

Taxing GE and Other Masters of the Universe

By Calvin H. Johnson



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General Electric Co. paid essentially no tax in 2010. A 35 percent tax on GE's economic income would have been \$6.8 billion, or \$4.7 billion with inflation adjustments. Generally accepted accounting principles and tax accounting allow too much expensing of investments, and ignore predictable future income, the use of tax havens, and accelerated depreciation.

The government can most easily and fairly collect the requisite tax from GE by imposing a tax on the fair market value of its capital. The government can charge GE \$6 billion to \$7 billion a year for access to public markets and GE and every corporation would be willing to pay that much to give its shareholders access to ready liquidity.

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As *The New York Times* reported in a page one story, General Electric Co. is a very rich company that pays very little income tax.¹ By its own reports to shareholders, GE paid income taxes of \$4 million for 2010.² The New York Stock Exchange (NYSE)

¹David Kocieniewski, "G.E.'s Strategies Let It Avoid Taxes Altogether," *The New York Times*, Mar. 25, 2011, at A-1.

²GE annual report for 2010, n.14, "Income Taxes," available at http://sec.gov/cgi-bin/viewer?action=view&cik=40545&accession_number=0001193125-11-047479&xbrl_type=v#.

Nontax generally accepted accounting principles treat deferred tax as if it were part of the effective tax rate, which is an error if the effective tax rate is a measure of the impact of tax on pretax internal rate of return (IRR). An analysis of how much tax reduces IRR uses deferred taxes as a reduction in adjusted basis,

(Footnote continued in next column.)

valued GE equity at \$194 billion at the end of 2010,³ making it the second richest corporation in the world, according to *Forbes*.⁴ The stock market reaches its price assuming future distributions discounted at roughly 10 percent per year compounded annually.⁵ In turn, shareholders' expected return becomes GE's own minimum acceptable after-tax return if GE is to increase shareholder value.⁶ GE shareholders thus are demanding and receiving a profit of about \$19 billion from their investments after all corporate tax, and expect that compound annual 10 percent return for the foreseeable future.⁷

GE is not losing money, as measured by the smart stock market. Tax on GE's \$19 billion economic income at its 35 percent corporate rate would have been \$6.8 billion for 2010. GE's tax in 2010 was thus 0.02 percent of the economic income that the smart

which *lowers* the IRR-reducing effective tax rate on GE (see, e.g., *infra* note 43). The analysis also ignores tax GE paid after audit in 2010 for other years and increases in tax that GE thinks it owes (on a more likely than not standard) but did not report.

³The fair market value of GE equity is computed by multiplying 10.7 billion outstanding shares by an \$18.2 share price, both as of December 31, 2010. Outstanding shares are from GE's 2010 annual report, "Statement of Financial Positions, Equity." NYSE market quote is from <http://www.yahoo.finance.com>.

⁴*Forbes* special report, "The World's Leading Companies," Apr. 4, 2010 (using a composite index and saying J.P. Morgan Chase and Co. dethroned GE as largest corporation this year). JP Morgan's earnings are more volatile than GE's, so GE may be back.

⁵Long-term returns on stock are estimated at between 9 and 11 percent. See Jeremy J. Siegel, *Stocks for the Long Run* 12 (2008) (finding 9 percent annual return on stock for period 1802 to 2006); Roger Ibbotson and Peng Chen, "Are Bonds Going to Outperform Stocks Over the Long Run? Not Likely." (July 2009), available at <http://corporate.morningstar.com/ib/documents/MediaMentions/AreBondsGoingToOutPerformStocks.pdf> (9.44 percent for period 1926 to 2009); MSCI Barra, "What Drives Long-Term Equity Returns?" (2010), available at <http://www.msibarra.com/research/articles/2010/What%20Drives%20Long%20Term%20Equity%20Returns%20%28Jan%202010%29.pdf> (11 percent for 1975-2009).

⁶See, e.g., Richard A. Brearly and Stewart C. Myers, *Principles of Corporate Finance* 221 (6th ed. 2000) (corporation's cost of equity is shareholder return).

⁷If GE accumulates its economic income, shareholders will expect economic income to increase by 10 percent, but the 10 percent demanded after-tax return includes both dividends and other distributions and appreciation of GE stock. This analysis will use 2010 income as an illustration with the understanding that in future years, the demanded income will increase to reach 10 percent compounded annually.

stock market thought GE had — which rounds out comfortably enough to zero. GE is very good at paying a trivial amount of or no tax. Without an improvement in U.S. tax law, we should expect to see GE's essentially zero tax rate continue into the foreseeable future.

The 10 percent return ignores inflation, which has been 3 percent over a sample 80-year period.⁸ Taking inflation out of GE's income would require GE to pay tax of only 35 percent times 7 percent times \$191 billion, or \$4.7 billion in 2010. It is a fundamental nontax and tax accounting convention that income and interest expense are computed without regard to the fact that some of it is just an offset to inflation. I have to go along with that convention, without endorsing ignoring inflation generally, because the available figures from the GE annual report ignore inflation and because every business and investment that competes with GE ignores inflation.

President Obama has appointed Jeffrey Immelt, the CEO of GE, to chair his Council on Jobs and Competitiveness. Immelt, by taking the job, now has a duty of loyalty to the United States. We are facing an impending budget catastrophe with the deficit at an unsustainable level of \$1.5 trillion.⁹ A person appointed to the board of an opera company should understand that he has an obligation to make or find contributions to fund the opera's production. So if Immelt's appointment makes sense at all, Immelt should now give good advice to Uncle Sam on how best to raise tax from GE. A reasonable suggested contribution from GE would be on the order of \$5 billion to \$7 billion a year.

Is that amount a reasonable target for GE? I have a proposal, made as a part of the Shelf Project, to replace the corporate tax with a per-quarter tax of 20 basis points on the fair market value of a corporation's capital.¹⁰ The FMV of GE's debt and equity was \$821 billion at the end of 2010,¹¹ and a 0.8 percent tax per year (20 basis points per quarter) on that market capitalization would be \$6.5 billion, or just under what a 35 percent tax on GE economic income would yield. The tax could be computed — without GE participation — at a random date during the quarter from publicly available quotes of

FMV.¹² Taxed market capitalization would include both equity and debt to suppress the incentives to move to debt. We could even adjust for inflation and collect \$4.7 billion tax from GE with a rate of only 14 basis points a quarter.

The logic of taxing the publicly traded value of GE securities is that investors get so much value out of ready liquidity, or the ability to cash out quickly when necessary, that the corporation will willingly pay the tax at that level as a cheap cost of providing ready liquidity to its investors. Family limited partnerships have successfully claimed that absence of liquidity will take away about 35 percent of the value of estate assets,¹³ and those claims are judicial precedents of value of liquidity. Money-losing companies would be especially eager to provide liquidity for their investors because without the chance to bail out quickly, investors would not take a chance on a risky corporation. Because sale is so important to shareholders, the corporation will not even try to avoid the tax by reducing FMV to its investors or withdrawing from an established market. The government raises revenue by selling rights to cut in the national forest, drill offshore, and broadcast on the electromagnetic spectrum, and there is no reason it shouldn't also sell access to public markets. The tax at a lower level also could work as a supplemental tax to the corporate tax — a kind of alternative minimum tax — to make sure that rich corporations pay at least some tax. The tax would apply to foreign corporations and publicly traded partnerships because they have access to U.S. public markets. Corporations benefit from the U.S. rule of law and liquidity on sale in U.S. public markets. The benefits that GE gets exceed the tax that we might fairly ask them to pay. With an impending budget catastrophe, surely, they should not be getting something for nothing.

It may well be that the value of listing on the NYSE should be assessed at lower than 0.8 percent a year — some of the data are from the period of the dot-com bubble.¹⁴ The value of ready public sale is an

¹²I like the idea of a randomized experiment: Some corporations would know the date on which their stock would be valued, for some the date would be picked in advance but the corporation would not know it, and for some the date would be chosen only retroactively. If it makes a difference, the government would thereafter use the system that raises the most revenue.

¹³See, e.g., *Estate of Miller v. Commissioner*, T.C. Memo. 2009-119, Doc 2009-11967, 2009 TNT 100-11 (giving a 35 percent discount to publicly traded stock held by a family partnership because the trust arrangement prevented marketability).

¹⁴Craig Doidge et al., "Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Over Time," National Bureau of Economic Research Working Paper 13079 (May 2007), available at <http://www.nber.org/papers/w13079>.

⁸Roger Ibbotson, *supra* note 5.

⁹Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2011 to 2021" (Publication No. 4236), at 2 (Jan. 26, 2011).

¹⁰Calvin H. Johnson, "Replace the Corporate Tax With a Market Capitalization Tax," *Tax Notes*, Dec. 10, 2007, p. 1082, Doc 2007-26347, 2007 TNT 238-36.

¹¹See *supra* note 3 as to stock value; GE's liabilities are from the balance sheet on its 2010 annual report, *supra* note 2.

empirical question. Still, a tax on market liquidity at a rate just below its value to investors makes sense whatever the level. Although I recommended a replacement of the corporate tax, a supplemental tax would work as well. An annual tax on market capitalization of 0.5 percent would raise \$3.25 billion a year from GE.¹⁵ There is no other way to tax GE (and similar companies) that is so simple and just.

House Ways and Means Committee Chair Dave Camp, R-Mich., has proposed a cut in the corporate and individual tax rates from 35 to 25 percent and making it revenue neutral by ending as yet unspecified tax preferences.¹⁶ Applying that proposal to tax GE's economic income at 25 percent, in 2010 it would have paid \$4.85 billion on the \$19 billion the smart market demanded.¹⁷ Tax is usually computed on a pretax amount. If we view the \$19 billion as an after-tax amount, then we need to gross that up to a pretax income of \$25.9 billion. Imposing a 25 percent tax rate, Camp's proposal yields \$6.5 billion on GE's 2010 income.¹⁸ Indeed, a real economic tax of 25 percent would reduce the pretax internal rate of return (IRR) by 25 percent. Reducing the pretax IRR by any defined nominal or statutory tax rate requires that GE have a basis in its assets equal to the value of investments.¹⁹ By my best estimate, GE has an adjusted basis of 91 percent of the FMV of its assets.²⁰ We can offset the lower-than-value basis and still reduce the pretax IRR by 25 percent, within the spirit of Camp's proposal, by increasing the tax by 1/91 percent, or to \$7 billion, for 2010. A fair tax on GE at 25 percent of income would yield \$7 billion a year.

A tax of \$6 billion to \$7 billion a year would reduce the value of GE stock, and it would reduce the pot from which the CEO and other officers draw their

salary. But neither reduction in shareholder value nor in officer pay seems terribly inappropriate. Our \$1.5 trillion deficit is a pending disaster and should call for some appropriate sacrifices by those most able to pay. Congress seems to have assumed that corporations would pay tax at 35 percent, to the detriment of shareholders and officers, by setting the corporate rate at that level. Section 1(h)(11), moreover, now gives shareholders 15 percent capital gains rates on dividends under the rationale that the corporation has already paid tax of 35 percent on the earnings distributed by the dividend. If the corporation did not pay tax, then 15 percent is a wrong rate²¹: The 15 percent is supposed to be the bracket for middle-income taxpayers. For GE shareholders who have a standard of living that would put them in the highest individual tax rates, 35 percent is the rate appropriate to their standard of living, and the 15 percent rate on the dividends they consume is inappropriately low. Shareholders and top officers of GE get richer because GE does not pay tax, and they might well be the people who most should bear the tax we collect from GE.

A. Wise or Legal?

Is GE's behavior illegal? GE is expecting to bear some penalties, so its positions are not strictly legal, but as far as this outsider can tell, GE's tax planning and positions are not criminal. And the civil penalties the company expects to bear do not make the penalizable positions a big part of the explanation for zero tax. By one index, GE is in the top 11 percent of companies in terms of aggressiveness in nontax accounting,²² which is plausibly correlated with aggressiveness in tax accounting. An aggressive company is taking risks and expects to lose some positions.

GE has a \$6.1 billion reserve for taxes that it did not report but thinks it owes, judged from the more likely than not standard.²³ Taxes may be ignored on the tax return if the taxpayer judges its return positions as having a one-third chance of success on the merits if challenged.²⁴ The taxpayer must nonetheless treat the tax as an accounting expense even

¹⁵A tax on GE equity only at 20 basis points a quarter would raise \$1.6 billion (0.08 percent * \$194 billion) for 2010.

¹⁶Meg Shreve and Eric Kroh, "Camp Considers 25 Percent Top Tax Rate," *Tax Notes*, Mar. 21, 2011, p. 1391. As Alice Rivlin pointed out in the article, we probably cannot afford a revenue-neutral assumption, given the size of the current deficits.

¹⁷25 percent * \$19.4 billion = \$4.85 billion.

¹⁸\$19.4 billion / (1-25 percent) = \$25.9 billion.

¹⁹Johnson, "The Effective Tax Ratio and the Undertaxation of Intangibles," *Tax Notes*, Dec. 15, 2008, p. 1289, *Doc 2008-24799*, 2008 *TNT* 242-46.

²⁰GE's 2010 annual report, *supra* note 2, listed assets of \$751 billion. That can be presumed to represent adjusted basis, except that deferred tax represents not basis but amounts that have not yet borne tax. Converting deferred tax (from n.14 of the 2010 annual report, *supra* note 2) to the pretax amount from GE's assets and subtracting reduces estimated adjusted basis to \$749.8 billion. At year's end, GE had equity worth \$194 billion and liabilities of \$627 billion, for a total investment value of \$821 billion. The ratio of adjusted basis to value was \$749.8 divided by 821, or 91.3 percent. Grossing up rates to adjust for the lower basis would increase tax by 1 divided by 91.3 percent, or 109.5 percent, and 109.5 percent of \$6.5 billion is \$7.1 billion.

²¹Johnson, "Corporate Distributions From Earnings and Beyond," *Tax Notes*, May 17, 2010, p. 813, *Doc 2010-9238*, 2010 *TNT* 97-7.

²²"KLD Audit Integrity Accounting, Governance and Risk Score," available at <http://eresearch.fidelity.com/eresearch/evaluate/snapshot.jhtml?symbols=GE> (accessed Apr. 13, 2011).

²³2010 annual report, *supra* note 2, at n.14.

²⁴Section 6662. A corporation may report taxes that have a reasonable chance of success (interpreted as 10 to 15 percent) but must flag the position on its tax return. It is my understanding that corporations do not want their positions flagged for the benefit of IRS auditors, especially when the position has little chance of success if challenged.

if not reported on the tax return if there is a 50 percent chance of it being due. The \$6.1 billion is the difference between the 33 and 50 percent chance of success on its tax return positions measured by GE's internal assessment. It is a mistake to allow GE to report less tax than it thinks it owes²⁵; let GE go to court with a refund claim if it wants to establish its more speculative positions. With consistency between generally accepted accounting principles and reporting standards, we could harness the accounting profession to enforce both tax and tax expense. In any event, because GE is its own judge, its probability assessments have to have some bias, so some of the \$6.21 billion in positions do not have the requisite one-third chance of success on the merits if challenged, and would — and should — be subject to penalty.

In the area of transfer pricing and international transactions, the law respects accounting between two wholly owned subsidiaries of the same multinational corporation, even when the entries “do not impinge on the world.”²⁶ We can comfortably presume that the accounting entries are self-serving and bear only accidental relationship to the economics.²⁷ Still, the test for fraud is whether the position will be upheld in court, not whether it reflects income, and courts uphold many positions quite distant from the underlying economics.

GE itself reports that it expects to pay penalties of \$109 million on unreported taxes from IRS challenges that do occur.²⁸ These are civil, not criminal penalties, but given the expected penalties, GE's reporting positions can't be strictly legal. In any event, the accrued penalty is a small fraction of the difference between zero and, say, the \$6 billion to \$7 billion we would collect a year by taxing the company's economic income. Even assuming a 40 percent penalty (which is high), \$109 million in penalties would implicate tax of *only* \$270 million. Corporate morality allows a corporation to arrange its affairs to take advantage of tax shelters and other artificial accounting losses²⁹; it is safe to assume GE is arranging its affairs rather ably.

²⁵Bret Wells, “Adopting the More Likely Than Not Standard for Tax Returns,” *Tax Notes*, Apr. 26, 2010, p. 451, *Doc 2010-7488*, 2010 TNT 82-10.

²⁶*Yosha v. Commissioner*, 861 F.2d 494, 498 (7th Cir. 1988) (Posner, J.) (defining sham transaction).

²⁷See *infra* text accompanying notes 46-66.

²⁸2010 annual report, *supra* note 2, at n.14.

²⁹See, e.g., *Gregory v. Helvering*, 69 F.2d 809, 810-811 (2d Cir. 1934): “Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.” (Learned Hand, J.) (holding against the taxpayer, however, because the arrangement was only in form a tax-favored reorganization and was not in substance what

(Footnote continued in next column.)

Dropping GE's tax from \$5 billion to \$7 billion a year to nothing, however, should not be presumed to be the result of careful congressional consideration of the value of a dollar. There is no great and wise tax system engineer who calibrates tax loopholes to give exactly the right amount of reward (that is, the lowest possible reward) for value that GE has given in return. To get down to zero tax from \$5 billion to \$7 billion, for instance, GE took advantage of tax shelters. A tax shelter, best defined, is a transaction that has a higher return after tax than before. As to shelters, the tax system acts not as source of revenue but as a kind of Cadillac welfare system. Shelters make GE's tax disappear. A zero tax across the board combined with no interest deductions would plausibly improve the allocation of capital. Zero tax leaves the decision of how to allocate resources to the free market, which is often presumed to represent real demand and utilities. Shelters, however, are subsidies that warp pretax demand and worsen the allocation of capital investments. When other investors are unavoidably bearing a tax on capital, a zero or negative tax on other investors is also unfair. Plus, we need the money.

GE benefited from many negative tax transactions simply by seeing an opportunity and taking it, usually when Congress didn't know what it was doing. Even when GE exploits specific provisions as Congress intended, the provisions are too generous, given the impending budget crisis. Under any explanation of how GE got from \$5 billion to \$7 billion tax to zero, an alternative road for taxing GE would be the better one.

B. Identifiable Reasons

How to tax GE also depends on why GE paid so little tax. Unauthorized disclosure of GE's tax return information would be a felony, punishable by up to five years' imprisonment.³⁰ If I or anyone knew the details of the transactions behind GE's zero tax, we would not discuss them. GE, however, discloses enough information on its SEC-mandated annual report that we can see the reasons for the drop to \$7 billion a year to zero, in broad terms:

- GE reduced tax by \$3 billion because U.S. GAAP and tax accounting that follows it are too conservative to capture the economics both in the capitalization of investment costs and estimation of future cash.

Congress intended to qualify as a reorganization). Cf. W.J. Bruns and K.A. Merchant, “The Dangerous Morality of Managing Earnings,” 72 *Management Accounting* 22 (Aug. 1990) (finding that managers generally were willing to arrange their affairs to report earnings that would be a misleading sample of long-term earnings, but that they condemned misdescriptions).

³⁰Section 7213(a).

- GE dropped tax by \$2.3 billion a year because we are giving too much respect to wholly owned subsidiaries incorporated in tax havens.
- GE seems to get benefits on the order of \$860 million a year from accelerated depreciation, and \$500 million from business tax credits.
- GE reports \$400 million less tax as unidentified miscellany.

Greater revenue for the impending crises can be pulled from each of the identifiable reasons why GE paid zero tax.

1. GAAP. GE reported earnings of \$11.6 billion in 2010 under nontax GAAP.³¹ A 35 percent rate on that amount would have yielded \$4 billion in tax.

The smart market for GE stock does a better job than GAAP in assessing economic position. GAAP refuses to take future cash into account until the amount is earned and fixed, except as to noncritical aspects. The smart market, by contrast, is willing to take estimates of expected future cash into account after discounting for time value and probability, even if the future cash is neither earned nor fixed. The tax system might well ride on the wisdom of the stock market to produce reliable figures, created by self-interested investors who put their money where their assessment is.

GAAP insists even more seriously on treating corporate investments in developing intangibles as total losses in cases in which the smart market recognizes that the development costs are good investments that have continuing value. Google, for instance, is considered a very valuable company by the competitive stock market that values its stock at \$171 billion.³² GAAP, however, insists that Google's primary asset, its wonderful search engine, has no asset value. According to GAAP, Google has some cash and near-cash portfolio stock holdings, but otherwise has assets worth listing of only \$7 million.³³ Tax follows GAAP in allowing expensing for most investments in developing intangibles.³⁴

The error of GAAP and tax in allowing expensing of intangibles is not trivial. Under an income tax, the ability to deduct immediately the cost of an intangible investment with continuing value means that the post-tax rate of return will be the same as the

pretax rate of return and that the income tax will not reduce the corporation's pretax position.³⁵ With an interest deduction when the expensed investment is debt financed, the tax system creates tax shelters, adding subsidy to the investment.³⁶ Whether a public company's investments are tangible or intangible also varies considerably. Perversely, an accounting-based tax gives the greatest advantage to awful computer games like *Grand Theft Auto IV* and imposes the largest handicaps on companies like Macy's that invest in tangible things.³⁷ A GAAP-based income tax cannot impose a uniform tax rate on alternative corporate investments because investments in intangibles aren't treated as investments — reason enough to abandon a GAAP-based corporate tax.

It is responsible to take the position that all investments should be expensed immediately under a cash flow consumption tax, and as a corollary, that all borrowing should be taxable income or no interest should be deductible.³⁸ It is not responsible to have some investments be treated as capital expenditures and some investments treated as immediate expenses so as to warp the flow of capital into awful but nonetheless expensed investments. It is not, moreover, responsible to allow expensing within a system that treats borrowing as tax exempt and part of deductible basis, and then allows an interest deduction.

The Treasury regulations, which allow generous expensing of intangibles, relied largely on the difficulty of ascertaining the scope, continuing value, and life of intangible investments. But the smart market will give reliable figures about value and solve all the accounting problems at once. A corporate tax working off the FMV of its stock is a better, easier tax than a tax working off GAAP concepts.³⁹

It is also commonly argued that we should at least tax GAAP income.⁴⁰ Taxing GAAP income is not a

³⁵The seminal piece is Cary Brown, "Business-Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hanson* 300 (1948).

³⁶Johnson, "Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation," 61 *Texas L. Rev.* 1013 (1983).

³⁷Johnson, *supra* note 19.

³⁸See, e.g., William D. Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," 87 *Harv. L. Rev.* 1113 (1974); Treasury Department, "Blueprints for Basic Tax Reform," at 113-143 (1977).

³⁹Johnson, "GAAP Tax," *Tax Notes*, Apr. 19, 1999, p. 425.

⁴⁰See, e.g., Harold Dubroff et al., "Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles," 47 *Albany L. Rev.* 354, 404-406 (1983) (arguing that tax should "resolve questions of the time of wealth increases by reference to a body of learning developed for precisely that purpose by a large, well-organized, and highly educated group of professionals").

³¹2010 annual report, *supra* note 2, statement of earnings.

³²Market capitalization is from Yahoo finance (Apr. 15, 2011).

³³Google stock had market capitalization of \$171 billion on April 15, but its accounting assets other than cash and marketable securities were only \$7 million. The Google search engine, which contributed to most of the \$171 billion value, is not an accounting asset. Google 2010 annual report, available at http://sec.gov/cgi-bin/viewer?action=view&cik=1288776&accession_number=0001193125-11-032930&xbrl_type=v (as of Apr. 16, 2011).

³⁴Reg. section 1.263(a)-4.

position I like⁴¹: GAAP earnings reported to shareholders are nothing but a convenient messenger. If that message bore 35 percent tax, no corporation could afford to give the message. In future years, all corporations would report zero official earnings on SEC-mandated statements and use another medium to tell shareholders how they are really doing. A tax system based on the FMV established by the smart market would do a better job of assessing economic position without losing the convenience of GAAP earnings. Still, the GAAP standard that calls for \$4 billion in tax from a very rich and prospering company is better than tax accounting that finds no taxable income and calls for zero in tax. It is reasonable that we should collect \$4 billion a year from GE on results like those from 2010 because the “science” of accounting finds that that is the appropriate level.⁴²

To get down to zero tax from \$4 billion GAAP tax, GE needed to take advantage of tax shelters that made GE cash “disappear.”

2. Global activities. Under figures from GE’s 2010 annual report, more than half the drop in tax from \$4 billion to zero — that is, \$2.3 billion — is attributable to global activities.⁴³ The U.S. system for global activities allows multinational corporations like GE to report a disproportionate amount of the total income from wholly owned subsidiaries in low-tax jurisdictions and to deduct a disproportionate amount of their total expenses against U.S. income.⁴⁴ The combination of immediate deduction

of expenses, deferred taxation of revenue, and foreign tax credits makes the U.S. tax system more generous than zero tax.⁴⁵ In its boxing match with the multinational corporations, Uncle Sam cannot hold up his gloves to protect his revenue interests very well. The techniques are disclosed in the literature (although not specifically the GE deals).⁴⁶

Multinational corporations report a disproportionate amount of their total revenue as attributable to wholly owned subsidiaries in tax havens. In theory, we tax income from whatever source derived, including foreign sources, but the U.S. tax system treats a thin piece of paper — the certificate of incorporation of a subsidiary incorporated with a mailbox in some tax haven — as if it establishes a separate economic interest or ownership of income and an adverse negotiating position. The separate incorporation means that the income can be treated as arising from an offshore mailbox and exempt from U.S. tax unless and until the cash in the subsidiary is brought home. Tax havens compete for multinational corporations’ business, offering them the opportunity to avoid U.S. tax.⁴⁷

Multinational corporations transfer or license intangible assets to the tax haven subsidiary, and then pay tax-deductible royalties to the sub. They can transfer undeveloped business opportunities to the sub without tax.⁴⁸ For businesses already established in the United States, the U.S. parent forms a carrying subsidiary so loaded with debt or preferred stock that the sub’s balance sheet value is zero. There is no built-in gain when the subsidiary is transferred overseas, carrying the business with it. A zero value asset

⁴¹Johnson, *supra* note 39.

⁴²I tend to use “science” of accounting ironically, concentrating on the deficiencies in accounting as a system of describing economics. But in some cases, including this one, GAAP accounting is \$4 billion better than nothing.

⁴³See 2010 annual report, *supra* note 2. Note 13 reports that global activities reduced the effective tax rate from 35 percent by 19.7 percent; and 19.7 percent divided by 35 percent times \$4 billion equals \$2.3 billion.

⁴⁴A GE spokesperson explained the low effective tax rate: Our consolidated income tax rate is lower than the U.S. statutory rate primarily because of benefits from lower-taxed global operations, including the use of global funding structures, and our 2009 and 2008 decisions to indefinitely reinvest prior-year earnings outside the U.S. There is a benefit from global operations as non-U.S. income is subject to local country tax rates that are significantly below the 35 percent U.S. statutory rate. These non-U.S. earnings have been indefinitely reinvested outside the U.S. and are not subject to current U.S. income tax. The rate of tax on our indefinitely reinvested non-U.S. earnings is below the 35 percent U.S. statutory rate because we have significant business operations subject to tax in countries where the tax on that income is lower than the U.S. statutory rate and because GE funds the majority of its non-U.S. operations through foreign companies that are subject to low foreign taxes.

Quoted in Kocieniewski, *supra* note 1. The low annual tax rate also applies to funds that GE has not declared to be indefinitely invested abroad, but U.S. GAAP accounting requires that GE set

(Footnote continued in next column.)

up a deferred tax account as if it had paid 35 percent tax on its income, although GE did not. See *supra* note 2 for proper analysis of deferred tax accounts.

⁴⁵J. Clifton Fleming Jr. et al., “Worse Than Exemption,” 59 *Emory L. J.* 79 (2009).

⁴⁶This section relies primarily on Jane G. Gravelle, “International Corporate Tax Reform: Issues and Proposals,” 9 *Fla. Tax Rev.* 469 (2009); Joint Committee on Taxation, “Present Law and Background Related to Possible Income Shifting and Transfer Pricing,” JCX-37-10 (July 20, 2010), *Doc 2010-16144*, 2010 TNT 139-13; and Rocco V. Femia, “Taxing Success: Income Shifting and the U.S. Taxation of Nonroutine Returns Earned by Foreign Subsidiaries,” 89 *Taxes* 21 (2011).

⁴⁷See, e.g., Adam Rosenzweig, “Why Are There Tax Havens?” 52 *Wm. & Mary L. Rev.* 923 (2010) (arguing that tax havens cannot be beat except by being bought off under the current tax system). One wonders how buying off all the possible tax havens would be possible when each has insatiable demands.

⁴⁸*Hosp. Corp. of Am. v. Commissioner*, 81 T.C. 520 (1983) (opportunity to run hospital in Saudi Arabia is given to Cayman Islands offshore tax haven sub); *Merck & Co. v. United States*, 91-2 USTC para. 50,456 (Ct. Cl. 1991) (upholding creation of offshore subsidiary to exploit foreign sale and distribution of pharmaceuticals).

can be transferred offshore without tax.⁴⁹ All growth in the value of the intangible or the carrying subsidiary thereafter occurs offshore.

The subpart F rules generally treat the income from movable passive assets, including intangibles, of controlled foreign subsidiaries as taxable immediately in the United States.⁵⁰ Subpart F does not apply to active businesses, however, and multinationals consolidate passive income from intangibles with disregarded entities that manufacture in another jurisdiction so that the tax haven subsidiary is not subject to subpart F.⁵¹ GE, moreover, has successfully lobbied for a special exemption from subpart F for its investment assets in its offshore financial and banking business.⁵²

The multinationals also strip the U.S. tax base on sales to U.S. customers by requiring U.S.-based affiliates to pay deductible expenses to the tax haven subsidiaries. Once the intangible underlying a factor of production has been located or transferred to the offshore haven, the expenses for use of that factor reduce the U.S. tax base. The multinationals also dampen U.S. revenue on affiliate transactions by giving U.S.-based affiliates a distribution contract with minimal profit, so that a large percentage of the profit on sales to U.S. customers is reported offshore.⁵³

The accounting among affiliates also produces U.S. tax shelters — that is, transactions better than having no tax — by de-linking revenue and expenses. Revenue is reported in the offshore haven, but expenses that caused the income — including interest, officer compensation, and research and development — are treated as U.S. expenses.⁵⁴

⁴⁹Whereas section 367 can result in tax to a shareholder on contribution to or merger with a foreign corporation, loading up the delivery corporation with debt and preferred stock will minimize or erase the realized gain.

⁵⁰Sections 951-965.

⁵¹See, e.g., JCX-37-10, *supra* note 46, at 122.

⁵²Section 954(h), enacted by Taxpayer Relief Act of 1997, P.L. 105-34, section 1175(a), and extended through 2011 by P.L. 111-312, section 750. Kocieniewski, *supra* note 1, suggested a tie-in between the extension of section 954(h) and GE's \$11 million contribution to school districts in the congressional district of House Ways and Means Committee member Charles B. Rangel, D-N.Y., when Rangel was chair of the committee.

⁵³JCX-37-10, *supra* note 46, at 105.

⁵⁴See discussion Robert H. Dilworth, "Federal Income Tax Reform: International Recommendations," *Tax Notes*, Dec. 6, 2010, p. 1113, *Doc 2010-23970*, or *2010 TNT 235-9* (recommending allocating more expenses of interest, administrative overhead, and R&D to haven revenue). Section 162(j) limits deduction of interest to offshore entities if the debt equity ratio exceeds 1.5 to 1. Proposals by the Obama administration would allocate interest expense to foreign-sourced revenue but not domestic R&D expenses. Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" (Feb. 14, 2011), *Doc 2011-3155*, *2011 TNT 31-21* (green book).

The accounting of the multinationals also artificially shifts profit from the United States to low-tax havens by charging high expenses to U.S. affiliates and charging low expenses to the offshore affiliate. The transfer pricing rules require the affiliated companies to charge the prices that would be required by arm's-length bargaining.⁵⁵ For marketable commodities, comparable prices rein in the manipulations, but for intangible contracts, there are no comparable prices, which allows more manipulation.⁵⁶ Affiliated groups have reported average returns of 24 percent in tax haven subsidiaries at the same time that they are reporting 4 percent returns on U.S. affiliates.⁵⁷ The tax havens have a higher share of tax-reported profits than they had of sales, compensation, or physical assets.⁵⁸ The income shifting to Bermuda and the Cayman Islands is especially aggressive: Bermuda affiliates report income that is 70 times the worldwide profits of the multinational corporation as a whole, and the Cayman Islands reports profits 25 times the worldwide average.⁵⁹ Whether profits are shifted by legal but aggressive accounting or by illegal means is not always clear.

GE tax counsel defends the zero tax on global activities by arguing that GE needs to be competitive with other corporations:

If U.S. companies aren't competitive outside of their home market, it will mean fewer, not more, jobs in the United States, as the business will go to a non-U.S. competitor. We believe that winning in markets outside the United States increases U.S. exports and jobs.⁶⁰

The argument is misleading accounting. The collection of tax does not destroy jobs or resources, but shifts them elsewhere. Taking \$6 billion to \$7 billion away from GE will reduce taxes or increase spending elsewhere and that will increase jobs. Indeed, GE's jobs are disproportionately overseas. GE reports 133,000 employees in the United States,

⁵⁵Reg. section 1.482-1.

⁵⁶JCX-37-10, *supra* note 46, at 20.

⁵⁷Martin A. Sullivan, "U.S. Citizens Hide Hundreds of Billions in Cayman Accounts," *Tax Notes*, May 24, 2004, p. 956, *Doc 2004-10866*, *2004 TNT 102-4*. See also Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," in *Fundamental Tax Reform: Issues, Choices and Implications* (2008).

⁵⁸Government Accountability Office, "U.S. Multinational Corporations: Effective Tax Rates Are Correlated With Where Income Is Reported," GAO-08-950 (Aug. 12, 2008), *Doc 2008-19132*, *2008 TNT 175-24*.

⁵⁹Sullivan, "Transfer Pricing Abuse Is Job-Killing Corporate Welfare," *Tax Notes*, Aug. 2, 2010, p. 461, *Doc 2010-16785*, *2010 TNT 147-2*.

⁶⁰Kocieniewski, *supra* note 1.

which is 46 percent of its 287,000 employees.⁶¹ Expenditure of the \$6 billion to \$7 billion elsewhere will create a higher proportion of U.S. jobs and more U.S. jobs. Taxing GE will increase U.S. jobs.

Under standard economic analysis, moreover, taxes on GE do not make it less efficient and competitive.⁶² Highly taxed, low-tax, and tax-exempt companies compete on par. All the competitors set their production, costs, and prices so that they break even on the last unit sold. There is no income tax on the last unit sold because there is no profit. Very high taxes are perfectly consistent with the efficient allocation of corporate capital. All the competitors, moreover, borrow money to invest, and borrowed money bears no corporate tax.

There is no sound economic argument for saying that GE should bear tax rates equal to the lowest tax rate in the world — an argument that would make it impossible to collect tax from anyone.⁶³ And if a lower tax rate on GE did have something to do with competition in the Cayman Islands and Bermuda, it would be wiser for the United States to give up on the competition rather than lose the billions of tax dollars that go to the mailbox subsidiaries there. Uncle Sam is not getting his money's worth for the revenue lost on global transactions.

The important aspect of economic efficiency, in any event, is not that every taxpayer must bear the least tax, but that taxpayers should bear the same tax on income from whatever source derived. The distortions caused by taxes are the high rates on some investments and low rates on others. By that measure, the solution is to bring tax on GE's global activities up to whatever level of tax, be it 25 or 35 percent, is expected on U.S. investments.

There are relatively moderate solutions to reduce the impact of tax havens, while leaving the core advantage of mailbox subsidiaries intact. Robert Dilworth has proposed allocating more of the interest, administrative overhead, and R&D expenses now deducted domestically to match untaxed revenue from the havens.⁶⁴ Bret Wells and Cym Lowell are considering a tax of about 10 percent on expenses paid to offshore affiliates, absent IRS ap-

proval of the reasonableness of the expense.⁶⁵ It is possible to expand the definition of U.S. permanent establishment so that activities of multinational employees nominally employed by an offshore affiliate are counted to make more of the multinational revenue U.S.-source income.⁶⁶ David S. Miller suggests 12 narrow amendments to current law, starting with not allowing subpart F income of foreign subsidiaries taxed to U.S. parents to be limited by the sub's earnings and profits.⁶⁷

A cleaner solution would be to stop giving respect to wholly owned subsidiaries in tax haven subsidiaries.⁶⁸ We would even give a tax credit with a per-country limit for income tax, if any, paid to the haven. The certificates of incorporation are just pieces of paper within a single economic unit. The tax haven subs are owned, controlled, and managed in the United States. There is no economic distinction between a subsidiary and a branch. We have adopted a kiddie tax to prevent infants from being considered the real owners of capital income,⁶⁹ and the mailbox subsidiaries have less will of their own or separate economic interests than a toddler does. On this issue, GAAP accounting, which requires that companies report on a consolidated basis, ignoring whether the company operates via branches or subsidiaries, is wiser than tax accounting.⁷⁰ The respect for subsidiaries or for transactions with or among subsidiaries is not required by the Constitution, which requires only that taxes that resemble requisitions be apportioned among the states,⁷¹ which allows taxation of income from whatever source derived,⁷² and which allows any kind of corporate tax because corporate taxes are an excise tax.⁷³

Disregarding tax haven subsidiaries also would end treating transactions among wholly owned

⁶¹Bob Sechler, "GE's Worldwide Workforce Down 5.6% in 2010 at 287,000," Fox Business News (Feb. 25, 2011), available at <http://www.foxbusiness.com/industries/2011/02/25/ges-worldwide-workforce-56-2010-287000/>.

⁶²See, e.g., Gravelle, *supra* note 46, at 476-477.

⁶³Cf. Johnson, "Repeal Roth Retirement Plans to Increase National Savings," *Tax Notes*, Aug. 16, 2010, p. 773, *Doc 2010-15996*, 2010 *TNT* 160-3 (arguing that repealing the tax exemption for savings would unambiguously increase national savings).

⁶⁴See, e.g., Dilworth, *supra* note 54, at 1117.

⁶⁵Bret Wells and Cym Lowell, "International Tax Reform: Source Is the Lynchpin" (draft of Apr. 11, 2011).

⁶⁶See, e.g., *Rolls-Royce Plc v. Deputy Director of Income Tax [India]*, ITAT Nos. 1496 to 1501/DEL of 2007 (activities of Rolls-Royce employees nominally employed by British parent made Rolls-Royce's income effectively connected with Indian business), discussed by Wells and Lowell, *supra* note 65, at 95-99.

⁶⁷David S. Miller, "How U.S. Tax Law Encourages Investment Through Tax Havens," *Tax Notes*, Apr. 11, 2011, p. 167, *Doc 2011-4766*, 2011 *TNT* 70-3 (Miller finishes his article, however, by suggesting that his reforms to stop encouraging tax haven transactions might be worse than doing nothing).

⁶⁸Jasper L. Cummings Jr., "Consolidating Foreign Affiliates," 11 *Fla. Tax Rev.* 143 (2011) (advocating mandatory consolidated returns with foreign affiliated corporations).

⁶⁹Section 1(g).

⁷⁰Financial Accounting Standards Codification 810-10-10-1.

⁷¹Johnson, "The Four Good Dissenters in *Pollock*," 32 *J. of Supreme Ct. Hist.* 162 (2007).

⁷²U.S. Const., Amend XVI.

⁷³*Flint v. Stone Tracy Co.*, 220 U.S. 107, 150 (1911).

affiliates as if they were real bargains negotiated between adverse economic entities. One should not expect to be able to prevent the shifting of profits to tax havens that for example are 70 times the average for the multinational group as a whole, as long as accounting entries within the group are treated as if they are real economic events.

An even simpler solution would be to compute income for the entire multinational corporation on a worldwide, consolidated basis and then allocate the total income among national jurisdictions by sales.⁷⁴ Formulary apportionment has the advantage of not needing to respect the transactions among wholly owned mailboxes as if they were real transactions. Under formulary apportionment, all the income attributed to the United States is U.S.-source income and there is no reason to give credits for taxes paid to other jurisdictions.⁷⁵ Changing to a formulary apportionment system, given our network of treaties with our trading partners, would be work. A tax on market capitalization would prove faster, more flexible, more efficient, and more effective.

3. Depreciation shelters. GE reported an effective tax rate of 7.4 percent of \$4 billion GAAP earnings, relying not on tax paid in 2010, but on deferred taxes of \$860 million.⁷⁶ Deferred taxes are taxes that have not been paid but that would have been paid if the tax system followed GAAP in its computation of taxable income. Treating them as if they were paid misleads the understanding of how taxes reduce pretax returns. The GAAP error of presuming a 35 percent tax on GAAP income is, however, a long-standing error.⁷⁷

The deferred tax account is a composite of many offsetting adjustments. Deferred tax is increased by depreciation deductions, under accelerated schedules, that are bigger for tax than under GAAP. Deferred tax, however, is reduced by tax deductions that are smaller under GAAP than tax because, for example, the tax system will not allow deductions

for warranties or other future payments that GAAP requires to be accrued early. GAAP expenses are also larger than tax deductions, reducing deferred tax in later years of an accelerated depreciation schedule for equipment. Deferred tax also includes amounts that GE will pay on repatriation. Deferred tax is a complicated account, and is only a rough assumption under limited information that allows us to estimate that \$860 million is attributable to accelerated depreciation.

Accelerated depreciation reduces the effective tax rate on investments in equipment. To identify the pretax IRR from an investment, the adjusted basis must be kept, up to the remaining value of the investment.⁷⁸ The IRR is the interest on the bank account that is identical in cash flows as the investment under examination. IRR is a universal yardstick allowing us to compare many investments that compete with each other but are not alike. Identifying the interest means simultaneously identifying the bank account balance on which the interest is earned. The bank account balance consistent with identifying IRR will equal the net present value of the future cash flows discounted at the IRR — that is, the remaining value of the investment. Accelerated depreciation drops basis below the remaining value of the investment and makes it impossible to have taxable income identify the real IRR from the investment.

In 2010 equipment was eligible for bonus depreciation, which allowed a deduction for half of basis when the equipment was placed in service,⁷⁹ then allows “double declining” depreciation for the other half of basis over a statutory tax life that is shorter than economic life. Under one reasonable set of assumptions, bonus depreciation reduces the statutory corporate tax rate of 35 percent to 10.4 percent in terms of real (IRR-reducing) effective tax rate.⁸⁰ The bonus depreciation schedules are stealth tax cuts because they are not well understood and reduce the real tax rate by more than two-thirds.

When low-taxed equipment is debt financed, moreover, the interest deduction turns the low rate into a tax shelter. Deduction of interest saves 35 percent of the interest, and the revenue caused by the

⁷⁴Reuven S. Avi-Yonah et al., “Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split,” 9 *Fla. Tax Rev.* 497 (2009); Avi-Yonah and Kimberly A. Clausing, “Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment,” in *Path to Prosperity: Hamilton Project Ideas on Income Security, Education, and Taxes* 319, 327 (2008).

⁷⁵The classic discussion of multinational corporations’ manipulations of the tax credit is Charles I. Kingson, “The Coherence of International Taxation,” 81 *Colum. L. Rev.* 1151 (1981).

⁷⁶2010 annual report, *supra* note 2, at n.14. The \$860 million is 7.4 percent times \$11.6 billion in reported earnings.

⁷⁷Johnson, *supra* note 19, shows adjustments necessary for taking deferred tax out of tax expense to calculate the impact of taxes on IRR. On accounting, *see, e.g.*, Accounting Research Bulletin No. 43 ch. 10B para. 4 (1953) (requiring allocation of income tax expenses paid in the future to the current period).

⁷⁸Johnson, *supra* note 19. The seminal work is Paul Samuelson, “Tax Deductibility of Economic Depreciation to Insure Invariant Valuations,” 72 *J. Pol. Econ.* 604 (1964).

⁷⁹Section 168(k)(4).

⁸⁰The assumptions for the calculation were a 10 percent pretax return, constant revenue, and an economic life of just under 10 years depreciated with a tax life of five years. Different assumptions about the pretax return will yield different results, with, for example, a higher pretax return yielding a larger drop in the statutory tax rate. The logic of the spreadsheet is much the same as that in the spreadsheets in *infra* note 81.

borrowing and matched with the interest is taxed at 10.4 percent, for a net subsidy to the equipment of 24.6 percent of income. The subsidy allows GE to tolerate fairly abysmal returns that are offset by the benefits of the tax shelter. The tax accounting mismatch between bonus depreciation and interest deduction also means that GE is generating artificial tax losses on profitable investments.⁸¹ Neither allowing poor investments to be profitable, which would lose money in a tax-free paradise, nor generating the artificial tax losses is a very good idea. Bonus depreciation probably was allowed under the misunderstanding that it would get closer to the untaxed nirvana, but the depreciation shelters actually make the economy worse by allocating capital into equipment that cannot pay its own way.

Without its equipment tax shelters, GE would have paid roughly \$860 million more tax on 2010 income, assuming that its net deferred tax was attributable to those shelters.

4. Business tax credits. GE's 2010 annual report states that business tax credits dropped its taxes by 4.4 percent of earnings, or \$500 million.⁸²

There is a consensus forming across party lines that discretionary spending by the federal government will need to be cut to avoid the impending budget catastrophe.⁸³ The Joint Committee on Taxation has called business tax credits synthetic spending. They resemble federal spending, except there are fewer rational controls and less competition for the resources. For example, the \$250 million credit for "Phase II qualifying gasification projects"⁸⁴ and the \$1.26 billion credit for some advanced coal facilities that are allocated among taxpayers both look like government spending, but without adult supervision. The credits, like all tax expenditures, are enacted by an unholy alliance between those who want big government subsidies and those who want small government. The alliance is internally inconsistent — one side or the other has to be wrong. The opponents of big government look at all tax reductions as a blow for liberty even when a reduction replicates a particularly wasteful government subsidy. And the proponents of the subsidy

are grateful to get it, with help from the political *opposition* to government subsidy.

On closer look at the research credit, I concluded that for example, it would be far more efficient if subsidies for research and innovation were administered as a reward by the National Science Foundation. Unworthy endeavors like the computer games mentioned above have become major beneficiaries of expensive and wasteful credits⁸⁵; Congress clearly does not know what it is doing with those credits. They need to be reviewed annually by both a substantive and an appropriations committee. Synthetic spending through the tax system is now twice as much as old-fashioned, explicit spending programs.⁸⁶ There is surely waste among the credits. The GE annual report, however, does not provide any detail on why it got the \$500 million in tax credits.

GE also reported a \$400 million reduction in tax for diverse reasons, with none being large enough to be material to GE overall earnings, but the absence of details makes it impossible to analyze why the last "immaterial" \$400 million was not paid in tax.

C. Conclusion

It is said that the French ancien régime fell because the richest country in Europe could not pay its debts. The regime could not pay its debts because the aristocracy, which held the wealth, was made exempt from tax.⁸⁷ GE is our aristocracy, both wealthy and exempt from tax on its economic resources. If we are to survive the impending budget crisis, we need to tap into the wealth of our nation.

We might improve the tax law on capitalization of intangibles, on offshore tax haven subsidiaries, on accelerated depreciation, and on tax credits, but each of those issues would entail hard, unpopular work by Congress to solve the real issues. A tax on market capitalization would cut the Gordian knot and solve all the problems, on a fair and

⁸¹Johnson, "Pretty Cruddy Investments Brought to You by Stimulus Depreciation," *Tax Notes*, Feb. 11, 2008, p. 731, *Doc 2008-1869*, 2008 *TNT* 29-41; and Johnson, "Depreciation Policy During Carnival: The New 50 Percent Bonus Depreciation," *Tax Notes*, Aug. 4, 2003, p. 713, *Doc 2003-17938*, 2003 *TNT* 150-28, give full spreadsheets showing the negative tax and lower pretax returns allowed by the tax shelter.

⁸²See *supra* note 2, at n.14.

⁸³See, e.g., Jeremy Scott, "Obama Tries to Recapture Momentum on Tax, Deficit Issues," *Tax Notes*, Apr. 18, 2011, p. 233.

⁸⁴Notice 2009-23, 2009-16 IRB 802, *Doc 2009-7802*, 2009 *TNT* 64-21.

⁸⁵Johnson, "Capitalize Costs of Software Development," *Tax Notes*, Aug. 10, 2009, p. 603, *Doc 2009-15569*, 2009 *TNT* 151-9.

⁸⁶Edward D. Kleinbard, "The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes," *Tax Notes*, May 18, 2009, p. 925, *Doc 2009-10867*, 2009 *TNT* 94-40.

⁸⁷See, e.g., Gail Bassenger, "Taxes," in *A Critical Dictionary of the French Revolution* 582-583 (1993) (concluding that the French ancien régime fell because it used a tax system so riddled with exemptions, privileges, and liberties that it could not reach the wealth of a prosperous country to solve the financial bankruptcy of the monarchy); Paul Kennedy, *The Rise and Fall of the Great Powers* 53 (1987) (saying that Spain fell because it relied on taxes only within Aragon to support its empire, and that even there, the aristocracy did not pay tax).

conveniently administrated basis. With the impending budget crisis, a tax on market capitalization of publicly traded corporations would be a good tax.

The Debate Over Oil and Mineral Taxes

By Jay Starkman



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Jay Starkman is a CPA and sole practitioner in Atlanta. This article is partially excerpted from his book, *The Sex of a Hippopotamus: A Unique History of Taxes and Accounting*. Stories from his book, humorous accounting videos, and tax songs are available at <http://www.starkman.com/hippo>. He can be reached at cpa@starkman.com.

Starkman examines the nearly 100-year history of the depletion allowance and other tax benefits for developing oil and mineral resources. For decades, these bounties have had a haphazard relationship with the need for energy and mineral incentives, and they are overdue for a comprehensive study and revision.

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The debate over raising taxes on the oil and gas industries cannot be fully understood without knowing the history and rationale of the current tax regime.

The Joint Committee on Taxation recently issued a report, "Description of Present Law and Select Proposals Relating to the Oil and Gas Industry," listing 10 tax benefits enjoyed by the oil and gas industry.¹ Indeed, what is needed is not just a review of the tax incentives for the production of oil and gas, but for all minerals that receive favorable treatment.

Early Tax Legislation

These benefits have their origin in tax laws passed almost 100 years ago. Many are historical

¹JCX-27-11 (May 11, 2011), *Doc 2011-10202*, 2011 TNT 92-22. The list consists of the credit for enhanced oil recovery costs (section 43), the marginal well tax credit (section 45I), the expensing of intangible drilling costs (section 263(c)), the deduction for qualified tertiary injectant expenses (section 193), the amortization period for geological and geophysical costs (section 167(h)), percentage depletion (sections 613 and 613A), the deduction for income attributable to domestic production of oil and gas (section 199), the exception from passive loss rules for working interests in oil and gas property (section 469), foreign tax credits for dual-capacity taxpayers (section 901; reg. section 1.901-2(a)(ii)), and the last-in, first-out inventory method (section 472).