax on its (net) economic income. In theory, a properly designed depreciation system under a pure income tax, known as "economic depreciation," would enable a business taxpayer to recover its cost in a business asset by properly matching periodic depreciation deductions with income generated by the asset during the same period. Depreciation deductions would be calculated based on the economic useful life of the asset (that is, the period over which the asset is expected to be productive) and the actual decline in value of the asset in each

period.To properly calculate the taxpayer's economic income, it also is appropriate under a pure income tax to allow the taxpayer to deduct interest expense related to debt incurred to finance the purchase of the asset, because the interest expense is an added cost of earning the income generated by the asset.

Under a pure consumption tax that is calculated by reference to sales or other income of a business (a cash-flow consumption tax; a subtraction-method value-added tax, such as the so-called Flat Tax or the Bradford X Tax; or an invoice-credit form of value- added tax), the cost of capital investments would be fully recovered at the time incurred either through a deduction equal to 100 percent of the asset's cost or, in the case of an invoice-credit value added tax, by means of a credit for prior taxes paid.

Unlike a pure income tax, a consumption tax exempts income from capital from tax. This exemption is implemented at the business level of a consumption tax by allowing business taxpayers to fully deduct the cost of a capital investment when incurred, a cost recovery mechanism known as "expensing." The effect of expensing is to exempt the income generated by the business asset from tax on a present value basis, assuming a constant rate of return and constant tax rates. This is so even if it appears that income generated by the asset is taxable because the taxpayer makes nominal tax payments to the government over the productive life of the asset. This analysis is know as the "immediate deduction-yield exemption equivalence" and is based on work postulated in 1942 by an economist named E. Cary Brown."

Because income from business assets is deemed to be exempt from tax under a consumption tax by reason of the expensing of capital investment, it is inappropriate to also permit the business taxpayer to deduct interest expense on debt incurred to finance the purchase or development of the expensed asset. To do so would create a negative tax that would provide an improper government subsidy to the taxpayer. Consistent with this analysis, the Growth and Investment Tax Plan recently proposed by the President's Tax Reform Advisory Panel would allow immediate expensing of all new business investment, but also would eliminate the deductibility of business interest. The Panel's

Report describes the proposal to deny the deduction of business interest as "an essential component" of the Plan. "Allowing both expensing of new investments and an interest deduction would result in a net tax subsidy to new investment. Projects that would not be economical in a no-tax world might become viable just because of the tax subsidy. This would result in economic distortions and adversely impact economic activity."

Present law is not a pure income tax but, rather, a hybrid tax system that has both income tax and consumption tax characteristics. I will be surprised if a fundamental reform of present law will result in a new tax law that one could describe as "pure." It is for this reason that I chose to raise the interest expense issue in my comments today.

We have seen a trend in U.S. tax policy toward liberalized cost recovery. Depreciation under present law is accelerated, that is, it is faster than economic depreciation, and in some instances, the statute provides for immediate expensing of capital investment, a prominent example being the so-called small business expensing (S. 179). Consumption tax proponents understandably identify expensing as a key element of any reform of the current tax system, and I would expect expensing or some form of accelerated depreciation would be considered as part of a reform of the business tax system.

I am concerned that in the legislative sausage factory, expensing will be perceived as an attractive component of a business tax package but the disallowance of interest expense will not, leading to the possible enactment of the tax subsidy to which the President's Panel referred. This subsidy will encourage a variety of tax shelters and other tax-motivated activities that will pose a very significant threat to the tax base.

If we could be certain that the interest income paid by business taxpayers would be subject to tax in the hands of the recipients, the revenue effect of the continued deductibility of interest expense would be of less concern, even though the distortive effects to which the President's Panel refers would continue to be troubling. However, we know that a sizeable portion of interest income is exempt from U.S. tax because corporate debt is owned by so-called tax-indifferent parties, including foreign lenders that are not

subject to U.S. tax. In 1989, the Joint Committee on Taxation reported that, based on 1987 data, foreign investors owned 13.3 percent of U.S. corporate bonds and an additional 62.2 percent were owned by insurance companies and pension funds, resulting in the current exemption from tax of a sizeable portion of the interest income received on corporate debt in their portfolios. I presume the percentages reported in 1989 are larger today.

The relationship between expensing and the deductibility of business interest expense, in my view, is a very significant issue. If I am correct, it will be important for the Subcommittee to analyze specific cost recovery proposals with this issue in mind.

As a final point, it is worth noting that the subsidy to which the President's Tax Reform Panel referred exists under present law, because interest expense frequently is incurred in connection with debt-financed business investments that are eligible for accelerated depreciation or expensing under Section 179. Thus, the tax treatment of business interest expense under present law also is an appropriate topic for examination.

Conclusion

At the beginning of my remarks, I mentioned that I had previously appeared before the Subcommittee to comment on two corporate tax reform topics, the transferability of corporate tax attributes and corporate mergers and acquisitions. References to those two previous appearances might seem merely evidence of my nostalgia, having no relevance to my comments today. I do value my interactions with the Subcommittee over the years, but I also I think the prior appearances to which I referred are relevant.

To the extent the tax law creates distortions, as do industry- specific or activity-specific tax preferences, and to the extent the tax law creates discontinuities, as does the deductibility of interest by a business taxpayer who is entitled to recover the cost of a capital investment faster that economic depreciation, there exist increased incentives to structure transactions to enable business taxpayers that do not have sufficient income to

fully use the tax preferences or interest deductions to directly or indirectly transfer those preferences to another taxpayer who can use them to reduce its tax liability or to merge with another business taxpayer that is able to use the tax benefit. As the Subcommittee considers corporate tax reform proposals, I encourage you to keep in mind the possible implications of these distortions and discontinuities.

Thank you very much. I will be pleased to attempt to answer any questions.