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Impact of Fundamental Tax Reform on Domestic Manufacturing

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The Effect of Tax Reform on Domestic Manufacturing

The Tax Reform Study Group within the Council on Tax & Fiscal Policy, an initiative of Joint Venture: Silicon Valley Network, submitted the following comments to the House Ways and Means Committee with respect to a July 31 hearing.

These comments are submitted pursuant to the House Ways & Means announcement of July 18, 1996. They are submitted for inclusion in the printed record of the hearing held on July 31, 1996, on the impact of fundamental tax reform on domestic manufacturing and on energy and natural resources; our comments focus only on domestic manufacturing. The Tax Reform Study Group previously submitted comments for the written record of the May 1996 hearing on the impact of tax reform on state and local governments, and the July 1996 hearing on the impact on international competitiveness.¹ The Tax Reform Study Group is also working on a more comprehensive comment letter to submit to the tax writing committees at a later date; such letter will expand upon the topics covered in this submission.

Background on the Tax Reform Study Group

The Tax Reform Study Group was formed in October 1995 and consists of individuals from business, state and local government, and academia who are interested in studying the proposals for reform of the federal and state tax systems and tax reform in general and their impact to Silicon Valley. The Group provides objective forums for people in Silicon Valley to learn about tax reform and how it affects them and their employers. The Group has sponsored several seminars on tax reform and maintains a Web page where interested people can obtain objective information on tax reform:

http://www.jointventure.org/tax/tax_fed.html

Joint Venture: Silicon Valley Network is a dynamic model of regional rejuvenation with a vision to build a community collaborating to compete globally. Joint Venture brings people together from business, government, education, and the community to act on regional issues

¹These comments can also be found at http://www.jointventure.org/tax/tax_fed.html, and *Doc 96-20565* (7 pages) or *State Tax Notes*, July 22, 1996, p. 253.

affecting economic vitality and quality of life. One of its initiatives is the Council on Tax & Fiscal Policy.

Drafting: The views expressed in the comment letter represent the collective views of the Tax Reform Study Group within the Council on Tax & Fiscal Policy of Joint Venture: Silicon Valley Network, and not necessarily the views of any individual members of the Study Group, the Council, or of Joint Venture. The primary draftspersons of these comments were William C. Barrett, Director: Tax, Export & Customs, Applied Materials, Inc.; Annette Nellen, Professor, San Jose State University; and Donald J. Scott, Director: Tax Compliance, Oracle Corporation; substantive contributions and review were provided by Jean Alexander, Counsel to the Chairman, California State Board of Equalization; Dan Kostenbauder, General Tax Counsel, Hewlett-Packard Company; Larry R. Langdon, Vice President — Tax, Licensing & Customs, Hewlett-Packard Company; David W. Mitchell, Hoge, Fenton, Jones & Appel Inc.; and Dr. John E. Thomson, Adjunct Fellow, Tax Foundation.

Introduction

These comments focus on selected issues relevant to manufacturers that have not received much attention in the tax reform debate relative to other issues. These topics include:

- the importance of R&D incentives to manufacturing and service companies;
- accounting methods; and
- impact on financial statements and stock prices.

Importance of R&D Incentives to Manufacturing and Service Companies

Various government and private studies have indicated that government incentives for research are justified in that society's rate of return on research exceeds that of the company incurring the research costs and risks. Thus, the company conducting the research and incurring the costs will not be able to completely reap the rewards of its research because some of the benefit will spill over to others.² For example, although re-

²Businesses may not find it profitable to invest in some research activities because of the difficulty in capturing the full benefits from the research. Costly technological advances made by one firm are often cheaply copied by its competitors. A research tax credit can help promote investment in research, so that research activities undertaken approach the optimal level for the overall economy. Therefore, the Com-

(Footnote 2 continued on next page.)

search leading to an innovative new drug can be protected by a patent to help a company obtain the economic benefits of its research, the fruits of the research will be enjoyed by others upon the patent's expiration. Because a company may not receive all of the return from its research investment, but will instead share some of it with society, there is justification for public support of such research.³

Research incentives also benefit society. Both government and private studies have shown that the credit for increasing research activities (section 41) has had an impact on the amount of research conducted. A 1989 General Accounting Office (GAO) report, "The Research Tax Credit Has Stimulated Some Additional Research Spending," stated that the research credit "raised corporate spending on R&E above the level that otherwise would have been achieved."⁴ This study, based on a sample of 800 corporations and economic models, concluded that the credit "stimulated between \$1 billion and \$2.5 billion of additional spending for the five years 1981 through 1985." Such an increase represented an increase of 15 cents to 36 cents for every dollar of foregone tax revenue due to the credit.⁵

A 1994 private study concluded that the GAO study underestimated the benefits of the research tax credit. This study estimated that the credit stimulated additional spending in the short run of about \$2 billion per year (in 1982 dollars) with foregone tax revenues of about \$1 billion per year.⁶

The economy also benefits from research activity. It has been estimated that at least half of the economic growth in the U.S. stems from advances in technology.⁷

mittee believes that, in order to encourage research activities, it is appropriate to reinstate the research tax credit and to modify certain rules for computing the credit." From: Small Business Job Protection Act of 1996 (H.R. 3448), Senate Finance Committee Report on H.R. 3448, S. Rpt. 104-___, June 1996, Explanation of Present Law.

³"The R&D Tax Credit: An Evaluation of Evidence On Its Effectiveness," a staff study prepared for the Joint Economic Committee of the U.S. Congress, S. Rpt. 99-73, August 23, 1985, p. 4 ("spillover benefits' . . . put R&D into the class of goods such as public health and sanitation, education, clean air and water, and defense that fall into the sphere of governmental responsibility.") Also see Congressional Research Service Issue Brief "The Research and Experimentation Tax Credit," by D. Brumbaugh, November 17, 1993 ("because the level of investment a firm undertakes depends on the return it alone can earn from the investment, without public support firms are willing to undertake less research than is warranted by its return to society.") Also see study and testimony of Barents Group LLC of KPMG Peat Marwick LLP; 95 TNT 65-20 (7/23/95); ("Social rates of return to R&D investments are typically about twice as high on average as private rates of return.")

⁴GAO, "The Research Tax Credit Has Stimulated Some Additional Research Spending," GAO/GGD-89-114, Sept. 1989, p. 22.

⁵1989 GAO report, *supra*, p. 22.

⁶"R&D Tax Policy During the 1980s: Success or Failure," by Bronwyn H. Hall, National Bureau of Economic Research, Reprint No. 1872, April 1994, p. 29.

⁷See July 18, 1996 testimony of The High-Technology Tax Restructuring Group before the House Ways & Means Committee, fn. 3. The statement is based on a 1995 report by the Office of Technology Assessment, "The Effectiveness of Research and Experimentation Tax Credits."

Manufacturers are the primary user of the research tax credit. In 1993, 75.2 percent of the aggregate amount of research tax credit claimed was claimed by manufacturing companies; 12 percent was claimed by service companies.⁸

Impact of a consumption tax on R&D. Two important R&D rules under our income tax system are section 41, *Credit for increasing research activities*, a tax incentive, and section 174, *Research and experimental expenditures*, a positive accounting rule. These R&D rules are particularly important to computer software development and hardware manufacturing companies. A significant element of both the deduction and credit for research expenditures relates to employee labor. Under a consumption tax, expenditures related to employee labor, including wages, fringe benefits, and payroll taxes do not reduce the taxable base. Thus, a consumption tax will eliminate a significant deduction attributable to R&D activity.

The treatment of R&D under our income tax system versus a consumption tax can be compared as follows:

R&D Expenditure:	Income Tax	Consumption Tax
Employee labor	Currently deductible under section 174.	Not deductible. ⁹
Outside labor (such as independent contractors).	Currently deductible under section 174.	Deductible business purchase.
Equipment	Not currently deductible, depreciation may be treated as a current deduction under section 174(a) & (c).	Deductible business purchase.

There appears to be some belief among tax reform proponents that the loss of R&D incentives (research tax credit and wage deduction) is more than offset by the benefit attributed to the current deduction of equipment. While this may be true for some capital intensive manufacturers, not all manufacturing R&D processes require significant equipment purchases. The software industry, for example, is highly labor intensive in both the development and manufacturing stages and the loss of the research tax credit and the wage deduction is not offset by a deduction for capital equipment. Tax reform proponents who seek to improve economic growth for the U.S. must consider how the tax burden

⁸Joint Committee on Taxation, *Impact on Small Business of Replacing the Federal Income Tax*, (JCS-3-96), April 23, 1996, p. 95.

⁹However, the Arney flat tax (H.R. 2060, 104th Cong., 1st Sess.) would allow a deduction for cash wages and certain retirement plan contributions; the USA tax (S. 722, 104th Cong., 1st Sess.) would allow a credit for payroll taxes.

is distributed among both labor-intensive and capital-intensive industries.

We suggest that more attention be paid to the potential impact of moving completely from an income tax with R&D incentives to a consumption tax with no R&D incentives (no research tax credit). Because R&D activity is a growth engine for the U.S. economy, further study must be made as to whether R&D activity will decrease under a consumption tax, and if so, reformers must then consider the impact to one of the key goals for tax reform — economic growth. This further study must consider:

- the impact of changed R&D tax incentives, along with other changes, such as reduced tax rates and the move to a territorial tax system, on a company's cost of doing business;¹⁰
- the impact of R&D incentives provided by other countries;
- the possible changed behavior of companies in response to reduced tax benefits for R&D activity;¹¹
- the varying impact of reduced R&D tax benefits among different industries;¹² and
- the possible impact to economic growth from reduced R&D tax benefits.

Accounting Methods

Current proposals: Only two of the current reform proposals include provisions on accounting methods: the USA tax proposal (S. 722, 104th Cong., 1st Sess.) and the National Retail Sales Tax proposal (H.R. 3039, 104th Cong., 2d Sess.). Under the USA tax proposal, a business would generally be required to use the accrual method of accounting; the all events test and economic performance requirement of current law would continue to apply. Generally, if a business was allowed to use the cash method of accounting under present law, it could continue to do so under the USA tax. The USA tax proposal directs the IRS to provide regulations (consistent with current section 447 and section 448) under which a new business might be able to adopt the cash method of accounting. The USA tax proposal also provides that certain changes or expansions of a busi-

ness may result in it no longer qualifying for use of the cash method, under regulations to be provided by the IRS. Under the USA proposal, the present rules on changes in method of accounting and bad debt expense, would remain.¹³

Under the National Retail Sales Tax proposal, the cash method is the general rule. However, a vendor could elect to adopt the accrual method to determine when tax is due on its sales. For taxable property and services sold under the installment method, tax is due when payment for the property and services is actually received. With respect to property and services returned to the vendor, the vendor would be entitled to a credit (refund) when actual payment for the returned property and services is made by the vendor.¹⁴ Apparently, a similar rule would apply to bad debts of a vendor using the accrual method (but a specific rule is needed to this effect).

The Armev flat tax (H.R. 2060, 104th Cong., 1st Sess.) does not mention accounting methods, but it implies, as does the Hall-Rabushka model upon which the Armev flat tax is based, that a cash method of accounting would be used. The subtraction VAT proposal of Congressman Gibbons also does not discuss accounting methods.

Considerations in Developing Accounting Method Rules: We suggest that the following principles be considered in developing accounting method rules for any tax reform proposal:

- One of the desired simplification provisions of many businesses is for increased book-tax conformity.¹⁵ However, conformity is not possible if the income tax system is replaced with a consumption tax, because books will still report income (not consumption). However, wherever possible, the goal of increased book-tax conformity should be followed.
- Under a consumption tax, where a business is allowed to immediately write off purchases of business assets, including land and inventory, timing rules will not be as important as under our current income tax system. For example, uniform capitalization rules and depreciation rules will be eliminated. Thus, the emphasis of current law on "clear reflection of income" from the perspective of the IRS (section 446(b) and Treas. reg. section 1.446-1(a)(2)) should no longer be the focal point of proper reporting of income and expenditures. Instead, emphasis should be placed on the methods used for book purposes (section 446(a) and Treas. reg. section 1.446-1(a)(1)), in order to achieve greater book-tax conformity.

¹⁰See July 18, 1996 testimony of The High-Technology Tax Restructuring Group, *supra*, for an example of how a consumption tax could increase the cost of U.S.-based R&D activities.

¹¹Changed behavior may include changes in a company's mix of domestic and foreign R&D spending, and increased use of outside contractors for R&D activity, relative to employee labor.

¹²The level of R&D spending among manufacturing industries varies. For example, in the automotive industry, R&D expenditures as a percentage of sales revenue is about 4 percent, while it is about 10 percent for the semiconductor industry and approximately 14 percent for the software industry. As reported by the Semiconductor Industry Association (SIA), based on a *Business Week* report; *SIA Annual Databook*, 1995, p. 41.

¹³The accounting method provisions of the USA tax proposal are at S. 722, *supra*, sections 220 to 226.

¹⁴H.R. 3039, 104th Cong., 2d Sess., section 22(e).

¹⁵See Joint Committee on Taxation, *Selected Materials Relating to the Federal Tax System Under Present Law and Various Alternative Tax Systems*, (JCS-1-96), March 14, 1996, p. 77.

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- The cash method of accounting should be considered an acceptable method of accounting for businesses with average annual gross receipts of \$5 million or less.¹⁶

Example: ABC Corporation is a publicly-traded company that prepares its financial statements according to generally accepted accounting principles (GAAP). For its year ended December 31, 1998, ABC's income statement reports:

Net sales		\$2,600x
Cost of sales		
Beginning inventory	\$500x	
Direct materials	\$600x	
Direct labor	\$700x	
Indirect costs	\$300x	
Ending inventory	<u>-\$400x</u>	\$1,700x
R&D		\$300x
Selling, general and administrative		<u>\$320x</u>
Operating income		\$280x
Interest, net		<u>\$120x</u>
Income from operations before income taxes		\$400x

Because ABC's financial statements are based on income, but its tax return is based on a consumption tax system, many book-tax differences will exist. However, for purposes of simplification, ABC should be allowed to start with the above numbers in determining its tax base under any of the consumption tax proposals. For example, under a subtraction method VAT, ABC would make the following adjustments:

- a) Eliminate labor, fringe benefits, taxes, interest and beginning and ending inventory included in its expenditures;
- b) Eliminate net interest income;
- c) Eliminate depreciation and amortization amounts;
- d) Remove gain or loss amounts from the sale of fixed assets;
- e) Include a deduction equal to the book amount of equipment, building, and land acquired and placed in service during the year (rules are required to ensure that there is no interest expense element included in this deduction); and

¹⁶As under section 448. Arguably, under a system where inventory is deducted when acquired, rather than when sold, a small business with inventory should not be precluded from using the cash method of accounting for tax purposes (this is not allowed under current law per Treas. reg. section 1.446-1(c)(2)(i), which requires a taxpayer with inventory to use the accrual method for purchases and sales). Rules can be provided to prevent possible abuses, such as large year-end inventory purchases made solely for tax purposes where the inventory is returned in the next year; see Revenue Ruling 79-188, 1979-1 C.B. 191.

- f) Increase its tax base for the book sales price of equipment, building, and land sold during the year.

The above adjustments should *not* be expanded to require ABC to apply the all events test and economic performance requirement to determine when it incurred expenditures and had basis in assets purchased. Similarly, ABC should not be required to apply the existing income recognition rules of IRC 451 and the regulations; instead, it should be allowed to use its book revenue amounts.

Impact on Financial Statements

Regardless of how U.S. tax reform evolves, the need to accrue state and foreign income tax liabilities in financial statements will continue under GAAP accounting although the geographic mix of income tax liability could change dramatically.¹⁷ For many companies, foreign income tax liabilities will likely increase in proportion to the corporate U.S. (state) tax liability. Income tax accounting with respect to foreign operations will become much more important to the global income tax provision and accordingly increases the administrative burden to U.S.-based tax departments in managing the income tax accounting work.

Discussion of transition issues in the tax reform debate so far have focused on the tax and economic reasons of either providing transitional rules or not providing such rules. However, another important aspect of transitioning from an income tax to a consumption tax is the impact on financial reporting. The impact of moving from an income tax to a consumption tax can have a significant impact on a company's income statement and balance sheet, and potentially on its business decisions and stock price. Financial reporting (GAAP) aspects of major federal tax reform include:

- the impact on a company's net deferred tax assets or net deferred tax liabilities in existence at the transition date;
- how the change from one set of rules to another should be reported on financial statements for the year of change; and
- what the incidence of the new tax is and whether or not it should be reflected on a company's income statement as the income tax currently is. For example, would the financial accounting rule for federal taxes be the same under the Army flat tax, USA tax, and national retail sales tax proposals?

A company's mix of deferred tax assets¹⁸ and deferred tax liabilities¹⁹ and whether the company is

¹⁷Financial Accounting Statement (FAS) 109, Accounting for Income Taxes.

¹⁸Deferred tax assets tend to represent nondeductible current expenses that will be deducted in the future and may represent such items as inventory reserves, deferred revenue, loss carryovers, and foreign tax credits.

¹⁹Deferred tax liabilities may exist for such items as book-tax depreciation differences.

in a net deferred tax asset or net deferred tax liability position can vary from year to year for a variety of reasons. The type of transitional rules provided can have a significant impact to companies, particularly those with net deferred tax assets. Tax reformers should consider the impact of limited transitional relief on both the tax and financial reporting positions of companies. Transition rules should take into account ways to prevent undue burdens for companies with significant tax attributes at the transition date.

Regardless of how U.S. tax reform evolves, the need to accrue state and foreign income tax liabilities in financial statements will continue under GAAP accounting although the geographic mix of income tax liability could change dramatically.

GAAP (FAS 109) requires tax law changes to be reflected in financial statements in the year enacted. Assuming that FAS 109 would continue to apply to a consumption tax, the value of net deferred tax assets and net deferred tax liabilities would decrease. Again, this would affect companies differently depending on their prior tax attributes. Whether or not transition rules exist to allow a tax benefit for loss and credit carryovers and undepreciated asset basis at the transition date will have an impact on corporate financial statements, stock prices, and transitional planning.

There are many unknowns with respect to the impact of tax reform on financial statements. For example, will the current income tax reporting rule under GAAP (FAS 109) apply to consumption taxes, or will a new rule be required? Also, what is the proper reporting of the particular consumption tax on the financial statement? For example, a national retail sales tax collected by a taxpayer should not be reported on the income statement. However, it is not clear whether the same would be true for a subtraction method VAT, although theoretically, the economic incidence of a subtraction method VAT is the same as for a sales tax (tax imposed on the final consumer). Additional uncertainties stem from these accounting unknowns which may have significant impacts on the economic impact of fundamental tax reform. For example, how will the stock market react to changes in balance sheets (likely improvements for companies with deferred tax liabilities, but likely reductions to earnings for companies with deferred tax assets) and effective tax rates?

Example: In the first year of the flat tax, Young Corporation (YC) has \$600 million in domestic revenue and flat tax deductions of \$330 million. Thus, YC's pretax income is \$270 million and its flat tax liability is \$54 million (20 percent tax rate). YC has \$70 million

in prepaid tax assets on its books, attributable to inventory reserves, loss carryovers, and research tax credit carryovers. Assuming no transitional rules exist to allow YC to ever obtain benefit of the prior inventory purchases or carryovers, the prepaid tax asset must be removed from YC's financial statements. YC's income tax provision for the first year of the flat tax would be:

Flat tax	\$54M
FAS 109 adjustment	<u>\$70M</u>
Total	\$124M
U.S. pretax income	\$270M
U.S. effective tax rate	46%

Without the FAS 109 adjustment, YC's effective tax rate would have been 20 percent. This example is a simplified one involving only three book-tax differences; a typical manufacturer would have significantly more book-tax differences to analyze. The impact of tax reform will raise many difficult accounting issues for companies due to the significant nature of the contemplated changes — analyzing the specifics of reserves, moving from a worldwide system to a territorial one, lack of transitional rules, and uncertainty as to the incidence of the tax burden.

Congress must consider the need for financial statement guidance that must follow reform of the federal tax system. The impact of tax reform on financial statements (and stock prices) must be included in the tax reform debate with respect to the technical and economic points, as well as providing a sufficient time frame for the accounting issues to be resolved.

Conclusion

Major federal tax reform presents significant accounting, economic, social, and political issues. Our comments above identified and discussed only three of these significant issues. To summarize, manufacturing companies are particularly sensitive to changes to the current treatment of R&D expenditures. Consideration of a consumption tax must take into account possible reduction in U.S. R&D spending and whether economic growth may be impacted adversely. Also, accounting method rules for any consumption tax proposal must consider how to best reach the simplification goal of tax reform, and realize that income tax standards for what is a proper method of accounting might not automatically apply to a consumption tax. The financial reporting (GAAP) issues indicate the need to consider the very broad brush tax reform sweeps over businesses beyond just their tax obligations to the government. In addition, financial reporting issues indicate the need to have a broad spectrum of parties involved to some degree in the tax reform process, including the Financial Accounting Standards Board.