2009 Erwin N. Griswold Lecture Before the American College of Tax Counsel: Rethinking the Advantage of Tax Deferral

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I want to thank the officers and Board of Regents of the American College of Tax Counsel for inviting me to give this lecture. It is a great opportunity to think more deeply about some ideas that have been with me for some time.

It appears to be customary at this event to talk about the speaker's connection to Erwin Griswold. Mine was fairly limited and perhaps not quite as positive as the previous lecturers. Dean Griswold was my teacher in the basic tax course, and about 20 years later, when I was Deputy Assistant Secretary for Tax Policy, he introduced me as the luncheon speaker at the New England Tax Institute. Eddie Cohen in his Griswold lecture mentioned that the Dean took so long to introduce him at that event, that there was no time to give his talk.[1] Unfortunately for my audience, the Dean did not know that much about me. Griswold, in fact, was almost certainly unaware that he was my teacher in a course in which I received my lowest law school grade. It is time to forgive. I hope, after nearly 50 years, the Dean, were he here today, would recognize that even he could make mistakes. At least I hope he made one.

Since I no longer do any consulting and have limited my teaching to the basic tax course, each year I know less and less about what concerns you each day. Therefore, it is not obvious how to proceed. It is certainly tempting to offer my advice to the new administration for new directions in tax policy. However, those of you who are familiar with my work are aware that would be totally out of character. Over nearly the last 40 years, my scholarship has been motivated by the proposition that we will continue to have an income tax, and I have tried to offer suggestions for making it more coherent and, hopefully, simpler. It seems sensible, therefore, to take advantage of this opportunity to attempt to increase awareness of some of my work and hopefully to get some feedback. I am particularly interested in how many of you already make use of the ideas I will discuss.

It has been more than ten years since I last spoke to a group of tax lawyers. In 1997 when I delivered the Woodworth Lecture in the Ways and Means Committee room, my theme was that it was "increasingly difficult to maintain that the tax base for capital income is even an approximate measure of true economic income from capital."[2] In an overly dramatic flourish, my title, *Saving the Income Tax*, made clear my belief that it was imperative that "real-

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[1] *See* Edwin S. Cohen, *The Erwin N. Griswold Lecture*, 12 Am. J. Tax Pol'y 1, 2 (1995).

[2] Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, 77 Tax Notes (TA) 967, 967 (Nov. 24, 1997), *reprinted in* 24 Ohio N.U. L. Rev. 493 (1998).

ization plays a less important role in the timing of both income and loss."[3]

I suggested that the first step to achieving an approximate match between taxable and economic income was to require mark-to-market for tradable securities, most debt instruments, and their derivatives. I recognized such a proposal, particularly if accompanied by elimination of the special treatment for capital gains, would not in itself engender a great deal of support or even interest.[4] I believe, however, that mark-to-market would make it more feasible to modify those elements of our income tax which lead to over taxation of income from capital. Thus, full loss offsets, elimination of the corporate level tax for publicly traded companies, and inflation indexing should be easier to achieve in a mark-to-market system. If so, the tax treatment of income from capital would certainly be fairer and more efficient and not necessarily any more burdensome overall.

Of course, I recognize that there are many potential roadblocks to the proposed course of action. Thus, the lecture was subtitled *An Agenda for Research*. My hope was that a group like this, or the ALI, would respond by setting up a panel to study whether the proposal was in fact feasible. I do make my students read the paper each year. But aside from that captive audience, my Woodworth Lecture has been generally ignored. While the surprising recent turmoil in the financial markets raises concerns, I continue to believe that this project is worthwhile, and I urge you to read the 1997 lecture and give it some serious thought.

I turn now to a more current project affecting the timing of income, which could also benefit from your input and advice. This project involves the claim that deferral of tax is often not an advantage unless it leads to more favorable tax treatment of what I will call the "interim investment income"—that is, the investment return between the date the deferred income accrues and the date it is taxed. This view of tax deferral suggests that the tax rate applied to this income is often the key to whether deferral is an advantage.

Using this idea (continuing in my guise as Don Quixote), in a 2007 article in *Tax Notes* magazine, I (and my coauthor Ethan Yale) proposed an alternative to the treatment of nonqualified deferred compensation.[5] We argued that the tax advantage of deferring compensation is, as I have said and will describe in more detail shortly, primarily the possibility of a reduced tax burden on the interim investment return. We suggested this advantage could be eliminated by a special tax on investment income, equivalent to the rate that would be paid by the employee on her own investments. Our point was that if investment income were appropriately taxed, deferral of compensation would no longer be a concern.

Therefore, we could give employees complete freedom to defer or receive

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[3] *Id.* at 968.

[4] *Id.*

[5] *See* Daniel Halperin & Ethan Yale, *Deferred Compensation Revisited*, 114 Tax Notes (TA) 939 (Mar. 5, 2007).

compensation at will and to secure any deferred compensation against the claims of the employer's creditors. In short, neither the constructive receipt nor economic benefit doctrine need apply.[6] The treatment of deferred compensation under section 409A could be substantially simpler.

Given the enormity of the complaints about the complexity and harshness of section 409A,[7] I hoped this proposal might attract the attention of the bar. On the other hand, I expected some concern from my fellow academics as to the just described elimination of the constructive receipt and economic benefit doctrines. Actually, very little of either occurred.

Perhaps, those who were intrigued by the proposal did not believe that such a radical idea could survive the legislative process or that the result might be a special tax on investment income on top of all the section 409A restrictions. Others, presumably, did not want to give up the advantage of potentially totally avoiding tax on the investment return and were willing to live with section 409A if they had to, or perhaps they hoped, not unreasonably, that this section would soon collapse under its own weight. It also may be that the concept underlying the proposal, which I think is not widely understood even within the academy, just did not get across. So forgive me if I view this as an ideal opportunity to try to clarify my views.

As I hope you are at least vaguely aware, for over 25 years, I have been focusing a good deal of my effort on so-called time value of money issues. In 1986, in an article entitled *Interest in Disguise: Taxing the "Time Value of Money*," I noted that, contrary to what I was taught in law school and in practice, the timing of income or deductions is often *not* important.[8]

Thus, in many cases where a taxable item, such as compensation, is deferred, the tax base and, therefore, the tax paid increases by the after-tax rate of return. Because this increase in tax liability occurs, the timing of the inclusion or deduction does not affect the present value of the tax liability with respect to compensation. (This is shown in Example 1.)[9]

In the example, the employee earns $100,000 in Year 1. However, payment

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[6] *See* Rev. Rul. 1960-31, 1960-1 C.B. 174.

[7] *See, e.g.*, Richard J. Bronstein, *Rethinking Code Sec. 409A*, Taxes: The Tax Magazine, Mar. 2006, at 179.

[8] Daniel Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 Yale L.J. 506, 522–24 (1986) [hereinafter Halperin, *Time Value of Money*].

[9]

Example 1	Compensation Deferred (Year 1)	Future Amount Payable (Year 10)
	$100,000	$150,000
Tax	$35,000	$52,500

At the relevant after-tax rate of return (50%), $52,500 and $150,000 are the future value of $35,000 and $100,000, respectively. As discussed below, the investment return ($50,000) is therefore *not* taxed to employee.

is deferred until Year 10, at which time the employee is to receive the amount originally set aside, increased by the return on an actual or hypothetical investment of this amount in specified property. In Year 10, the employee receives $150,000 and, under current law, is taxed on this amount at that time.

Given these rules, we have generally explained the advantage of deferred compensation as delayed taxation until Year 10 of both the original compensation ($100,000) and the interest element ($50,000). In contrast, I suggest that the amount subject to tax on distribution ($150,000) is actually the future value of the original compensation—the amount earned ($100,000) increased by the after-tax rate of return.

The tax also increases by a similar percentage as long as the marginal tax rate remains the same (in the example, 35%). At the relevant after-tax rate of return, the tax that would have been paid in Year 1 ($35,000) is equivalent in terms of present value to the tax paid in the year of distribution ($52,500). Tax is deferred, but it increases to compensate for the deferral.

Looked at this way, the $100,000 compensation is fully taxed despite the delay but—*and this is key*—the investment income ($50,000) is not taxed to the employee at all. This is so even though, since the nominal amount subject to tax is the sum of the original compensation plus the investment income, it appears that the investment return is taxed. (Again, look at Example 1.) From this perspective, deferral can be said to result in tax exemption for investment income. However, that is not the whole story.

For similar reasons, the employer's deduction, again, $150,000 in Year 10, can also be described as the future value of the original compensation. Therefore, the employer does, despite the delay, actually deduct the true value of the compensation. However, just as the employee is not taxed on the investment return, the employer effectively gets no deduction for the additional $50,000, which could be considered interest on the deferred amount. From that vantage point, since the employer is taxed on investment income as it is earned and gets no offsetting deduction, deferred compensation effectively results in taxation of the investment return at the employer level. Although the investment income is, thus, effectively not exempt, this shift in taxation will be an advantage if the employer's marginal tax rate is lower.

Thinking of the treatment of deferred compensation as if the original compensation is fully taxed and the interest element is exempt not only makes it easier to understand the advantage but is also a more accurate description of the impact of deferral. To appreciate why it is more accurate to focus on the tax burden on investment income, consider the impact if the deferred compensation were invested in tax-exempt bonds or perhaps life insurance.

(Here look to Example 2.)[10] Since this income is exempt in all circumstances, the possible advantage of shifting the tax burden to an effectively tax-exempt employer disappears. In the example, the return is eight percent to both the employee and the exempt employer, and the accumulated income is the same even though the employer invested the full before-tax compensation ($100,000) rather than the $65,000 after-tax amount. This would not be true if the treatment of deferred compensation were appropriately described as tax deferral for both the original compensation and the investment return. If that were so, the advantage of deferring tax on the original compensation should remain despite the tax-exempt investment. Importantly, when the tax base increases, deferral does not amount to an interest-free loan. Rather, one is borrowing from the government at one's own after-tax rate of return. In the example, one is effectively borrowing $35,000 by the deferral of tax and repaying $52,500.

In short, aside from the possibility of a different tax burden on the interim investment income, deferral or acceleration of deductions or income is in many cases not an advantage or disadvantage. Of course, the timing of inclusion and deduction could affect the marginal rate of tax. Thus, if the employee's marginal rate at the time of distribution is lower than it was when the compensation is earned, there would be a tax savings to the employee. Similarly, the corporation could save taxes if it gets a greater benefit from the deferred deduction, perhaps, because section 162(m) no longer applies to the employee.[11] I will, for purpose of this discussion, however, ignore these effects, which my proposal would not affect, and focus on the treatment of the interim investment income. I believe this is most relevant in assessing whether the current treatment of deferred compensation is appropriate.[12]

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Example 2	Compensation Paid Currently	Compensation Deferred Employer not taxable
	$100,000	$100,000
Tax Paid at 35%	$35,000	
Net Investment	$65,000	$100,000
Tax-Exempt Interest at 8%	$5,200	$8,000
Paid to Employee		$108,000
Tax at 35%		$37,800
Net to Employee	$70,200	$70,200

[11] This section limits to $1 million the deduction for nonperformance based compensation paid by a publicly held corporation to its current CEO and the four highest compensated officers for the taxable year as reported to shareholders under the Securities Exchange Act of 1934. *See* I.R.C. § 162(m).

[12] *See* Halperin & Yale, *supra* note 5, at 941–42 (describing reasons supporting this position).

While this idea that deferral may not be advantageous may be not well understood even within the academy, perhaps surprisingly, we all know, or at least we accept, that Roth IRAs[13] and traditional IRAs[14] can be equivalent.[15] *Same idea.* The deferred amount included in income on the distribution from the traditional IRA ($150,000 in the example, assuming the deferral is within an IRA) is merely the future value of the amount contributed to the Roth ($100,000) and taxed at that time. Thus, if tax rates do not change, in terms of present value, the tax paid is identical. Put another way, a Roth has neither a current deduction nor a future inclusion. A traditional IRA has both. However, while the nominal amount of the deduction and the inclusion are different, in present value terms, the deduction for the contribution to the traditional IRA ($100,000) and the inclusion of income on distribution ($150,000) are equal. Thus, if tax rates do not change, the deduction and inclusion offset each other, and the combination is the same as if both were eliminated, as they are in the Roth.

In the case of both IRAs, there is, of course, complete exemption for investment income. With respect to nonqualified compensation, however, since the interim investment return is taxed to the employer rather than to the employee, there is an overall tax savings whenever the employer's extra tax, if any, on the investment income is lower than the amount the employee would pay on her own investments.

Since the tax rate on corporations is generally equivalent to the top individual rate, the employer's tax burden would seem to be less only if the employer is exempt from tax. This could occur if the employer is a government or tax-exempt institution, a foreign entity not subject to United States tax, or has tax losses (including carryovers) in excess of taxable income.

However, in the case of government and tax-exempt employers, in most cases, section 457 requires current taxation of even unfunded deferred compensation. It does permit deferred taxation of the investment return, but since ordinary income rates apply, much, if not all, of the advantage is eliminated. An alternative to section 457 (and 457A, described next), of course, would be to allow these exempt entities to defer compensation as long as the investment return was subject to current tax at the rate the employee pays on her own investments.

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[13] *See* I.R.C. § 408A.

[14] *See* I.R.C. § 408.

[15] *See, e.g.*, E. Frank Stephenson & Doug Waggle, *A Reexamination of the Tax Effects of Traditional and Roth IRAs*, 2001 Law Rev. Mich. St. U. Detroit C. L. 139, 140 (2001) (comparing Lewis's Roth IRA with Clark's traditional IRA: "Once the difference in the timing of the tax payments is accounted for, Lewis and Clark pay equal amounts of tax on their IRAs."). I might note in passing that the equivalence of the Roth and traditional IRA depends on the relative size of the accounts. The taxpayer owns the entire Roth, but effectively only a portion of the traditional account. The government effectively owns a portion equivalent to the marginal tax rate, which it will collect on distribution. Therefore, if the two accounts are the same size, the Roth provides more in the way of tax-free buildup.

Beginning this year, there is treatment similar to section 457 for certain foreign entities and partnerships with tax-exempt partners, under section 457A, a provision apparently even more complex than section 409A.[16] Assuming (probably, too optimistically) that section 457A will be fully effective in preventing reduced taxation of investment income outside the United States, shifting of the tax burden to the employer now appears to raise a problem of an overall lower rate of tax on investment income, primarily in the case of corporations with net operating losses.

However, there is one important exception to the idea that deferred compensation will be tax advantaged only if the employer is not paying taxes, namely equity-based compensation. In short, since dividends (or payments in redemption of stock) are not normally deductible, the fact that the corporation is effectively not deducting the time value return, with respect to equity-based deferred compensation, is not a departure from normal treatment. Therefore, there is no corresponding extra tax burden on the employer to offset the exemption to the employee. Equity-based deferred compensation is unequivocally a tax advantage, even if the employer is fully subject to current tax on its investment income and even if the employer must pay more tax currently because its deduction for compensation is deferred.

I am not sure if this advantage of equity-based compensation is widely understood. In fact, the academic literature has only recently addressed this issue in detail.[17] Michael Knoll and David Walker have discussed the tax advantages of equity-based compensation, both beginning with the assumption that the employee is effectively exempt on the investment return.[18] Knoll assumes that the level of corporate equity, and therefore the corporate tax burden, will not change and discusses the tax advantage to the employee by comparing her alternative investment choice.[19]

Walker does not hold equity constant and expressed the belief that there is no tax advantage to equity-based compensation if the total equity of the corporation increases by the amount deferred.[20] In that case, there would be an additional corporate level tax, which is said to offset the effective tax exemption at the employee level. Thus, if the cash saved by deferring compensation is used to expand the size of the corporation (or to pay debt which had

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[16] *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 801, 122 Stat. 3765, 3929–33.

[17] I "discovered" (I think that is the right word) this potential advantage towards the end of the five years I spent working on "Time Value of Money." Since, at this late date, it was difficult to rewrite the text, which described the problem in terms of employers that were effectively tax exempt, I inappropriately primarily described this important point in a footnote, as if it were only of passing interest. *See* Halperin, *Time Value of Money*, *supra* note 8, at 540 n.133. Of course, few read the footnote.

[18] *See* Michael S. Knoll, *The Tax Efficiency of Stock-Based Compensation*, 103 Tax Notes (TA) 203, 210–12 (Apr. 12, 2004); David I. Walker, *Is Equity Compensation Tax Advantaged?*, 84 B.U. L. Rev. 695, 708–27 (2004).

[19] *See* Knoll, *supra* note 18.

[20] *See* Walker, *supra* note 18, at 727–36.

previously provided an interest deduction), the size of the corporate tax base increases ostensibly, offsetting the advantage to the employee.[21] Therefore, Walker has attempted to determine, as an empirical matter, how often there is an increased corporate tax base as a result of the issuance of stock options, or other equity-based compensation, in lieu of cash compensation.[22]

It has recently occurred to me that this approach may not be correct. In short, if there is more income at the corporate level, there should be both a corporate and a shareholder level tax. Since, in the case of equity-based deferred compensation, only the corporation is taxed on the additional income, there is a tax advantage. The fact that the corporate tax base increases does not in itself offset the employee's exemption for investment income.

To explain further, as noted, deferred compensation can be thought of as exempting the investment return to the employee and denying a deduction to the employer for the distribution of this return. These effects offset if the parties are in the same bracket as long as the employer corporation would otherwise have been entitled to a deduction. In the case of equity-based compensation, the employer would not have had a deduction in any event, and therefore the fact that the corporate tax base goes up if the corporation substitutes equity for debt or the corporation expands would seem to me to be insufficient.

This advantage for equity-based compensation suggests that nonqualified deferred compensation offers a tax benefit in more circumstances that we might have thought. It also seems likely that the economic downturn will increase the number of corporations not currently subject to tax. Finally, there seems to be a reasonable prospect that the corporate rate may be lowered without reducing individual rates.[23] Thus, despite section 409A, deferred compensation remains a problem.[24]

I believe that the least disruptive course to removing the advantage would be to tax the investment income earned on deferred compensation at the employee's rate. The appropriate tax rate on investment income can be achieved if we require employer withholding on the relevant investment income and report both the investment return and the withheld taxes on a W-2.

Of course, the reference to the *relevant* investment income jumps over the

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[21] *Id.* at 731–32, 735.

[22] *See id.* at 742–53.

[23] Ryan J. Donmoyer & Peter Cook, *Rangel Plans Push to Cut Top Corporate Tax Rate to 28 Percent*, Bloomberg, Nov. 15, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=ag7lSuB.yyII ("New York Representative Charles Rangel said he's revising his tax overhaul proposal to reduce U.S. corporate tax rates to 28 percent, down from the current rate of 35 percent."); Peter Ferrara, Commentary, *Tax Cuts Would Really Stimulate*, Forbes.com, Feb. 4, 2009, http://www.forbes.com/2009/02/04/tax-cut-stimulus-opinions-contributors_0204_peter_ferrara.html ("For the U.S. economy to remain internationally competitive, the federal corporate rate should be slashed to 20%.").

[24] Although, I suppose it is possible that if employees must really rely on the creditworthiness of the employer, they may have recently become more reluctant to do so. Perhaps, there is always a silver lining in any disaster.

complex question as to how this income would be identified. I am confident, however, that given time, the problem is soluble. A starting point would be to recognize that the arrangement between the employer and the employee could, depending on the circumstances, be described in one of three ways and taxed accordingly. Thus, the employee has either made a loan to the employer, an equity investment in the employer, or has utilized the employer as a conduit to hold her investments. The latter, which is the easiest to implement, occurs when the amount deferred is segregated and invested on behalf of the employee, as it often is.[25]

Despite the difficulty of identifying the amount and the nature of the appropriate investment return, my recent proposal was offered in the spirit of furthering simplicity. It is premised on the idea that if we can achieve an appropriate level of tax on investment income, we need not be concerned about the circumstances under which deferral can be achieved. We can continue to allow deferral of tax on the compensation itself and, in fact, make it easier to accomplish. In short, deferred compensation could be taxed when paid without regard to constructive receipt or economic benefit. Funding could be allowed so the employee need not rely on the credit worthiness of the employer to achieve deferral. While we still must identify the existence of deferred compensation and the return thereon, most of the complexity of section 409A would be eliminated.

As I have previously indicated, I am nervous about the policy implications of this possible largesse to a largely affluent group. However, we would, in many circumstances, be increasing the tax burden. We also have to recognize that both tax reform and tax simplification have a price.

If the focus on investment income can win acceptance, there are, I think, many other potential applications. Although, in the 1986 article, I focused on deferred compensation, it was exposure to a number of issues when I was at the Treasury that turned me on to the idea that deferral or acceleration of income or deductions might not be that important if we could achieve the appropriate treatment of investment income. Alvin Warren summarized the existing literature on the possibility that deferral is not an advantage in a 1986 article in the *National Tax Journal* entitled *The Timing of Taxes*.[26] Among other issues, Warren considered estate and gift taxes, dividend payments, and the treatment of mutual life insurance companies.

Continued exploration has brought home the ubiquitousness of the circumstances to which this idea could apply. For example, in a work in progress, I examine related activities of a charitable organization and the exemption of income from such activity which is set aside for future expenditures[27]—to

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[25] Halperin & Yale, *supra* note 5, at 943–44.

[26] *See* Alvin C. Warren Jr., *The Timing of Taxes*, 39 Nat'l Tax J. 499 (1986).

[27] *See* Daniel Halperin, Does Tax Exemption for Charitable Endowments Subsidize Excess Accumulations (June 10, 2008) (unpublished manuscript, on file with author); *see also* Daniel Halperin, *Income Taxation of Mutual Nonprofits*, 59 Tax L. Rev. 133, 141–42 (2006) (making similar point).

take a random example, Harvard University setting aside current tuition to pay my salary next year.[28] Example 3 shows that Harvard would not be harmed if the amount put aside to pay my salary were taxed and the salary deducted when paid. In other words, the exemption for income which is used for expenditures that would be deductible when incurred may not be an advantage.

To explain further, in the example, $100,000 (the amount effectively deducted by the exemption in Year 1) is the present value in Year 1 of the $110,000 salary payment in Year 2. The example demonstrates that there may be no difference in result between the current exemption and actually taxing the income and allowing the deduction in the normal course. Exemption can be thought of as merely allowing a properly measured current deduction for the present value of that future salary payment.

To take another example, which is more relevant to many of you, you can apply this analysis to deferral of foreign earnings, an insight I owe to Professor Warren. I think we generally think that postponing repatriation of overseas profits reduces the tax burden on these earnings. *Not so*. Since the tax base increases by the after-tax rate of return, the present value of the tax liability is unchanged by deferral alone. Unless we get another tax holiday,[29] delay alone will not reduce the burden on earnings which are eventually repatriated.

Again, the important factor is the avoidance of U.S. tax on the *earnings produced* by the funds kept overseas. Recognition that avoiding the U.S. tax on the earnings on the unrepatriated amount is the real advantage suggests that we could eliminate or mitigate the advantage of deferral by imposing a U.S. tax on the actual or imputed return on the deferred amount. In fact we do impose a tax on passive income under Subpart F.[30]

Perhaps more relevant to your concerns, this approach to deferral could make it easier to decide whether repatriation makes sense. Thus, this analysis

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Example 3		Current Law	Income Taxable
Year 1	Harvard puts aside for future salary	$100,000	$100,000
	Tax at 35%	____	$35,000
	Investment	$100,000	$65,000
	Return 10% (after-tax, if any)	$10,000	$6,500
	Total	$110,000	$71,500
	Tax Savings $110,000 deduction		$38,500
Year 2	Amount available for salary	$110,000	$110,000

[29] *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 422, 118 Stat. 1418, 1514–19 (codified at I.R.C. § 965).

[30] *See* I.R.C. §§ 951(a)(1)(A)(i), 952(a)(2), 954(a)(1), (c).

suggests that the repatriation decision should be based upon the comparative after-tax rate of return between foreign and domestic investment. Income earned abroad is presumably subject to a lower tax rate, but here, attention should be paid to the possibility of increased *before*-tax earnings in the United States. The United States Chamber of Commerce has urged unsuccessfully that the stimulus package again allow foreign earnings to be repatriated at a reduced rate so companies could, in their words, use these earnings to "ameliorate some of the liquidity challenges," "relieve some stress on the commercial paper market," "make contributions to their pension plans," and "generally increase funds available to business."[31]

The claim that another tax holiday is appropriate and the attention being paid to the most efficient means of repatriation certainly suggests that there are superior opportunities in the United States.[32] If so, after-tax earnings could be higher despite a greater tax burden. In particular, this could occur if repatriated earnings replace borrowing, which would have cost more than the foreign rate of return.

In addition to the after-tax return, however, companies could care about the financial statement impact of repatriation and the cash outlay to pay the U.S. tax. As to the latter, I would assume that, in most cases, companies will have access to the capital markets, the current situation being an aberration. Moreover, as noted above, the amount "borrowed" from the Treasury by deferring repatriation is not interest-free. If it is ever repaid by repatriation, it carries interest at the company's own after-tax rate of return.

I understand that the potential U.S. tax on foreign income will not be a current charge to earnings as long as the company represents that the earnings will be permanently invested by the foreign subsidiary.[33] Thus, repatriation could impact earnings per share. It is of concern that a financial statement focus, which is often misleading, too often affects behavior (a subject for another day). In this case, it may be particularly troublesome that, under the analysis put forth here, the burden of the U.S. tax will not be affected by deferral unless, of course, "permanently reinvested" actually means permanent.

In any rate, if I am right that the burden on repatriated foreign earnings is not affected by deferral, then the current distribution of dividends by domestic corporations to their shareholders would similarly not increase the tax bur-

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[31] *See* Letter from R. Bruce Josten, Executive Vice President for Gov't Affairs, U.S. Chamber of Commerce, to the Members of the U.S. Congress (Nov. 7, 2008), *available at* http://www.uschamber.com/issues/letters/2008/081107_econstimulus.htm.

[32] *See, e.g.*, Rosanne Altshuler & Harry Grubert, *Repatriation Taxes, Repatriation Strategies, and Multinational Financial Policy*, 87 J. Pub. Econ. 73 (2002).

[33] *See Accounting for Income Taxes,* Statement of Financial Accounting Standards No. 109, § 31 (Fin. Accounting Standards Bd. 1992).

den.[34] This assumes that the rate imposed on the distribution is not affected by the delay, which is, of course, more likely to occur as long as dividends are taxed at the same rate as capital gains.[35]

As described above in the case of deferred compensation, the delayed distribution, while larger, is equal to the future value of the dividend which could have been distributed earlier. It does not effectively include the investment return. Thus, while deferral of the distribution does not affect the shareholder's tax burden on the dividend, the shareholder pays no tax on the interim corporate income. This income remains taxable at the corporate level, and of course, there is no deduction for any distribution. Thus, as to the interim return, only the corporate tax rate matters.

This insight might become useful if, in fact, Congress goes ahead and reduces the corporate tax rate, as many have suggested. If this occurs, we will once again have to evaluate the possible advantage of Subchapter C as compared to a pass-through entity. This comparison can be complicated since a lower corporate rate indicates that after-tax earnings would accumulate at a faster rate inside a C corporation than they could in a pass-through entity. On the other hand, the single rate that would apply to a pass-through entity could be lower than the combined corporate and shareholder rate.

Suppose, for example (see Example 4),[36] that in the case of a pass-through entity, the individual level tax would be 35%, leaving $65 after tax out of each $100 of income. On the other hand, the combined corporate and shareholder level tax would be 40% (perhaps a corporate rate of 25% and a capital gain rate of 20%), so the after-tax return from a Subchapter C corporation would be effectively only $60 on $100 of income (whether or not the shareholder level tax is deferred).

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[34] *See* Am. Law Inst., Federal Income Tax Project, Subchapter C: Proposals on Corporate Acquisitions and Dispositions and Reporter's Study of the Taxation of Corporate Distributions 350 (1982); David F. Bradford, *The Incidence and Allocation Effect of a Tax on Corporate Distributions*, 15 J. Pub. Econ. 1 (1981); Warren, *supra* note 26, at 501.

[35] *See* I.R.C. § 1(h)(3)(B).

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Example 4

	Pass Through	Subchapter C
Income	$100	$100
Tax on entity income	$35 (35%)	$25 (25%)
		$75
Capital gain at 20%	___	$15
Net after tax	$65	$60

Return on $65 bears tax burden at 35%.
Even though the corporation invests $75, since 20% will be paid to the IRS on distribution, the effective investment is $60. Still, the return on $60 if it bears a tax burden of 25% will eventually produce a higher accumulation.

The question is how long the after-tax Subchapter C corporate income (effectively $60) would have to stay in corporate solution, producing income taxed at the corporate rate (25%), to exceed the amount that could be accumulated by investing $65 subject to a tax rate of 35%. While the calculation seems complex, it is made simpler when one recognizes that the combined corporate–shareholder rate is not dependent on the timing of the distribution. Thus, the relevant tax burden can be examined by applying both the corporate and shareholder tax on Subchapter C corporate income as if the after-tax corporate income were distributed immediately. This is so even though these earnings have not yet been taxed to the shareholder and remain inside the corporation subject to the corporate rate on future earnings.

So far I have attempted to convince you that, if one focuses on present value, deferral in more circumstances than one might imagine does not affect the true value of the income or deduction. Delay does not matter because the base goes up. To determine if there is, nevertheless, an advantage to deferral, attention must be paid to the taxation of the interim investment return. In some cases, as noted above in the case of deferral of compensation or corporate distributions, the taxation of the investment return is shifted to another party who may be in a lower bracket. Foreign earnings may be subject to a lower foreign tax rate. In other cases, the investment income may disappear entirely from the tax base (which may occur in the case of the deferral of tax on unrealized appreciation). In other situations (my university example), the investment income tax base may not be shifted at all.

These variations in results hamper the ability to achieve more widespread understanding of the impact of deferral in these circumstances. Another difficulty is that, despite what I have said up to now, deferral is *not* always neutral. That is, deferral *does* affect the true value of the income or deduction on some occasions. For example, the amount of the nominal deduction for a capital expenditure is the same whether the amount is currently deducted (*i.e.*, expensed) or capitalized and depreciated over time. Since the acceleration of the deduction does not reduce the amount deducted, the benefit of the deduction must, in present value terms, increase. In short, if the nominal amount does not change, timing has to matter.

As we have long understood, acceleration of a deduction in these circumstances is, contrary to what I have said about deferred compensation, equivalent to an interest-free loan from the Service. The tax saved by the early deduction is repaid (without interest) at the time the deduction would normally be allowed. Therefore, even if the tax savings from the ability to expense a capital expenditure were invested in tax-exempt bonds, deferral remains an advantage. Assume accelerating a deduction of $100,000 (by expensing) produces a temporary tax savings of $35,000. The benefit (the investment return on $35,000 for the period that the deduction has been accelerated) remains whether or not the earning are exempt. Since the advantage is truly an interest-free loan, placing the tax savings in a tax-exempt investment does not eliminate the advantage of avoiding the need to actually borrow and pay

interest.

Nevertheless, we learned 35 years ago from Bill Andrews that what he described as a cash flow consumption tax can also be said to be equivalent to tax exemption for investment income.[37] Andrews demonstrated that a system which allowed expensing of all investments and capital expenditures can be said to exempt investment income. How can this be explained?

It must be true that even though the claimed result of deferral, tax exemption for investment income, is the same as in the case of deferred compensation, the analysis in the case of expensing has to be different. In fact, the mechanism here is to assume that expensing and the inherent tax savings would allow for the gross up of an investment. For example (see Example 5),[38] expensing of a $100,000 investment in machinery saves $35,000 in tax, which would allow the investment to be increased from $65,000 to $100,000. In these circumstances, since expensing makes the basis zero, the government effectively owns 35% of the investment and receives 35% of all income and sales proceeds. The taxpayer owns only 65%, its out-of-pocket cost, net of tax savings. The return on the extra $35,000, 35% of the total investment ($5250 in the example), would be sufficient to pay the tax on the $15,000 of income from the entire $100,000. Therefore, the return on the taxpayer's $65,000 share ($9750 in the example) is effectively tax-free.

More recently, the literature has challenged the universality of this kind of gross up, claiming that expensing effectively exempts only what is sometimes referred to as the normal return on investment.[39] The intuition for this claim is that expensing would not affect the size of the investment in the machinery in my prior example. Perhaps the business is satisfied with the $65,000 machine and sees no reason to increase the investment to $100,000. Perhaps an increased investment is not available. As I often say in class, Bill Gates

[37] William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 Harv. L. Rev. 1113, 1126–28 (1974).

[38]

Example 5	Investment	Taxpayer's Share	Government Share
	$100,000	$65,000	$35,000
Return at 15%	$15,000	$9,750	$5,250
Tax at 35%	$5,250 (Government Share)		
Net	$9,750 (Taxpayer's Share)		

[39] *See* Noel B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 Tax L. Rev. 17, 26 (1996) ("[T]he cash flow tax exempts the yield on an investment only to the extent of the rate of return available on the reinvested tax savings . . . ."); Alvin C. Warren Jr., *How Much Capital Income Taxed Under an Income Tax Is Exempt Under a Cash Flow Tax?*, 52 Tax L. Rev. 1 (1996).

could not have started one and a half Microsofts (the equivalent of increasing the investment in the machine from $65,000 to $100,000).

So the taxpayer may invest only $65,000 in the machine and use the $35,000 tax savings from expensing to invest in a lower yielding asset or, in the extreme, to buy Treasury bills, here assumed to pay a five percent return (see Example 6).[40] In the latter case, as shown in the footnote, the return on the investment is $11,500 before tax and $7475 after tax. It turns out that, as shown by the hypothetical investment in the footnote, the net income ($7475) equals what have been earned on a $65,000 investment earning 15%, if only five percent (the return on the treasuries) were tax-free.

Thus, if the tax savings is invested in treasuries, deferral does not result in the equivalent of a tax-free return to the extent the return on the machine exceeds the return on the Treasury bills. In other circumstances, a business that does not want to increase its investment might use the tax savings from expensing to reduce debt that it otherwise would have to incur to buy the machine. If the taxpayer reduces borrowing, what is saved, of course, is interest expense, consistent with the description of deferral as an interest free loan. In this instant, one can say that expensing leads to exemption of income at the rate of the interest that would have been paid on the loan which is now unnecessary.[41]

Under these scenarios, the amount of tax-free income could be the income earned from the machine if the investment in the machine increases to $100,000, the rate of income from the alternative business investment if the taxpayer cannot or does not want to expand the investment in the machine, income at the risk-free rate if no additional business investments are available, or income at the borrowing rate if expensing results in debt reduction. Since the response is not obvious, those with more direct business experience than the typical academic may have a role to play in the debate as to how much income would be effectively exempt under a cash flow consumption tax.

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Example 6

			Hypothetical Investment		
Investment	$100,000		5%	10%	Total
$65,000 at 15%	$9,750	$65,000	$3,250	$6,500	$9,750
$35,000 at 5%	$1,750	Tax	$0	$2,275	$2,275
	$11,500		$3,250	$4,225	$7,475
Tax at 35%	$4,025				
Net	$7,475				

[41] The immediate deduction for $100,000 saves $35,000 in tax, which allows borrowing to be reduced by that amount. At 10% the interest cost on that loan would have been $3500, or $2275 after tax. The tax at 35% on a $65,000 investment earning ten percent, or $6500, would also be $2275. So eliminating the ten percent interest has the same effect as if the first ten percent earned on the taxpayer's share of the investment were tax-free.

There is a similar debate in the academy as to the actual burden of the income tax. Some claim that the difference between the burden of, at least, a perfect income tax and a perfect consumption tax, might be much smaller than we might have thought. This literature suggests that the only difference is that the income tax imposes a burden on the risk-free rate of return and the consumption tax does not.[42] Thus, both would tax whatever infra-marginal return is subject to the burden of the consumption tax as just discussed. Neither would tax the return to risk-taking. Only the income tax would affect the riskless return.

To make this a bit clearer, let us return to the earlier example of a $65,000 investment in machinery. The assumption is that the adoption of an income tax with a 35% rate, as compared to a tax-free world or a consumption tax, would cause an increase in the investment in the machinery from $65,000 to $100,000. Since, as noted above, the return on the extra $35,000 would be sufficient to cover the tax on the full $100,000 investment, the result is to effectively exempt the return on the machine from tax.

But unlike the case of expensing, $35,000 is not available from an immediate tax deduction. It must come from another source at some cost to the taxpayer. One possibility is the sale of investments producing a risk-free return. If this occurs, the investor suffers a loss of the risk-free return on the $35,000 investment. At a five percent rate, the risk-free return on $35,000 would be $1750. This cost of increasing the investment in the risky machine turns out to be equal to the tax that would have been paid had the entire $100,000 earned the risk-free rate. Thus, if $100,000 were invested at five percent, the return would be $5000 and the tax thereon $1750. So if this scenario occurs, the burden of the income tax (here, the loss of the return on a $35,000 investment in risk-free assets) is said to be the equivalent of the tax that would be paid on the risk-free return from the entire portfolio rather than the nominal amount paid which would be much higher.

However, I think we need to take the argument that there is little to gain from insisting on a tax on income from capital with a grain of salt. First, the analysis is based on a perfect flat rate income tax, one with full loss offsets and, I believe, indexing for inflation. Second, it is not clear that this portfolio shift, the increase in investment in risky assets, will occur, at least to the extent implied. Finally, this analysis does not suggest that we cannot impose a burden on capital, only that, due to the portfolio shift, the burden cannot be sensitive to the rate of return on investment. For example, we could have an annual wealth tax in lieu of an income tax (putting aside constitutional concerns), which would, like an income tax, increase the burden on the wealthy. But this, of course, imposes the same burden on those with $100,000 of assets regardless of the rate of return.

In any event, for those who accept the argument, I assume the takeaway is

[42] *See* David A. Weisbach, *Taxation and Risk-Taking with Multiple Tax Rates*, 57 Nat'l Tax J. 229 (2004).

that since the difference is so small, there is no reason to insist on retaining an income tax. Thus, there are continuing calls to shift all, or at least more, of the burden to taxes on consumption, which since it does not tax income from capital, is said to not significantly impact the savings-consumption decision as the income tax does.[43] Apparently, to justify this change in approach, the efficiency gain from this shift is presumed to be significant. How these conflicting ideas could be reconciled, I will leave for another day and almost certainly other people.

Some, who call for this shift in tax base, might prefer to distribute the tax burden based on relative consumption rather than relative income. Others, however, accept the current approach, which takes account of investment income in measuring ability to pay and insist that the degree of progression need not change even if the base becomes consumption.[44]

Most obviously and simply, we could at least in theory impose a tax only on wages and income from self-employment, but make the tax rate schedule more progressive to take account of the fact that the level of savings thereby eliminated from the tax base is greater at higher income levels. Thus, the tax burden of each income class could remain constant.

I understand the math, but such a step seems politically unlikely. First, there is at least a psychological ceiling on the top rate, and an explanation that the burden has *not* increased because investment income is no longer taxed seems unlikely to carry the day. Secondly, given the disparity in the level of savings among individuals with a given amount of earned income, some, who have little or no savings, will suffer from the increased tax rate on earned income without the offset of a substantial decline in their taxable income. While this disparity may tend to even out over a lifetime, the immediate increase in burden would be, at least politically, troubling.

In any event, a new consumption tax is unlikely to take the form of a more progressive wage tax. Perhaps most importantly, it is too transparent to be politically acceptable. I once appeared on a panel with a supporter of *The Flat Tax*,[45] who described the flat tax to the audience as taxing all income equally as the politicians invariably do. In contrast, the book claims that the flat tax is an improvement over the income tax precisely because it imposes no burden on income from capital.[46] After challenging his description in public, I asked the speaker privately why he described the impact of the flat tax as he did. He

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[43] *See* Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 Stan. L. Rev. 1413 (2006).

[44] *See id.* at 1429–30 ("The tax on interest income may redistribute from the rich to the poor, but we can achieve equal redistribution through a more progressive tax on labor income that does not distort savings decisions. . . . Even if we believe in substantial redistribution, a consumption tax remains superior.").

[45] Robert E. Hall & Alvin Rabushka, The Flat Tax (2d ed. 1995).

[46] *See id.* at 40–41 ("The justification for consumption taxes rests on their built-in incentives to save and invest. By exempting investment from taxation, consumption taxes encourage investment and discourage spending.").

replied that no one favors the flat tax when it is described as impacting only earned income. Perhaps enough said.

There are, however, more salient reasons why a tax on consumption would, like the flat tax, more likely take the form of a cash flow tax, that is universal expensing, or a universal traditional IRA. First, a tax on earned income requires that income from self-employment be separated from return on investment since the former would be taxed and the latter would be exempt. As practicing lawyers know better than I, this would not be easy in the case of a sole proprietorship or partnership with substantial investment capital, nor would it be easy to police the payment of inadequate compensation by closely held corporations. Since under a cash flow tax, all funds withdrawn from investment and used for consumption would be taxed, the source of the funds need not be identified.

Secondly, unlike a wage tax, a cash flow tax would, or at least could, for the reasons previously described above, tax above normal or infra-marginal returns. If the investment in Microsoft does not increase over what it would be in a tax-free world (the investment in the machine remains at $65,000 in my example), the tax burden on Bill Gates is greater than the burden on those who did less well. This would be perceived as fairer and apparently, despite the tax burden, would be claimed not to have an adverse impact on investment.

If such a cash flow tax is to maintain the current distribution of the tax burden, however, it would have to be progressive. A progressive cash flow tax, however, would appear to increase the burden on the so-called normal return from capital, which is inconsistent with the stated goal. Thus, I continue to doubt whether maintaining (or improving) the current progressivity of the income tax can be achieved while alleviating the burden on capital income. Whether it is worth alleviating this burden, therefore, depends on the efficiency gain (how much additional investment) as compared to the equity loss from even greater disparity in after-tax income.

What I have tried to do here is to expose, perhaps to a greater extent than one normally sees outside the law reviews, some of the ideas now being discussed in the academy. In my 1997 Woodworth Lecture, I made the suggestion that mark-to-market for marketable securities could make the income tax both simpler and fairer and called for practitioners to consider whether the proposal was feasible.[47] In turn, the income-consumption tax debate makes assumptions about business behavior, which could profitably be examined by those who know more about such things.

Finally, I think the insight that deferral or acceleration of income and deductions is often unimportant, that the key is achieving the appropriate rate of tax on the interim investment return, might open the way to both better income measurement and tax simplification. Again, practitioners can help determine whether this approach is viable.

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[47] *See* Halperin, *supra* note 2, at 968.

ATPI, which draws much of its support from this group, has recognized that the possibility for sensible tax law could be enhanced if economic theorists had greater exposure to both legal academics and practicing lawyers and accountants.[48] It has sponsored a number of conferences to this end, including, relevant to this discussion, *Taxing Capital Income* (in 2006).[49] I applaud this effort and urge even greater participation from the Bar. In particular, I welcome your thoughts as to whether you believe that the analysis of deferral presented here could be helpful not only for tax reform but in making business decisions as well. I am particularly interested in hearing about the extent to which you believe this alternative view of tax deferral may already be understood and applied. Thank you.

[48] *See generally* American Tax Policy Institute, americantaxpolicyinstitute.org.

[49] *See* Taxing Capital Income (Henry J. Aaron, Leonard E. Burman, & C. Eugene Steuerle eds., 2007).