

TESTIMONY OF  
GEORGE A. PLESKO  
SLOAN SCHOOL OF MANAGEMENT  
MASSACHUSETTS INSTITUTE OF TECHNOLOGY  
BEFORE THE COMMITTEE ON FINANCE  
UNITED STATES SENATE  
FEBRUARY 13, 2003

Chairman Grassley, Ranking Member Baucus, members of the Committee, thank you for inviting me to testify at today's hearing marking the release of the Joint Committee on Taxation's Investigative Report on Enron.

There has been substantial anticipation of this report in the academic tax community, as I am sure there has been in other areas. Those of us who study the effects of the tax code are usually only able to examine behavioral patterns across broad groups of firms facing different tax incentives. The ability to better understand the mechanics of specific transactions firms have used provides important insight into the operation of the tax system, and the incentives and motivations of individual firms and their managers.

My charge this morning is to provide a context for the JCT report. To do this I will address three issues that are not specific to Enron, but which are generally related to the financial and tax reporting environment firms face. First, I will discuss the differences in the accounting systems for financial and tax purposes, and the growth in these differences over time. For publicly traded firms there are two sets of accounting numbers: those reported to investors, through quarterly and annual financial reports, and those reported annually to the Internal Revenue Service for tax purposes. While there is strong historical and economic justification for them being different, the relation between the two appears to have changed dramatically during the late 1990s. The

causes of this divergence are not fully understood, but one possible factor is the increased ability to structure financial and tax transactions in ways that affect only one set of reporting numbers.

Second, I will address the issue of whether improvements can be made in disclosure of tax information by publicly-traded firms. While both the financial and tax reporting systems have rules to provide a reconciliation to the other, neither set of disclosures appear to be currently adequate. The tax footnote and other tax disclosures in a firm's 10-K do not provide sufficient detail to identify many of the tax characteristics of interest to users. Similarly, the Schedule M-1 of the Form 1120 is not sufficiently detailed to provide the IRS and other government users with all of the information they could benefit from having.

Finally, I will briefly touch on the administration's proposals for dividend relief, and the effects such a change could have on firms' incentives to engage in tax minimizing transactions.

### **Book-Tax Reporting Differences**

Treasury, in its 1999 report on tax shelters and related testimony, suggested the disparity in both the levels and growth rates of book and taxable income is partial evidence of the growth in shelters. To examine this issue, one must start with an understanding of the principles of each reporting system

Financial Accounting Standard Board's (FASB) Statement of Financial Accounting Concepts No. 1 (CON1), "Objectives of Financial Reporting by Business Enterprises," issued in 1978, outlines the objectives of financial reporting. The essential element is that financial accounting provide information useful to investors and creditors in making investment and other decisions about firms. Concept No. 2 (CON2), "Qualitative Characteristics of Accounting Information," issued in 1980, describes the characteristics of accounting information that make it

useful. Of the five qualities outlined, two, relevance and reliability, are considered the primary qualities. By relevant, the information provided should be helpful to external users in making their decisions. Reliability, in the context of CON2, merely implies the data presented "represents what it purports to represent." CON2 also recognizes that collection and dissemination of information is not costless, and the perceived benefits of a disclosure must exceed the perceived costs associated with it.

Other characteristics of quality financial accounting information are comparability and consistency. Comparability and consistency require financial accounting information to be similar across firms, and that each firm use accounting methods consistently over time. These criteria do not require the financial accounting rules to be implemented uniformly in each company. This is in contrast to the approach taken in much of the tax law where uniformity in the accounting for economic events is required.

The discretion left by accounting standards for firms to differ in their application of the accounting rules is viewed as a virtue of the system. It is generally assumed that allowing managers financial reporting discretion can increase the quality of the information they provide. Owing to this discretion, managers of firms within the same industry can reach different conclusions about how to recognize revenues and/or expenses, in order to provide information on each firms' unique circumstances to their respective shareholders.

CON1 recognizes that tax authorities may have informational needs beyond the general user, but also the authority to obtain information on their own:

... both the information needed to enforce tax laws and regulations and the information needed to set rates for public utilities are specialized needs. However, although both taxing authorities and rate-making bodies often use the information in financial statements for their purposes, both have the statutory authority to require the specific information they need to fulfill their functions

and do not need to rely on information provided to other groups. (Paragraph 26)

CON1 also makes explicit that the goals of financial accounting are not based on assisting regulatory authorities:

The objectives in this Statement are those of general purpose external financial reporting by business enterprises. The objectives stem primarily from the informational needs of external users who lack the authority to prescribe the financial information they want from an enterprise and therefore must use the information that management communicates to them. (Paragraph 26)

By contrast, the objective of the Internal Revenue Code (IRC) is the efficient and equitable determination of tax liabilities and the collection of revenue. To facilitate the work of the Internal Revenue Service, the IRC permits fewer choices in the application of accounting methods than are available to determine financial reporting income. A secondary objective of the IRC is to provide incentives or disincentives for particular economic or social activities.

Tax accounting specifies certain approaches to income and expense recognition that differ from financial accounting. Even when both systems allow for the same revenue or expense, the measurement rules may be very different. For example, for financial reporting firms can calculate depreciation based on idiosyncratic determinations of specific asset lives and residual values that reflect their economic value. Tax depreciation is based on explicit asset classifications that, on average, appear to allow faster recovery than implied by economic depreciation.

When comparing a financial statement to a tax return, the income can differ because of the entities included in each report as well as how the income is defined for each purpose. There are two sources of income measurement differences between financial reporting and taxable income. First, tax and financial reporting rules may allow for differences in the timing of revenue and expense recognition. These timing differences result in differences in the amount of income

recognized for financial reporting and tax purposes for a given period, but net to zero over time. Consider again the depreciation of tangible assets. For financial reporting purposes depreciation is generally calculated on a straight-line basis over an estimate of an asset's expected useful life. For tax purposes, depreciation is generally calculated using an accelerated method. In the early years of an asset's life, accelerated depreciation for tax purposes will result in taxable income being lower than income for financial reporting purposes. Because total depreciation over an asset's life can sum to no more than the asset's cost, depreciation taken in the later years of an asset's life will be lower for tax purposes than for financial reporting purposes.

The second source of difference between financial reporting and taxable income arises when revenue or expense is recognized under one system but not the other. For example, interest on municipal bonds and a portion of intercorporate dividends received are generally excluded from a corporation's taxable income, but considered income for financial reporting purposes. Unlike timing differences, these differences do not reverse (and are thus referred to as permanent differences) and do not give rise to deferred tax assets or liabilities and related expenses. Firms are required to quantify material permanent differences in a reconciliation of the firm's effective tax rate in their tax footnote. Notably, non-qualified stock options generate substantial permanent differences that are not reconciled in the tax footnote.

In addition to these measurement differences, it is also important to note that entities combined in the financial reports will generally be more inclusive than the consolidated entity for tax purposes. For financial reporting purposes, firms are required to file consolidated financial statements for worldwide operations in which the parent has at least a 50 percent interest. For tax purposes, consolidation is voluntary and is only permitted for 80 percent owned domestic corporations. As a result, an observed set of consolidated financial statements can

include any number of separate taxable entities.

Beyond the differing objectives of financial reporting and tax rule makers, firms face different incentives for financial reporting and tax reporting. Specifically, managers of firms may have incentives to increase income reported to shareholders while at the same time making choices that minimize reported taxable income. It is apparent from the academic literature and from known transactions that neither tax nor financial reporting considerations consistently dominates the other. Firms may be willing to pay more in taxes if it is necessary to achieve financial reporting objectives, or decrease reported earnings if the tax savings are large enough.

The conflicting objectives guiding the development of rules for financial reporting and tax reporting and the differing incentives of preparers with respect to the two different measurements ultimately result in differences between financial reporting income and taxable income. Data on the differences in income reported under each system has been published only sporadically and not necessarily in comparable ways, but some comparisons over time can be made. Data from the 1970s suggest book net income was approximately 20 percent larger than after-tax tax net income (ranging from 7 percent in 1975 to nearly 40 percent in 1972). During the late 1990s book net income exceeded after-tax tax net income by more than 36 percent in each year, including a difference in excess of 70 percent in 1998. These percentages, however, mask the economic significance of the magnitude of these differences. From 1996 to 1998, the dollar amount of the difference in pretax income grew from \$92.5 billion to more than \$159.0 billion, an increase of nearly 72 percent. In 1998, the difference in pretax income equaled 24.2 percent of total tax net income. This growth from 1996 to 1998 does not appear to be driven primarily by stock options, which reduce taxable income without affecting book income. Overall, from 1996 to 1998, tax net income fell slightly while pretax book income grew 8.5

percent.

In a paper coauthored with Gil Manzon of Boston College and published a year ago in the *Tax Law Review*, we conclude a small number of factors are responsible for a significant amount of book-tax differences, and that accounting and economic factors explain a relatively stable share of the difference in each year. However, given the increasing magnitude of the difference, the dollar value of the unexplained portion is continuing to increase.

The evidence shows that large book tax differences are neither economically insignificant nor a transitory feature of the tax system. A full understanding of the tax system, and firms' response, requires access to comprehensive information about the specific sources of accounting differences, a point I will address below. However, an important consideration particularly relevant to today's discussion is whether these large differences are due to firms actively seeking to decrease their taxable income, to efforts to overstate their financial reporting income, or a combination of both.

Given the potentially competing tax and financial reporting incentives, a well-designed tax strategy may well reduce taxable income, leaving income reported for financial purposes unaffected. David Weisbach (2002) asserts that “[v]irtually no shelters in the current market reduce book income.” While any reporting difference should be reflected in the Schedule M-1 or the tax footnote of financial statements, the degree of detail within these schedules is insufficient to easily make inferences about sheltering activities.

The Senate Committee on Governmental Affairs held a series of hearings during 2002 on the role of financial institutions played in Enron's collapse. These hearings highlighted transactions which primarily resulted in Enron improperly recording revenues or improperly classifying sources of cash flows. On January 2, 2003, the Permanent Subcommittee on Investigations of

the Senate Committee on Governmental Affairs, released a report on *Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions*. Each of these transactions were related to Enron's initiatives on electronic trading in the paper and pulp industry. Regarding these transactions, three (*Fishtail, Bacchus, Sundance*) were classified by the Subcommittee staff as sham asset sales, and do not appear to have been motivated by tax reasons nor directly affected Enron's tax liability. Rather, as the report suggests these transactions "enabled Enron to produce misleading financial statements that made Enron's financial condition appear better than it was." (page 3) The fourth transaction, *Slapshot*, was categorized as a sham loan designed to reduce Canadian taxes, but which would not reduce U.S. tax liabilities or produce a tax benefit for financial reporting purposes. The report concluded

The cumulative evidence from the three Subcommittee hearings demonstrates that some U.S. financial institutions have been designing, participating in, and profiting from complex financial transactions explicitly intended to help U.S. public companies engage in deceptive accounting or tax strategies. This evidence also shows that some U.S. financial institutions and public companies have been misusing structured finance vehicles, originally designed to lower financing costs and spread investment risk, to carry out sham transactions that have no legitimate business purpose and mislead investors, analysts, and regulators about companies' activities, tax obligations, and true financial condition. (Page 2)

The results of the Permanent Subcommittee's report suggest that many of the book tax differences of Enron were not solely due to tax-minimizing behavior, but rather inappropriate revenue recognition. If companies engage in both types of transactions, book tax differences will be even larger. However, it is not clear firms provide sufficient information for outside monitors to disentangle these effects. The next section specifically addresses this issue.

## **Disclosure**

An important element of outsiders ability to understanding the role of taxes is being able to know the amount of taxes paid. On July 8, 2002, Chairman Grassley wrote the Treasury Secretary and the Chairman of the Securities and Exchange Commission asking “whether 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.”

To provide my answer to the additional question of whether “sufficient tax information is already publicly available,” the short answer is no, it is not. As the Chairman observed in his letter, analysts had differing estimates of Enron’s taxes even though common financial information was available to all. The difficulties in the ability to reconcile the tax return and the financial statements are not limited to Enron, nor are the affected users only the financial community. It does not appear to me that either tax authorities, or investors, have all of the information that could be made available about a firm’s tax position, and major improvements would not be difficult to achieve. Shortcomings in the current state of financial and tax information suggest a failure of both sets of regulatory guidelines.

At this point, I am not convinced full public disclosure of corporate returns is warranted, and recognize the confidentiality concerns expressed by firms as to revealing potentially sensitive competitive information. However, I am convinced that more and better disclosure of tax information could be achieved with little, or no, additional administrative or economic cost to the firm.

Lillian Mills of the University of Arizona and I have outlined a proposal for substantial revisions to the Schedule M-1. The existing schedule, largely unchanged since its introduction in 1963, currently provides insufficient detail related to many reconciliation issues. Our

proposed modifications provide for a more detailed reconciliation anchored to income numbers reported in a firm's 10-K.

In addition to improvements in tax administration, we conclude that any debate on public disclosure of corporate tax return information should begin with the idea of disclosing the information on the Schedule M-1. We argue that, potentially, the entire M-1 of each return filed could be made publicly available, as it contains information that others, such as FASB, have already deemed as important to the general public. Revisions to the Schedule M-1 should not pose a significant problem to firms from either a regulatory burden or competitiveness standpoint. From a burden view, the details that would be provided in a modified M-1 should already be available as part of a firm's normal filing. From a competitive perspective, any concern that these disclosures would harm a company should be considered only to the extent to which new information goes beyond the detail a firm should be providing under GAAP.

### **Dividend Relief and Tax-Minimizing Transactions**

Let me address a final issue this committee will soon be considering, and one related to the broader accounting issues we are discussing today. This issue is the effect of recently proposed changes to the taxation of dividends, and in particular the incentives that any change may have on the aggressive pursuit of tax minimizing behavior. While the general topic of dividend relief is outside the scope of today's hearing, the argument has been made that the proposal will discourage companies from engaging in aggressive tax planning because "[t]he less tax paid by a corporation, the less tax-free cash that can be paid to its shareholders" (Treasury Office of Public Affairs, KD-3762, January 14, 2003). While this statement is qualitatively true, I think any quantitative effect is likely to be small.

There are strong economic arguments to be made for integrating the corporate and individual taxes as part of a broad and fundamental tax reform. Tax distinctions between debt and equity invite complicated transactions as firms seek to exploit one or the other characterization. Many of these types of transactions were typical of those engaged in by Enron. However, taxes are not always the primary motivation, but rather other incentives that firms face in the financial markets, or incentives faced by managers within the firm.

The assumption has always been that firms seek to maximize shareholder wealth by increasing the value of their shares. Consistent with this is the maximization of after-tax profits or cash flows. Theory suggests firms should consider the tax situation of their investors, but there is no strong evidence that firms operate in such a manner. The market solves this issue on its own, with market participants making investments in opportunities that match their desires for taxable or tax-preferred returns. Many market participants will either not benefit or remain indifferent to dividend relief. In such an environment, it will still make sense for corporations to maximize their own after-tax profits. Further, given the continued preference for long-term capital gains, taxable investors may still be better off through a combination of tax minimization, retention, and deferral. The incentive to minimize taxes will continue to be reinforced unless alternatives to current managerial compensation schemes are developed, as they tend to focus on after-tax returns or stock prices.

Thank you, again, for the opportunity to be here today. I look forward to the further discussion of these issues.

## Selected References and Sources for Additional Information

- Dworin, L., 1985, "On Estimating Corporate Tax Liabilities from Financial Statements." *Tax Notes*, (December 2): 965.
- Manzon, G., and G.A. Plesko, 2002, "The Relation Between Financial and Tax Reporting Measures of Income," *Tax Law Review* 55(2): 175.
- Mills, L., K. Newberry and D. Trautman, W.B., 2002, "Trends in Book-tax income and Balance Sheet Differences," *Tax Notes* (August 19): 1109.
- Mills, L., and G.A. Plesko, 2003, "Bridging the Reporting Gap: a Proposal for More Informative Reconciling of Book and Tax Income," working paper, University of Arizona and MIT
- Plesko, G.A., 2000, "Book-Tax Differences and the Measurement of Corporate Income," in *Proceedings of the Ninety-Second Annual Conference on Taxation, 1999* (Washington DC: National Tax Association): 171.
- Plesko, G.A., 2000, "Evidence and Theory on Corporate Tax Shelters," *Proceedings of the Ninety-Second Annual Conference on Taxation, 1999* (Washington DC: National Tax Association): 367.
- Plesko, G. 2002. Reconciling Corporation Book and Tax Net Income, Tax Years 1996-1998. *SOI Bulletin*, (Spring): 1.
- Plesko, G.A., 2003, "An Evaluation of Alternative Measures of Corporate Tax Rates," forthcoming, *Journal of Accounting and Economics*.
- Talisman, J., 2000, "Penalty and Interest Provisions, Corporate Tax Shelters" U.S. Department of the Treasury, Testimony before the Senate Committee on Finance (March 8)
- U.S. Department of the Treasury, 1999, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (Washington, D.C.: U.S. GPO).
- U.S. Senate, 2003, "Report On Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated By U.S. Financial Institutions," Committee on Governmental Affairs, Permanent Subcommittee on Investigations, (January 2)
- Weisbach, D., 2002, "Ten Truths About Tax Shelters," *Tax Law Review*, 55: 201.