

Can the Smart Market Solve the Problem of Undertaxed Intangibles?

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Calvin H. Johnson, *Organizational Capital: The Most Important Unsettling Issue in Tax*, 148 **Tax Notes** 667 (2015), available at [SSRN](#).

In his article, *Organizational Capital: The Most Important Unsettling Issue in Tax*, Professor [Calvin Johnson](#) argues that the undertaxation of intangibles is “the most important, most damaging issue in tax policy” and proposes a radical solution to remedy the problem: a new tax based on the trading value of public companies.

As Johnson explains, intangibles are undertaxed because businesses deduct—rather than capitalize—most expenditures related to self-created intangibles. At the same time, businesses report income from self-created intangibles over a period of years. As Cary Brown demonstrated, allowing an immediate deduction for expenditures that produce future income is the equivalent of exempting the income from tax. Thus, much income from self-created intangibles is in effect tax free.

The deduction for self-created intangibles contravenes the fundamental income tax principle, articulated in [INDOPCO v. Commissioner](#) and other Supreme Court jurisprudence, that expenditures producing future benefits should be capitalized and amortized over time as income is realized. As Johnson notes, Treasury regulations issued during the George W. Bush administration severely undermine the fundamental capitalization principle. The regulations so blatantly flout the capitalization principle that commentators have dubbed them the “anti-INDOPCO” regulations and have questioned their legality. The regulations, along with statutory provisions, lower court case law and other administrative guidance, allow taxpayers to deduct almost all costs of self-created intangibles.

The magnitude of the problem is enormous. By some estimates, \$1 trillion or more of investments in intangibles is expensed rather than capitalized under the national accounting rules that measure economic productivity, indicating that a comparably large dollar amount is deducted for tax purposes. The 2014 Senate Finance Committee and House Ways & Means Committee proposals to require capitalization of just two types of costs—research and development and advertising—would have raised an estimated \$362 billion in tax revenues over ten years. A more comprehensive capitalization requirement for self-created intangibles would increase tax revenues by several times that estimate.

The undertaxation of intangibles benefits some companies and industries more than others. Johnson cites Google and Microsoft as examples of companies whose self-created intangible assets, as evidenced by market capitalization, are worth hundreds of billions of dollars, but whose balance sheets show none of these assets. In large part because these companies deduct the costs of developing their intangible assets, Johnson argues, their effective rate of tax is a small fraction of the nominal 35 percent rate. In contrast, companies like Macy’s, whose market value closely approximates the assets on its balance sheet, pay tax at or near the nominal rate.

This disparity in effective tax rates leads to what Johnson considers to be the most serious problem created by the undertaxation of intangibles: distortions in investment decisions that produce inefficient misallocations of capital. Investors choose to invest Google rather than Macy’s, even if Macy’s would be

a better investment the absence of Google's tax advantage. Businesses choose to self-create intangibles rather than to acquire them in the market because they can deduct the costs of self-created intangibles, while they must capitalize acquired intangibles, even where, in the absence of tax considerations, it would be more efficient to acquire them in the market. These distortions in investment decisions reduce economic productivity and are costly to society as a whole.

To remedy the problem of undertaxed intangibles, [I have proposed](#) to capitalize and amortize over five years a broad array of costs related to the creation of intangibles, including research and development, advertising and market research, worker training, executive compensation, and strategic planning. Johnson argues that such a cost recovery approach would encounter many practical difficulties, such as matching specific costs with identifiable assets and determining accurate recovery periods. In addition, and perhaps more importantly, Johnson observes that such an approach, even if it could be implemented with reasonable accuracy, would fail to tax what he calls "organizational capital," by which he means the value of intangibles over and above the costs related to their production. Some components of organizational capital that Johnson identifies are (1) the ability to access public markets and (2) the first-mover advantages for companies like Microsoft.

Johnson proposes a more radical solution to the problem of undertaxed intangibles: a new tax based on the trading value of public companies. He argues that his proposal would both avoid the practical problems of a cost recovery approach to intangibles taxation and capture the value of all intangibles including organizational capital. His proposal would essentially tax intangibles on a mark-to-market basis.

Johnson's proposal is intriguing and theoretically sound but raises many design and implementation questions. Johnson provides scant detail about how the tax rate under his proposed tax would be calibrated, other than to say that a rate equivalent to the current tax rate on corporate income could be extrapolated using market capitalization and an assumed cost of capital interest rate. In addition, as Johnson concedes, a tax based on trading values would obviously work only for publicly traded companies, which constitute a very small percentage of businesses. Under Johnson's proposal, the vast majority of businesses, which are privately held, would not be subject to the new tax. For these businesses, the problem of undertaxed intangibles would have to be addressed in other ways such as the cost recovery solution I have proposed. Finally, Johnson's proposal places faith in what he calls the "smart market," despite indications that the market may not be so smart. However, as Johnson points out, the current tax and accounting treatment of intangibles is so deeply flawed that even an imprecise solution would almost certainly be an improvement.

Whether Johnson's smart market proposal can better address the problem of undertaxed intangibles than a more conventional cost recovery approach is open to debate. Either way, however, I wholeheartedly agree with Johnson that it is a serious problem that deserves the attention of law and policy makers and I applaud his creative and bold proposal.

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