

## A Primer for Tax Practitioners in Policy, Economics, and Accounting

by Benjamin M. Willis



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In this article, Willis looks at some foundations of tax policy through the lens of economics and accounting, and he reviews the collapse of Enron and Arthur Andersen.

Tax is about money. Tax practice is often about using the policies found throughout the Internal Revenue Code to eliminate tax costs and create real economic value for a client. Companies rightfully view their tax departments and outside tax practitioners as adding substantial economic value. After all, tax policies are designed to either encourage or discourage decisions such as smoking, buying a hybrid car, donating to a charity, or saving for retirement. Clients expect tax practitioners to know which activities are encouraged and their incentives. For example, by taking less money from taxpayers through credits, the government can boost the residential real estate market or entrepreneurship. Conversely, the federal government may reduce interest deductions or tax credits to collect more tax

revenue, which can have downstream effects on spending or investment.

Those who deal with tax directors and CFOs must know how to explain to corporate boards or their equivalent, directly or indirectly, how the policy-based tax rules affect their financial statements, and thus how valuable companies appear. A tax practitioner's goal is to help them make sense of it all. Accounting measures financial information that helps in understanding the repercussions of economic decisions. The required accounting knowledge can prevent overstatements of value by reporting tax risks in company filings. Financial statements show investors a company's economic position, divulging assets, liabilities, and contingencies. Those who want to truly understand tax rules must understand when cash rules. Three topics help me appreciate the big picture in tax: policy, economics, and accounting.

### Policy

In tax politics and policy, "follow the money" is an important credo to remember. As in the 1976 movie "All the President's Men," about Watergate and President Nixon's resignation, the characters played by Dustin Hoffman and Robert Redford are repeatedly told to follow the money to discover the truth. The Wu-Tang Clan's song "C.R.E.A.M.," from their 1993 album "Enter the Wu-Tang: 36 Chambers," reveals an apt update of this tax principle: "cash rules everything around me." After all, it was Warren Buffett who pointed out that he, a billionaire investor, paid a lower rate than his assistant, based on the design of the tax laws.

Tax funds the government, which, it has been said, is the cost of a civilized society. But who pays tax? Anyone who earns income that exceeds a

threshold. While President Lincoln created the first federal income tax in 1861 to fund the Civil War, he was no believer in trickle-down economics. The individual exemption then was \$800, which was a hefty sum. He supported the working man as opposed to the rich and believed only the wealthiest should be paying the bulk of taxes. Lincoln explained: “Capital is only the fruit of labor, and could never have existed if labor had not first existed. Labor is the superior of capital, and deserves much the higher consideration.” As a founder of the federal income tax laws, he would be surprised at the favoritism capital now receives. This is a fundamental change in fiscal policy that has continued to expand throughout the code: putting the wealthy in charge of allocating tax incentives allegedly aimed at benefiting the poor.

Based on fiscal policies that became wildly popular in the 1980s, the tax cuts enacted during the George W. Bush and Trump administrations favor those who earn money from capital-rich industries (for example, oil and real estate) and those with millions of dollars who gain from their capital. In the early 2000s, Bush lowered the rates on capital gains and dividends. Trump further entrenched the intergenerational transfer of wealth by signing into law an estate tax exemption that jumped from roughly \$5 million to \$10 million in 2018 and reduced the tax rate by nearly 3 percent for those making more than half a million dollars annually. But much of tax policy results from economic views, which can differ wildly. Economic policy supports the reasoning behind most tax rules, whether you think lower-income families are most likely to spend tax savings on necessities or you think upper-income taxpayers will opt to give their employees pay raises instead of adding to family trust funds that escape the estate tax and receive a basis step-up (the so-called angel of death loophole for the rich).

### Economics

The economic policies that drive tax rules can come from many sources, but in the United States those policies are articulated through Treasury and Congress. The Treasury Office of Tax Policy (OTP) develops and implements tax policies and programs, reviews regulations and rulings, provides economic and legal policy analysis, and

supplies estimates for the president’s budget, fiscal policy decisions, and cash management decisions. After joining the OTP in 2013, I was surprised that roughly half of my colleagues were economists. I quickly understood why: Tax can be a powerful economic tool, and its effects must be considered in light of economic models.

The Office of Tax Analysis (OTA) — which aids the OTP and reports to the Treasury assistant secretary for tax policy — is responsible for official administration estimates of all federal receipts in the president’s budget and revenue estimates for actual and proposed tax legislation. OTA develops and operates several major microsimulation models and maintains large statistical databases to analyze the economic, distributional, and revenue effects of alternative tax proposals and tax systems. Its models are often based on tax return samples provided by the IRS Statistics of Income Division. Because the OTA assists with the president’s budget proposal, this office helps determine what is good or bad for the economy, and the executive branch acts in part based on those determinations, with the help of Congress if a law is needed to implement those principles.

Of course, Congress can make its own economic determinations of what programs and projects to fund based on separate economic principles that may not align with the executive’s. In fact, the Congressional Budget Act of 1974, which provides for current oversight rules, was a response to President Nixon’s unilateral and aggressive withholding of spending authority. The act created the Congressional Budget Office and ensured the power of the purse remained with Congress, which must authorize the president’s budget requests. This would include, for example, construction funding for a \$5.7 billion steel wall to keep people from crossing the U.S.-Mexico border.

Most agree that how Americans are taxed should be based on a bipartisan determination. Generally, it takes 60 votes in a 100-member Senate to exceed a budget spending allocation, unless the reconciliation process is used for an adjustment in spending, revenue, and debt. Reconciliation requires only a simple majority in the House and Senate. But when the two congressional chambers are controlled by

opposing parties, bipartisan agreement is the only way to go as, for example, in addressing technical corrections for the Tax Cuts and Jobs Act.

Tax rules are often used to promote economic redistribution, such as Opportunity Zone tax incentives designed to bring investment into low-income census tracts. This example shows the interconnectedness of economic programs created by Congress — like Medicaid, Temporary Assistance for Needy Families, and other programs for the country's general welfare — to provisions in the code. The interaction between congressional economic goals and programs and those of the executive agencies that administer them can produce tension based on their potentially different economic agendas.

There are certainly other examples of the legislative and executive branch each pursuing economic policies that serve different sets of taxpayers; for example, budget allocations enacted through congressional appropriations to housing assistance programs compared with real estate-based tax incentives and contracts allocated or awarded by executive agencies. We have yet to see whether the largest real estate benefits of the TCJA will go to builders, owners, or residents of low-income housing. But for all stakeholders, measuring the value of the economic and tax benefits requires an understanding of accounting principles.

### Accounting

On any balance sheet, whether you are a household or a large multinational corporation,  $\text{assets} = \text{liabilities} + \text{equity}$ . Thus, for example, if an owner's equity increases, that means either assets increased or liabilities decreased. But for most tax practitioners, this is the tip of the iceberg. Generally, corporations with at least \$10 million in assets and securities held by more than 500 shareholders must file annual and quarterly financial statements with the SEC. Those statements are prepared by accountants and must follow generally accepted accounting principles. Accounting principles applied by tax practitioners to financial statements that comport with valid economic principles can provide incredible tax and financial benefits. Understanding financial statements, the tax risks they declare, and the tax assets and liabilities they

disclose, including those that are deferred, can have a tremendous impact on stock value, executive compensation and options, the ability to take on debt, and the success of CFOs and tax directors.

Calculating tax amounts due to the IRS is based on a definition of income completely different from that used in SEC filings that rely on GAAP. The SEC and GAAP requirements are intended to use objective measures to prevent companies from informing stakeholders they are more valuable than they indeed are. For this purpose, GAAP aims to reflect economic reality, although this may not always occur. Conversely, tax accounting (for example, cash method, accrual method) is designed to ensure taxes are being paid for the income earned by the company after accounting for the many policy-based deductions, exclusions, and depreciation allowances throughout the code.

The differing rules for tax income and GAAP income offer much fodder for creative tax practitioners to help companies benefit from the complexities of these rules. Common book-to-tax differences often stem from different thresholds used to determine if an expected liability or asset should be considered. This means a company can look much more profitable to its stakeholders than its tax returns might indicate. This could be advantageous to a company that has no tax liability and large financial statement profits. Many large companies with highly-skilled tax practitioners are well-known for this. It may also encourage some to keep their tax returns private, although even billionaires like Buffett aren't afraid to share their reliance on generous code provisions. However, sometimes the use of the different book and tax rules can prove disastrous, especially for overly aggressive taxpayers and their tax practitioners, who should stay well-informed of situations that cross the line.

### The Collapse of Enron and Arthur Andersen

From the 1990s into 2001, Enron's goal was to convince the public of enormous amounts of false economic value, notwithstanding the many policy-based rules aimed at preventing this. Enron was in the energy business and became the largest trader of natural gas and seventh-largest corporation in America. Kenneth Lay and later

Jeffrey Skilling were the CEOs of Enron during the periods that led to its collapse. They devised schemes that led to the manipulation of the accounting numbers reported in Enron's SEC filings. The manipulation of its profitability and value led to the largest bankruptcy in corporate America at that time.<sup>1</sup> Executives with inside information were able to sell their stock shortly before its true economic value became known and recognized large, favorably taxed capital gains while thousands of employees lost fortunes just days later.

Enron's signature mark-to-market accounting treatment — signed off on by Arthur Andersen — allowed Enron to record profits even before they came in the door. But Enron's natural gas operations were failing, and the profits were entirely unrealistic. Mark-to-market accounting allows for the valuation of assets based on their current value instead of book value. Mark-to-market works well for publicly traded stocks because their value is continually determined by numerous daily market purchases. Enron's energy business epitomizes assets for which you wouldn't use this method of accounting. There is no clear market value for a soon-to-be-built power plant's anticipated earnings based on a plethora of uncertainties such as the future price of energy, number of possible customers, and costs of supplying energy.

In Enron's case, the company would begin building an asset, such as a power plant, and immediately claim the projected profit on its books even though no profit was made. If the revenue from the power plant was less than the projected amount, instead of showing the loss in its SEC filings, the company would then transfer the liability to an off-the-books corporation, where the loss would go unreported.

Lee A. Sheppard explained at the beginning of the crisis that Enron's concerns could have been related to "bank secrecy and were just hiding

things from shareholders, insurance companies and partners, not just the I.R.S."<sup>2</sup> After *The Wall Street Journal* posted information that the claimed mark-to-market profits were in fact losses, the SEC opened an investigation. The certified financial statements signed by Arthur Andersen and provided to the SEC were frequently blamed as the reason most said they were unaware of the true financial health and value, or lack thereof, of the company. In 2002 Arthur Andersen voluntarily surrendered its licenses to practice as CPAs in the United States.

Martin A. Sullivan explained that on "July 30, 2002, in response to the Enron bankruptcy, President Bush signed an accounting reform bill, the Sarbanes-Oxley Act of 2002 (P.L. 107-204)."<sup>3</sup> Section 404 of Sarbanes-Oxley requires a top-down risk assessment and reporting document disclosures of tax risks, like the risk that the projected gains or losses may never result. It also established the Public Accounting Oversight Board to oversee public audits and accounting practices, with a policy goal of preventing countless stakeholder losses again. The failure of Arthur Andersen's audit and tax responsibility to Enron has forever changed how tax practitioners perform their duties and should not be forgotten by anyone looking to protect their clients with integrity.<sup>4</sup> ■

<sup>2</sup>David Cay Johnston, "Enron's Collapse: The Havens; Enron Avoided Income Tax in 4 of 5 Years," *The New York Times*, Jan. 17, 2002; see Lee A. Sheppard, "Gremlins in the Global Dealing Regulations," 22 *Ins. Tax Rev.* 284 (2002) ("Bush administration officials are up to their eyeballs in embarrassing Enron revelations, Enron's auditors admitted to significant document destruction, and just about everyone in Houston who owns a business suit has a conflict of interest. The president claimed that Enron's chairman, a Bush family friend who has been his largest individual donor, backed his opponent for governor of Texas. A heads-up on an impending bankruptcy filing is one thing, but it's kinda odd to call the guy who was the Bush campaign's chief fundraiser when you get into financial trouble. (*The New York Times*, Jan. 11, 2002, p. A1; *The Wall Street Journal*, Jan. 11, 2002, p. A3.) It's all the more amazing that this stuff should hit the front pages given that you cannot take a picture of a financial accounting scandal.").

<sup>3</sup>Martin A. Sullivan, "Does the Trickle-Down Theory for Pensions Hold Water?" *Tax Notes*, Feb. 24, 2003, p. 1180.

<sup>4</sup>Reed Abelson and Jonathan D. Glater, "Enron's Collapse: The Auditors; Who's Keeping the Accountants Accountable?" *The New York Times*, Jan. 15, 2002 ("The collapse of Enron and the role of its auditor, Arthur Andersen & Company, have galvanized a discussion in the profession, among regulators and within Congress over the future of the industry.").

<sup>1</sup>George J. Benton, "The Quality of Corporate Financial Statements and Their Auditors Before and After Enron," *Pol'y Analysis* No. 536 (Nov. 6, 2003).