GAAP Tax

by Calvin Johnson

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There have been proposals over the years, Johnson explains, to use income reported by corporations to their shareholders under Generally Accepted Accounting Principles, or "GAAP," as the base for computing corporate taxable income. Johnson argues against using GAAP as a tax base. In many circumstances, corporations can underreport their earnings without adverse nontax consequences. In other circumstances, he argues, a tax on GAAP income would cause reported earnings to shrivel. Corporations will replace reported earnings with footnote disclosures or third-party rating standards or some other form of communication that will be less efficient than reported earnings, but will not be taxed. The shift away from reported earnings will damage the efficiency of the stock markets, Johnson argues, without producing government revenue.

A tax on GAAP must be compared to a better alternative, Johnson says, which is to tax a corporation on the change of its stock price, plus the dividends it has distributed. Change in stock price is a sounder tax base than GAAP, and Johnson criticizes GAAP as resting on bad theory. A tax base equal to changes in stock price plus dividends would be less sensitive to tax than GAAP, Johnson says. Johnson concludes by listing the kinds of companies that would pay more tax under a tax on change in share price than they pay either under current law or under a GAAP tax.

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Corporations report more income to their shareholders under generally accepted accounting principles (called "GAAP") than they report to their government for tax purposes. If we used nontax "GAAP" or book accounting for tax purposes, then we would have a broader tax base. In an appraisal presented to the most recent National Tax Association conference, Kenneth Wertz estimates that we could reduce corporate tax rates from the current 35 percent down to 28 percent by using income as reported under GAAP as a base for corporate tax. /1/

This report opposes a tax on GAAP. Reported GAAP income seems elastic enough that taxing it would cause the reported earnings to shrivel. Reported earnings is just a communication from management to the market related to what the stock of the corporation is worth. If there is a 28 percent or 35 percent tax on the amount communicated, then management will find less expensive ways, around the tax toll charge, by which to communicate the worth of their stock. A shriveling of the reporting of earnings would both reduce tax revenue and also damage the pricing mechanisms of the capital markets. There is a better alternative to a tax on GAAP, which would tax the substance and not just the shadows. A corporate tax base equal to changes in corporate share price, plus its dividends, would generate a sounder tax, based on better theory, and would also be less sensitive to tax.

I. Bit of History

A. The Irony of Thor Power Tool

The issue of whether tax should conform to GAAP or book income is an old issue. CPAs have long argued that tax should follow the "science of accounting" /2/ as determined by CPAs. /3/ In 1979, in the Supreme Court case of Thor Power v. Commissioner, the Chamber of Commerce, writing as an amicus for the taxpayer, argued that Congress intended that GAAP should be the "primary calculus" from which taxable income was computed. /4/ GAAP, the Chamber of Commerce argued, should be presumed to define taxable income, absent fraud, abuse, or a congressional attempt to subsidize activity. I wrote a counter amicus brief in Thor Power, arguing against the presumption. /5/ The inventory write-downs in Thor, the brief argued, were unproven. GAAP, the brief argued, leaned toward conservatism or understatement of income. Leaving determinations of tax up to the accountants, the brief argued, would allow a corporate taxpayer to determine its tax by its own say-so. Tax accounting, the brief said, was too important to be left to the accountants. The Supreme Court held for the government, saying that the presumption that tax must follow GAAP is "insupportable given the vastly different objectives that financial and tax accounting have." /6/ To my accounting friends I argued, ungracefully, that Thor stands for the proposition that accountants can do anything they want, but that has nothing to do with the tax system.

One should be wary of getting one's dreams. It turns out that using GAAP as the corporate tax base would be a pro-reform move because a tax on GAAP income would broaden the tax base and allow a drop in marginal rates. There is irony in that. The function of GAAP, under SEC auspices, is to prevent management puffery of income. The function of tax accounting law, under IRS auspices, is to prevent management understatement of income. GAAP and tax books have drifted apart, however, in part because of Thor, and management has succeeded in beating each regulatory scheme in detail, so as to report higher income to their shareholders under the anti-puffery rules than they report to their government under the anti-understatement rules.

If we used just a single set of books for both GAAP and tax, it is said, we could dampen some management manipulation. Taxable income is now described as "a free variable," meaning that management can push income downward without adverse consequences. If GAAP and taxable income conformed to each other, then corporate management could understate its tax accounts only at the cost of giving its shareholders financial statements that reflect a very dour view of how well management has been running the company.

B. The Bragging Tax of 1986

For the years from 1987 through 1989, GAAP income was subject to a tax that could be as high as 10 percent. Under section 55(f) of the code, as enacted by the Tax Reform Act of 1986, one-half of the difference between a corporation's GAAP income and its taxable income was a part of the base for the 20 percent alternative minimum tax. /7/ A 20 percent tax on one-half of the extra GAAP income could mean a 10 percent tax on what amounted to a corporation's bragging to its shareholders. The 10 percent bragging tax was set to end after three years, as it was being enacted, /8/ apparently because the bragging tax was considered to be insufficiently generous to capital. /9/ Both Kenneth Wertz and the proposal here, however, would reduce nominal corporate tax rates when the corporate base expands so as to leave the overall effective tax rates on corporations the same. Not every industry, however, would pay the same tax. We are both talking about structure of tax and not seeking to increase the amount of tax revenue collected from corporate capital.

II. The Troubles with a GAAP Tax

A tax on GAAP is probably not a very good idea. There are too many situations in which corporations can understate GAAP income without adverse consequences. Even for corporations for which GAAP income makes a difference, reported GAAP income should be expected to shrink to very modest levels if taxed. The suppression of reported GAAP income would harm the efficiency of the public markets for equity.

A. Immunity From Discipline

Conforming GAAP and tax would not discipline corporations whose stock is not traded on a public market. A closely held company, not trying to market its stock, does not care very much about the GAAP income reported on its financial statements. Closely held companies can tell their owners and creditors about their value and how they are doing, behind closed doors, with information and numbers that have very little resemblance to GAAP earnings. They can communicate in private and still report zero or trivial accounting earnings.

Even publicly traded companies commonly find it useful to understate both GAAP and taxable income. The Thor Power Tool case itself, for instance, involved a big write-down of inventory generating losses used for both tax and GAAP accounting purposes. The big write-down seems to have happened because management was trying to dump costs off onto prior management. In the tax year at issue, a takeover of the Thor Power Tool Company occurred. /10/ New management of the company got to close the books and hence write the report card on old management. New management had a strong motive to reduce the GAAP income for old management' reporting year. The more costs that new management could dump into the year at issue, the worse that old management would look, and the better new management would look by comparison. More costs written off in the reporting year, moreover, would mean that less costs would show up in the subsequent financial reports for which the new team had responsibility. The taxpayer was plausibly suppressing income for the year in question for both tax and GAAP purposes.

More generally, it seems to be rational, fairly often, for a corporation to anticipate future losses on its GAAP income statements. A publicly traded corporation will sometimes take what is called a "big bath" if it already expects a bad year. /11/ Moving losses forward into the already bad year hurts the company less than the losses would hurt if they were reported when the losses are ripe, spread out over the following years. The market tends to forget about the one bad year after some time, whereas losses reported year after year for many years reminds the market continually about how bad the news is coming from within the company. A big bath deduction would help the company for both nontax and tax reasons.

Corporations also sometimes manipulate their stock prices by deferring income to set up a trend line that looks good. If the company defers early income into later years, it can present to the market an ever-improving schedule of earnings. Extraordinary price earning ratios come about not because of earnings expected to continue at current rates, but because of the expectation of continuous improvements. The formula for valuing growth, $1/(i-g), can produce extraordinary price-earnings ratios, when the market assumes a rate of improvement, g, that is a substantial fraction of general discount rates, i, and the market assumes the growth will extend perpetually into the future. /12/ Many companies will thus defer GAAP income to set up a good extrapolation or trend line. If tax conformed to GAAP, the companies would get a tax cut as a bonus, even as they are manipulating the price of their stock.

B. Elastic GAAP Income

Taxing GAAP would also motivate companies to reduce the income they report to potential investors even when they are not immune from some adverse effects from understating income. Driving down reported income would be terrible for the efficiency of the stock market. GAAP earnings are just messages from managers who prepare financial reports to investors who use them. Taxing GAAP could be very much like shooting the messenger and messengers tend to be quite easily deterred by threats of being shot. Shareholders undoubtedly would find some other way of finding out about the performance of their corporations, but not by way of the message imparted by reported GAAP earnings.

Taxing GAAP would make U.S. accounting more like German accounting. German accounting is nearly useless for equity investors because German accounting has lots of hidden reserves, which are reversed into income in bad times. The reserves and reversals mean that the company presents a smoothed-out picture to its equity investors that does not tell investors very much about current conditions inside the company. /13/ Poor German financial accounting is a plausible factor explaining much of why German stock markets are so thinly developed. /14/

With the thinness of the stock market, German companies must rely heavily on bank debt for their capital. German accounting conservatism may well come in part from German conservatism in general, but a plausible alternative explanation of conservatism of German book income is that Germany imposes tax on that book income. /15

If tax and GAAP had to conform in the U.S., one should expect reported GAAP income to drop significantly. Under the efficient market thesis, investors get their information from all published sources and not just from the reported income figure. It does not matter, moreover, what format a corporation uses to disclose information to the public because the smart market will digest the information quickly and incorporate it in pricing decisions. /16/ Under the smart market thesis, for instance, footnote disclosures work about as well as earnings. Reported earnings do not matter much. If straightforward earnings reports were taxed, moreover, one might expect to see a new industry of information middlemen or brokers sprout up to fill the gap. The corporation would ship gigabytes of information to the new brokers and the broker would publish an index with some units of measurement relevant to ascertaining fair price of the stock. Perhaps Merrill-Lynch or Fidelity Investments, Morningstar or Bloomberg, Standard and Poor or Value Line, or some other company could become the company that administers a new standard rating system and puts its name on the ratings. Perhaps they would all put forward rival standards and yet another company would collect them all for any stock. Replacing reported earnings with footnote disclosures or some third-party rating system would undoubtedly mean a loss of some efficiency in communicating to the market, but the replacement would have the advantage of not being taxed.

When conformity of tax to GAAP was tried in the United States in 1954, U.S. corporations responded quickly with material reductions in taxable income. In 1954, Congress enacted two provisions intended to bring "[t]ax accounting...more nearly in line with accepted business accounting by allowing prepaid income to be taxed as it was earned...and by allowing reserves to be established for known future expenses." /17/ Corporations reacted immediately by establishing reserves for future expenses and deferral of received prepayments, which the Supreme Court described as having "a disastrous impact on the Government's revenue." /18/ A year later, Congress reacted to the revenue hole by repealing the provisions retroactively.19

Relying on a tax on GAAP income as a source of income will not produce much government revenue, it is fair to conclude, but a tax on GAAP is very likely to suppress whatever valuable financial information is contained in reported earnings.

C. Delta Stock Price Instead

A tax on GAAP must also be compared with a better idea. For those publicly traded companies for which a GAAP tax would be meaningful, why not tax changes in the price of the cooperation's own stock? A publicly traded company would have a tax base for a year equal to the algebraic sum of changes in the quoted price of its stock, plus its distributions to shareholders during the year. The delta-stock-price base might be a moving average over the prior three years or so, so as to dampen some of the volatility of stock prices.

A tax on change in stock price plus distributions would use the smart market to give accurate data about the worth of the company. The data provided by the smart market is of very much higher quality than GAAP-generated data. Current price of a share represents the summation of vectors representing millions of dollars of investment research incurred by investors who are working intensely in their own self interests. /20/ In the smart market, information is not hobbled by aged accounting conventions that often undercut finding the fair market value of the firm.

For a publicly traded company, reported earnings are a shadow or omen, useful in their own way, but value of stock is the underlying substance that shareholders care about. A delta-stock-price tax would probably not suppress good financial information because a change in stock price would measure something that matters and that shareholders care about. The earnings message can be replaced, but stock price can be taken away only by doing real harm in the shareholders' economic situation.

1. Integration? The proposal here is for tax on change in stock price (plus dividends) to replace only the section 11 corporate tax, but that is solely because of the focus of the debate on a GAAP tax to replace or support the corporate tax. There is no reason why the same tax collected at the corporation level might not also replace the shareholder tax as well and lead to full integration of the corporate and individual income tax. /21/

2. Poverty of accounting. In this context, it is also useful to remind ourselves about how bad the theory is that underlies GAAP. Since the 1940s, the fundamental precept of GAAP has been the "matching" of expenses against related income. /22/ The function of matching is to create a sample within a single-year report that might be typical for the firm over the long term. The only reason why a sample that might be typical is so important is that 1940s technology needed a perpetuity assumption to evaluate price.

The tool for determining price to be paid for stock, compatible with available technology, was to multiply current earnings by a price-earning ratio. Price-earnings ratio is the inverse of interest rate. GAAP earnings, under the matching rule, tries to shoehorn all that has happened and will happen to a firm into a single figure that might be said to look like an interest rate. /23/ Matching is blind to the time value of money because it shifts the time for reporting cash, without noting that the differences in time will make a difference in value. Matching often badly distorts outsiders' understanding of the net present value net worth of the firm. /24/ When matching theory was developed, however, there was not much choice. The perpetuity assumption was needed to come up with a price or present value. There were then no computer spreadsheet programs to find discounted present values of future uneven cash flows that might vary in interesting patterns in future years. Even time value discounting by compound interest under an exponent, i.e., 1/(1+i) /n, was mathematically burdensome at the time.

GAAP accounts also give too little loyalty to the balance sheet. As a matter of theory, the assets on a balance sheet should represent corporate wealth or capital, much as the balance of a bank account represents the depositor's wealth or capital. The assets on a balance sheet should explain corporate income from use of its capital much as a bank account balance explains interest earned on the bank account. GAAP accounting is too conservative to describe the corporation's capital, however, because GAAP ignores even manifest value in favor of historical cost and because GAAP refuses to recognize intangible assets the corporation itself has created. /25/ Income and balance sheet are inversely related; every cost is debited either as an expense against current income or as an asset on the balance sheet. Thus, if the balance sheet fails to describe the wealth of the corporation, it follows that GAAP income statement has also failed to describe the corporation's income. The difference between the book value net worth of a company based upon asset debit balances and the real value of the company determined by the aggregate market value of 100 percent of its stock is a measure of the cumulative error of GAAP income accounts over the past years. For the typical publicly traded corporation, the shortfall in book assets is material. Accounting theory may someday be better, but for now GAAP accounting is a pretty sick puppy.

3. Who's hurt? A tax on changes in stock price plus distributions would have a much broader base than a tax on GAAP, but rates should be adjusted to keep the effective rate at whatever level is desired. Specific companies would be hurt, however, because both tax and GAAP commonly ignores or under-prices valuable assets, and the delta-stock-price tax would capture the aggregate value of

those assets as the corporation increases in real value. The difference between a delta stock price tax and a GAAP tax or the current base would be especially large in the following kinds of companies:

(1) companies with valuable consumer brand names such as Coca-Cola or McDonald's; /26/

(2) pharmaceutical companies, which expense their research costs; /27/

(3) software companies like Intuit or Microsoft, which expense their investments in the development of software; /28/

(4) petroleum companies, which now deduct the cost of drilling successful wells; /29/ and

(5) service providers with human capital, but no more tangible assets. /30/

A tax on changes in stock price plus distributions would have a much broader base than a tax on GAAP, but rates should be adjusted to keep the effective rate at whatever level is desired.

The price of stock reflects the smart-market appraisals of the real value of the above assets, although they are not recorded as GAAP assets or as tax basis. Valuable assets that are not recorded on the balance sheet would mean, under a tax on GAAP, that those corporate resources have never been subject to corporate tax. A delta-stock-value tax base, however, would be broad enough to capture real values that both current tax and GAAP now miss.

III. Conclusion

A tax on income computed under nontax, generally accepted accounting principles would not be a good tax. Reported GAAP income would drastically shrink although the corporation's financial fortunes would be unchanged except for lower taxes. The smart market, which sets the price of shares, would find ways to get information about corporate health no longer included in GAAP income. Taxing GAAP would cut off a useful channel of information to investors, but it would not raise much revenue. A far better alternative is to tax the substance, rather than the messenger, by imposing a tax on increases in the price of the corporation's shares, plus the distributions that the corporation has made in the year. Since GAAP income is based on such poor theory, a tax on change in share price, imposed at the corporation level, would better measure the improvements in the corporation's economic situation, which the corporate tax is trying to reach.

/1/Kenneth Wertz, A Book Income Tax, Proceedings
of 91st Annual Conference on Taxation, 1998 (forthcoming 1999).

/2United States v. Anderson, 269 U.S. 422,
440 (1934).

/3See, e.g., Harold Dubroff, M. Connie Cahill,
Michael Norris, "Tax Accounting: The Relationship of Clear Reflection
of Income to Generally Accepted Accounting Principles," 47 Albany
L. Rev. 354, 404-405, 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."); American Institute
of Certified Public Accountants, Conformity of Tax and Financial
Accounting 132 J. of Accountancy 75 (1971) (tax and accounting
are based on common objective of fair determination of business income
on annual basis); Lasser & Peloubet, "Tax Accounting Versus Commercial
Accounting," 4 Tax L. Rev. 343, 347 (1949) (arguing that
tax law adopts a "strained, awkward, and difficult" departure
from GAAP, made by "men, no doubt eminent in their own fields,
but almost entirely innocent of any technical accounting knowledge").

/4/Brief for Amicus Curiae Chamber of Commerce
in Thor Power Tool Co. v. Commissioner [439 U.S. 522 (1979)],
October Term, 1977, at 3.

/5/Brief for Amicus Curiae Taxation With
Representation Fund and the Tax Reform Research Group in Thor
Power Tool Co. v. Commissioner [439 U.S. 522 (1979)], October Term,
1977.

/6Thor Power Tool Co. v. Commissioner, 439
U.S. 522, 540-544.

/7/Section 56(f), as enacted by Tax Reform Act of
1986, Pub. L. No. 99-514, section 2085. Professor Michael Graetz advocated
a minimum tax on book income at 26 Tax Reform Proposals: Hearings
before Senate Finance Comm., 99th Cong., 1st Sess. 50.

On the effects of the 1986 "bragging tax" on
company financial reports, compare Siing-Wu Wang, "The
Relationship Between Financial Reporting Practices and the 1986 Alternatie
Minimum Tax," 69 Accounting Rev. 495 (1994) (finding that
alternative minimum tax suppressed reported GAAP income) with

Won W. Choi, Jeffery D. Gramlich, and Jacob K. Thomas, "Potential Errors in Detection of Earnings Management: Reexamining the Studies of the AMT of 1986" (manuscript Sept. 1998) (concluding that it is premature to conclude that tax on GAAP suppressed reported GAAP income given, for instance, the other motives for shifting both book and taxable income among the years).

/8/The section 56(f) adjustment for book or GAAP income was replaced for years after 1989 by section 56(g) "adjusted current earnings."

/9See, e.g., Ernest S. Christian, Jr., George J. Shutzer, & Kathleen M. Nilles, "Fundamental Flaws in the Minimum Tax Depreciation Preference," Tax Notes, July 14, 1986, p. 151 (arguing that alternative minimum tax proposals will deny capital-intensive industries benefit of 200 percent declining balance depreciation and overtax capital); Byrle M. Abbin, "A Brief Critique of the Ways and Means Alternative Minimum Tax Proposal," Tax Notes, Oct. 28, 1985, p. 415 (arguing that alternative minimum tax on depreciation will erode value of accelerated depreciation under regular taxable income).

/10/Stewart-Warner Inc. acquired the taxpayer, Thor Power Tool Co., in late 1964. 439 U.S. at 526.

/11See, e.g., Lee Berton and Gay Sands Miller, "Accountants Debate Tightening Rules for 'Big Bath' Write-Offs by Companies," Wall. St. J., Feb. 11, 1986.

/12/The formula $1/(i-g) represents the present value of $1 of annual cash, growing beyond $l by percentage g, valued at discount rate i. The formula is valid only for i

/13See, e.g., David Hawkins, "Daimler-Benz: A U.S. GAAP Based Stock" in Stephen Zeff & Bala Dharan, Readings and Notes on Financial Accounting at 596 (5th ed. 1997); Yakov Amihud & Maurizio Murgia, "Dividends, Taxes and Signaling: Evidence from Germany," 52 J. of Finance 397, 406 (1997) (arguing that German accounting rules are less informative than in the United States).

/14/Stephan Prowse, "Corporate Governance in an International Perspective: A Survey of Corporate Control Mechanisms Among Large Firms in the U.S., U.K. Japan and Germany," 4 Financial Markets, Institutions & Instruments 1, 19 (1995) (lax disclosure requirements in Germany may have discouraged nonbank sources of corporate finance). See Rafael La Porta, et al., "Legal Determinants of External Finance," 52 J. of Finance 1131 (1997) (surveying the law of 49 developed countries and concluding that stock markets are not important in countries that fail to protect shareholder rights).

/15/David Hawkins, supra note 13, at 598.

/16/William H. Beaver, "What Should Be the FASB's Objectives?," 137 J. of Accountancy 49, 52 (August 1973).

/17/Sen. Report No. 372 on Internal Revenue Code of 1954, 84th Cong., 1st Sess. at 3 (1954) describing Internal Revenue Code of 1954, sections 452, 462, 68A Stat. 158.

/18American Auto. Assoc. v. United States, 367 U.S. 687, 695 (1961).

/19/69 Stat. 134 (1955).

/20See, e.g., Burton Malkiel, "Is the Stock Market Efficient?," Science 1313, 1317 (March 10, 1989) (answering largely yes); Foot & Perold, "New Trading Practices and Short-Run Market Efficiency," NBER working paper No. 3498 (Oct. 1990) (arguing that stock prices react fully to news within 15 minutes of the time the news becomes available).

/21See, e.g., Joseph Dodge, "A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal," 50 Tax L. Rev. 265, 194 (1995); David Weisbach, "A Partial-Mark-to-Market System," 53 Tax L. Rev. (forthcoming 1999).

/22See generally W.A. Paton & A.C. Littleton, An Introduction to Corporate Accounting Standards (1940).

/23/Calvin Johnson, supra note 12, 19 Cardozo L. Rev. at 660-662 for a more extended explanation of the critique of price-earnings ratios.

/24See Calvin Johnson, "The Illegitimate 'Earned' Requirement in Tax and Nontax Accounting," 50 Tax L. Rev. 379-382 (1995) (arguing that GAAP fails elementary time-value-of money principles and giving examples).

/25See infra notes 26-30 and accompanying text.

/26See, e.g., Bernard Condon, "Gaps in GAAP," 163 Forbes 76 (January 25, 1999) (arguing that GAAP fails to include the value of valuable intangible assets such as trademarks, pharmaceutical research, and workforce). For an argument that firms should be able to capitalize the value of their brand names under GAAP (although they do not), see Peter Farquhar, Julia Han and Yuri Ijiri, "Brands on the Balance Sheet," Marketing Management 16 (Winter 1992) reprinted in Stephen Zeff & Bala Dharan, Readings and Notes on Financial Accounting at 351 (5th ed. 1997).

/27/Section 174 (allowing immediate deduction of investments in research and experimental costs); Accounting for Research and Development Costs, Statement of Financial Accounting Standard No. 2, para. 49 (1974) (requiring the immediate expensing of research and development costs).

/28See Rev. Proc. 69-21, 1969-2 C.B. 303 (allowing expensing of cost of developing software); Accounting for The Costs of Computer Software to be Sold, Leased or Otherwise marketed, Statement of Financial Accounting Standard No. 86 para. 3-6 (1985) (requiring immediate expensing of research and development costs of software prior to technological feasibility and general capitalization of development costs after technological feasibility is established).

/29Section 263(c) (allowing immediate expensing of the costs of drilling oil wells); Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies, Statement of Financial Accounting Standard No. 25 (1979) (allowing capitalized asset to reflect either the costs of only successful efforts or to reflect the full cost of entire drilling program).

/30/Accounting Principles Board Opinion No. 17, Intangible Assets paras. 11, 24 (1970) (costs of developing intangible assets which are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business as a whole are expensed when incurred).