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## Bridging the Book-Tax Accounting Gap

**ABSTRACT.** The book-tax accounting gap allows corporations to minimize their earnings for tax purposes while maximizing them in reports to investors, all within the letter of the law. Although the U.S. Treasury has reported the rising divergence between book and taxable income with alarm, scholars and policymakers have yet to consider fundamental reform. This Note proposes eliminating the book-tax divide by moving to a book-conformed system. Implementing this proposal will both cut down on rampant corporate tax sheltering and help restore the integrity of the financial accounting system.

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*Accounting is no longer a way to provide an accurate and unified view of a company's finances. Instead, it has become a means to an end. For the public books, the goal is to achieve smooth and steady earnings growth that will lift the value of the company's stock . . . . For the IRS, the goal is the exact opposite—keeping income, and thus taxes, to a minimum.*<sup>1</sup>

## INTRODUCTION

Corporations in the United States use two different sets of accounting rules when preparing their financial statements for investors and their tax returns for the Internal Revenue Service (IRS). The so-called book-tax accounting gap that results from the differences between the rules allows firms to shelter income from tax authorities while inflating earnings in reports to investors. In 1999, the U.S. Department of the Treasury (Treasury) released data indicating a rise in the ratio of reported book income to taxable income in the 1990s, which it interpreted as evidence of increased tax-shelter activity.<sup>2</sup> Although scholars have not conclusively verified Treasury's interpretation,<sup>3</sup> the data and their implications are clear. Whether corporations are using abusive tax shelters or simply taking greater advantage of deliberate disparities between tax and financial-accounting standards, they have increasingly demanded tax-favored investing and financing activities that "create noise in the estimation of financial and taxable income."<sup>4</sup>

As Treasury, Congress, and numerous scholars and practitioners have recognized, when the law severs the tax consequences of a transaction from its economic consequences, the results can be pernicious.<sup>5</sup> Accounting gimmicks create shelters for sophisticated taxpayers to reduce their tax liability,

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1. Alan Murray, *Inflated Profits in Corporate Books Is Half the Story*, WALL ST. J., July 2, 2002, at A4.
  2. U.S. DEP'T OF TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 32 (1999) [hereinafter TREASURY WHITE PAPER], available at <http://www.treas.gov/press/releases/reports/ctswhite.pdf> ("[O]ne feature of many tax shelters is that they reduce taxable income and taxes without reducing book income.").
  3. See Lillian F. Mills et al., *Trends in Book-Tax Income and Balance Sheet Differences*, 96 TAX NOTES 1109 (2002) (surveying the scholarly literature and finding that the growing book-tax gap may be due to incentives for management to engage in tax shelters or to technical differences between the tax and accounting rules).
  4. Gil B. Manzon, Jr. & George A. Plesko, *The Relation Between Financial and Tax Reporting Measures of Income*, 55 TAX L. REV. 175, 211 (2002).
  5. See *infra* notes 43-57 and accompanying text.

decreasing government revenue and increasing the tax burden on the rest of the citizens. And, as recent financial scandals have demonstrated, the book-tax divide also hurts capital market investors because it creates opportunities for businesses to mislead shareholders and investors about firms' actual economic health. Moreover, the complexity of maintaining two separate sets of books (three, for those firms potentially subject to the corporate alternative minimum tax (AMT)) generates tremendous compliance costs and incentives for cutting corners. As one commentator has stated, the presence of two different sets of accounting rules, each plagued by imprecision and subject to multiple interpretations, gives corporations "two different bites at the apple."<sup>6</sup> What used to be seen as an economically advantageous distinction between tax and financial accounting may now be considered a "credibility gap."<sup>7</sup>

Where did the dangerous book-tax divide come from, and why do Congress, regulators, and accountants continue to tolerate it? The most common justification—endorsed by businesses and all three branches of government, including the Supreme Court—is that financial accounting and tax accounting have different goals and thus require discrete methodologies. Federal income taxation is intended primarily to raise money for the government. Legislators also use the tax code to provide economic incentives for socially beneficial activities. Financial accounts, meanwhile, must provide current and potential investors with an accurate picture of a corporation's economic position. Defenders of the divide have argued that a unified system cannot accommodate these differing objectives.<sup>8</sup>

This Note, by contrast, argues that the asserted benefits of the book-tax divide no longer justify its substantial costs in terms of tax compliance, revenue collection, economic policy, and the perceived fairness of U.S. income tax laws. This Note proposes a system of near-total accounting conformity. Such a regime would compromise neither the tax system's primary goal of raising revenue, nor the financial accounting system's primary goal of providing investor information—although legislators would no longer be able to use the tax code as a wide-ranging social policy tool (and a means of giving favors to preferred constituents). Under this Note's proposal, the starting point for taxable income should be financial income as reported to investors, which more closely approximates economic income than does current taxable income.<sup>9</sup>

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6. George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209, 227 (2001).

7. Murray, *supra* note 1.

8. See *infra* notes 23-25 and accompanying text.

9. See Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in READINGS IN THE ECONOMICS OF TAXATION 54, 59 (Richard A. Musgrave & Carl S. Shoup eds., 1959)

A few of the most important tax provisions—for example, credits for research expenses and for foreign income taxes paid—should be retained as selected departures from reported financial income, but the scale and scope of those departures should remain limited in order to prevent tax preferences and exceptions from eroding the system.

This Note proceeds in five parts. Part I traces the history of the book-tax divide, unraveling the theoretical, institutional, and doctrinal reasons for its existence. Part II discusses the two major problems that result from the gap: tax sheltering and accounting fraud. Part III examines past reforms that have aimed to partially close the book-tax gap. None of these reforms has been fully successful, but each offers important lessons about book-tax conformity. Part IV addresses and rebuts each of the major objections to book-tax conformity. Finally, Part V lays out a proposal to conform the two accounting systems that would cut down on tax sheltering and accounting fraud without endangering the government's attempts to raise revenue equitably or the Financial Accounting Standard Board's (FASB) attempts to regulate financial accounting standards.

## I. A TALE OF TWO SYSTEMS

Early endorsements of the book-tax gap relied on the idea that the book and tax accounting systems had different objectives. Changes over time, however, have eroded these original justifications and have undermined the institutional and doctrinal support for maintaining two separate systems.

### A. *The Book-Tax Gap in Theory and Practice*

Today, it is easy to talk about the book-tax gap as a fact of life. Yet the existence of two different income-reporting systems was not preordained. The computation of taxable income begins (and has long begun)<sup>10</sup> with “the

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(stating that income is “the money value of the net accretion to one's economic power between two points of time”); *see also* HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938) (“Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.”). Financial income more closely approximates these definitions because it lacks the myriad tax preferences and exemptions that characterize taxable income.

10. *See* Internal Revenue Code, ch. 1, § 41, 53 Stat. 1, 24 (1939) (codified as amended at I.R.C. § 446 (2000)) (prescribing that taxable income “shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books of [the] taxpayer”); Revenue Act of 1916, ch. 463, § 13(d), 39 Stat. 756, 771 (codified as amended at I.R.C. § 446

method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.”<sup>11</sup> In the post-World War II period, however, the tax code has not adopted generally accepted accounting principles (GAAP) as the mandatory, or even presumptive, starting point for calculating corporate taxable income. Rather, the modern Treasury has “recognized that no uniform method of accounting can be prescribed for all taxpayers,”<sup>12</sup> and the IRS has stated that any method that “clearly reflects income” is permissible.<sup>13</sup> In evaluating a given method, the IRS favors consistency over any specific methodology.<sup>14</sup> Although IRS regulations declare that income calculated using GAAP will “generally” be considered a clear reflection of income,<sup>15</sup> the IRS has denied taxpayers’ attempts to interpret this provision as creating a presumption in favor of income calculated under GAAP standards.<sup>16</sup> Courts interpreting the tax code follow the same rule. When GAAP treatment does not reflect the current-year economic reality of the transaction, the taxpayer “finds no shelter beneath an accountancy presumption.”<sup>17</sup>

With no clear and simple way of translating amounts between the two systems, corporations can elect how to report income to investors and to the IRS. Analysts have shown that the GAAP rules prescribing methods for reconciling financial-statement income to reported taxable income can lead to significant inaccuracies in estimating actual corporate taxes paid and effective tax rates.<sup>18</sup> Under FASB guidelines, firms report a current-year “tax expense”

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(2000)) (providing for the first time that a “corporation . . . keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may . . . make its return upon the basis upon which its accounts are kept”); see also Melvin T. McClure, *Diverse Tax Interpretations of Accounting Concepts*, J. ACCT., Oct. 1976, at 67-68 (arguing that “the original intent of the [tax] law was to determine taxable income on the basis of accounting principles”).

11. I.R.C. § 446(a) (2000).

12. 26 C.F.R. § 1.446-1(a)(2) (2005).

13. *Id.*

14. 26 C.F.R. § 1.446-1(c)(1)(iv)(b)(2)(ii) (2005) (providing that “[n]o method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year”).

15. 26 C.F.R. § 1.446-1(c)(1)(ii)(C) (2005).

16. In 1991, the IRS declared that it does not consider GAAP conformity a “controlling factor” because to do so would impose a uniform accounting method (the accrual method) on all taxpayers in contravention of recognized tax policy and explicit regulations. I.R.S. Priv. Ltr. Rul. 91-13-003 (Apr. 3, 1991).

17. *Thor Power Tool Co. v. Comm’r*, 439 U.S. 522, 542 (1979).

18. See, e.g., Gary A. McGill & Edmund Outslay, *Lost in Translation: Detecting Tax Shelter Activity in Financial Statements*, 57 NAT’L TAX J. 739, 745-47 (2004) (illustrating the difficulty of using Enron’s financial statements to determine whether it actually paid taxes as an

based on current book income. They also delineate the portions of that expense currently owed and those portions that are deferred either temporarily or indefinitely.<sup>19</sup> Yet this tax expense bears little relation to the actual taxes a corporation pays in any given year, due to differing tax and financial-reporting rules regarding corporate consolidation, disparate treatment of foreign income and taxes paid, discrepant accounting periods, and net-operating-loss carrybacks and carryforwards. Subsequent tax reassessments may also bias the book-tax comparison.<sup>20</sup> Because of this complicated reconciliation method, the information reported to the IRS on the Schedule M-3 (the schedule that reconciles book income to taxable income)<sup>21</sup> may not, in fact, represent the actual dollar-value difference between economic income and income subject to tax. This disconnect between income measurements under the two systems led to the infamous and unanswered question: “Did Enron pay taxes?”<sup>22</sup>

Nevertheless, supporters of separate book and tax accounting have justified the distinction based on the two systems’ differing goals. As the tax code mushroomed over the twentieth century, Congress deviated from imposing taxes on actual economic income on the assumption that “tax preferences” or “tax expenditures” would stimulate economic activity or other socially useful behaviors. Thus, the corporate tax return is aimed at measuring only the items of economic income deemed “taxable” under U.S. law—in other words, those that are not the subject of an explicit exemption or tax preference. Financial statements, by contrast, should give investors and the public access to accurate, reliable information about a corporation’s economic income, its ongoing activities, and its financial prospects.<sup>23</sup> If the primary consumers of the financial

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example of “the limits of current [GAAP] reporting rules in answering the ‘big’ question (i.e., how much did the corporation pay the U.S. Treasury in income taxes)”; see also Howard Gleckman et al., *Tax Dodging: Enron Isn’t Alone*, BUS. WK., Mar. 4, 2002, at 40 (“Truth is, figuring out how much tax a company actually pays is almost impossible. Tax returns are not public. And financial statements often hide tax payments.”).

19. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 109, ACCOUNTING FOR INCOME TAXES 17-25 (1992) [hereinafter SFAS NO. 109], available at <http://www.fasb.org/pdf/fas109.pdf>.
20. For a discussion of these factors, see Manzon & Plesko, *supra* note 4, at 203-04.
21. For a critique of the Schedule M-3 as a solution to the book-tax divide, see *infra* notes 103-110 and accompanying text.
22. Gary A. McGill & Edmund Outslay, *Did Enron Pay Taxes?: Using Accounting Information To Decipher Tax Status*, 96 TAX NOTES 1125, 1125 (2002).
23. That financial accounting information is crucial to public investors is reflected in the fact that since the 1930s the SEC has been the “final arbiter of financial accounting rules for” public companies. GEORGE MUNDSTOCK, A FINANCE APPROACH TO ACCOUNTING FOR LAWYERS 7 (1999).

statements, present and potential investors and creditors of a corporation,<sup>24</sup> have adequate information, then the public market can allocate capital appropriately.<sup>25</sup>

Moreover, an institutional gap separates the bodies that govern tax and financial accounting, entrenching the distinction between the two systems. While tax accounting remains firmly the province of the IRS, the Securities Exchange Act of 1934 created the Securities and Exchange Commission (SEC) and gave it the authority to set and oversee financial reporting standards.<sup>26</sup> Since that time, the SEC has delegated responsibility for setting the rules of financial accounting to the private sector—namely, the American Institute of Certified Public Accountants, the FASB, and the Public Company Accounting Oversight Board (PCAOB) created by Congress in 2002—under the assumption that business and accounting experts have greater “expertise, energy and resources” than the federal government when it comes to assessing U.S. business transactions.<sup>27</sup> In contrast to tax accounting, financial accounting lacks clear standards or controlling authorities.

### *B. Nine Justices and the Gaping Divide*

Despite the marginal role that courts generally play in tax law,<sup>28</sup> judicial intervention has been critical to maintaining the book-tax accounting gap. In

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24. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 1, OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES 13-14 (1978) [hereinafter SFAC No. 1], available at <http://www.fasb.org/pdf/con1.pdf>.

25. See Alvin D. Knott & Jacob D. Rosenfeld, *Book and Tax (Part One): A Selective Exploration of Two Parallel Universes*, 99 TAX NOTES 865, 870-71 (2003).

26. Securities Exchange Act of 1934, ch. 404, § 4(a), 48 Stat. 881, 885 (codified at 15 U.S.C. §§ 77s(a), 78m(b)(1) (2000)).

27. *Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards*, Accounting Series Release No. 150, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72.172 (Dec. 20, 1973). Sarbanes-Oxley perpetuated this reliance on the private sector, declaring that the SEC “may recognize, as ‘generally accepted’ for purposes of the securities laws, any accounting principles established by a standard setting body” that, among other criteria, “is organized as a private entity.” Sarbanes-Oxley (SOX) Act of 2002, Pub. L. No. 107-24, § 108(b)(1), 116 Stat. 745, 768 (codified as amended at 15 U.S.C. § 108(b)(1) (Supp. II 2002)).

28. Although the courts successfully blocked late-nineteenth- and early-twentieth-century attempts to enact an income tax on constitutional grounds, ever since the Sixteenth Amendment sanctioned income taxation in 1913, “the general authority of the Congress in the field of taxation has not been significantly challenged [in court].” MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 53 (rev. 4th ed. 2002).



the seminal 1979 case *Thor Power Tool Co. v. Commissioner*, the Supreme Court erected a legal bulwark that, for nearly three decades, has blocked efforts to move toward book-tax conformity. In a strongly worded opinion by Justice Blackmun, the Court noted “the vastly different objectives that financial and tax accounting have,”<sup>29</sup> and held that in light of the different objectives, “any presumptive equivalency between tax and financial accounting would be unacceptable.”<sup>30</sup> According to the Court, the financial accountant’s duty to provide useful information to management, shareholders, and creditors dictates an approach dominated by conservatism and “hospitable to estimates, probabilities, and reasonable certainties” of the business’s future prospects.<sup>31</sup> The IRS, on the other hand, must seek to collect revenue equitably and in sufficient amounts to meet the government’s needs.<sup>32</sup> Given these responsibilities, “the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty,” and the accountant’s conservatism cannot be allowed to dictate the IRS’s revenue-collection efforts.<sup>33</sup> Noting that GAAP rules themselves are open to interpretation, the Court envisioned a doomsday scenario of book-tax conformity: “[A] firm . . . could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay. Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable.”<sup>34</sup> The Court denied such unilateral power to the Thor Power Tool Company, ruling that the IRS could modify the company’s reported loss on an unsold-inventory write-down even though the loss conformed to the company’s financial accounting statements. Thus, in one fell swoop, the Supreme Court granted the IRS broad powers to recharacterize transactions reported in a manner consistent with the taxpayer’s financial accounts.

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29. 439 U.S. 522, 542 (1979).

30. *Id.* at 543; see also *Frank Lyon Co. v. United States*, 435 U.S. 561, 577 (1978) (“[We] are mindful that the characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same.”).

31. *Thor Power*, 439 U.S. at 542-44.

32. *Id.* at 542.

33. *Id.* at 543.

34. *Id.* at 544.

Cases citing *Thor Power* have demonstrated the breadth of its holding.<sup>35</sup> Although several courts have factually distinguished *Thor Power*—for example, when the taxpayer’s income reporting appears to have complied with explicit directions of the Code and regulations<sup>36</sup>—none has questioned the Court’s rejection of book-tax conformity as a defense of reported taxable income. Moreover, the Code has historically deferred to the IRS in determining the proper accounting treatment for tax purposes, providing textual support for the holding in *Thor Power*. Section 446(b) of the Code provides that if the taxpayer’s accounting method “does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.”<sup>37</sup> The IRS has specified that among the various measures that may “clearly reflect” income, GAAP conformity is to be a factor, but not the “controlling factor.”<sup>38</sup> *Thor Power* has thus become a potent symbol of the book-tax divide’s permanence and has helped perpetuate the dual accounting system that breeds both tax shelters and accounting fraud.

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35. See, e.g., *Travelers Ins. Co. v. United States*, 303 F.3d 1373, 1384 (Fed. Cir. 2002) (refusing to apply a de novo standard of review to the IRS Commissioner’s determination of the taxpayers’ tax liability); *PNC Bancorp v. Comm’r*, 212 F.3d 822, 832 (3d Cir. 2000) (“The Supreme Court [in *Thor Power*] has held that financial accounting standards such as SFAS 91 do not dictate tax treatment of income and expenditures.”); *Corra Res., Ltd. v. Comm’r*, 945 F.2d 224, 226 (7th Cir. 1991) (stating that “a taxpayer may not hedge bets at the Treasury’s expense”); *Thomas Nelson, Inc. v. United States*, 694 F. Supp. 428, 434 (M.D. Tenn. 1988) (stating that “the IRS has determined that [the taxpayer’s] attempt to use the cash method of accounting failed to reflect its income clearly, and the IRS therefore has recomputed that income using the accrual method. The taxpayer now has the burden of proving that the IRS’s action is ‘clearly unlawful’ or ‘plainly arbitrary’”).
36. In *Thor Power*, the company relied on no explicit statutory or regulatory guidance to justify its reporting of an inventory loss in conformity with its financial accounting loss. The Fifth Circuit, considering a transaction similar to that in *Thor Power*, has limited *Thor Power*’s write-down of unsold inventory to cases where “the taxpayer offer[s] no objective evidence to verify its estimate of reduced market value” as mandated by the Code. *St. James Sugar Coop. v. United States*, 643 F.2d 1219, 1225 (5th Cir. Unit A May 1981).
37. I.R.C. § 446(b) (2000). The regulations under § 446 authorize the Commissioner to mandate the accounting treatment of any transaction not explicitly covered by the Code as long as, “in the opinion of the Commissioner, it clearly reflects income.” 26 C.F.R. § 1.446-1(c)(1)(ii)(C) (2005).
38. I.R.S. Priv. Ltr. Rul. 91-13-003 (Dec. 18, 1990). The IRS relies on four standards: (1) year-to-year accounting consistency; (2) GAAP conformity; (3) “substantial identity” of results using the taxpayer’s asserted method and the IRS’s chosen method; and (4) whether the method results in a matching of income and expenses. The IRS based its rejection of book-tax conformity on § 446 and the accompanying regulations, case law, and legislative history. *Id.*

While *Thor Power* established the judiciary's original endorsement of the book-tax divide's theoretical underpinnings, *First Federal Savings & Loan Association of Temple v. United States*<sup>39</sup> stands for the proposition that a taxpayer may use that divide for the express purpose of reporting less income to tax authorities. In *First Federal*, a Texas district court considered whether the taxpayer, a savings and loan institution, should be allowed to recognize a loss incurred on a mortgage-pool swap with another thrift institution.<sup>40</sup> The government relied on *Thor Power's* broad grant of authority to the Commissioner to argue that under § 446, taxable income can depart from book income only when the Commissioner explicitly orders such a departure. In the absence of that type of mandate, the government argued, book-tax conformity must be the rule. The court summarily rejected that argument, holding that the government's reading of § 446 would be inconsistent with the Code as a whole, which includes numerous examples of transactions that are treated differently for tax purposes and financial purposes. It therefore ruled that the broad discretion *Thor Power* seemed to vest in the Commissioner applies only in cases in which the Code does not mandate the accounting treatment of particular items.<sup>41</sup> In the subsequent *Cottage Savings* decision, the Supreme Court followed a different line of reasoning but reached the same result, upholding the taxpayer's asserted tax loss in the absence of book-tax conformity.<sup>42</sup> The Court's decisions stand for the proposition that a taxpayer may report a tax loss even where there is no reported book loss, and the Commissioner cannot dictate otherwise. In other words, the Supreme Court has created a tax shelterer's dream.

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39. 694 F. Supp. 230 (W.D. Tex. 1988), *aff'd on other grounds*, 887 F.2d 593 (5th Cir. 1989).

40. Over several years, this question arose in five different cases, leading to five IRS defeats: one in tax court, *Leader Fed. Sav. & Loan Ass'n v. Comm'r*, 57 T.C.M. (CCH) 846 (1989); two in federal courts of appeals, *Fed. Nat'l Mortgage Ass'n v. Comm'r*, 896 F.2d 580, 584, 587 (D.C. Cir. 1990); *San Antonio Sav. Ass'n v. Comm'r*, 887 F.2d 577, 591 (5th Cir. 1989); and two before the Supreme Court, most famously (or infamously) in *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991), as well as *First Federal* itself. These cases show the tug-of-war between the courts, which have sanctioned book-tax disparities in a wide range of situations, and Treasury and the IRS, which identify the book-tax gap as an important and dangerous element of many tax shelters.

41. *First Federal*, 694 F. Supp. at 238 n.7 (“[T]he particular accounting method at issue in [*Thor Power*] was not governed or controlled by any specific Code section, which is precisely what kept that case . . . within the purview of the Commissioner.”).

42. *Cottage Savings*, 499 U.S. at 567 (reasoning that legal differences resulting from the exchange of title to a mortgage “are ‘material’ for purposes of the Internal Revenue Code”).

## II. LURKING IN THE GAP

### A. Tax Shelters

Despite its long lineage, theoretical justifications, and judicial endorsement, the book-tax gap has become a festering problem for both the tax and financial accounting systems. Both Treasury and the congressional Joint Committee on Taxation (JCT) include in their definitions of abusive tax shelters those transactions in which the tax treatment is severed from the financial treatment.<sup>43</sup> Treasury's 1999 white paper listed "lack of economic substance" and "inconsistent financial and accounting treatment" as the first two "common characteristics" of a corporate shelter, noting that with "most recent corporate tax shelters involving public companies, the financial accounting treatment of a shelter item has been inconsistent with its Federal income tax treatment."<sup>44</sup> Treasury went on to link explicitly the book-tax gap associated with a given transaction to its lack of economic substance: "This characteristic [of differing accounting and tax treatments] is consistent with the observation that corporate tax shelters generally do not have any underlying economic substance other than tax savings. If the transaction had economic substance, the result generally would be reported on the financial statements."<sup>45</sup> Thus, Treasury concluded, a "successful shelter with a book-tax disparity is Elysium for a corporation; it not only reduces the corporation's tax liability, but also reduces its effective tax rate."<sup>46</sup>

Similarly, the JCT included among its five "corporate tax shelter indicators" the combination of "significant reasonably expected net tax benefits and a reasonably expected 'permanent difference' for U.S. financial reporting purposes under generally accepted accounting principles."<sup>47</sup> One of President Clinton's budget proposals also argued that financial-accounting preferences—in other words, the items in which reported financial income is higher than reported taxable income—were part of the corporate-tax-shelter

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43. TREASURY WHITE PAPER, *supra* note 2, at 12-14; *see also* STAFF OF J. COMM. ON TAXATION, 106TH CONG., COMPARISON OF RECOMMENDATIONS RELATING TO CORPORATE TAX SHELTERS MADE BY THE DEPARTMENT OF TREASURY AND THE STAFF OF THE JOINT COMMITTEE ON TAXATION 3-5 (Comm. Print 2000) [hereinafter COMPARISON OF RECOMMENDATIONS] (listing five "corporate tax shelter indicators").

44. TREASURY WHITE PAPER, *supra* note 2, at 12-14 (internal citations omitted).

45. *Id.* at 14 n.50.

46. *Id.* at 14.

47. COMPARISON OF RECOMMENDATIONS, *supra* note 43, at 5.

phenomenon.<sup>48</sup> And more recently, the 2003 JCT report on the investigation into Enron's book-and-tax accounting revealed that book-tax differences were critical to Enron's financial misrepresentations.<sup>49</sup>

Academics and administrative agencies have amply documented that the book-tax gap has grown over the past fifteen years. In 1999, Treasury calculated that the aggregate ratio of pretax book income to taxable income grew from an average of 1.25 during 1990-1994 to 1.86 in 1996.<sup>50</sup> These figures indicate that firms are paying tax on smaller and smaller proportions of their income. Scholars have corroborated Treasury's assertion that "the difference between book income and taxable income has increased recently"<sup>51</sup> by looking at financial statements, publicly available information,<sup>52</sup> tabulated tax-return data,<sup>53</sup> and effective tax rates.<sup>54</sup> George Plesko finds that the difference between pretax book income and taxable net income peaked in 1999 at over \$300 billion for all U.S. corporations, before falling to slightly negative figures in 2001 (when corporations had excess book losses).<sup>55</sup> These data suggest that when the economy is booming and corporate profits are rising, the Treasury is not collecting its share of the gains. Favorable tax-depreciation rules appeared to account for a decreasing portion of the book-tax differential during the second

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48. OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2000, at 71 (1999).

49. 1 STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 8 (Comm. Print 2003) [hereinafter REPORT OF INVESTIGATION OF ENRON], available at <http://www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html>.

50. TREASURY WHITE PAPER, *supra* note 2, at 32.

51. *Id.*

52. See, e.g., Mihir A. Desai, *The Divergence Between Book Income and Tax Income*, 17 TAX POL'Y & ECON. 169-206 (2003); Manzon & Plesko, *supra* note 4, at 199.

53. See, e.g., Mills et al., *supra* note 3; George A. Plesko, *Corporate Tax Avoidance and the Properties of Corporate Earnings*, 57 NAT'L TAX J. 729 (2004) [hereinafter Plesko, *Corporate Tax Avoidance*]; George A. Plesko, *Reconciling Corporation Book and Tax Net Income, Tax Years 1996-1998*, STAT. INCOME BULL., Spring 2002, at 111, available at <http://www.irs.gov/pub/irs-soi/98cobkin.pdf>.

54. George K. Yin, *How Much Do Large Public Corporations Pay? Estimating the Effective Tax Rates of the S&P 500*, 89 VA. L. REV. 1793, 1797-98 (2003) (finding that the average effective tax rate of the S&P 500, excluding the permanent difference created by the different stock-option-expensing rules, fell by 7.1% from 1995 to 2000 (from 30.11% to 27.98%)).

55. Plesko conjectures that this drop is due to the economic downturn of those years. Plesko, *Corporate Tax Avoidance*, *supra* note 53, at 731-33 fig.1. Plesko's data begin in 1995, when the book-tax difference was just over \$100 billion.

half of the 1990s, while nondepreciation differences rose from negative figures in 1995 to nearly a third of the total difference by 1999.<sup>56</sup> These data provide additional evidence of increased sheltering beyond specifically legislated tax preferences. The latest comprehensive study finds that the aggregate book-tax difference of non-financial-services U.S. corporations (as opposed to the full array of firms that Plesko studied) turned dramatically positive again in 2003, soaring to over \$156 billion—the highest level since 1986, nearly three times the 1999 peak for these types of firms, and more than a tenfold increase in the span of one year.<sup>57</sup>

By enabling firms to shelter book income from the IRS, the Code essentially gives corporations interest-free loans financed by the federal government—and ones that they will often never repay.<sup>58</sup> Indeed, a study released in December 2004, based on the largest existing survey of tax-shelter activity, suggests that corporations are in fact using tax shelters as financing. The study found that firms using tax shelters had an average debt-to-assets ratio nearly 30% lower than that of comparable firms—19%, as compared to 27.4%—despite having had comparable ratios before engaging in the tax shelter.<sup>59</sup> If this difference were entirely attributable to tax shelters, it would mean that U.S. taxpayers were bankrolling 8.4% of the operating costs of tax-sheltering corporations. It also suggests higher capital risk for shareholders and creditors than financial statements (or corporate credit ratings) reveal, because the implicit loan from the government might disappear if the IRS were to catch on and prohibit the shelter.

The only in-depth analysis of what the tax rate structure would look like under a uniform accounting system confirms that such a system would allow for lower corporate tax rates.<sup>60</sup> Conducted in 1998, this study found that for tax years 1994 and 1995, flat-rate corporate taxes of 26.3% and 28.4%,

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56. Nondepreciation differences accounted for nearly the entire difference for firms with net income, whose book-tax differences peaked in 2000. *Id.* at 733-34 figs.2-3.

57. Michelle Hanlon & Terry Shevlin, *Book-Tax Conformity for Corporate Income: An Introduction to the Issues* 12-13, 38-39 tbls.1-2 (Nat'l Bureau of Econ. Research, Working Paper No. 11,067, 2005), available at <http://www.nber.org/papers/w11067>. Financial institutions are excluded from the data because they operate in a highly regulated environment and are subject to different tax and accounting rules. *Id.* at 11.

58. For a discussion of the concept of tax deferral as an interest-free loan, see GRAETZ & SCHENK, *supra* note 28, at 288. The loan principal is the amount of financial income that taxpayers are able to shelter multiplied by the marginal tax rate.

59. John R. Graham & Alan L. Tucker, *Tax Shelters and Corporate Debt Policy* 15-16 (Aug. 17, 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=633042>.

60. Kenneth L. Wertz, *A Book Income Tax: First-Order Computations*, in NAT'L TAX ASS'N, PROCEEDINGS: 91ST ANNUAL CONFERENCE ON TAXATION 314, 315 (1999).

respectively,<sup>61</sup> would be revenue-neutral vis-à-vis the 35% rate that applies to most corporate income. Having replicated that analysis for tax years 1990, 1995, and 1998-2002,<sup>62</sup> I find that the revenue-neutral rates rise as high as 36% or 37% in years of economic downturn (2001 and 2002), but fall significantly below 30% in 1995 and 1998-2000, hitting 27.15% and 26.51% in two of those years.<sup>63</sup> The average revenue-neutral rate is just over 31%, or 4% lower than the current rate. Thus, over a period that has seen both economic growth and recession, the corporate tax rate under a unified system could be lower than the current rate.

### B. Fuzzy Numbers

Tax shelters are not the only pernicious byproduct of the book-tax divide. As recent history shows, corporations have become more willing to push the boundaries of accounting rules, abandoning the relative conservatism that historically characterized financial accounting. Analysts have noted the

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61. Because the overall amount of reported book income will differ from year to year, revenue-neutral tax rates will also change. When total book income drops in downturn years, a higher tax rate is necessary for the system to remain revenue-neutral.

62. For Wertz's methodology, see Wertz, *supra* note 60, at 315, 316 tbl.1. I followed his methodology with some deviations:

(1) Pretax book income was derived from the financial statement by adding state and federal income taxes paid back to post-tax net earnings. State taxes were calculated as 18% of the federal income tax provision, per the Compustat database on U.S. public corporations. Standard & Poor's, Compustat Database, <http://www.compustat.com> (providing fundamental and market data) (last visited Nov. 1, 2005).

(2) Certain deductions from pretax book income were made to reflect those tax deductions that would still be available under a conformed book-tax accounting system. Wertz deducts state taxes paid, interest received on state and local government bonds, dividends received, and operating losses. Following the 2005 Federal Income Tax Code, I deducted state sales taxes but did not deduct state income taxes paid. See I.R.C. § 164 (LexisNexis 2005) (providing that individuals and corporations may deduct either state income taxes or state sales taxes paid, but not both).

(3) A credit for foreign income taxes paid was then added to the total. Unlike Wertz, I also added back the credit for research and development expenses. See *infra* note 181 and accompanying text.

(4) The applicable tax rate was then calculated as the rate which, when multiplied with the sum derived from the previous steps, yielded the same amount of tax as the actual tax provision in that given year.

63. Source data for these calculations are from INTERNAL REVENUE SERV., STATISTICS OF INCOME, CORPORATION INCOME TAX RETURNS: BALANCE SHEET, INCOME STATEMENT, AND TAX ITEMS FOR SPECIFIED YEARS, 1990-2002, Historical Table 13, available at <http://www.irs.gov/taxstats/article/0,,id=117514,00.html>.

similarity between the accounting frauds revealed in recent years and tax shelter transactions. With regard to the Enron transactions, for example, one scholar observed that in both tax and financial accounting, “complex structures are created by financial engineers . . . to facilitate apparent compliance with vague, inconsistent, and confused rules. . . . Moreover, the motivations of [tax fraud and accounting fraud] are similar: to meet earnings growth targets set by the marketplace.”<sup>64</sup> As the *Wall Street Journal* has remarked, “lying to shareholders and lying to the IRS are just opposite sides of the same coin.”<sup>65</sup> That “coin” is the book-tax divide, which allows corporations to separate misrepresentations on each side from one another. Thus, an increase in reported financial income will not necessarily translate into higher taxable income, while a reported tax loss does not always entail reporting lower profits to investors.

Some commentators have even suggested a causal connection between tax sheltering and accounting fraud:

When professionals get used to pushing the limits of literal compliance in one area, might it be that the practice extends to other, related areas? . . . [If so, the] aggressive planning and Rambo-cowboy mentality that has bred the current crop of corporate tax shelters may have paved the way for pushing the envelope in other areas as well.<sup>66</sup>

Moreover, Treasury has noted accurately that if a corporation reduces its effective tax rate one year by finding a tax shelter with a book-tax disparity, “the corporation may be under pressure to continue to engage in corporate tax shelters in order to meet market expectations of maintaining the low [tax] rate.”<sup>67</sup>

Despite these similarities (and perhaps causal connections) between tax sheltering and accounting fraud, the legislative and regulatory responses to tax problems have differed remarkably from those to financial-accounting problems. The wave of corporate scandals in the past several years has prompted public outrage, focusing attention on the accounting gimmicks that businesses use to shield debt and inflate assets.<sup>68</sup> Among other reforms,

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64. Peter C. Canellos, Letter to the Editor, *TAX NOTES TODAY*, Feb. 18, 2002, 2002 TNT 34-55 (LEXIS).

65. Murray, *supra* note 1.

66. Alice G. Abreu, *Corporate Tax Shelters: The Slippery Slope to Enron?*, *TAX NOTES TODAY*, Mar. 26, 2002, 2002 TNT 58-26 (LEXIS).

67. *TREASURY WHITE PAPER*, *supra* note 2, at 14 n.53.

68. See, e.g., Gleckman et al., *supra* note 18, at 40; Murray, *supra* note 1.



Congress “jump[ed] on the accounting industry with fists at the ready,”<sup>69</sup> by passing the Sarbanes-Oxley Act,<sup>70</sup> which created the PCAOB to oversee public company auditors.<sup>71</sup>

In contrast, the tax side of corporate-accounting manipulation has not inspired bold responses from Congress or regulators.<sup>72</sup> The *Wall Street Journal* has chastised Congress for “having addressed only half of the credibility crisis that afflicts corporate America.”<sup>73</sup> While Sarbanes-Oxley “will make it harder for companies to mislead shareholders about how much they are earning,” it did “nothing . . . to deter them from misleading the Internal Revenue Service about how little they are earning.”<sup>74</sup> By linking book to tax treatment, a conformed system would achieve that objective.

### C. *Killing Two Birds with One Stone*

Harmonizing tax and financial accounting would reduce the damaging incentives built into the two separate systems. Firms have opposing goals for their financial statements and tax statements: They want to maximize the income they report to investors while minimizing the taxable income they report to the IRS. As long as the consequences of shifting financial income upward remain isolated from tax accounts and vice versa, companies can achieve both objectives. In recent years, corporations have succumbed to

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69. Stephen Barlas, *New Spotlight on Accounting Standards*, STRATEGIC FIN., Feb. 2002, at 23, 23.
70. On the impact of the Sarbanes-Oxley Act on tax accounting, see Steven F. Holub et al., *Effects of the SOA on the Accounting Profession*, 35 TAX ADVISER 571 (2004). See also PERMANENT SUBCOMM. ON INVESTIGATIONS, S. COMM. ON HOMELAND SEC. & GOV'T. AFFAIRS, 109TH CONG., THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY 4 (Comm. Print 2005) [hereinafter PERMANENT SUBCOMM. ON INVESTIGATIONS REPORT].
71. SOX, Pub. L. No. 107-204, § 101, 116 Stat. 745, 750-53 (2002) (codified as amended at 15 U.S.C. § 7211 (Supp. II 2002)).
72. One notable exception is the set of standards the PCAOB issued in August 2005, which (1) restrict the tax services that accountants can provide to corporate clients; (2) prohibit the marketing of “aggressive” tax postures; and (3) forbid auditors from entering contingent fee arrangements for tax services. The standards also require companies’ audit committees to approve any proposed tax services before the companies begin them. PUB. CO. ACCOUNTING OVERSIGHT BD., RELEASE NO. 2005-02, ETHICS AND INDEPENDENCE RULES CONCERNING INDEPENDENCE, TAX SERVICES, AND CONTINGENT FEES (2005), available at [http://www.pcaobus.org/Rules/Docket\\_017/Form\\_19b-4\\_Tax\\_Services.pdf](http://www.pcaobus.org/Rules/Docket_017/Form_19b-4_Tax_Services.pdf). Although promising, these are a limited exception to the general rule of regulatory passivity.
73. Alan Murray, *Narrowing Tax Gap Should Be Priority of Next Congress*, WALL ST. J., Oct. 8, 2002, at A4.
74. *Id.*

increasing pressures to maximize profits.<sup>75</sup> By taking ever more aggressive steps to raise financial income while lowering tax liability, corporations may gradually cross the shadowy line between exercising sound business judgment and abusing the rules. By linking the consequences of tax and book reporting, a unified system could make such abusive accounting more painful and less attractive. If any increase in reported book income also meant increased tax liability, or if intended tax losses had to appear in financial statements, the tradeoff would induce corporations to be cautious in reporting to investors and would likely increase the amount of income reported to the IRS.

Such a system would also reduce the dual accounting system's enormous compliance costs. In a survey of hundreds of U.S. tax executives conducted a decade ago, a "significant number" of respondents endorsed book-tax conformity along book-income lines.<sup>76</sup> Respondents cited lack of conformity as a major source of their firms' tax-compliance costs.<sup>77</sup> When asked how the tax laws might be changed to lower compliance costs, these corporations listed book-tax conformity second only to uniformity of state and federal income taxes. And several tax officers endorsed a system that would start from book income and allow selected departures for taxable income.<sup>78</sup> Presumably,

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75. See PERMANENT SUBCOMM. ON INVESTIGATIONS REPORT, *supra* note 70, at 9 ("By 2003, dubious tax shelter sales were no longer the province of shady, fly-by-night companies with limited resources. They had become big business, assigned to talented professionals at the top of their fields and able to draw upon the vast resources and reputations of the country's largest accounting firms . . ."); Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775 (1999); Janet Novack & Laura Saunders, *The Hustling of X Rated Shelters*, FORBES, Dec. 14, 1998, at 198. In contrast, Jonathan Macey has argued that "Enron's collapse demonstrates the *strength* of the U.S. system of corporate governance, namely the intensely competitive environment in which U.S. management teams operate. . . . [I]n rare cases like Enron, the 'pressure-cooker' environment leads managers of U.S. corporations and their advisors to take shortcuts and mislead investors about corporate performance." Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 396 (2004); see also TREASURY WHITE PAPER, *supra* note 2, at 28-29 ("[C]orporate officers are paying greater attention to the effect of taxes on their reported earnings. . . . Effective tax rates may be viewed as a performance measure, separate from after-tax profits.").
76. Joel B. Slemrod & Marsha Blumenthal, *The Income Tax Compliance Cost of Big Business*, 24 PUB. FIN. Q. 411, 428-29 (1996) (reporting that twenty-one respondents cited the lack of conformity between book and taxable income as a principal factor responsible for high tax-compliance costs).
77. The book-tax disparity was listed directly behind the frequency of changes to the tax code, evenly tied with the controlled-foreign-corporation rules, and ahead of the transfer-pricing rules. *Id.*
78. *Id.* at 431.

conformity appeals to U.S. businesses because it promises them a more stable tax system and lower compliance costs.

### III. WHAT WILL NOT WORK

Tax authorities have tried various reforms to alleviate the effects of the book-tax accounting gap. Yet as the persistence of sheltering and accounting fraud demonstrates, these reforms have been largely unsuccessful, because they have failed to address the substance of the divide, have created additional problems of their own, or both. Nonetheless, some of them can serve as useful precedents for book-tax conformity, providing valuable insights on how to ensure that such a system succeeds.

#### A. *Unhappy Precedents*

A system of accounting conformity along book-income lines, such as the structure proposed in this Note, is reminiscent of two prior ideas: the 1986-1989 corporate AMT, and Treasury's 1999 white paper proposal for a book-income tax floor. Yet the AMT and the white paper proposal shared two critical weaknesses that the system advanced in this Note escapes. The first is their complexity. Conformity is simpler than both the corporate AMT and the white paper proposal (which Treasury acknowledged would create "significant complexity") in that it would not require that taxpayers calculate separate book and tax incomes and then be taxed on the higher of the two.<sup>79</sup> Such a dual system prevailed from 1986 to 1989, when the corporate AMT was structured to tax corporations on the excess of book income over reported taxable income. Its implementation reflected a second crucial weakness, however, which doomed the system from the beginning: By predicating AMT liability on the existence of a book-tax gap, lawmakers in 1986 simply shifted the pressure point of tax planning from taxable income to book income. Despite the AMT's failure as a means of taxing book income, the 1986-1989 corporate AMT does provide a valuable precedent for the base-broadening changes that a conformed accounting system would require. As Professor Graetz has explained,

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79. TREASURY WHITE PAPER, *supra* note 2, at 116; *see also* Terrence R. Chorvat & Michael S. Knoll, *The Case for Repealing the Corporate Alternative Minimum Tax*, 56 SMU L. REV. 305, 317 (2003) ("The corporate AMT is among the most complex parts of the corporate tax."); Lee A. Sheppard, *The Book Income Preference in the Corporate Minimum Tax*, 33 TAX NOTES 616, 616 (1986) (stating that "[t]he corporate income tax can usefully be thought of as three taxes"); Slemrod & Blumenthal, *supra* note 76, at 425-26 ("One feature of the tax code that is widely viewed as complex is the alternative minimum tax . . .").

“[p]roceeding to a broad-based, low-rate tax by first expanding the minimum tax base should provide important information concerning the tax base that will ultimately be made generally applicable and should eliminate a vast number of disputes over transitional issues.”<sup>80</sup> This Note draws upon the old AMT as a model for a broader tax base that nevertheless retains certain of the most important tax preferences.

Like the 1986-1989 corporate AMT, current Code provisions that require taxpayers to link the book and tax treatment of certain specific transactions also serve as precedents for a broader, fully conformed system.<sup>81</sup> The legislative histories of such provisions suggest that legislators were motivated in part by the desire to follow the lead of financial accountants, whether in applying the matching concept to prepaid income,<sup>82</sup> accepting the LIFO method for certain businesses as the accounting industry has done,<sup>83</sup> or using the accrual

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80. Michael J. Graetz, *The 1982 Minimum Tax Amendments as a First Step in the Transition to a “Flat-Rate” Tax*, 56 S. CAL. L. REV. 527, 566 (1983). Although Professor Graetz wrote in reference to the individual AMT imposed in 1982, he observed that the same transitional, base-broadening approach could be used with respect to regular corporate taxes. *Id.* at 564-65.

81. These specific conforming transactions include: (i) the last-in, first-out (LIFO) conformity requirement for end-of-year inventory valuation under § 472(b) and (c), Internal Revenue Code of 1954, ch. 1, § 472, 68A Stat. 3, 159 (current version at I.R.C. § 472(b), (c) (2000)); (ii) the § 166(a)(2) limit on bad debt deductions, *id.* at § 166, 68A Stat. at 50 (current version at I.R.C. § 166(a)(2) (2000)); (iii) the regulatory limit on the deferral of certain prepayments for goods until no later than such payments are accrued in the financial statements, Treas. Reg. § 1.451-5 (as amended in 2001); (iv) sections 455 and 456, which defer the inclusion of prepaid subscription income and membership dues, respectively, until earned and accrued under financial reporting rules, Technical Amendments Act of 1958, Pub. L. No. 85-866, tit. I, § 28(a), 72 Stat. at 1625 (codified as amended at I.R.C. § 455 (2000)); Membership Organizations Act, Pub. L. No. 87-109 § 1(a), 75 Stat. at 222 (1961) (codified as amended at I.R.C. § 456(a) (2000)); (v) section 471, which links the tax treatment of some manufacturing inventory costs to their book treatment, Internal Revenue Code of 1954, § 471, 68A Stat. at 159 (codified as amended at I.R.C. § 471(a) (2000)); and (vi) the pre-1986 § 166(c), which used the reserve method for deducting worthless debts, Internal Revenue Code of 1954, § 166(c), 68A Stat. at 50 (repealed 1986).

82. Lawmakers discussed the enactment of § 456 (which holds corporate taxpayers liable for tax on certain prepaid income in the year in which an accounting liability for the services or products sold is generated, rather than when the income is paid) in the context of “the relationship of income tax accounting to generally accepted accounting principles.” S. REP. NO. 87-543, at 2 (1961).

83. 83 CONG. REC. 5043-44 (1938) (statement of Sen. Lonergan) (stating that in the industries where LIFO accounting is permitted, “LIFO is recognized by the leading accounting authorities as most accurately reflecting income”). For a discussion of the dual evolution of accounting and legislative views of the LIFO method, see Alvin D. Knott & Jacob D. Rosenfeld, *Book and Tax (Part Two): A Selective Exploration of Two Parallel Universes*, 99 TAX NOTES 1043, 1047-48 (2003).

method.<sup>84</sup> As these examples illustrate, lawmakers have shown that it is both feasible and desirable to conform tax accounting to financial accounting for certain transactions, and they have attempted to do so within the confines of the Code.

Yet the current Code is inadequate for combating the tax-shelter problem more broadly. The 2004 American Jobs Creation Act (AJCA),<sup>85</sup> for example, has been called “[t]he most radical revision of business taxes since 1986.”<sup>86</sup> Though it does contain no fewer than thirty-nine separate provisions related to tax shelters,<sup>87</sup> these measures follow the familiar, worn approaches—increasing reporting requirements, increasing penalties,<sup>88</sup> and making micro-changes and “repeated revision[s]”<sup>89</sup> to the statute and regulations, all while increasing complexity exponentially.<sup>90</sup> A February 2005 report by the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Government Affairs employs the same strategy, recommending that Congress, the IRS, the SEC, and the Department of Justice continue their enforcement efforts through further legislative and regulatory tweaks and increased penalties on wrongdoers.<sup>91</sup> Yet such changes have thus far been unsuccessful in attacking tax shelters, while contributing to the Code’s increasing complexity. As the Commissioner of the IRS has stated, complexity may itself be detrimental to curbing shelters, because it “facilitates behaviors at

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84. In 1916, Congress required that a corporation “make its return upon the basis upon which its accounts are kept.” Act of Sept. 8, 1916, ch. 463, § 13(d), 39 Stat. 756, 771 (repealed 1918).

85. Pub. L. No. 108-357, 118 Stat. 1418 (codified as amended in scattered sections of I.R.C.).

86. Roger Russell, *For Better or Worse, Jobs Creation Act of '04 Is Here*, ACCT. TODAY, Nov. 8, 2004, at 10.

87. AJCA §§ 811-849, 118 Stat. at 1575-1607 (codified as amended in scattered sections of I.R.C.). These methods of attacking tax shelters were repeated in modified form in the Bush Administration’s thirteen fiscal year 2005 proposals to combat abusive transactions. U.S. DEP’T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2005 REVENUE PROPOSALS 111-38 (2004) [hereinafter TREASURY FY 2005 REVENUE PROPOSALS], available at <http://www.treasury.gov/offices/tax-policy/library/bluebk04.pdf>.

88. Of the thirty-nine tax shelter provisions in the AJCA, twelve deal with penalties and tax administration and enforcement. AJCA §§ 811-822.

89. MINORITY STAFF OF THE PERMANENT SUBCOMM. ON INVESTIGATIONS, S. COMM. ON HOMELAND SEC. & GOVT. AFFAIRS, 108TH CONG., U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS: FOUR KPMG CASE STUDIES: FLIP, OPIS, BLIPS, AND SC2, at 18 (Comm. Print 2003).

90. See TREASURY FY 2005 REVENUE PROPOSALS, *supra* note 87, at 111-38.

91. PERMANENT SUBCOMM. ON INVESTIGATIONS REPORT, *supra* note 70, at 7-9.

variance with those intended by Congress.”<sup>92</sup> If the Bush Administration is serious about cracking down on corporate tax shelters, it is time to close the book-tax gap.

### B. Disclosure

One particularly popular strategy for alleviating the effects of the accounting gap has been increased disclosure. Yet recent corporate accounting scandals and persistently increasing book-tax gaps demonstrate that this easy answer, which the government has routinely pursued instead of striving for far-reaching change, has failed to solve the problem. This is because disclosure of the book-tax difference increases compliance costs without solving the underlying problem.

Disclosure is popular among some economists and tax practitioners who believe that it is inherently valuable to have two sets of data on corporate financial activity.<sup>93</sup> Because estimated taxable income “provides information to stock market participants incremental to the information in pretax book income and vice versa,” these commentators believe that “the incremental information in one (or the other) measure would be lost if the same set of rules were used to calculate both measures.”<sup>94</sup> In part because it is more politically palatable, many prominent figures in Washington have also endorsed disclosure of the book-tax difference—rather than closing the gap altogether—as an effective way to protect investors and the public from accounting fraud.<sup>95</sup>

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92. Mark W. Everson, Comm’r of Internal Revenue, Testimony Before the President’s Tax Advisory Panel on Federal Tax Reform 4 (Mar. 3, 2005), [http://www.taxreformpanel.gov/meetings/pdf/everson\\_03032005.pdf](http://www.taxreformpanel.gov/meetings/pdf/everson_03032005.pdf).

93. See, e.g., Plesko, *Corporate Tax Avoidance*, *supra* note 53, at 730-31. Plesko notes that the benefits run both ways: “From a tax administration perspective, book income provides a separate measure of the income and expense items that can be compared to the values reported on the tax return,” *id.* at 730, while the tax return’s “measure of income separate from that reported to shareholders . . . ha[s] been used to address a number of accounting issues,” *id.* at 731. See also Manzon & Plesko, *supra* note 4; Mills et al., *supra* note 3; Kenneth A. Petrick, *Comparing NIPA Profits with S&P 500 Profits*, SURV. CURRENT BUS., Apr. 2001, at 16; Terry Shevlin, *Corporate Tax Shelters and Book-Tax Differences*, 55 TAX L. REV. 427 (2002); Mihir A. Desai, *The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation* (Nat’l Bureau of Econ. Research, Working Paper No. 8866, 2002), available at <http://www.nber.org/papers/w8866>.

94. Shevlin, *supra* note 93, at 438.

95. See, e.g., Peter C. Canellos & Edward D. Kleinbard, *Disclosing Book-Tax Differences*, 96 TAX NOTES 999 (2002); Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35; Lillian F. Mills & George A. Plesko, *Bridging the Reporting Gap: A Proposal for More Informative Reconciling of*

Senator Charles Grassley raised the possibility of greater disclosure in a letter to Treasury Secretary Paul O'Neill and SEC Chairman Harvey Pitt in the summer of 2002.<sup>96</sup> A short time earlier, a *Wall Street Journal* columnist had suggested public disclosure of corporate tax returns as a first step toward restoring the credibility of public company accounting. Acknowledging that the hundreds of pages of data involved in even a relatively simple corporate tax return "may not be much use to the average investor," the columnist expressed the hope that "conscientious stock analysts . . . could spend their time analyzing the gaps between book and tax income, attempting to find truth in between."<sup>97</sup>

Yet complete disclosure of corporate tax returns seems impractical due to both administrability and privacy concerns. With regard to administrability, forced public disclosure would add hundreds of pages to the information that corporations already make available to the public, adding large amounts of redundant or useless data without providing any coherent system for wading through it. As for privacy, full disclosure of all the elements of a detailed corporate tax return could harm business competition.<sup>98</sup> For these reasons, legislators, policymakers, and academics have also given much attention to intermediate options, such as "summary version" disclosure of corporate tax returns,<sup>99</sup> enhanced tax reconciliation on corporate financial statements,<sup>100</sup> or

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*Book and Tax Income*, 56 NAT'L TAX J. 865, 886-89 (2003); *Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2270 (2004).

96. Letter from Senator Charles Grassley, Ranking Member, Senate Fin. Comm., to Paul J. O'Neill, Sec'y, Dep't of the Treasury, and Harvey C. Pitt, Chairman, SEC (July 8, 2002), available at [http://grassley.senate.gov/index.cfm?FuseAction=PressReleases.Detail&PressRelease\\_id=3706&Month=7&Year=2002](http://grassley.senate.gov/index.cfm?FuseAction=PressReleases.Detail&PressRelease_id=3706&Month=7&Year=2002) (asking whether, in light of recent events in corporate finance, "the information contained in the corporate tax returns of publicly traded companies could be of benefit to government regulators as well as shareholders and workers").
97. Murray, *supra* note 1.
98. In response to Senator Grassley's July 2002 query, SEC Chairman Pitt responded that public tax-return disclosure would provide only "marginal" benefits to investors and regulators. See David Lenter et al., *Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives*, 56 NAT'L TAX J. 803, 806 (2003) (quoting statement of Chairman Pitt); see also *id.* at 814-27 (dismissing arguments that full public disclosure of corporate tax returns could improve financial regulation, enhance capital market efficiency by improving the quality of publicly available information, or improve the quality of income reporting on corporate returns).
99. Letter from Senator Grassley to Secretary O'Neill and Chairman Pitt, *supra* note 96.
100. Letter from Paul O'Neill, Sec'y, Dep't of the Treasury, to Senator Charles Grassley (Aug. 16, 2002), reprinted in TAX NOTES TODAY, Oct. 9, 2002, 2002 TNT 196-18 (LEXIS).

some combination thereof.<sup>101</sup> But commentators have not reached a consensus on whether such disclosure would protect businesses sufficiently or on how to determine what should be disclosed.<sup>102</sup> Moreover, any movement along those lines would add complexity to the already cumbersome book-tax accounting regime.

After public disclosure, a less dramatic option for making firms accountable for their book-tax gaps would be to require businesses to include more information on their tax returns.<sup>103</sup> Starting with tax year 2004, the IRS has phased in a new Schedule M-3 that significantly expands the book-tax information corporations must disclose.<sup>104</sup> The IRS asserts that the more detailed M-3 disclosures “will help us target our examination efforts on high-risk areas, thereby improving and speeding the audit process.”<sup>105</sup> Indeed, the IRS has even gone so far as to suggest that it might ease the tax-shelter-reporting requirements if the M-3 proves successful.<sup>106</sup>

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101. Canellos & Kleinbard, *supra* note 95, at 1000-01 (proposing consolidated disclosure of the tax returns and the book-tax reconciliation in the financial statements).

102. Congressman Lloyd Doggett introduced a bill, which never passed, proposing that corporations electronically file a report with the IRS that would elaborate on the book-tax disclosure of the full tax return by identifying the specific items that comprised the book-tax gap. These would be made publicly available and searchable. Corporate Accountability Tax Gap Act of 2003, H.R. 1556, 108th Cong.

103. Lenter et al., *supra* note 98, at 817, 827.

104. “Pretax book income” is the sum of a corporation’s financial net income (the post-tax income claimed in its financial statements) and its federal income tax. “Tax net income” is the corporation’s pretax income. Corporations must report both figures to the IRS on Schedule M of the annual corporate tax return. The new Schedule M-3 imposes a uniform starting point for book income (namely, the net income reported to the SEC on a corporation’s 10-K annual report), provides a formula for reconciling the different entity-consolidation rules of financial and tax accounting, requires itemized reporting of each transactional component of the book-tax difference (for example, stock options and depreciation expenses), and requires corporations to differentiate between permanent and temporary differences. Internal Revenue Serv., Instructions for Schedule M-3 (Form 1120), at 3-4 (2005) [hereinafter Instructions for Schedule M-3], available at <http://www.irs.gov/pub/irs-pdf/i1120sm3.pdf>. The transactional-accounting approach ought to help auditors detect misstatements in the tax return. A 1999 study recommended that auditors should use transactional, or “component,” reporting to catch corporate tax evaders, because it allows auditors to look at the separate components of reported income. Shelley C. Rhoades, *The Impact of Multiple Component Reporting on Tax Compliance and Audit Strategies*, 74 ACCT. REV. 63, 63 (1999).

105. Kurt Ritterpusch, *Corporate Taxes: IRS Rolls Out New Schedule M-3 for Reporting Book-Tax Differences*, Daily Tax Rep. (BNA) No. 130, at G-5 (July 8, 2004) (quoting IRS Commissioner Mark Everson).

106. Alison Bennett, *IRS May Ease Book-Tax Disclosure Trigger if New Schedule M-3 Successful, Official Says*, Daily Tax Rep. (BNA) No. 24, at G-2 (Feb. 6, 2004).



To be sure, the M-3 is better than the old M-1. Because the M-3 uses a standard book-income base,<sup>107</sup> its itemized reporting enhances the quality of the information available to tax auditors, and standard categories allow the IRS to make comparisons across corporations.<sup>108</sup> These changes will generate data that may be useful in any attempt to narrow the book-tax gap, and the M-3 may be used as a template for a uniform accounting system. In fact, the IRS declared soon after the M-3 was introduced that filing the form will satisfy a corporation's requirement to disclose to the IRS "reportable transactions" that engender a "significant book-tax difference."<sup>109</sup> Yet greater disclosure, even on the M-3, does not go far enough. Reporting alone does nothing to address the substance of the divide. So long as the law permits a substantial gap between financial and tax income, corporations will have opportunities—and incentives—to avoid taxation and engage in accounting fraud. In fact, even some who have advocated public disclosure of the book-tax difference actually consider this recommendation to be merely a stopgap measure.<sup>110</sup>

Only book-tax conformity can remove the opportunities and incentives to inflate financial income and reduce taxable income. The unsuccessful precedents discussed in this Section—the 1986-1989 corporate AMT, Treasury's 1999 proposal of a book-income floor, the specific conforming transactions in the Code, and increased disclosure—go only halfway toward closing the book-tax accounting gap. By leaving the divide in place, they invite corporations to continue manipulating the accounting gap to their greatest advantage. As one commentator noted:

No matter how much money Congress pours into the SEC, or how strong an accounting oversight board it creates, corporations will always have the resources and ability to outwit regulators . . . as long as they have the incentive. Reuniting book and tax income would take

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107. The M-3 instructs any corporations that file a Form 10-K with the SEC to use the net income from the 10-K income statement; for all other corporations, the form retains the old, vague "books and records" language. Internal Revenue Serv., Instructions for Forms 1120 and 1120-A, at 10 (2005) (providing instructions for Schedule M-1), available at [http://www.irs.gov/pub/irs-pdf/i1120\\_a.pdf](http://www.irs.gov/pub/irs-pdf/i1120_a.pdf); Instructions for Schedule M-3, *supra* note 104, at 3-4.

108. These changes are summarized in Charles Boynton & Lillian Mills, *The Evolving Schedule M-3: A New Era of Corporate Show and Tell?*, 57 NAT'L TAX J. 757, 764-66 (2004).

109. Rev. Proc. 2004-45, 2004-31 I.R.B. 1.

110. For example, one journalist who endorsed disclosure added that "over time, Congress and the Securities and Exchange Commission should work to bring the two measures of income into closer alignment . . . a unified definition of income for both book and tax purposes would go a long way toward alleviating the current problems." Murray, *supra* note 1.

away some of that incentive. If a company wants to overstate its income, it would have to pay more taxes as a result. And if it wanted to reduce taxes, it would have to moderate its income claims.<sup>111</sup>

In other words, the only way to eliminate manipulation of the gap is to eliminate the gap altogether.

#### IV. ANSWERING THE CRITICS

In a world of pure accounting conformity—where financial statements and income tax returns derive from one common set of precise rules—financial net income and tax net income would be the same.<sup>112</sup> Although many contend that total uniformity is not a feasible goal in the United States, common arguments against conformity are circular and often conflict with one another. A system of near-total accounting conformity could avoid these pitfalls.

##### A. Market Efficiency

One camp of book-tax conformity critics argues that conforming book and tax income will destroy the supposed market relevance of the financial statements that corporations produce under U.S. accounting rules. These conformity opponents cite the many Organization of Economic Cooperation and Development (OECD) countries, particularly those in the European Union,<sup>113</sup> that legislate book-tax conformity, noting that they do not design their accounting rules to provide a true economic picture of corporations' financial activities. Rather, the German accounting rules, for example, are designed to present a company's asset base to creditors, so that "[t]he main objective of [German] financial accounting is thus similar to the function of income computation for tax purposes."<sup>114</sup> Such rules predominate in economies across the OECD, where the capital markets have historically played a much smaller role in financing corporate activity. Where equity investors are

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111. *Id.*

112. Some countries have such pure accounting conformity. Under German tax law, for example, "commercial financial statements form an authoritative basis for tax accounts . . . [so] the amount of tax to be paid is calculated on the basis of the figures published in the financial statements." Sabine D. Selbach, *The Harmonization of Corporate Taxation & Accounting Standards in the European Community and Their Interrelationship*, 18 CONN. J. INT'L L. 523, 571-72 (2003).

113. *See id.*

114. *Id.* at 573.

expected to be less important for corporations, it is more acceptable to introduce tax-mandated departures from economic income into the corporate financial statements.<sup>115</sup>

In contrast with such systems, the financial accounts of a U.S. corporation ideally should provide a full picture of the corporation's financial activities and prospects—its true economic income—to both shareholders and investors. In its purest, value-free, judgment-free form, financial accounting has been likened to cartography:

Accounting is financial mapmaking. The better the map, the more completely it represents the complex phenomena that are being mapped. We do not judge a map by the behavioral effects it produces. . . . We judge [it] . . . by how well it represents the facts. People can then react to it as they will.<sup>116</sup>

Recent events show that this extreme version of empirical accounting remains aspirational. Indeed, the FASB itself has made clear that although an “aura of precision” surrounds the accounting profession, the “information provided by financial reporting often results from approximate, rather than exact, measures. The measures commonly involve numerous estimates, classifications, summarizations, judgments, and allocations.”<sup>117</sup> Because GAAP often provides guidelines and standards rather than strict rules, managers and accountants have considerable discretion over how they apply those standards to particular fact patterns, as the recent corporate accounting scandals have demonstrated.<sup>118</sup> Thus, the idealistic portrait of “cartographic,” scientific accounting ignores the individual judgment calls that financial statements reflect. Those who argue against book-tax conformity on the grounds that it would corrupt financial accounting start from a false premise. And even if financial accounting were a cartographic science, conformity would not sully it because the whole purpose of the conformed system would be to tax a base of

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115. Lenter et al., *supra* note 98, at 819-20.

116. David Solomons, *The Politicization of Accounting*, J. ACCT., Nov. 1978, at 65, 70-71.

117. SFAC NO. 1, *supra* note 24, at 12.

118. See Lillian F. Mills & Kaye J. Newberry, *The Influence of Tax and Nontax Costs on Book-Tax Reporting Differences: Public and Private Firms*, J. AM. TAX'N ASS'N, Spring 2001, at 1, 3-4 (contrasting the large amount of discretion that managers have in applying GAAP with the stricter tax accounting rules); Frank Heflin & William Kross, *Book Versus Taxable Income 6-7* (Jan. 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=604528> (noting that as a measure of economic performance, taxable income contains more “mandated rule” errors than GAAP, but GAAP contains more “managerial bias” errors than taxable income).

true economic income; the only exceptions would be written into the tax code, not into the accounting system itself.

### B. Conservatism

Another set of book-tax conformity critics has argued that financial accountants practice excessive conservatism, which, if linked to taxation, would hamper the government's efforts to collect revenue.<sup>119</sup> Under this view, conformity would give managers dangerous incentives to minimize income in order to reduce tax liabilities,<sup>120</sup> and "[r]eported GAAP income seems elastic enough that taxing it would cause the reported earnings to shrivel."<sup>121</sup>

Even under conditions of conformity between tax and book accounting, however, the temptation to reduce tax liabilities by lowering reported income does not seem to dominate managerial accounting choices. Scholars have shown that when faced with either a specific conforming transaction or the 1986-1989 book-income AMT trigger (which made corporations liable for tax on the higher of taxable income or book income), public-firm managers have tended not to adopt tax positions that would reduce reported book income.<sup>122</sup>

Starting with book income rather than taxable income would have the beneficial effect of reintroducing the conservatism that, according to financial accounting doctrine, should dominate corporate bookkeeping.<sup>123</sup> A unified accounting system would encourage conservatism because premature or excessive revenue recognition (or delayed expense recognition) would have adverse tax consequences for the corporation. In fact, recent scholarship has

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119. *Thor Power Tool Co. v. Commissioner* relied on this theory, noting that in light of the tax system's major goals—"the equitable collection of revenue" and "protect[ing] the public fisc"—the conservatism-induced "understatement of income is not destined to be [Treasury's] guiding light." 439 U.S. 522, 542 (1979). Thus, "any presumptive equivalency between tax and financial accounting would be unacceptable." *Id.* at 543.

120. See, e.g., Knott & Rosenfeld, *supra* note 83, at 1061 ("It is . . . likely that aligning book and tax income would serve to generally erode the quality of financial statements, without actually changing the incentives to deter abusive management.").

121. Calvin Johnson, *GAAP Tax*, 83 TAX NOTES 425, 425 (1999).

122. See Mills & Newberry, *supra* note 118, at 6.

123. David A. Guenther et al., *Financial Reporting, Tax Costs, and Book-Tax Conformity*, 23 J. ACCT. & ECON. 225, 240 (1997) ("[I]ncreasing book-tax conformity caus[es] firms to accrue financial statement income more slowly."); Gil B. Manzon, Jr., *Earnings Management of Firms Subject to the Alternative Minimum Tax*, J. AM. TAX'N ASS'N, Fall 1992, at 88, 89 (stating that, from 1986 to 1989, "[f]irms subject to a high marginal tax rate on reported income managed their earnings downward relative to firms subject to a low marginal tax rate on reported income").

found that managers currently use the book-tax gap to create deferred tax expenses rather than immediate tax liabilities that reduce reported financial income.<sup>124</sup> These deferred tax expenses can be useful earnings-management tools when corporations would otherwise fall below analysts' earnings targets, report earnings declines, or report losses.<sup>125</sup>

Moreover, data show that although book accruals historically have dominated tax accruals in their power to explain current stock returns, that dominance decreased from 1986 to 1997 (the years when the book-tax gap was growing) and disappeared entirely from 1997 to 2001 (the peak years of the book-tax gap).<sup>126</sup> In those years, it is likely that deferred tax expenses accounted for an increasingly large proportion of the growing book-tax gap, taking reported financial income farther and farther away from economic reality (as reflected in the stock valuation). By substantially eliminating deferred tax expenses, uniform accounting would reduce such opportunities for potentially misleading earnings management while still permitting valid managerial accounting discretion.

Admittedly, as discussed above, the Code has already incorporated various triggers to force recognition of tax income in cases where the book-tax ratio becomes too high, or for certain red flag transactions.<sup>127</sup> But these provisions just draw lines in the sand, essentially inviting corporations to shelter income in the book-tax gap up to a certain point. Book-tax conformity (with a few specific exceptions) would eliminate these arbitrary lines.

### C. Tax Preferences

A third set of critics of book-tax conformity point out that this system would reduce the ability of Congress to use the tax code for policy purposes. As

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124. Mills & Newberry, *supra* note 118, at 4; John Philips et al., *Earnings Management: New Evidence Based on Deferred Tax Expense*, 78 ACCT. REV. 491 (2003). Areas of such earnings management include, but are not limited to, bad debt write-offs, depreciation expenses, delayed or accelerated revenue recognition, and advance payments. In all of these cases, managers can increase reported financial income or smooth out the peaks and valleys of earnings without increasing taxable income. In so doing, they create deferred tax expenses out of the temporary timing difference between taxable income and financial income. The FASB defines a "temporary difference" (previously known as a "timing difference") as that difference, "sometimes accumulating over more than one year, between the tax basis of an asset or liability and its reported amount in financial statements." SFAS NO. 109, *supra* note 19, at 5.

125. Philips et al., *supra* note 124, at 492.

126. Heflin & Kross, *supra* note 118, at 16-17.

127. See *supra* notes 81-84 and accompanying text.

the preceding Part explained, moving to accounting conformity would sacrifice the many tax preferences that currently reduce taxable income for most corporate taxpayers. Although the new system should retain a few of the most important tax preferences,<sup>128</sup> the vast majority of existing preferences are inappropriate to an accounting system that aims both to raise revenue and to provide valuable economic information to shareholders and investors. Tax preferences create complexity in the tax code, which permits the wealthiest and most well-advised taxpayers to engage in tax sheltering. Moreover, complexity in and of itself can foster financial accounting fraud. Under accounting conformity, legislators would have to stop using the tax code as a locus of social and economic policymaking and would instead have to redirect the tax system toward the fundamental goal of raising revenue in an equitable manner.

Those who favor departures from a simple, uniform tax base (in other words, tax-code preferences) commonly raise two arguments.<sup>129</sup> First, some deviations may be necessary to provide an accurate measure of well-being; for example, the child care credit reflects the fact that workers with children bear a built-in cost-of-living expense that their fellow citizens without children do not. Second, tax preferences can increase economic efficiency when they correct significant market failures. The definition of such “failures,” however, depends on who does the defining. Some might consider the home-mortgage-interest deduction a preference in this second category, because it corrects the market’s failure to incentivize the socially beneficial act of home ownership; others might put the deduction for employer-provided health care in this camp, because the health care field is “plagued” by market flaws such as “imperfect information.”<sup>130</sup> Yet only a very few of the preferences in the Code meet either of these two criteria. In a 2002 article, Michael Graetz asserted that in the previous decade, Congress and the White House had used the income tax as “chicken soup,” dosing out preferences “as a magic elixir to solve all the nation’s economic and social difficulties. If the nation has a problem in access to education, child care affordability, health insurance coverage, or the financing of long-term care, an income tax deduction or credit is the answer.”<sup>131</sup>

Not only do the existing preferences often fail to advance the goals of accurately measuring well-being and enhancing efficiency, they make the Code much more complex. The number of loopholes and preferences contained in

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128. See *infra* Subsection V.B.2.

129. For a discussion of these two arguments and the potential counterarguments, see JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN’S GUIDE TO THE DEBATE OVER TAXES* 218-19 (3d ed. 2004).

130. *Id.* at 224.

131. Michael J. Graetz, *100 Million Unnecessary Returns*, 112 *YALE L.J.* 261, 274 (2002).

the personal and corporate tax codes borders on the absurd. As Stanley Surrey noted as far back as 1972 (when a plurality of Americans still considered the federal income tax to be the “fairest tax” in the land)<sup>132</sup>:

The tax subsidies tumble into the law without supporting studies, being propelled instead by clichés, debating points, and scraps of data and tables that are passed off as serious evidence. A tax system that is so vulnerable to this injection of extraneous, costly, and ill-considered expenditure programs is in a precarious state from the standpoint of the basic tax goals of providing adequate revenues and maintaining tax equity.<sup>133</sup>

Boris Bittker articulated how massively the tax law departs from economic income when he remarked that the idea that a perfect tax system would use a “comprehensive base” of income “impl[ies] that sections 61(a), 162, 165, 166, 167, and 212 are the only operative provisions needed for an ideal computation of taxable income.”<sup>134</sup> Although Bittker’s point is extreme, it would be no exaggeration to say that a good portion of the remaining 9833 provisions of Title 26 represent departures from a true measurement of the net change in one’s economic power.<sup>135</sup>

Such extensive loopholes in the tax code make interpreting and complying with the rules enormously difficult, thereby disproportionately benefiting wealthy taxpayers who can devote resources to sophisticated tax planning. Widespread tax planning in order to lower tax liabilities, in turn, breeds resentment among the population at large, who perceive those with greater means as evading their share of the tax burden—a dangerous dynamic in a tax system that depends on self-assessment.<sup>136</sup> As one commentator has pointed out, “taxpayers’ willingness to resist the economic temptation of tax sheltering is historically tied to their perception of the overall fairness of the Code.”<sup>137</sup>

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132. MICHAEL J. GRAETZ, *THE U.S. INCOME TAX: WHAT IT IS, HOW IT GOT THAT WAY, AND WHERE WE GO FROM HERE* 3 (1999).

133. GRAETZ & SCHENK, *supra* note 28, at 43 (quoting *Hearings Before the Subcomm. on Priorities and Economy in Gov’t of the J. Economies Comm.*, 92d Cong. 48-59 (1972) (statement of Stanley S. Surrey, Assistant Secretary, Department of the Treasury)).

134. Boris I. Bittker, *A “Comprehensive Tax Base” as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 932 (1967) (defining the tax base as gross income minus losses, bad debts, depreciation, business expenses, and other expenses for the production of income).

135. See Haig, *supra* note 9; see also SIMONS, *supra* note 9.

136. *Developments in the Law—Corporations and Society*, *supra* note 95, at 2271.

137. *Id.*

Tax authorities have tried various strategies to curb abuse of these myriad tax preferences, but their failures have demonstrated that solutions short of conformity cannot solve the problems to which tax code complexity gives rise. The 1986 corporate AMT was one such effort. In an attempt to improve public perceptions of the corporate income tax, opponents of corporate tax evasion instituted the corporate AMT, which required that firms reporting too large of a book-tax difference calculate their taxes using an alternative formula based on book income. The corporate AMT's proponents believed this measure would effectively eliminate the book-income "preference" – the idea that corporations could report substantially lower taxable income as compared to book income – and would rein in those companies that were abusing the myriad tax preferences in the Code. Moreover, the AMT had the advantage of not requiring lawmakers to dismantle that system of preferences, because it existed alongside the current system as a check.

The problem with using the AMT to attack the book-income preference, however, was that it still permitted tax planning; in other words, it did not solve the problems of complexity. Corporations could easily lower their tax liability by distributing the book-income adjustment strategically across years – for example, by leasing rather than selling goods.<sup>138</sup> Thus, as early as 1987, Bittker commented that "the book income remedy is concerned solely with perceptions, since the adjustment depends on what the corporation reports, not on the underlying facts."<sup>139</sup> Indeed, the final legislation paid remarkably little attention to how corporations accounted for the economic reality that the AMT tax base was supposed to approximate.<sup>140</sup>

The corporate AMT was a roundabout and ineffective measure, leaving in place the two separate accounting systems and simply establishing a book-income trigger for alternative tax liability (or, since 1989, a reported-earnings trigger). As a result, the corporate AMT has not only tolerated the existing

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138. Dan Dhaliwal & Shiing-wu Wang, *The Effect of Book Income Adjustment in the 1986 Alternative Minimum Tax on Corporate Financial Reporting*, 15 J. ACCT. & ECON. 7, 7 (1992).

139. BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 5.08, at 46 (5th ed. 1987).

140. The statute left the book-income starting point vague, like the old Schedule M-1. It simply listed a hierarchy of "applicable financial statement[s]," descending from SEC filings to audited statements, other government-mandated filings, or financial statements prepared for creditors, shareholders, or other nontax purposes. Tax Reform Act of 1986, Pub. L. No. 99-514, § 701(a), 100 Stat. 2085, 2327 (codified as amended at I.R.C. § 56(f)(2) (2000)). In fact, the tax law did not even require that the statement representing book income conform to GAAP. As the Senate Finance Committee Report explained, lawmakers did not intend "to establish the Secretary of Treasury as an arbiter of acceptable accounting principles." S. FIN. COMM. REP. NO. 99-313, at 136 (1986).



Code complexity, it has exacerbated it. In effect, the AMT subjects corporations to three separate tax regimes every year.<sup>141</sup> Indeed, because corporations can generally deduct their compliance costs from taxable income, the complexity of the AMT actually reduces the net revenues the provision raises to minimal – and perhaps even negative – levels.<sup>142</sup>

In addition to fostering tax sheltering, tax preferences and the complexity they engender have the potential to encourage accounting fraud. The JCT has identified the book-income preference resulting from the book-tax divide as a key factor in Enron's accounting malfeasance. It found that the corporation took advantage of the differing book and tax accounting rules to create future tax benefits that could increase current reported financial income.<sup>143</sup> Enron "excelled at making complexity an ally," engaging in tax-motivated transactions that "used exceedingly complicated structures and [that] were designed to produce tax benefits extending far into the future."<sup>144</sup> In other words, because financial reporting of deferred-tax assets and liabilities does not account for the time-value of money, Enron was able to report distant future tax benefits in highly inflated present-value dollars. Amid a litany of other recommendations and observations, the JCT also supported changing GAAP rules on accounting for income taxes.<sup>145</sup> Like the corporate AMT, however, such a suggestion would simply leave in place the book-income preference and create ever greater complexity amid efforts to attack abuses of the preference.

Defenders of the current system claim that the benefit of tax preferences demands keeping the Code as it is. Yet the complexity of the current Code,

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141. Sheppard, *supra* note 79, at 616 (stating that the corporate income tax can be thought of as three taxes: a regular corporate tax, an alternative minimum tax, and a tax on excess book income). In the mid-1990s, economists estimated that the corporate AMT raised tax-compliance costs of corporations by 18% relative to those corporations not subject to the AMT. Slemrod & Blumenthal, *supra* note 76, at 426. The JCT found that the AMT accounted for almost 17% of corporations' total tax-compliance costs. STAFF OF J. COMM. ON TAXATION, 106TH CONG., PRESENT LAW AND BACKGROUND RELATING TO THE MARRIAGE TAX PENALTY, EDUCATION TAX INCENTIVES, THE ALTERNATIVE MINIMUM TAX, AND EXPIRING TAX PROVISIONS 37 (Comm. Print 1999).

142. The available data suggest the overall compliance cost associated with the AMT may be several times the revenue that the provision collects. Chorvat & Knoll, *supra* note 79, at 324-25; *see also* Slemrod & Blumenthal, *supra* note 76.

143. REPORT OF INVESTIGATION OF ENRON, *supra* note 49, at 102 ("Indeed, many of the structured transactions were designed to permit Enron to begin reporting the financial accounting benefits of a transaction immediately even though the Federal income tax benefits (which generated the financial accounting benefit) would not occur until significantly into the future." (internal citations omitted)).

144. *Id.* at 16; *see also id.* at 7 tbl.3.

145. *Id.* at 26.

a direct result of preferences, has become unmanageable and counterproductive.<sup>146</sup> As President Bush's tax reform panel stated in the spring of 2005, after hearing testimony from government officials, academics, and businesses: "Our business tax code is littered with special provisions providing special rates, deductions, or credits. These provisions—designed to encourage particular conduct or business activity—create complexity, volumes of new regulations, opportunities for tax shelters, and unfairness."<sup>147</sup> The surest way to make certain that corporations are paying their fair share of the tax burden is to close the loopholes. A book-tax link along book-income lines would necessarily do so. Without taking such a step, attempts to bring tax liability closer into line with book income have thus far proven futile.

#### *D. Applicability*

Some opponents of book-tax conformity argue that such a remedy is over-inclusive, because it would apply to all firms, including small and privately held businesses.<sup>148</sup> Some critics focus on small firms, contending that the system should at least be phased in over time for those firms, as was the recently introduced Schedule M-3.<sup>149</sup> Smaller firms are initially exempt from filing the M-3, which requires companies to report substantial amounts of information that is not readily available under current corporate-accounting systems and is time-consuming and expensive to produce. Thus, smaller taxpayers with fewer resources have received some extra time to prepare themselves for the new reporting burden. Because book-tax uniformity has the benefit of simplicity, however, this logic would not apply to the new system this Note proposes. As a result, unlike the M-3, this system could cover companies of all sizes from the beginning.

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<sup>146</sup> Pamela F. Olson, Assistant Sec'y for Tax Policy, U.S. Dep't of the Treasury, Address to the Tax Executives Institute, Washington, D.C. (Dec. 18, 2002), in *TAX NOTES TODAY*, Dec. 19, 2002, 2002 TNT 244-35 (LEXIS).

<sup>147</sup> The President's Advisory Panel on Federal Tax Reform, *America Needs a Better Tax System* 3 (Apr. 13, 2005), <http://www.taxreformpanel.gov/04132005.pdf>.

<sup>148</sup> See Mitchell L. Engler, *Corporate Tax Shelters and Narrowing the Book/Tax "GAAP,"* 2001 *COLUM. BUS. L. REV.* 539, 596-97.

<sup>149</sup> The M-3 applied for the 2004 tax year only to companies with total assets of at least \$10 million at year's end. In addition, such firms have the option, in the first year of filing the M-3, to report only temporary and permanent differences, not the actual dollar amounts of book and tax income or loss for each type of transaction that creates such a difference. See Kurt Ritterpusch, *Corporations Urged To Use 2004 M-3 Transition as Trial Run for Compliance*, *Daily Tax Rep. (BNA)* No. 147, at GG-1 (Aug. 2, 2004).

Others argue that the conformed accounting system need not apply to privately held firms, because they do not face the same incentives to maximize book income as do public companies that report to shareholders. When managers' jobs depend partly on satisfying the consumers of the New York Stock Exchange or the NASDAQ, they have greater incentive to play with the numbers to reach revenue targets, both by maximizing book income and by reducing federal tax liabilities. Furthermore, because public company managers are more likely to have heavily incentive-based compensation, they are more sensitive to how reported book income affects the market value of the firm's stock.<sup>150</sup> Indeed, empirical analysis shows that public firms report, on average, larger book-tax differences than their privately held counterparts.<sup>151</sup>

At the same time, however, the book-tax gap does exist in private-company reporting, where it generates the same complexity and provides the same tax shelter opportunities. Moreover, requiring both public and private firms to adhere to the conformed accounting system would make the tax system more equitable and avoid the oft-raised criticism that conformity, if applied only to public or large corporations, would "selectively den[y] intended tax preferences to a limited group of taxpayers" (in other words, the large taxpayers who would be denied the preferences of the non-conformed system).<sup>152</sup> Thus, the conformed accounting system should apply to both public and private firms.

## V. CLOSING THE GAP

The asserted benefits of the book-tax accounting gap no longer justify its substantial costs: increased tax sheltering and accounting fraud. Moreover, the objections that opponents raise to a conformed system, while significant, are not insurmountable. This Note's proposal would cure the ills of the current system by replacing it with near-total book-tax conformity, with a few carefully delineated exceptions. Though conformity could technically be achieved along either book or tax lines (either of which would eliminate the book-tax gap),<sup>153</sup>

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150. C. Bryan Cloyd et al., *The Use of Financial Accounting Choice To Support Aggressive Tax Positions: Public and Private Firms*, 34 J. ACCT. RES. 23, 28 (1996).

151. Mills & Newberry, *supra* note 118, at 2 (confirming the results of Cloyd et al., *supra* note 150).

152. Engler, *supra* note 148, at 542.

153. Given the two accounting systems' conflicting objectives and the myriad differences between the financial and tax accounting rules, some critics claim that it is impossible to make a reasoned choice between book and tax accounting as the basis for a unified system. See, e.g., Knott & Rosenfeld, *supra* note 83, at 1058, 1060; Hanlon & Shevlin, *supra* note 57, at 18.

this Note proposes conformity along book lines, because book income better measures true economic income than does tax income.<sup>154</sup> This Part sets forth the contours of the proposed book-conformed system, explaining who should make decisions about how it is governed and addressing how some of the most difficult rules should be formulated.

#### A. *The Slippery Slope of Tax Politics*

Skeptics have correctly noted that a primary difficulty in moving to book-tax conformity would be identifying who determines the parameters of the new system.<sup>155</sup> If the tax system conforms to book income, they argue, Congress will be unable to resist the temptation to add tax preferences and, as a result, financial accounting will fall prey to Washington politics. Critics in this camp therefore assume that under uniform reporting, financial income would gradually come to resemble present-day taxable income.<sup>156</sup> Ultimately, politically motivated lawmakers will erode the tax base, while simultaneously degrading the quality of financial information provided to investors.<sup>157</sup>

To avoid those pitfalls, this Note proposes that Congress play a confined role at the beginning of the transition process, in order to legislate the primary tax departures from book income. Subsequently, however, the decisionmakers should be the FASB and Treasury. By limiting Congress's power to legislate changes to the accounting rules, the new regime would prevent lawmakers

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154. For a discussion of economic income and its relation to financial income, see *supra* note 9 and accompanying text. A recent study of corporate returns from 1987 to 2001 finds that “book income is a relatively better measure of [corporate economic] performance than taxable income,” but that taxable income still measures the economics of certain specific transactions better than financial income. Heflin & Kross, *supra* note 118, at 15. Tax income seems a particularly valuable measure of economic reality in two situations: first, when a corporation recognizes losses—suggesting that GAAP’s distortions increase when liabilities exceed assets; and second, during eras of soaring corporate profits, such as from 1997 through 2001, when book-income inflation apparently rose. *Id.* at 3. Both instances, however, support the use of book income rather than tax income for the conformed accounting system. For unprofitable corporations, which face tremendous pressure to disguise losses from shareholders, book-income-based taxation would provide an informative link between publicly disclosed losses and lower tax liabilities. And as for periods of rapid economic growth, such as 1997 through 2001, accounting conformity would impose severe consequences—in the form of higher tax liabilities—on corporations that inflated their reported book income.

155. See, e.g., Knott & Rosenfeld, *supra* note 83, at 1060–61; Hanlon & Shevlin, *supra* note 57, at 18.

156. Hanlon & Shevlin, *supra* note 57, at 18.

157. Knott & Rosenfeld, *supra* note 83, at 1061.

from heading down the slippery slope of preferences for favored home-state business interests. It would thus protect against the allegedly inevitable result of Congress's continually enacting book-tax differences to satisfy special-interest groups and constituencies.

As a first step, Congress would enact the basic framework of the conformed system, identifying the very few necessary departures from book income. As lawmakers select these exceptions carefully from the dizzying array of current-law deductions or credits, they should consider the total dollar amount of deductions or credits to determine the significance of each tax measure relative to corporate income. Dollar amounts alone, however, cannot dictate the decision. Ultimately, legislators must remember that conformity aspires to reassert the primary goals of tax and corporate accounting: collecting revenue and providing information through the accurate measurement of economic income. The Bush Administration should set up a forum akin to the current presidential advisory panel on tax reform, consisting of academics, practitioners, government officials, and businesses, to advise Congress on how to proceed. The panel's meetings should be open to the public to increase the transparency of the process. Panelists should pay special attention to the problem of tax shelters and to the enforceability of tax law.

Once lawmakers have determined the areas where the tax law may depart from GAAP, Treasury should be charged with formulating the regulations to implement the new legislation. Its aim, like that of Congress, should be to preserve simplicity. The reduced number of new regulations would be far less complex than under the current Code, because the vast majority of accounting rules would come from the current financial accounting system and would already be familiar to businesses.

Furthermore, to ensure that the new system remains unsullied by politics, Treasury should import into the new conformity regime the limits that the FASB has established to ensure the neutrality of its standard-setting activities. As the body reasoned in 1978, accounting standards should reflect reality, not influence it:

The role of financial reporting in the economy is to provide information that is useful in making business and economic decisions, not to determine what those decisions should be. . . . [I]nvestors, creditors, and others make capital formation decisions, and it is not a function of financial reporting to try to determine or influence the outcomes of those decisions. . . . Thus . . . information that is directed toward a particular goal, such as encouraging the reallocation of resources in

favor of a particular segment of the economy, [is] likely to fail to serve the broader objectives that financial reporting is intended to serve.<sup>158</sup>

This FASB statement stands in contrast to the current congressionally (and generally) accepted idea that the tax code should influence behavior. The new system should adopt the FASB's, rather than Congress's, understanding of the purpose of the rules. If the implementing regulations adopted such a limit, legislators might be discouraged from chipping away at a uniform accounting system the same way they have done with the tax code.

Finally, the FASB should retain its current role of supervising and revising the accounting rules. Involving the private-sector FASB is essential to preserving the integrity and value-relevance of reported income for shareholders and investors. International analysis has shown that the value-relevance (defined as the utility in the pricing of stocks) of reported income is lower in countries where tax rules influence financial accounting rules, but rises when private-sector bodies are involved in setting accounting standards.<sup>159</sup>

Some defenders of the book-tax gap have raised a political concern that if corporations' tax consequences are too closely linked to their reported financial statements, the powerful corporate tax lobby might begin to target the FASB.<sup>160</sup> But a new system of mandatory funding for the FASB has helped to insulate it from tax politics. Before 2003, the FASB relied on contributions from accounting firms and the business community for about 30% of its operating budget.<sup>161</sup> Sarbanes-Oxley changed the funding structure of the FASB, completely replacing the system of voluntary contributions with mandatory fees imposed on securities issuers.<sup>162</sup> As the staff of the Senate Banking, Housing, and Urban Affairs Committee explained, the Act sought both "to formalize the SEC's reliance on the FASB" and "to strengthen [its] independence . . . by assuring the funding and eliminating any need for it to

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<sup>158</sup>. SFAC No. 1, *supra* note 24, at 16.

<sup>159</sup>. Ashiq Ali & Lee-Seok Hwang, *Country-Specific Factors Related to Financial Reporting and the Value Relevance of Accounting Data*, 38 J. ACCT. RES. 1, 2 (2000).

<sup>160</sup>. David M. Maloney & Robert H. Sanborn, *Interactions Between Financial and Tax Accounting Caused by the Tax Reform Act of 1986*, ACCT. HORIZONS, Dec. 1988, at 21. The authors wrote in the context of the book-income adjustment of the 1986-1989 corporate AMT, but they delivered a more general warning about the dangers of "increas[ing] the interaction between the . . . (GAAP) concept of financially reported income and the federal tax system's definition of income," *id.* at 21, as a result of which "[t]he lobbying efforts currently aimed at the Congressional tax legislation process might be redirected toward the FASB." *Id.* at 25.

<sup>161</sup>. Knott & Rosenfeld, *supra* note 25, at 868.

<sup>162</sup>. SOX, Pub. L. No. 107-204, § 109(d)-(e), 116 Stat. 745, 770 (2002) (codified as amended at 15 U.S.C. § 7219(d)-(e) (Supp. II 2002)).

seek contributions from accounting firms or companies whose financial statements must conform to [its] rules.”<sup>163</sup> In the new conformed system, the government should maintain this scheme for funding the FASB.<sup>164</sup> With the added protections of the new system’s regulatory limits on congressional authority, this scheme will insulate the FASB sufficiently from political pressures to prevent legislators from eroding the tax base as they have done under the current tax code.

The FASB should not operate in complete isolation from the political branches, however. Rather, book-tax conformity would require significant government involvement. For one thing, as many commentators have noted, Congress is unlikely to cede the authority to set the standards for government revenue collection completely to the private sector.<sup>165</sup> Moreover, ongoing corporate-accounting scandals, and the public outcry for strong government action that led to the passage of Sarbanes-Oxley, have cast doubt upon the common wisdom that the government should not interfere in financial accounting.<sup>166</sup> The SEC already has broad authority to regulate financial accounting, most of which it has delegated to private-sector bodies. And as early as 1939, SEC Chairman Jerome Frank noted:

We want to be sure that the public never has reason to lose faith in the reports of public accountants. . . . I understand that certain groups in the profession are moving ahead in good stride . . . but if we find that they are . . . unable . . . to do the job thoroughly we won’t hesitate to step in to the full extent of our statutory powers.<sup>167</sup>

If a conformed system were to link tax and financial accounting, this crisis of confidence in financial accounting would deepen. Any conformed system will therefore require the government to “step in,” as Frank envisioned, to both accounting systems.

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163. S. REP. NO. 107-205, at 13 (2002).

164. In his seminal article on how industries may “capture” their regulators, George Stigler noted that the “only way” to ensure that regulators will not be subservient to the industries they serve “would be to . . . reward [regulators] on a basis unrelated to their services” to the industry. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 17-18 (1971).

165. See, e.g., Knott & Rosenfeld, *supra* note 83, at 1060-61; Hanlon & Shevlin, *supra* note 57, at 18.

166. Luppino, *supra* note 95, at 177-78.

167. Marquis G. Eaton, *Financial Reporting in a Changing Society*, J. ACCT., Aug. 1957, at 25, 30 (quoting Jerome Frank).

To satisfy these concerns, the new system should feature a permanent committee made up of representatives from Treasury, the FASB, and Congress. This information-sharing framework would permit the FASB to give Congress and Treasury advance notice of proposed rule changes. While Treasury and Congress should not have a definitive voice in the FASB's proposed rule changes, they should have the opportunity to give their opinions in advance of a vote. Such a system would sufficiently insulate the GAAP rulemaking process from political influence, while still ensuring that Congress and Treasury have at least some influence on the rules used to account for taxable income, as well as sufficient advance notice of any changes. In sum, while responsibility for setting accounting standards would remain with the FASB, Congress and Treasury would be allowed to participate in any deliberations and would have privileged access to information regarding ongoing modifications in the rules.

### *B. Tricky Transactions and Limited Preferences*

The new system should depart from strict book conformity in only two major respects. First, it must find a principled way to deal with the tricky transactions that the two current systems treat dramatically differently. These areas include the consolidation rules, dividends received by corporate shareholders, foreign taxes, tax-exempt bond interest, net operating losses, research and development, depreciation, and corporate inversions. Second, it must embrace a few important departures from book income that serve essential functions in the current Code.

#### *1. Reconciliation Mechanisms*

A uniform system will have to close the massive gap between the consolidation rules of GAAP and those of tax accounting. Consolidation rules specify under what conditions affiliated corporations are permitted to consolidate their accounts for the purposes of financial reporting or filing tax returns. GAAP requires firms to consolidate entities in which the parent has at least a fifty percent voting stake,<sup>168</sup> whereas the tax law permits consolidation only for eighty percent controlling interests.<sup>169</sup> In addition, firms may consolidate only domestic subsidiaries on their tax returns, whereas financial statements must incorporate both domestic and foreign-majority-owned

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<sup>168</sup>. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 94, CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES 7 (1987), *available at* <http://www.fasb.org/pdf/fas94.pdf>.

<sup>169</sup>. I.R.C. § 1504(a)(2) (2000).



subsidiaries. And while the tax law permits a deduction for dividends received from corporate holdings,<sup>170</sup> financial statements must include the income from dividends received from any unconsolidated entity holdings.

If the purpose of consolidated tax reporting is, as the Supreme Court once put it, to achieve “the equitable apportionment between [consolidated corporations] of the tax thus computed,”<sup>171</sup> then a uniform system should adopt financial reporting’s fifty percent standard. To follow tax law’s stricter eighty percent threshold would exclude significant assets and liabilities from a parent corporation’s financial statements, substantially degrading the quality of the information reported to investors. In computing tax liability, however, companies should exclude the income and losses of foreign subsidiaries from their tax returns. Foreign entities are not U.S. taxpayers, and U.S. parent corporations should not be permitted to net foreign-subsidiary losses against U.S.-taxable income.

A uniform system should also reflect the recent FASB guidance on consolidating “variable interest entities,” the special purpose entities (SPEs) that have become infamous because of their role in the Enron scandal. Previously, a firm could form an SPE to keep debt off its balance sheet (in the case of Enron, hiding massive amounts of debt from investors) but could still deduct the losses for tax purposes if the SPE were treated as a partnership. Under revised rules that the FASB issued at the end of 2003, a firm must consolidate any SPE in which it has a “variable interest.”<sup>172</sup> The latter term is defined as any “contractual, ownership, or pecuniary” interest (including equity and regardless of whether there is any associated voting power) that fluctuates with the net assets and obligations of the entity.<sup>173</sup> The parent must consolidate the entity if its at-risk investment meets any one of three definitions, which generally describe cases in which the investment does not bear the “characteristics of a controlling financial interest” as described in the rules.<sup>174</sup> Thus, the new guideline closes the loophole that allowed taxpayers to keep an entity off the books simply by failing to obtain a majority voting interest. The guidance provides a ten percent safe harbor, but above ten percent it supplements the bright-line numerical rules with a “qualitative” and

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170. I.R.C. § 243 (2000).

171. *Comm’r v. Morgan’s, Inc.*, 293 U.S. 121, 127 (1934).

172. FIN. ACCOUNTING STANDARDS BD., INTERPRETATION NO. 46(R), CONSOLIDATION OF VARIABLE INTEREST ENTITIES 6 (2003), *available at* <http://www.fasb.org/pdf/fin%2046R.pdf>.

173. *Id.* at 30.

174. *Id.* at 12.

“quantitative” analysis of the interest at stake.<sup>175</sup> The purpose is to “improve comparability between enterprises engaged in similar activities” and “provide more complete information about the resources, obligations, risks, and opportunities of the consolidated enterprise” to the users of financial statements.<sup>176</sup> The conformed system proposed in this Note would adopt the revised FASB rule.

## 2. Limited Tax Preferences

Although conformity along the lines of book income should be the rule, the new system should retain a select few essential tax preferences, which this Note defines as those preferences that preserve the principle of double taxation of corporate income<sup>177</sup> and those that preserve important social and economic policy objectives. The primary provision that serves the first principle is the § 243 dividends-received deduction, which ensures that corporations and stockholders are not taxed on the same income more than twice, preserving the double-taxation principle of corporate income taxation.<sup>178</sup> In addition, the credit for foreign income taxes ensures that U.S. taxpayers do not pay taxes on foreign-source income in more than one jurisdiction.<sup>179</sup> Because these are two of the most important mechanisms for avoiding double taxation, the uniform system should preserve them.

In order to protect the most important social and economic policy provisions, the new system should retain the deduction for interest received on state and local bonds<sup>180</sup> and the research tax credit,<sup>181</sup> both of which promote

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<sup>175.</sup> *Id.* at 13.

<sup>176.</sup> *Id.* at 7.

<sup>177.</sup> The principle holds that corporate income should be taxed once at the corporate level and once at the personal level when distributed to shareholders, and it is the foundation of the “classical” U.S. corporate income tax system. See Herwig J. Schlunk, *I Come Not To Praise the Corporate Income Tax, But To Save It*, 56 TAX L. REV. 329 (2003).

<sup>178.</sup> I.R.C. § 243 (2000); see also *United States v. Georgia R.R. & Banking Co.*, 348 F.2d 278, 283 (5th Cir. 1965) (“The purpose of § 243 is to eliminate the multiple taxation of corporate earnings which would otherwise occur whenever one corporation holds shares of stock in another corporation. Thus, the deduction seems to be directed . . . to the preservation of income from the stock . . .”).

<sup>179.</sup> I.R.C. § 901 (2000); see also *Comm’r v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932) (“[T]he primary design of the provision was to mitigate the evil of double taxation.”).

<sup>180.</sup> I.R.C. § 103 (2000); see also *Fox v. United States*, 397 F.2d 119, 122 (8th Cir. 1968) (“The legislative history clearly indicates that the purpose of the [state and local bond interest] exclusion is to permit state and local governments to obtain capital at a low rate of interest.”).

favorable investments. The state and local bond interest exemption, by allowing local governments to borrow at lower interest rates than other issuers, raises important issues of federalism and revenue-sharing that a conformed accounting system cannot appropriately address.<sup>182</sup> One commentator has called the exemption of interest on state and local bonds a “[c]lassic example” of a purposeful deviation from economic income enacted to “stimulate desirable activity by reducing the effective rate of tax on such activity.”<sup>183</sup>

The new system should also retain the research credit, which arguably corrects the market imperfections that otherwise prevent companies from realizing the full economic gains of research expenditures. As Congress noted when renewing the credit in 1996:

Businesses 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.<sup>184</sup>

The research credit falls within the category of tax preferences that fix existing market distortions rather than creating new ones. As such, it is an important tool that should be preserved in a unified accounting system. In fact, book-tax conformity with a research credit may have the beneficial effect of minimizing the incentives for firms to become highly leveraged, reducing the risk of future meltdowns such as Enron’s and Worldcom’s.<sup>185</sup> Some have conceived of the research credit as a “nondebt tax shield” that should substitute for the use of leverage in corporate finance, but only to the extent that it changes a firm’s marginal tax rate.<sup>186</sup> This means that by lowering a firm’s effective tax rate, the research credit makes additional debt (and the associated interest deductions)

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181. I.R.C. § 41 (2000).

182. According to constitutional theory, the states cannot tax the instruments that the federal government uses to raise money, and neither can the federal government tax the instruments that the states use. *Ambrosini v. United States*, 187 U.S. 1, 7 (1902). The Supreme Court has held that a tax upon the states’ borrowing power falls under this constitutional prohibition. *Nat’l Life Ins. Co. v. United States*, 277 U.S. 508, 521 (1928).

183. Engler, *supra* note 148, at 549.

184. STAFF OF J. COMM. ON TAXATION, 104TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS 105 (Comm. Print 1996).

185. John R. Graham, *Taxes and Corporate Finance: A Review*, 16 REV. FIN. STUD. 1075, 1079 (2003).

186. *Id.* at 1089-90.

less important as a source of corporate finance. In addition, debt is more attractive as the tax rate rises; interest deductions become more valuable the higher the tax bracket. If a uniform accounting system sufficiently broadens the tax base to permit corporate rate reductions, the net effect could be reduced debt-equity ratios.

Additionally, the conformed system should allow taxpayers to carry forward net operating losses, and thus, as the Supreme Court put it, “to set off . . . lean years against . . . lush years, and to strike something like an average taxable income computed over a period longer than one year.”<sup>187</sup> This ensures the equal treatment of taxpayers with regular income and those with income that fluctuates from year to year. If not for this provision, the income tax would become like a tax on capital for those taxpayers whose income in any given year was less than the allowable deductions.

Depreciation is currently treated differently in tax and financial accounting, and a uniform system must resolve this disparity. It would be quite easy for a conformed system to use accelerated tax depreciation (known as the modified accelerated cost recovery system (MACRS)) rather than GAAP’s straight-line depreciation.<sup>188</sup> Accelerated tax depreciation, which divides assets into various classes, each with a statutorily defined useful life, provides uniform treatment for all companies, allowing for predictability and comparability across firms. Moreover, capital markets would lose little value-relevant information, because financial depreciation is not currently based on economic depreciation in any event, and the actual expected asset life could still be disclosed separately.<sup>189</sup> Businesses have complained that tax depreciation exacts high compliance costs,<sup>190</sup> but the cost savings from the vastly simplified conformed accounting system would more than offset the continued compliance cost of MACRS.<sup>191</sup>

Finally, the AJCA’s approach to cracking down on corporate-inversion transactions—in which, to lower its effective tax rate, a corporation reincorporates in a foreign jurisdiction by forming a foreign subsidiary that becomes its parent—provides a model for the base-broadening changes that the new system would have to make. The Act disallows any corporate-level loss from corporate-inversion transactions and prevents the application of net operating losses or deductions against any recognized gain from inversion.

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187. *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, 386 (1957).

188. “The most obvious book-tax difference that could be conformed is that for depreciation.” Hanlon & Shevlin, *supra* note 57, at 29.

189. *Id.*

190. See Slemrod & Blumenthal, *supra* note 76, at 428.

191. See Engler, *supra* note 148, at 549.

Whereas the tax law generally considers eighty percent ownership as the threshold for corporate parentage, the AJCA's loss and deduction limits cover inversions in which the U.S. shareholders of the former U.S. corporation hold sixty to eighty percent of the foreign subsidiary's stock, and the limits apply for ten years after the inversion transactions.<sup>192</sup> The new system should follow this approach to corporate parentage more broadly, extending it beyond the inversion situation. It should also apply the GAAP consolidation rules, which consider any ownership above fifty percent to indicate a parent-subsidary relationship, throughout the uniform accounting system.

The exceptions listed above should be the only major areas of book-tax difference. These provisions would preserve the double taxation of corporate income (the dividends-received deduction and foreign tax credit), would ensure equity among similarly situated taxpayers and help smooth out peaks and valleys in income across years (the net operating loss carryover), and would stimulate valuable capital investment and research (accelerated depreciation and the research credit). If Congress wants to stimulate other business activities, such as the provision of employee health care, it should do so through direct subsidies rather than indirect tax breaks. Only in this way can the tax system meet the goals of simplicity, equity, and enforceability.

## CONCLUSION

As the book-tax gap has grown over the last fifteen years, it has attracted increasing attention and has spawned ever greater debate. This Note's proposal is just one of many competing solutions to the problem of tax shelters and accounting fraud, and it will certainly be controversial. Even if Americans are not able to agree on a modified book-tax accounting standard, they may be able to agree that the status quo is even worse. Under the current tax system, the taxpayers with the greatest resources are able to steadily reduce their effective tax rates through selective income reporting and tax sheltering. This inequity breeds discontent. By contrast, the FASB has compared its vision of the consensus around accounting principles to the rules of the road: Because drivers agree that speed limits and traffic lanes make sense, they "observe traffic laws in the interest of their own and general traffic safety, so long as others do the same."<sup>193</sup> If all businesses were forced to respect the same rules, as they would be under a conformed accounting system, the tax and accounting

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192. I.R.C. § 7874 (LexisNexis 2004).

193. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 2, QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION ¶ 17, at 15 (1980), available at <http://www.fasb.org/pdf/con2.pdf>.

rules would be far more easily enforced. As a result, both the tax and accounting systems would better serve their underlying objectives.

The current political and economic climate presents an ideal moment for adopting book-tax conformity. First, the amount of tax sheltering and accounting fraud becomes more alarming every year, making the need for conformity increasingly urgent. Second, there is currently political momentum to revise the tax code dramatically. President George W. Bush has appointed a high-level commission to study fundamental tax reform,<sup>194</sup> and its findings are supposed to provide the basis for the Administration's reform plan.<sup>195</sup> Now is an opportune moment to overhaul the tax system.

Moreover, both the Bush Administration and Congress have made clear their intent to lower corporate tax rates.<sup>196</sup> In an age when federal deficits are soaring, and revenue neutrality is a political imperative, Congress must offset any such rate reduction with base-broadening measures. Modified book-tax conformity would achieve the base-broadening objective by prohibiting the vast majority of tax preferences for corporate transactions. Moreover, near-uniformity of accounting standards would wash away the harbor for abusive tax shelters that the book-tax difference provides.<sup>197</sup> Such a change would ensure revenue neutrality without politically difficult increases in personal income taxes (another area where the Bush Administration wants to make permanent rate cuts<sup>198</sup>) and would help remedy the perceived inequities of the corporate tax, which often seems to allow large taxpayers to avoid paying their share of taxes.

The government's primary revenue-raising method forces its citizens to navigate a monstrosly complex legal regime that is riddled with inequities and inefficiencies. As the Code and the associated regulations become ever more Byzantine, compliance costs rise and corporate tax avoidance becomes the exclusive domain of the wealthy and the well-advised. If government persists in cracking down on shelters through traditional means—even if those

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194. Exec. Order No. 13,369, 70 Fed. Reg. 2323 (Jan. 7, 2005).

195. Edmund L. Andrews, *Planning for a Tax Overhaul Will Have To Wait, Bush Says*, N.Y. TIMES, June 17, 2005, at A18.

196. H.R. REP. NO. 108-755, at 275 (2004) (Conf. Rep.) (“The conferees . . . expect that the tax-writing committees will explore a unified top corporate tax rate in the context of fundamental tax reform.”).

197. For an analysis of tax shelters as “omissions from the tax base,” see David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 231-41, 232 (2002).

198. See President's Address Before a Joint Session of the Congress on the State of the Union, 41 WEEKLY COMP. PRES. DOC. 126, 127 (Feb. 7, 2005) (“I will send [Congress] a budget that . . . makes tax relief permanent . . .”).

methods achieve some success – “tax sheltering can be expected to become even more concentrated, available to only the most sophisticated taxpayers.”<sup>199</sup> In other words, the standard “tax reforms” actually perpetuate a vicious cycle: Complexity leads to tax planning, which leads to greater complexity to outwit the planners (and greater perceptions of unfairness), which leads to more tax planning. Only a drastic overhaul such as book-tax conformity can stop the cycle.

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<sup>199</sup>. *Developments in the Law – Corporations and Society*, *supra* note 95, at 2271.