Insight

The Rhetoric vs The Reality of a Corporate Book Tax

GORDON GRAY | OCTOBER 28, 2021

Executive Summary

- Senators King, Warren, and Wyden have proposed a corporate minimum tax based on financial or "book" income.
- This proposal is animated by reports of large, profitable firms that, in a given year, pay little or no income tax.
- Those analyses, and thus the animating features of the tax, rely on a series of misleading and irreconcilable arguments.

Introduction

Congressional Democrats are debating tax policies to offset the spending commitments in the reconciliation bill that has been slowly working its way through the House of Representatives. The appetite among Congressional Democrats to *enact* significant tax increases is altogether less robust than the campaign rhetoric suggested. Opposition to specific tax policies such as increases in corporate and capital gains rates has forced the tax debate into more unconventional territory. Whereas the House Ways and Means Committee reported a tax subtitle that was fairly traditional in its approach to raising revenue, Senate opposition to these proposals has led to a last-minute scramble for more esoteric tax increases. Perhaps no tax proposal under discussion is more rooted in rhetoric and misperception than the proposed minimum tax on corporations.[1]

This policy is grounded in annual lamentations over a fluid but significant number of major corporations that, in a given year, have zero tax liabilities, despite being profitable according to financial statements. The policy purports to eliminate that phenomenon. Examining the major claims by the proposal's advocates reveals something of a disconnect between the rhetoric and the reality of policy.

Specifically, the bill sponsors claim that the new tax will 1) tax a certain number of companies otherwise not paying tax, 2) preserve the "good" tax breaks, and 3) raise hundreds of billions in new revenue. Each of these claims is buttressed by misleading and somewhat irreconcilable arguments.

A Solution in Search of a Problem

Just about every year, progressive outrage is renewed by reports that a certain number of U.S. firms faced zero or negative tax liabilities in a given year. These reports are based on highly misleading analyses gleaned from public financial statements. These analyses credulously report tax payments as a share of financial statement income to determine firms' effective tax rates. The first major disconnect between the rhetoric and reality in this tax debate is that income for purposes of financial statements and income as reported to the Internal Revenue Service are entirely different concepts. The public, including progressive think tanks, do not have access to companies' tax filings. The analyses elide this inconvenience and assert these effective tax rates – including zero and negative rates – as evidence of profitable firms failing to pay the *sine qua non* of public finance: the elusive "fair share."

Income as reported in financial filings such as annual reports or 10-Ks is determined by the application of Generally Accepted Accounting Principles (GAAP). For U.S. firms, these principles are determined by a private, independent board of accountants known as the Financial Accounting Standards Board (FASB).

Income subject to tax is determined by tax laws enacted by Congress. Elected officials regularly adjust the tax base and applicable levies. The charitable deduction, child tax credit, and home mortgage deduction are key examples of how Congress shrinks the tax base and tax liabilities for prescribed activities such as charitable giving, child rearing, and home ownership. It is no different for corporations, for which Congress has enacted over $1 trillion in such tax benefits over the next decade.

Indeed, the reasons why the "offending" firms in any given year have no tax liability is because these entities were engaged in the very activities that Congress chose to subsidize. Moreover, it can be the case that otherwise healthy firms may have unprofitable years, either due to the business cycle or their own development cycle. Some of the United States' most prominent startups have been at once valuable but unprofitable in a given year. The tax code sensibly does not attempt to tax firms experiencing losses. Indeed, the corporate tax code allows firms to carry-back and carry-forward losses. These are deliberate tax policies in the same vein as tax credits and tax deductions that subsidize presumably desirable activities. Key examples of these include the Research and Experimentation credit, accelerated depreciation, and "green" energy credits.[2]

Evaluating the Book Tax Policy Against Supporters' Claims

Senators King, Warren, and Wyden have proposed a 15 percent minimum tax on corporations that have average net income as reported on financial statements over 3 years of $1 billion. According to Senator Warren, this policy "would ensure companies that report over $1 billion in profits to shareholders pay at least a 15 percent tax rate on those gigantic profits." Additionally, Senator Warren claims this would apply to roughly 200 companies, would preserve the value of business credits, raise "hundreds of billions in revenue," and "put an end to profitable corporations getting away with paying zero (or less) in taxes."

Each of these claims in in tension, and to some degree irreconcilable. Specifically, the proposal is putatively aimed at only 200 companies. This reflects the highly misleading analysis that informs this policy. The number companies ensnared in these zero-tax analysis change every year. The analyses are a mere snapshot that reflect not only the state of the U.S. tax code, but also the economy, and the individual firms' business models. Over the next decade, the number of firms that would be ensnared by this is thus unknowable. Moreover, as noted, the accounting principles that determine book income are determined by FASB – a private, quasi-independent body. This tax policy outsources the determination of the tax base to this entity, which it will, to some degree over the next decade.

One of the key reasons for firms facing zero tax liability in a given year are tax benefits legislated by Congress to subsidize activities deemed desirable. Elected officials, not incidentally, are fond of taking credit for these policies and activities. A sterling example can be found within Senator Warren's proposal, which claims to "preserve the value of business credits – including R&D, clean energy, and housing tax credits – and allow credits for taxes paid to foreign countries." These are examples of the very policies that animate this tax debate. Firms reduce their tax liabilities with these credits. Relative to a book measure of income, these firms would face lower effective tax rates than otherwise and potentially become ensnared in this tax. The two concepts are at odds and belie the thin reed on which the proposal is predicated.

Last, the proposal purports to raise hundreds of billions of dollars in revenue. This is possible only to the extent to which the firms are denied those tax benefits that Congress otherwise has enacted. But already, the proposal contains nine "general adjustments" away from a tax on pure book income.[3] Some of these are broader than others, but it is instructive that by the sponsors' lights, some activities are worthy of accommodation.

Relative to book income, taxable income is not much more than this, but for an alternative set of "general adjustments." One can easily envision this list of adjustments growing and becoming just another parallel tax code with which major U.S. firms must comply.

Conclusion

Congress is in search of tax increases to finance new spending and is exploring less conventional approaches to revenue raising. Rather than painfully eliminating the tax preferences that give rise to the phenomenon of major firms paying little to no federal income tax in a given year, some policymakers are considering layering a new alternative minimum tax based on an entirely separate concept of corporate income. In so doing, they will outsource the determination of the corporate tax base to a board of accountants, while likely retaining many of the same features that drive this issue to begin with. The result will be a tax policy that inefficiently raises revenue without ending the "problem" that inspired it.

[1] A similar approach was briefly adopted in response to similar observations in 1986 but was eventually abandoned in favor of what became the corporate AMT: https://scholar.smu.edu/cgi/viewcontent.cgi?article=2650&context=smulr

[2] For more on key distinctions between book income and taxable income see: https://www.jct.gov/publications/2020/jcx-4-20/

[3] SEC. 56A(c)