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Testimony before the
Senate Finance Committee
Our Business Tax System: Objectives, Deficiencies and Options for Reform
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Mr. Chairman, Ranking Member Baucus and Members of the Committee:

I am the National Director of Ernst & Young LLP's Quantitative Economics and Statistics practice.[*] I was previously the Director and Chief Economist of the U.S. Treasury Department's Office of Tax Analysis between 1986 and 1990.

I appreciate the invitation to testify before the Committee on the issue of our business tax system, and particularly options for reform.[1] Given the breadth of the topic of business tax reform, I will restrict my comments to the issue of reasons why many corporations prefer a lower corporate tax rate to more targeted tax reductions. My testimony is based on a recent Tax Notes article, entitled "Where's the Applause? Why Most Corporations Prefer a Lower Tax Rate."[2]

The President's Advisory Panel on Federal Tax Reform outlined a Growth and Investment Tax Plan for a business cash-flow tax—essentially an expensing option that allows for a first-year 100% write-off of capital investment. One might have expected that this plan—which many economists claim would result in a zero effective tax rate for new capital investment—would have inspired a collective standing ovation from corporate finance and tax officers. Instead, the response has been similar to the proverbial sound of "one hand clapping."

Why the tepid response from the corporate community? The Tax Council Policy Institute recently asked multinational corporations to rank a range of alternative tax reform options—and, according to the survey, the clear favorite was lowering the corporate tax rate to 25 percent compared to other incremental or fundamental tax reforms.[3]

With economists and the business community differing so widely in their response to the Advisory Panel's expensing option, many observers wonder why the disconnect. Here are seven reasons why many corporations prefer a lower corporate tax rate to the proposed option of expensing capital investments.

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[1] The views expressed in this testimony are my own, and don't necessarily reflect the views of my firm or clients.
[2] Tom Neubig, "Where's the Applause? Why Most Corporations Prefer a Lower Tax Rate," Tax Notes, April 24, 2006, p. 483-6.
[3] Tax Council Policy Institute, The U.S. International Tax Regime: Confronting the Challenge of the Evolving Global Marketplace, February 10-11, 2005, Final Report, p. 90.

1) *Expensing offers only a timing benefit, and doesn't reduce corporations' book effective tax rate. A lower corporate marginal tax rate would lower corporations' book effective tax rate and increase book net income for most corporations.*

Most economists don't think book taxes matter. Most corporate tax and financial officers value permanent, rather than temporary, book tax differences. From the perspective of the corporate officer, expensing accelerates tax deductions into the first year, providing only a timing tax difference rather than a permanent tax difference for book purposes.

With expensing, public corporations would have large deferred book tax liabilities, yet would still have a high book effective tax rate on current income. While most economists believe that book corporate 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.

In contrast, reducing the corporate marginal tax rate would immediately lower corporations' book effective tax rates, thereby increasing their reported after-tax book profits. A lower corporate marginal tax rate would also immediately reduce corporations' deferred book tax liabilities and assets—a welcome development in an environment where most of the largest companies report deferred tax liabilities.

A lower corporate tax rate would necessitate re-measuring existing deferred tax liabilities and assets, and also result in an increase or charge to earnings in the period the legislation is enacted. Companies in a net deferred tax liability position would have an increase in reported after-tax income from the tax benefit associated with a lower tax rate on their deferred tax liabilities. Of the 50 largest companies within the Fortune 500, 32 have a net deferred tax liability and 18 have a net deferred tax asset. When the State of Ohio enacted legislation phasing down its corporate income tax rate on June 30, 2005, a number of public corporations reported higher profits due to the future tax rate reductions in their second quarter financial results.

2) *Corporations already expense a large fraction of their capital investment. A lower tax rate would benefit both their tangible and their intangible investments—a benefit not offered by the business cash-flow tax.*

Undeniably, proposals for expensing would lower the economic effective tax rate for depreciable property, land and inventories. But, a recent study found that business investment in intangibles—research and development, copyrights, computerized databases, development of improved organization structures, and brand equity—is now as large as the spending on tangible capital. And, through the deduction for wages associated with the creation of the self-constructed intangible assets, a large portion of investments in intangible assets are already expensed under the current system.

Expensing would benefit depreciable and capitalized investments, but would provide no incremental benefit to intangible assets that are currently expensed. A lower corporate marginal tax rate, on the other hand, would benefit income from all tangible and intangible investments. A lower corporate marginal tax rate would also benefit existing intangible investment, since the tax rate at which it expensed the investment would be higher than the tax rate at which the future income would be taxed.

3) *Expensing is unlikely to occur without a counterbalancing loss of interest deductibility. A lower corporate marginal tax rate could occur with continued interest deductibility.*

The Advisory Panel's report emphasizes the necessity of combining expensing with repeal of interest deductibility to prevent negative economic effective tax rates. "Eliminating the business interest deduction for non-financial firms is an essential component of the Growth and Investment Tax 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." (Advisory Panel, p. 164)

As a result, the valid comparison isn't just expensing versus a lower corporate tax rate, it is expensing combined with loss of interest deductions versus a lower corporate tax rate with interest deductions.

It should be noted that debt-financed capital investment is already calculated as having an economic effective corporate tax rate of zero with economic depreciation, and a negative economic effective tax rate with the current accelerated depreciation. "By contrast, the average tax rate on debt-financed investment is negative (-15%), as deductions for interest, together with deductions of items such as accelerated depreciation, more than offset the income generated from debt-financed investment." (Advisory Panel, p. 100)

So, expensing would really only help a small fraction of corporate investment: equity-financed tangible investments. Because of the loss of the interest deduction, debt-financed tangible and intangible investment would be worse off under the business cash-flow tax. For this reason, a lower corporate marginal tax rate on top of the current interest deduction and accelerated depreciation for tangible capital would be more advantageous for many corporations compared to expensing or a business cash-flow tax.

4) *Corporations invest to earn above-normal returns, not just the "normal" or risk-free return. While expensing reduces the tax rate on only the risk-free return, a lower marginal tax rate applies to the <u>entire</u> return to capital,*

Economists distinguish between four different returns to investors: 1) a "normal" or risk-free return for deferring consumption, or a "return to waiting"; 2) an expected risk premium; 3) a return due to entrepreneurial skill, a unique idea, a patent or other specific factors; and 4) an unexpected return from good or bad luck where the actual return differs

from the expected return. The Advisory Panel report (p. 150) states "Removing the tax on the first component, the return to waiting, is the key to removing taxes from influencing savings and investment decisions." The Panel report stresses that both an income tax and a "post-paid" consumption tax (expensing) fall on the other three components, which they say has "important implications for the distributional effects" of reform.

Academic economists argue that in competitive markets businesses can only earn the "normal" or risk-free return to capital on their last (marginal) dollar of investment. By this reasoning, expensing will provide an incentive for additional investment. However, the Growth and Investment Tax Plan with expensing but without an interest deduction would impose a tax on returns in excess of the "normal" or risk-free return arising from risk-taking, entrepreneurial effort or innovation. Consequently, the academic economists' zero tax rate argument only applies to a very small fraction of a company's total investment—just to that last dollar of investment, and only to the portion equivalent to a risk-free return. But, the reality is that companies don't invest just to earn a risk-free return; they expect to earn returns to justify their risk-taking, specialized factors and competitive positioning.

Economic proponents of expensing like to point out that under a business cash flow tax profits above the risk-free return would be taxed. They argue that taxing "rents" is equivalent to a lump-sum tax, causing no economic distortions. Again, we are reminded that the economists and the corporate tax officers are two very different audiences.

While most economists are focused at the "margin", businesses make investments that are large, discrete, finite, risky and also include substantial entrepreneurial and innovative efforts. When entering a market with a sizeable investment, a company looks at its total after-tax return. While a company might earn a risk-free return from the time-value of money from accelerating depreciation deductions, companies invest to earn a significantly higher return on their total investment. On the other hand, a lower corporate tax rate would reduce the tax on all corporate income—both the normal risk-free return income as well as the return to risk-taking, entrepreneurial skill and innovation.

5) *Many companies would not receive the full benefit of expensing without also being able to receive immediate refunds.*

Many companies, especially while transitioning to the business cash flow tax model, would not benefit from the full effect of expensing, because expensing would eliminate all taxable business cash flow for many companies. Unless the government provided immediate cash refunds, they would only realize a fraction of the potential benefits that expensing might offer. Many more companies would find themselves in a net operating loss (NOL) carry forward position with expensing.

The Advisory Panel did propose that the business cash flow tax with expensing would also include NOL deductions with interest. And, economists' present value calculations would show that corporations are made whole with an interest adjustment to NOLs.

However, corporations don't normally choose to invest in Treasury securities earning a risk-free return. Deferring the tax benefits of expensing beyond the initial year, even with a risk-free interest rate, is not the equivalent of a zero economic effective tax rate when a corporation considers the other, more potentially rewarding, opportunities available for its investments or payments to shareholders.

6) *Expensing reduces the tax wedge on one margin, but a lower tax rate would reduce the tax wedge on all margins.*

The Advisory Panel notes that its Simplified Income Tax proposal for a territorial system of international taxation would put increased pressure on transfer pricing. (Advisory Panel, p. 242) Indeed, transfer pricing issues are important when marginal tax rates differ across countries, and currently the U.S. has one of the highest statutory corporate tax rates. The Organization for Economic Cooperation and Development (OECD) calculates the U.S. combined federal/state corporate tax rate to be 39.3% compared to an OECD average of 31.2 %. Other marginal decisions, such as debt versus equity financing, are influenced by the statutory marginal tax rate. Marginal and average tax rates also influence location decisions.

While some economists argue that expensing would eliminate the differential tax treatment of tangible and intangible investments, a lower corporate marginal tax rate would reduce the tax wedge for all corporate decisions, including location decisions, the corporate non-corporate decision, debt equity financing decisions, transfer pricing, etc.

7) *Corporate tax rates could increase in the future. Expensing leaves large deferred tax liabilities that could be subject to significant future tax increases.*

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

If tax rates increase in the future, then public corporations' large deferred tax liability from expensing would become even larger on prior investments. In addition, a higher tax rate and increased deferred tax liability would reduce reported book income in the year of the change. Academic economists might think that corporations would be indifferent to the possibility of future tax changes, or at least treat the possibility of a tax rate increase as offsetting the possibility of a tax rate decrease. In reality, though, many corporate officers and tax directors would see a much larger downside from a tax rate increase than benefit from a tax rate decrease. Negative surprises seem to have a larger adverse effect than the positive effect from positive surprises. In today's business environment, jobs and options can be lost with negative surprises; a positive surprise, on the other hand, might elicit a one-time bonus.

Expensing would create large deferred tax liabilities. And, many theoretical economists might argue that these could later be taxed at higher rates without adverse economic effects since the investments had already been made. This is the same argument that many economists use for estimating the future economic benefits of moving to a consumption tax (either a value-added tax or business cash flow tax), since the shift can be financed by imposing taxes on old capital (existing investments). This is another reason why corporate officers are skeptical of expensing and also economic arguments of efficiency.

Conclusion

Given the very different perspectives and day-to-day challenges of the academic economists and the business community, it is unlikely that the Growth and Investment Tax Plan—or any tax reform proposal that resembles a consumption tax—will draw raves from both audiences. And, while the Advisory Panel's business cash-flow tax proposal retains the appearance of the current corporate income tax—with expensing and a repeal of interest deductibility added to the mix—it is still, at its core, a variant of a consumption tax. Part of the explanation for the disconnect between academic economists and the business community is what might be called the "Red Riding Hood disguise" – hiding a consumption tax in income tax clothing.

Expensing capital investment would provide significant tax benefit to many corporations. But still, most corporations—even many of those who would benefit from expensing—are likely to favor lower marginal rates as part of any incremental tax reform. And, while expensing would significantly reduce the taxation of equity-financed depreciable property, the business cash-flow tax (with repeal of interest deductibility) would increase the tax burden on debt-financed tangible and all intangible assets. Plus, expensing would not lower book effective tax rates.

Academic economists are correct when they say that expensing can result in a zero effective tax rate on the risk-free return to marginal investment. However, the underlying assumptions and limited focus of their analysis (marginal investment, equity-financed tangible investments, no financial statement effects, no principal-agent incentive effects) neglect the fact that businesses are seeking high total after-tax returns to their investments, including the return to risk-taking, innovation, and entrepreneurship.

These seven reasons seem to be why many corporate tax directors and officers have not stood up with many economists to applaud expensing and the proposed business cash-flow tax. Most of the corporate tax community would prefer to see the U.S. join other countries in lowering the corporate marginal income tax rate.

Thank you for inviting me to make this statement. I would be happy to answer any questions.