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Retroactive Taxation and the Baucus Proposal

By
Michael Schuyler

Introduction

Senator Max Baucus (D-MT), chairman of the Senate Finance Committee, has released a series of staff discussion drafts that suggest numerous changes in international taxation, tax enforcement, and the tax treatment of capital costs.[1] The centerpiece of the plan is a cut in the federal corporate income tax rate, which is currently the highest among the world's developed economies.[2] The draft does not specify the target rate, because that will depend on revenue estimates and refinement of the plan, but Senator Baucus expects it will be under 30 percent. To pay for the lower rate, the plan would expand the definition of taxable income, an action known as base broadening.

Senator Baucus hopes the proposals will provide the basis for tax reform legislation. A press release issued by the Senate Finance Committee stated that while this is "not a final plan, the staff discussion drafts are intended to spur a conversation about areas where Republicans and Democrats may be able to reach agreement on how to fix the broken tax code."[3]

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[1] For a summary of the international tax proposals and links to more detailed information, *see* Senate Finance Committee, *Baucus Unveils Proposals for International Tax Reform*, Nov. 19, 2013, http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14.
For a summary of the enforcement proposals and links to more details, *see* Senate Finance Committee, *Baucus Unveils Proposal to Combat Tax Fraud, Make Filing Safer, Simpler and More Efficient*, Nov. 20, 2013, http://www.finance.senate.gov/newsroom/chairman/release/?id=a4f8205c-d286-4a41-a61d-753d1abd23d3.
For a summary of the capital cost recovery provisions and links to more details, *see* Senate Finance Committee, *Baucus Works to Overhaul Outdated Tax Code*, Nov. 21, 2013, http://www.finance.senate.gov/newsroom/chairman/release/?id=536eefeb-2ae2-453f-af9b-946c305d5c93.

[2] *See* William McBride, *How Tax Reform Can Address America's Diminishing Investment and Economic Growth*, TAX FOUNDATION FISCAL FACT NO. 395 (Sept. 23, 2013), http://taxfoundation.org/article/how-tax-reform-can-address-america-s-diminishing-investment-and-economic-growth. For a discussion of effective corporate tax rates, which are also among the world's highest, *see* Phillip Dittmer, *U.S. Corporations Suffer High Effective Tax Rates by International Standards*, TAX FOUNDATION SPECIAL REPORT NO. 195 (Sept. 13, 2011), http://taxfoundation.org/article/us-corporations-suffer-high-effective-tax-rates-international-standards.

[3] *See Baucus Unveils Proposals for International Tax Reform*, *supra* note 1.

The senator states that while he "believes tax reform as a whole should raise significant revenue," the current proposals are "intended to be long-term revenue neutral."[4] However, it is likely the plan would be a net tax increase in the short term, although the draft documents are unclear on this point.

A notable feature of Senator Baucus's proposal is that it includes three major, retroactive tax increases that will be used to pay for the corporate tax rate reduction. Retroactive tax increases are not unprecedented and may be legal, but they do raise serious policy issues and more than a few eyebrows. They smack of breach of faith, and they have the potential to discourage future economic activity by undermining certainty and trust in the tax system and the government. This Fiscal Fact describes the proposed retroactive taxes and then briefly outlines policy arguments for and against retroactive taxation.

Baucus's Proposed Changes to the Tax Code

Deemed Repatriation

The United States is one of the few nations with a worldwide income tax system: U.S. individuals and businesses must pay U.S. tax on income earned abroad as well as on U.S. income. All but a handful of nations have territorial income tax systems: income earned outside the country is either exempt from the nation's tax or taxed at a sharply reduced rate.[5] Because of fears that the combination of worldwide taxation and the exceptionally high corporate tax rate will prevent U.S. businesses from being able to compete abroad, current federal law furnishes partial relief. U.S. taxpayers may claim a foreign tax credit for income taxes paid to other nations on foreign-source income, and they may defer U.S. tax on the income of foreign subsidiaries until they realize the income by bringing it into the United States (known as repatriation).

Accumulated overseas earnings have increased rapidly in recent years because the world is becoming more integrated economically, foreign economies and markets are growing relative to the U.S. market, and the U.S. tax on repatriated earnings creates a powerful lockout effect. According to some recent estimates, the accumulated foreign earnings of U.S. companies may now be in the $2 trillion range.[6]

Under current law, those past earnings are not subject to U.S. tax unless and until they are repatriated. A "deemed repatriation" provision in the Baucus proposal would change the rules for the tax treatment of those past earnings. This provision states that "historical earnings of foreign subsidiaries that have not been

[4] *Id.*

[5] For a fuller discussion, *see* Philip Dittmer, *A Global Perspective on Territorial Taxation*, TAX FOUNDATION SPECIAL REPORT NO. 202 (Aug. 10, 2012), http://taxfoundation.org/article/global-perspective-territorial-taxation.

[6] *See* Douglas Holtz-Eakin & Gordon Gray, *Ending the Lockout of Overseas Earnings: An Update* (Aug. 2013), http://americanactionforum.org/uploads/files/research/Overseas_Earnings.pdf.

subject to U.S. tax are subject to a one-time tax at a reduced rate of, for example, 20% payable over eight years."[7]

The Senate Finance Committee does not say how much it expects the deemed repatriation provision to collect, but some estimates, after allowing for foreign taxes already paid on the earnings, are in the vicinity of $200 billion.[8]

Repeal the Current Depreciation System, Including for Existing Assets

When Congress changes the rules regarding capital cost recovery allowances, it normally does so prospectively. For example, the Tax Reform Act of 1986 (P.L. 99–514), which the Baucus proposal describes as the "last major overhaul of our country's tax code,"[9] replaced the old Accelerated Cost Recovery System (ACRS) with the Modified Accelerated Cost Recovery System (MACRS), but specified that property placed in service before 1987 would continue to be depreciated under old law. It is not unheard of for Congress to change cost recovery rules retroactively, but those changes typically do not go far back and are in taxpayers' favor, meaning that existing capital does not receive smaller depreciation allowances than promised. For instance, the Job Creation and Worker Assistance Act of 2002 (P.L. 107–147), which became law in March 2002, created a temporary, 30 percent bonus expensing allowance (mostly for equipment) and retroactively extended the effective date back to September 11, 2001.

The Baucus proposal would create a new depreciation system, effective January 1, 2015. Depreciable assets would be divided into five categories. Four would be pools with yearly depreciation rates of 38 percent, 18 percent, 12 percent, and 5 percent. For comparison, if one assumes a 5 percent discount rate, these pools' depreciation allowances would have approximately the same present values as straight-line depreciation over 4 years, 9.5 years, 14 years, and 34 years, respectively.[10] The fifth category would include structures and some utility property and require straight-line depreciation over 43 years. In general, depreciation would be slower and the present value of depreciation allowances much smaller than under current-law MACRS.

In a break with precedent, the new system would apply to existing depreciable assets, not just future ones.[11] In an example furnished by Congress's Joint Committee on Taxation (JCT), consider a residential rental

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[7] U.S. Senate Committee on Finance, *International Business Tax Reform Discussion Draft*, Nov. 19, 2013, http://www.finance.senate.gov/imo/media/doc/Chairman's%20Staff%20International%20Discussion%20Draft%20One%20Pager.pdf.

[8] *See* Billy House & Sarah Mimms, *Baucus Floats Ways to Close Tax Loopholes for Overseas Businesses*, NATIONAL JOURNAL, Nov. 19, 2013, http://www.nationaljournal.com/congress/baucus-floats-ways-to-close-tax-loopholes-for-overseas-businesses-20131119.

[9] U.S. Senate Committee on Finance, *Summary of Staff Discussion Draft: Cost Recovery and Accounting*, Nov. 21, 2013, http://www.finance.senate.gov/newsroom/chairman/download/?id=b932d649-2a64-4827-a7a4-d2f177592a49.

[10] Straight-line depreciation was computed using the half-year convention.

[11] We thank Gary Robbins of Fiscal Associates for bringing this to our attention.

property that cost $907,500 and was placed in service in June 2005.[12] Under MACRS, residential rental property is depreciated over 27.5 years using the straight-line method. By the end of 2014, the property would have received 10 years of depreciation allowances, and it would be scheduled to receive 18 more. The Baucus proposal would switch the 10-year-old property to the new system in 2015. Annual depreciation deductions would suddenly drop from $33,000 to $18,000 and the depreciation schedule would be stretched out until 2047 instead of being completed in 2032.

The draft proposal does not provide estimates of how much revenue the suggested depreciation regime is expected to raise over the budget window, but $500 billion to $750 billion is a reasonable guess. Much would come from the system's prospective application to future investments but a substantial share would come from its retroactivity (particularly for existing structures and utility property).

Repeal LIFO

The last-in, first-out (LIFO) method of inventory accounting assumes the last items added to inventory are the first sold. A different inventory accounting method is first-in, first-out (FIFO), which assumes the oldest items in inventory are the first sold. For the last 75 years, the federal tax code has permitted businesses to use LIFO if they wish. The Revenue Act of 1938 gave this option to a small group of businesses, and Congress extended the option to all businesses in the Revenue Act of 1939.

Under current federal tax law, businesses often cannot deduct their inventory costs when they buy or construct items or commodities but must wait until they sell the items from inventory. In that context, LIFO more closely reflects current replacement cost, provides better protection against inflation than FIFO, and usually results in lower reported taxable income.

Because the general price level has risen over time, reported inventory costs are usually higher under LIFO than FIFO. The Baucus proposal would disallow LIFO. The disallowance would be retroactive in that it would force businesses that have been using LIFO to bring into current income the accumulated difference between LIFO and FIFO accounting for all past inventory.[13] One study estimated that, in 2007, 38 percent of Fortune 500 companies used LIFO and had accumulated LIFO reserves of $82 billion.[14] Many smaller C corporations and many pass-through businesses also use LIFO, which implies total accumulated LIFO reserves would be still higher. The Baucus proposal would let businesses pay the added tax over eight years.

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[12] *See* Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft to Reform Certain Business Provisions*, JCX-19-13, Nov. 21, 2013, at 26, http://www.finance.senate.gov/newsroom/chairman/download/?id=ccfc8169-75a8-4cfb-be20-51ba32eb9551.

[13] In real, inflation-adjusted dollars, the costs of old items in inventory are roughly the same as the costs of recent additions to inventory, on average. In effect, LIFO is roughly similar to assuming the oldest items are sold from inventory first but with an adjustment for inflation so that historic costs are not understated and income overstated, in real terms. Ending LIFO and entering the accounting difference would retroactively undo the de facto inflation adjustment.

[14] John Kostolansky, *The Impact Of LIFO In The Fortune 500 In 2007*, 25 JOURNAL OF APPLIED BUSINESS RESEARCH 11-20 (Sept./Oct. 2009), http://journals.cluteonline.com/index.php/JABR/article/view/1002/986.

Advantages of a Retroactive Tax Increase

A retroactive tax hike has appeal from the perspective of the tax collector. Provided the tax was unexpected, taxpayers will not have engaged in advance planning to reduce what they owe, and that means more money for the treasury. Although not quite the same thing, the phrase "shooting fish in a barrel" comes to mind.

An unexpected retroactive tax hike supposedly has an advantage in terms of efficiency—but only if it is not seen as a precedent for more retroactive taxes in the future. Taxes normally distort people's behavior, but a surprise, retroactive tax increase will have had no disruptive effect on past behavior because it played no role in those decisions. It will cause no distortions in future behavior only if taxpayers view it as a one-shot deal. That is a big "if."[15]

Disadvantages of a Retroactive Tax Increase

Retroactive tax increases may well cause taxpayers to fear more after-the-fact tax hikes down the road. In that event, the retroactive tax will distort future economic behavior, thereby reducing efficiency and slowing growth. The odds of this happening if the Baucus proposal were to become law are probably enhanced because the proposal contains not one but three substantial retroactive tax increases. Moreover, the proposed retroactive taxes are directed at business activity and investment is sensitive to expected after-tax returns. Therefore, the economic distortions could be large.

Another concern is fairness. If people make economic decisions and commitments under one set of tax laws and regulations, it can be inequitable if they are later told they will be taxed on their past actions according to different, harsher rules.[16]

A third issue is that a large tax increase will strain some taxpayers financially, especially if the tax hike is unexpected. The retroactive taxes in the Baucus proposal would be both large and unexpected. The element of surprise accentuates the financial stress because taxpayers may already have committed to other purposes the money now needed for taxes. For example, a foreign subsidiary of a U.S. company may have reinvested its earnings in new facilities or acquisitions that cannot be readily liquidated to pay the parent's deemed repatriation tax. To their credit, Senator Baucus and his staff would spread the retroactive taxes on deemed repatriations and the repeal of LIFO over eight years. That would ease the crunch, but many companies would have such large retroactive tax bills that they would still be under considerable financial pressure.

A fourth consideration is that the tax change would not be a total surprise since the discussion draft has a proposed effective date of Jan. 1, 2015. That would give businesses more than a year to plan around the

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[15] By similar reasoning, economists see few efficiency gains from retroactive tax cuts, even for cuts that would reduce tax distortions if applied prospectively.

[16] Fairness may not be a pressing issue if a tax package contains other provisions affording sufficient benefits to leave taxpayers whole. The Baucus draft proposal would do this for many taxpayers, but many other taxpayers would lose more from the retroactive provisions than they would gain from the rest of the package.

change if they think it has any significant possibility of becoming law, say by announcing a merger with a company abroad, as Applied Materials recently did.[17] Such workarounds would be costly and inconvenient for the businesses involved, and they would reduce the efficiency and competitiveness of the U.S. economy. For the government, this is an indication that the proposed policy shift will not deliver the promised budget windfall.

Conclusion

The tax reform proposal Senator Baucus has unveiled in draft form leans heavily on three large retroactive tax increases, which will raise revenue to pay for a corporate tax rate reduction. It would impose unexpected tax bites for past actions on companies with accumulated foreign earnings, many investors with depreciable property, and business that have used the LIFO method of inventory accounting. Retroactive tax increases, especially such large ones, violate a core principle of sound tax policy: people should be able to count on some stability in the taxation of investments made in the past, with appropriate grandfathering to maintain trust and confidence in the system going forward

[17] *See* William McBride, *The Long Goodbye to U.S. Corporations*, TAX FOUNDATION TAX POLICY BLOG, Oct. 9, 2013, http://taxfoundation.org/blog/long-goodbye-us-corporations. Applied Material and other (formerly) U.S. companies, such as Eaton Corporation and Perrigo, were reacting to the unfavorable tax climate in the United States under current law. The proposed changes would intensify what Mieko Nakabayashi and James Carter have called the "move-out" effect. *See* Mieko Nakabayashi & James Carter, *America Goes It Alone on High Corporate Taxes*, WALL STREET JOURNAL, July 18, 2013, http://online.wsj.com/news/articles/SB10001424127887324348504578606381626042740.

National Press Building
529 14th Street, N.W., Suite 420
Washington, DC 20045

202.464.6200
www.TaxFoundation.org

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