Testimony of Michelle Hanlon

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Chairman Baucus, Ranking Member Hatch, and distinguished members of the Committee, I appreciate the opportunity to participate in this hearing on corporate tax reform and investment incentives. I am an associate professor of accounting and taxation at the Sloan School of Management at the Massachusetts Institute of Technology. I am an editor of the *Journal of Accounting and Economics* and the chair of the accounting group at MIT Sloan.

The main point of my testimony is that financial accounting implications for publicly traded companies can influence the effectiveness of tax policies, including policies related to investment. The financial accounting effects represent a non-tax cost (or benefit) that public companies consider in their decision-making process. Thus, public companies' responses to tax policies are not only governed by the tax effects, but also the financial accounting effects, often producing unintended consequences.

I illustrate the financial accounting effects using current U.S. tax policies. The United States has one of the highest statutory corporate tax rates in the world. In recent years, rather than reducing the corporate statutory tax rate, our policies have instead included targeted tax provisions such as bonus depreciation and the IRC Section 199 Domestic Production Activities Deduction in attempts to reduce economic effective tax rates and provide incentives for investment. The research evidence on whether these policies have spurred aggregate investment is mixed (i.e., not conclusive). Furthermore, because the U.S. has retained such a high corporate tax rate, U.S. multinational corporations hold a great deal of cash overseas, an amount in excess of $1 trillion. Financial accounting has affected corporations' tax policy response in each of these cases.

I offer a detailed discussion and support in the remainder of the document, but a summary is as follows. First, companies respond less than predicted to bonus depreciation partly because the tax savings are not reflected on a firm's accounting income statement. Second, the Section 199 deduction was structured as a deduction at least partially because of financial accounting. Specifically, companies with substantial deferred tax assets on their accounting balance sheets would have had to write-down these assets if the provision were structured as a rate cut. Structuring the provision as a deduction, however, has led to a complex tax rule. Finally, financial accounting provides an unintended, additional incentive for multinational companies to leave cash in offshore locations. If the foreign earnings are designated as permanently reinvested for financial accounting purposes, repatriating the cash and subjecting it to U.S. taxation requires not only an additional cash outlay but an additional financial accounting expense as well. Companies' reluctance to repatriate foreign earnings leads to more corporate debt in the U.S., lower payouts to shareholders, and quite possibly less investment in the U.S. and less efficient investment in foreign jurisdictions. I would like to emphasize, however, that given the current tax rules, the financial accounting treatment is correct. A reduction in the corporate tax rate (and/or move to a territorial tax system) would simultaneously lower both the tax and accounting disincentives related to the repatriation of foreign earnings.

The remainder of the document proceeds as follows. I first provide a brief discussion of the reporting rules for public corporations in the U.S. to provide a basis for describing the accounting effects of tax policy. I then provide evidence on the importance of accounting to firm management and describe the accounting effects related to bonus depreciation, Section 199, and the international tax system of the U.S. I close with conclusions and caveats.

Book-Tax Differences and Accounting for Income Taxes

Publicly traded companies compute two different measures of income every year – taxable income and financial accounting (book) income. The two measures of income are computed for different purposes. Financial accounting is intended to measure economic performance for external stakeholders. The rules for computing accounting income are conservative in nature, requiring the recognition of expenses and losses earlier than the recognition of income and gains. Taxable income is not publicly available and is not intended to inform external parties. The rules for taxable income are, of course, not guided by conservatism. Rather the income tax rules are written to ensure taxpayers do not understate their income and to raise revenue to finance the government.

The line item differences between book and taxable incomes are referred to as book-tax differences and include two types – temporary and permanent. Temporary differences are items of income or expense that are included in both income computations but in different time periods. Thus, a temporary difference in the current period will reverse in some future period. The classic example of a temporary book-tax difference is depreciation. In the early years in the life of a depreciable asset, tax depreciation (accelerated) will often be greater than book-depreciation (generally, straight-line). As the asset nears the end of its life, however, this difference will reverse such that the same total amount of depreciation is taken for both book and tax purposes over the life of the asset.[1]

The financial accounting rules require firms to account for these temporary differences. The income tax expense on the financial accounting income statement is an accrual based expense; it is not the cash taxes paid by the company. In essence, what this means is that the income tax expense related to this period's accounting earnings is accrued (i.e., expensed) regardless of when the cash is paid. In the depreciation example, for instance, the company receives an additional tax deduction in the current year but in some future period will have a tax deduction for depreciation

[1] For simplicity, I ignore salvage value sometimes used for financial accounting.

that is less than book depreciation expense. Thus, for financial accounting, the future tax related to the reversal is accrued (expensed) in the current period. As a result of the accrual basis accounting for income taxes, accelerated depreciation does not reduce income tax expense for accounting purposes in the current period even though it saves cash taxes in the current period.

Such an accrued expense (or benefit) without a corresponding cash payment (or receipt) creates a liability or asset on the firm's accounting balance sheet. The liabilities, termed deferred tax liabilities, represent the tax effects of future book-tax difference reversals that result in an increase to future taxable income relative to book income (or a decrease in future book income relative to taxable income). The depreciation example above creates (or increases) a deferred tax liability in the years that tax depreciation is greater than book depreciation. The assets, termed deferred tax assets, represent the tax effects of future book-tax difference reversals that reduce future taxable income relative to future book income (or increase future book income relative to future taxable income).

Deferred tax assets and liabilities are computed by taking the tax rate expected to be in effect in the period that the temporary book-tax differences reverse times the cumulative temporary book-tax differences (i.e., differences between book and tax bases). Thus, a corporate tax rate increase causes an increase in the amount recorded for deferred tax liabilities and a corresponding increase in income tax expense in the period in which the rate change becomes known. A rate increase applied to net deferred tax assets increases the amount recorded for deferred tax assets (i.e., computed at the higher rate) and decreases income tax expense. Conversely, a corporate tax rate decrease requires a decrease in the amount recorded for deferred tax assets and liabilities. Thus, for firms with deferred tax assets in excess of deferred tax liabilities, a tax rate decrease reduces recorded net deferred tax assets on the balance sheet and results in a one-time decrease to reported accounting earnings.

The total amount of deferred tax assets and liabilities are substantial. Ernst & Young recently tabulated the deferred tax assets and liabilities in the financial statements of the 50 largest U.S. companies (ranked by 2009 revenues). The gross deferred tax assets totaled $521 billion in 2010 for these companies and the deferred tax liabilities totaled $465 billion.[2]

Permanent differences are straight-forward. The classic example is municipal bond interest. This type of interest income is not taxable so is not included in taxable income in any period, current or future. Municipal bond interest is, however, included in accounting income. Thus, there is a difference between book and taxable incomes that is permanent in nature – it will never reverse. Because there is no future reversal there is no deferred tax asset or liability. Thus, permanent

[2] Neubig, T., C. Abell, and M. Cox (2011) "Some Financial Reporting Considerations for the Tax Reform Debate: Changing the Corporate Tax Rate" Ernst & Young Tax Insights Report. Deferred Tax Assets net of the valuation allowance totaled $396 billion.

differences affect the income tax expense on the firm's income statement and correspondingly affect reported accounting income.

The Importance of Accounting and How Tax Policies Affect Accounting Numbers

Accounting income is an important performance measure used in the capital markets, many lending contracts, and often for internal performance evaluation. Indeed, there is a long-line of research in accounting that shows that companies will often tradeoff tax savings in exchange for more favorable accounting treatment. One example, documented in a study I co-authored with Merle Erickson and Ed Maydew, is that some companies that were accused of fraudulently overstating financial accounting earnings by the Securities and Exchange Commission (SEC) also overstated their income to the Internal Revenue Service. Management at these companies paid cash (to the IRS) in order to overstate their accounting earnings.[3] In addition, two recent surveys of managers reveal that when asked 1) most CFOs surveyed rank accounting earnings as the most important benchmark for investors (not cash flow from operations or free cash flows), and 2) 85% of surveyed tax executives of publicly traded companies state that top management at their companies view the effective tax rate for financial accounting purposes (defined as total income tax expense for accounting purposes divided by pre-tax accounting earnings) as being at least as important or more important than cash taxes paid.[4]

Bonus Depreciation

As stated above, accelerated depreciation, including bonus depreciation, is a temporary book-tax difference and therefore, does not affect accounting earnings. Tom Neubig wrote an article in 2006 that he entitled "Where's the Applause?"[5] He presented portions of that article in his testimony before this committee that same year. In the article, he discusses the Growth and Investment Tax Plan outlined in the President's Advisory Panel on Federal Tax Reform. This plan essentially included an expensing option allowing for a first-year 100% write-off of capital investment. Contrary to his expectations, the response from corporate America was the "proverbial sound of one hand clapping." Companies much preferred the alternative reform option of a lower corporate tax rate. One reason Neubig offers about why companies were not excited about the targeted expensing provision is that it is only a timing benefit and does not reduce the accounting effective tax rate.

[3] Erickson, M., M. Hanlon, and E. Maydew (2004) "How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings" *The Accounting Review* (April).

[4] Graham, J., C. Harvey, and S. Rajgopal (2005) "Economic Implications of Corporate Financial Reporting" *Journal of Accounting and Economics* and Graham, J., M. Hanlon, and T. Shevlin (2011) "Inside the Corporate Tax Department: Insights on Corporate Decision Making and Tax Planning" working paper.

[5] Neubig, T. 2006. "Where's the Applause? Why Most Corporations Prefer a Lower Rate" 111 *Tax Notes* 483 (April 24).

A recent study by economist Jesse Edgerton also provides evidence on this issue.[6] He compares the effectiveness of accelerated depreciation to the effectiveness of the investment tax credit, which in contrast to accelerated depreciation reduces income tax expense and increases accounting earnings. He concludes that the investment tax credit had more of an effect on investment than accelerated depreciation because of the accounting benefits of the credit.

Section 199 Domestic Production Activities Deduction

Under the rules for Section 199, qualified activities are eligible for a deduction equal to 9% of the lesser of taxable income derived from qualified production activities, or taxable income. For a C-corporation subject to the highest corporate tax rate, the provision results in qualified activity income being subject to a 31.85% rate rather than a 35% rate. By structuring the provision as a deduction rather than a corporate tax rate reduction, the benefits were made available to non-corporate taxpayers. In addition, it avoided a negative financial accounting effect for the firms with deferred tax assets. Hanna (2011) describes the efforts by these companies to obtain deduction treatment – they wanted a deduction rather than a rate cut in order to avoid the earnings charge that would result from a tax rate reduction (i.e., from a write-down of the tax assets).[7]

While the tax rules allow an additional deduction under Section 199, there is no analogous expense for financial accounting purposes and never will be. Thus, a permanent difference is created and the Section 199 deduction reduces accounting income tax expense. In other words, the Section 199 deduction has no mitigating financial accounting effect. However, it is important to note that a rate cut would not have a mitigating accounting effect either. To the extent that Section 199 as implemented is more complex than a rate cut, it will be more expensive to comply with and more expensive to audit. Indeed, Section 199 is a Tier 1 audit issue.

In the case of Section 199, the importance of accounting is demonstrated by the form in which the tax policy was implemented. The subset of firms with deferred tax assets did not want the value of those accounting assets to be diminished by a tax rate cut. Both forms of the policy would provide the same cash flow investment incentives, if any, and neither would result in mitigating accounting effects with respect to investment incentives. The issue was one of the impact on accounting earnings from reducing the value of tax assets that were on the balance sheet from prior, unrelated transactions.

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[6] Edgerton, J. (2011) "Investment, Accounting, and the Salience of the Corporate Income Tax" working paper, Federal Reserve Board.

[7] Hanna, C. (2009) "Corporate Tax Reform: Listening to Corporate America" *J Corp Law* 283 (Winter). See also White, G. (2011) "Dead Space 2: Tax Rip-Off? *Tax Notes*, October 3; and Poterba, J., N. S. Rao, and J. K. Seidman (2011) "Deferred Tax Positions and Incentives for Corporate Behavior Around Corporate Tax Rate Changes" *National Tax Journal*, March. I note that other jurisdictions have also adjusted the form or method of implementation of tax policy because of the deferred tax issue, for example the state of Ohio and the U.K. See Neubig et al. (2011) and Poterba et al. (2011) referenced above for further discussion.

This example offers insights for broader tax policy options. If the U.S. determines, based on an evaluation of all other costs and benefits, that a corporate tax reform option of base broadening in exchange for a lower corporate tax rate is the best policy, then the fact that some firms have deferred tax assets should not prevent the U.S. from moving forward. In other words, in my opinion, the fact that some firms with deferred tax assets would have to write-down the value of those assets if corporate tax rates are reduced should not stop the U.S. from lowering the corporate tax rate. Even this sub-set of companies will benefit from lower rates if they become profitable in the future.

Worldwide Taxation and High Statutory Tax Rate

Operating income earned by a U.S. multinational in a foreign subsidiary is not included in U.S. taxable income until the earnings are repatriated.[8] For financial accounting purposes, the income is included in reported earnings in the period earned. Thus, the foreign income included in accounting earnings but not included in U.S. taxable income (until repatriated) is a temporary book-tax difference which requires a deferred tax liability and a related deferred tax expense to be recorded. There is an exception, however, to the deferred tax accounting for these earnings (in ASC 740, previously in APB 23). This exception requires firms to designate the amount of foreign earnings that are "permanently reinvested." For earnings that are permanently reinvested, the book-tax difference will not reverse – it is a permanent difference – and thus no deferred tax liability or expense is recorded. Permanent difference treatment reduces income tax expense and increases earnings compared to a case where the U.S. income tax is fully accrued. The result of this exception to deferred tax accounting is that the accounting statements are more comparable to the statements of companies in jurisdictions with territorial taxation because there is generally no home country tax to record in territorial regimes. This also puts U.S. companies in a more competitive position relative to companies from territorial jurisdictions in terms of accounting returns.

If a U.S. multinational repatriates earnings that were previously designated as permanently reinvested the company not only has to pay cash taxes but also has to record an accounting expense. This accounting effect is an additional reason why firms do not repatriate earnings.[9] One anecdote is found in a letter to the editor of the *Wall Street Journal* written by James Tisch, CEO of Loews, that states "Unbeknownst to many…GAAP allows corporations to avoid the accrual of taxes on foreign earnings…The results of the interaction of our repatriation tax laws and the GAAP accounting rules is that very little in the way of foreign earnings are repatriated…The accounting penalty for repatriating even a penny of foreign profits is so great that those foreign funds will not come back to the U.S…" (July 5, 2008).

[8] The repatriated amount is taxable at the U.S. rate and a foreign tax credit is allowed. Expense allocation rules are used in determination of the allowable credit.

[9] To be sure, neither taxes nor accounting are likely primary drivers of foreign investment or retention of cash overseas (especially for non-intangibles based companies). Companies consider many factors – growth in the foreign markets, location of customers, and other determinants – which often dominate tax and accounting considerations.

Further evidence is found in a recent survey of tax executives. Depending on the sample, between 44% and 65% of the respondents indicate that the financial accounting effect is important in their decision of whether to repatriate earnings. Indeed, overall, the financial accounting effect has an importance rating that is statistically equal to the importance rating of the cash tax effect.[10]

Conclusions and Caveats

The main point of the above testimony is that financial accounting effects can act to mitigate or strengthen incentives provided by the tax code. That is, financial accounting effects have the potential to blunt the intended incentive effects of policies designed to lower the effective U.S. corporate tax rate and they have the potential to lead to unintended consequences.

Studies have shown that "taxes matter" in the sense that the timing of investment is altered as a result of bonus depreciation provisions, but the evidence that aggregate investment is responsive is very mixed. The Section 199 deduction is complex and as a result is costly to comply with for taxpayers and is costly to audit and enforce for the tax authority. Financial accounting has a role in each of these outcomes. Bonus depreciation does not reduce the income tax expense for financial accounting and thus does not reduce a company's effective tax rate, mitigating the responsiveness to the incentive. The reason that Section 199 is a deduction and was not implemented as a rate cut is, it seems, in part due to the fact that with a rate cut, companies with large deferred tax assets are required to write those assets down and value them using the new, lower tax rate.

There are currently large amounts of cash held overseas by U.S. multinationals. The reluctance to repatriate these earnings leads to more debt in the U.S., lower payouts to shareholders, and quite possibly less investment in the U.S. and less efficient investment in foreign jurisdictions. Research indicates that the disincentive to repatriate foreign earnings due to the relatively high U.S. corporate statutory tax rate is exacerbated by financial accounting effects.

In sum, financial accounting effects can affect responsiveness to tax policies. Thus, financial accounting implications and the related incentives for managers should be considered when writing tax policy in order to maximize responsiveness and correctly score provisions. However, in my opinion, the fact that some firms with deferred tax assets would have to write-down the value of those assets if corporate rates are reduced should not stop the U.S. from lowering the corporate tax rate. Even this sub-set of companies will benefit in the future from lower rates, assuming these companies become profitable.

A few caveats to this testimony are in order. The above discussion deals only with corporate income taxes. Corporations pay many other types of taxes (e.g., value added taxes in other

[10] Graham, J., M. Hanlon, and T. Shevlin (2011) "Real Effects of Accounting Rules: Evidence from Multinational Firms' Investment Location and Profit Repatriation Decisions" *Journal of Accounting Research* 49.

countries) that contribute to their tax burden. In addition, many businesses operate in a non-corporate form. How these companies are affected by corporate tax reform is important. For example, if bonus depreciation is eliminated and the corporate tax rate reduced, those operating under a non-corporate form will not receive the benefit of the lower rate. The same is true for small C-corporations if only the top corporate rate is reduced. Moreover, the discussion above highlights financial accounting considerations which are generally only important for publicly traded firms or private firms that are large enough to have either publicly traded debt or other stakeholders that demand GAAP-based financial statements. Firms that are not required to prepare financial accounting statements will not have financial reporting incentives.

Thank you for holding this series of hearings on tax reform and inviting me to participate. I look forward to your questions.