Keeping Us Honest about the Timing Flaws in the Income Tax

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Daniel I. Halperin & Alvin C. Warren Jr., *Understanding Income Tax Deferral*, **Tax L. Rev.** (forthcoming), available at SSRN.

We all do it once in a while. In the haste of trying to make a point in class, or in a hurried comment to the press, we overstate the effect of the failure of a tax law rule to take into account the time value of money. "The effect of deferral of income," we may boldly assert, "is the exemption of the earnings on the amount deferred." A recent short essay by Dan Halperin and Al Warren entitled *Understanding Income Tax Deferral* should help us all stay a bit more accurate when we make these claims. As Halperin and Warren point out, although in some limited circumstances the benefit of deferral *can* be the exemption of the earnings on the amount deferred, often the effect of an apparent deferral is more limited and more nuanced. In some cases, timing flaws produce only reduced taxation, not full exemption, while in other cases rules that seem to involve timing flaws merely shift income to other taxpayers or to other taxing jurisdictions. Halperin and Warren remind us that it can be very important to be able to distinguish between these results. This paper will displace Halperin's 1986 classic in my must-read recommendations for beginning teachers of tax.

There is little that is actually new in the essay. However, it is a much-needed and succinct guide to the principles involved when considering the effect of timing in the rules defining the income tax base. Thirty years ago, when interest rates were high, correcting the timing mistakes embedded in the income tax law was a high policy priority. For example, the original issue discount rules were tightened and applied to many more transactions (in sections 1271, 1274 and 7872) and the possibility of accruing costs before payment were substantially curtailed (through various changes in the taxation of retirement savings and in sections 461(h)). In this era, the principles Halperin and Warren newly examine here became a mainstay of tax policy analysis. No one participating in policy discussions could afford not to understand them.

But in the recent era of extremely low interest rates, these timing issues may seem hardly worth the effort it takes to learn them with any rigor. And these principles have become more sloppily invoked in policy arguments.

Despite low interest rates, a thorough understanding of time-value interactions remains crucial to understanding current tax policy debates. Without them, one cannot understand the ways in which the income tax may continue to evolve to become more like a consumption tax. Nor can one fully understand the stakes in revising the US approach to taxing the offshore earnings of multinationals, which is the subject of a companion primer written by Warren. It is in these discussions that the failure to pay close attention to the application of the underlying time value principles can lead to exaggeration and inaccuracy.

This short piece thus outlines succinctly what is—and what is not—at stake when tax rules fail to reflect the exact time at which a value that normatively should be treated as income is created. The familiar bottom line is that when an item of income excluded (or, more familiarly a unwarranted deduction is granted), the resulting reduction in income tax due is the same as if the income on the erroneously-

accounted-for amount were explicitly made exempt. Halperin and Warren are careful to be precise about the conditions that must be met in order for this proposition to hold in the real world: the initial rate of return must remain available for all re-investments of tax savings, the tax savings must be available for such immediate reinvestment when these savings first arise and on each iteration of reinvestment, and the tax rate must remain constant. (Their assumption is actually stated in a slightly weaker way, that there must be "enough taxable income to absorb the deduction." The difference is trivial in the abstract, but could be crucial in real tax policy debates. For instance, because withholding of wage income makes immediate reinvestment difficult, the analysis may not apply when the only income to be offset is wage income.) They emphasize that if the initial rate of return cannot be replicated on the reinvestment, *the return on the original investment is exempt but only to the extent of this lower return.* Halperin and Warren also emphasize the similarly overlooked point that *the benefit of the deferral can also be less than the value of an exemption* if the return on the tax saved by the deferral is not itself subject to deferral.

After clarifying these simple but often overlooked variations of the partial (and occasional full) exemption of returns through deferred inclusion or inappropriate deduction, Halperin and Warren point out the relationship of this phenomenon (which they refer to as "pure deferral") to what they somewhat reluctantly refer to as "counter-party" deferral. In such cases, a benefit is derived from the timing of the tax treatments only because of the tax treatment of another potential taxpayer during the period of deferral.

An individual taxpayer and his or her IRA provide one example of a pair of "counter parties"; a U.S. parent corporation and its non-U.S. subsidiary provide another example. If tax rates remain constant, there is a benefit to a deductible IRA only because the earnings within the IRA are not taxed; as is well known, this benefit is the same as if the deduction were not allowed and the earnings within the IRA were not taxed. Similarly, there is a tax benefit to the deferral of the offshore income of multinationals only because this leaves the earnings on the funds in non-U.S. subsidiaries not taxed at US rates. In other words if tax rates remain the same, the tax avoided upon contribution (or, in the case of US multinationals, deferral) has the same present value as the tax to be paid upon withdrawal from the IRA (or repatriation). The tax play turns on the rules governing the taxation of the fund during the period of deferral.

Put still another way, a deduction in time 1 will be entirely and exactly offset by an inclusion of that amount plus the return on that amount in time 2. Note, however, that the additional tax imposed at time 2 can only be either an amount that undoes the earlier benefit, or a tax on the return during the interim time period itself; it cannot be both. Counter-party deferral amounts to exemption only when there has been no other tax on the return in the interim.

The difference between the two phenomena distinguished by Halperin and Warren can be confusing, because many examples that are asserted in some situations as if they involved pure deferral actually involve only counterparty deferral. The difference is not as well-specified by Halperin and Warren as it might be, but the gist of the difference is whether an amount is completely omitted from the income tax base of all of the parties to the transaction, or whether it is only effectively moved temporarily from one taxpayer to another, and then restored to the original taxpayer. In "pure deferral", for example in the case of accelerated depreciation, the amount in question is initially omitted from the tax base and will reappear only as the same nominal value; in "counter-party deferral", the amount will reappear increased by a rate of return, as in the case of tax-preferred savings accounts.

The recent attempt of Halperin and Warren to lay out with some precision what is at stake in the various phenomena loosely called "deferral" is a welcome contribution and should become a go-to primer. The essay includes the math critical to the analysis, but in a way that does not require the reader to be able

to reproduce it in order to get the full message. It is also a useful review of the literature produced by tax academics in law schools (significantly by Halperin and Warren themselves) that connects the relatively simple financial principles regarding the time value of money with the on-the-ground tax policy debates in which they properly appear.

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