Honey, I Shrunk the Tax Year

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Agenda

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• Inequities Due to Annual Accounting Concept
• NOL Carrybacks and Carryforwards
• Other TCJA Provisions
• Capital Loss Carrybacks and Carryforwards
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Overview and Background of Annual Accounting Concept
Overview

• Has the TCJA “shrunk” the tax year too much (e.g., repeal carrybacks, limit carryforwards, accelerate income per GAAP treatment)?

• If so, what is the best remedy?
  • Expand tax period to 24 or 36 months?
  • Or, more limited, “rifle shot” solutions (e.g., restore carrybacks, relax limits on capital losses)
Annual Accounting Concept

• Conceptually, taxing income on a transactional or even lifetime basis may be the most logical.

• However, the government must collect revenue on a regular basis so some period for measuring income must be used.

• Since the beginning of the income tax, the government has used a 12-month period.
  • The reasons are not entirely clear.
  • Some explanations include that (a) GAAP income statements are typically a 12-month fiscal year, (b) government budgeting is annual, (c) agriculture was a dominant industry at the advent of the income tax, and (d) the annual accounting concept was used in other countries successfully.
  • One scholar has made a strong case for a 24-month period (see slide 34).
Annual Accounting Concept

• The tax law requires rules to measure income in the annual accounting period.
• The two key rules are realization and methods of tax accounting (typically accrual).
• Realization. Mark-to-market ("MTM") realization of gains and losses each year may be the best measurement of "income."
  • But MTM approach for most assets is impractical due to (a) difficulty in measuring value of the assets, and (b) unfairness of taxing gains without cash ("paper profits").
  • 2008 recession showed that unusual market conditions can render MTM unreliable.
• Accrual/Methods of Accounting. Methods generally are designed to clearly reflect income, but certain rules accelerate income and defer deductions/losses (e.g., Section 461(h), prepaid income), creating timing distortions.
Inequities – Lumpy or Fluctuating Income

• Lumpy profit and loss can result in the taxpayer’s payment of tax when there was no true profit on a transaction, venture or even over the taxpayer’s lifetime.

• A taxpayer with fluctuating income can pay more tax than a taxpayer with steady income (by being included in higher brackets in some years).
Inequities – Premature Amount Realized

• A taxpayer can include amount realized in one year based on anticipated future events that never materialize in later years.
  • E.g., electing out of installment reporting (fixed or contingent); taxable reorg and P stock declines in value before sold
  • E.g., even not electing out for a contingent sale may result in inappropriate deferral of basis

• Thus, a taxpayer could have gain in one year and a loss in later years.
  • The taxpayer typically will be unable to carry back the loss (individuals can’t carry back capital losses and corporations only have a three-year carryback). Thus, the taxpayer often will lose time value of money.
  • At worst, the taxpayer will be unable to use the loss (quite possibly a capital loss) for many years or at all.
Inequities – Premature Accrual

• Similarly, the taxpayer may accrue income based on anticipated future events that don’t materialize.
  • Examples:
    • An energy company receives and reports a lump sum payment for product over a multi-year period and the parties agree several years later to an early termination of the contract.
    • A construction company reports income on the percentage of completion method for a fixed price, multi-year roadbuilding project, and determines that estimated total costs were significantly understated.

• The taxpayer gets an offsetting loss in a later year but may not be able to carry back (either because no net loss or carryback unavailable under carryback rules).

• Thus, at a minimum, the taxpayer loses time value of money.
Provisions to Address Inequities

• Congress
  • Section 1341
  • Section 111
  • Section 460
  • Section 186
  • Section 167(g)

• Courts
  • Arrowsmith doctrine
  • Tax benefit rule
  • Rescission doctrine
NOL Carrybacks and Carryforwards
NOL Carrybacks/CARRYFORWARDS – History

• Started with *Burnet v. Sanford & Brooks*¹

• Congress responded in 1918.
  • One-year carryback and carryforward
  • Legislative history suggests fairness (alleviating inequities from annual accounting, especially lumpy income issues), and desire to mitigate the effects of the economic downturn following the First World War.

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NOL Carrybacks/Carryforwards – History

• Congress has periodically limited or expanded the ability to carry back in reaction to economic expansion or contraction.
  • 1918 – Introduced carryforward (1 year) and carryback (1 year)
  • 1921 – Reauthorized carryforward but not carryback
  • 1942 – Reauthorized carryback (2 years)
  • 1950 – Shortened carryback (1 year)
  • 1954 – Extended carryback (2 years)
  • 1958 – Extended carryback (3 years)
  • 1997 – Shortened carryback (2 years)
  • 2002 – Extended carryback for taxable years ending in 2001 and 2002 (5 years)
  • 2009 – Extended carryback (5 years, initially only for electing small businesses)
NOL Carrybacks/Carryforwards – History

• *Libson Shops*¹ explained that the carryback/carryforward policy was to permit a degree of income averaging and thereby treat taxpayers with fluctuating income the same as taxpayers with steady income.

  • See also: *United States v. Foster Lumber Co., Inc.*, 429 U.S. 32 (1976); *Todd v. Commissioner*, 77 T.C. 246 (1981), *aff’d*, 682 F.2d 207 (9th Cir. 1982).

Policies – Avoiding Tax on Capital

• Not really an “income” tax if the result is taxing capital because the taxpayer doesn’t have lifetime income but still pays income tax.
  • Example: X has losses in years 1-4 and an equal amount of income in year 5. X then dissolves. Unless X can fully utilize the losses from years 1-4 to offset the income in year 5, X will pay tax despite having no “net income.”

• Disallowing carrybacks increases the likelihood of a tax on capital.
  • Example: X has $100 profit in year one and $100 loss in year two and then liquidates. Without a carryback, X is taxed on $100 when X had no lifetime income.
Policies – Income Averaging

• Congress allowed some income averaging between 1964 and 1987; purpose was to avoid bunching of income resulting in higher rates.

• The provisions basically allowed taxpayers with significant fluctuations in income to re-determine their tax liability as if the income had been earned ratably over the current year and the preceding five years.

• Congress repealed the averaging rules in 1986 in light of the “significantly flatter rate structure” and the relatively low 28% maximum rate (exception for farm and fishing income).

• While discussed in terms of averaging income, the goal of carryback/carryforward regimes seems more focused on taxing the correct amount of income than achieving the “correct” rate.
Policies – Summary

• Taxing only net “income”
  • Query whether the appropriate measure of “net income” is over the taxpayer’s entire life or with respect to a particular trade or business or even a particular transaction.

• Horizontal equity: Treat taxpayers with fluctuating incomes similarly to taxpayers with steady income (both in measuring net “income” and in the applicable rate)

• Protect distressed taxpayers from further cash flow difficulties
Pre-TCJA Law

• Corporations and individuals could carry back 2 years and forward 20 years.
  • Over time, the carryback period has varied between 1 and 5 years; Congress typically reacts to periods of economic downturn by adopting longer carryback periods.
    • Taxpayers with specified liability losses (e.g., from a product liability or environmental loss) could carry back losses for up to 10 years.
  • Carryforward period has varied between 1 and 20 years.

• Section 172(f) was passed in connection with the Section 461(h). The policy was to recognize that losses should be matched with the years in which the loss was latent but taxpayer was earning income related to the activity.
TCJA Changes to Carrybacks/Carryforwards

• New Rules under Section 172:
  • No carryback for the first time since 1942.
  • Unlimited carryforward but capped at 80% of taxable income each year.
  • Bad outcome for taxpayer as present value of losses used 20 years out is very small (and may end up being subject to limitations).
  • Legislative history offers no policy justification, but usually the policy advanced for limited carryback is protecting revenues.

• Applies to both corporate and non-corporate taxpayers.
  • A 2-year carryback period still allowed for farming losses and losses from certain non-life insurance companies.

• Repeal of special carryback for specified liability losses.
  • This seems especially wrong from a policy perspective.
  • A taxpayer could have substantial losses, but no income to offset.
Capital Loss
Carrybacks/Carryforwards
Current Law – Capital Losses

• The TCJA did not change the rules on carryback and carryforward of capital losses.
  • Corporate taxpayers can carry forward capital losses up to 5 years (10 if loss is attributable to a foreign expropriation loss) and carry back capital losses up to 3 years (exception for foreign expropriation losses).
  • Non-corporate taxpayers cannot carry back capital losses but can carry forward losses indefinitely.
  • For non-corporate taxpayers, capital losses can only offset capital gains and up to $3,000 of ordinary income per year.
Capital Loss Policy – Why Limited to Capital Gain?

• The main justification seems to be limiting taxpayer’s ability to selectively recognize losses but defer gains.
  • If you believe that realization rules are a compromise and Haig-Simons accretion should be taxed currently, then the capital gain limitation backstops the realization rules.
  • This selective realization rationale is particularly important for individuals who get a step-up at death (i.e., complete elimination of tax on the gain).

• Also, for individuals, it seems fair to have the benefit of capital losses be at the same tax rate as capital gains.
  • Note that Section 1231 gains don’t have this limitation. A vestige of WWII: unfair to tax the involuntary profits (not so limited under current law) realized by shipping companies when their vessels were requisitioned for military use or destroyed by enemy action.
Policy – Capital Loss
Carrybacks/Carryforwards

• The initial policy justification for no carryback for non-corporate taxpayers in unclear. One argument is that individuals are likely to have investment gains in the future and don’t need any carryback to smooth.
  • Again, protecting federal revenues. But not sure why different rule for corporations.

• The initial policy justification for limited carryforward for corporate taxpayers is also unclear. All losses are business related and thus similar to regular losses.
Other TCJA Provisions “Shrinking” the Tax Year
Section 451(b) – Book Conformity Rule

• For accrual method taxpayers, the “all-events” test with respect to any item of gross income will not be treated as met any later than when such item is included on an applicable financial statement.
  • This rule does not apply where the taxpayer uses a special method of accounting (e.g., installment sales; completed contract method).
  • These rules override the special rules applicable to debt instruments.
  • Per the legislative history, these rules are not intended to override the realization requirement.

• The reliance on GAAP can deviate from the “all-events test” and even the fundamental “realization” principle, thus in some cases taxing income that does not yet exist or will never exist.
  • For example, ASC 606 often requires net income to be recognized for sales that would not satisfy the traditional “all-events” test because the product has not been completed and sold and delivered, and Section 451(b) may be interpreted to accelerate the gross revenue but not the cost of sales.
Section 451(b)

• When combined with the new GAAP standard of ASC 606, the net impact of the provision is to exaggerate the acceleration of income because it is a “one-way” street.
  • Examples:
    • An estimate of contingent performance bonuses that increase income must be anticipated.
    • Conversely, contingent price concessions and rebates, and anticipated bad debts, would not be taken into account currently even though based on an accurate estimate of the actual outcome.

• Thus, the rules are likely to create the inequities discussed previously relating to the annual accounting period.
Taxing Capital Gains
Background – Current Law

• Non-corporate taxpayers have a significantly lower rate on capital gains.
• Corporate taxpayers have the same rate for capital gains and ordinary income (since 1986) but utilization of capital losses is limited.
Five main policies have been advanced:

- Encourage savings and investment;
- Compensate for “bunching” of income in year of sale;
  - Only justified with progressive rate structure
- Avoid “lock-in” effect (i.e., aversion to selling);
- Avoid taxing gain attributable to inflation (i.e., not a real gain); and
- Minimize the impact of double taxation.
  - This only justifies the lower rate on stocks v. other types of capital assets
Indexing
Is Indexing a Good Idea?

• Generally, indexing would increase a taxpayer’s basis in assets each year by an inflation factor.
  • The goal is to avoid taxing “gains” attributable to inflation.
  • Leads to more accurate measurement of income.

• Leads to more equal tax treatment of returns over time. Without indexing, the tax rate on the return fluctuates with the inflation rate.

• Perhaps not appropriate for capital assets if lower capital gains rates already compensate for taxing inflationary “gains.”

• Also, taxpayers benefit from deferral as appreciation occurs, thereby offsetting tax on inflationary gains to a degree.

• A pure indexing proposal also would increase depreciation deductions from the asset by an inflation factor.
  • However, this may not be appropriate where taxpayers are already allowed accelerated depreciation and, in some cases, full expensing.
Is Indexing a Good Idea?

- Increased compliance and administrative costs for taxpayers as basis would need to be adjusted by an inflation factor.
  - Keeping track of the date of acquisition/improvements would be important.
  - Determining proper depreciation deductions would be complicated.
- Without indexing, the tax system perhaps has built in tax rate fluctuation.
  - Higher effective tax rates during periods of high inflation could promote “lock-in” effect.
  - Lower effective tax rates during deflation (usually during a recession) could promote spending.
Extending the Tax Accounting Period
Proposal for a 24- to 36-Month Tax Period

• Annual tax accounting period is a product of path dependence – no good justification for using 12-month period, as opposed to a 24- or 36-month period.

• Primary objective of finite tax accounting period (raising revenue) is not jeopardized by a longer tax period.
  • Estimated tax payments and withholding regimes ensure that the government has a consistent revenue stream.

• IRS typically audits corporations in multi-year cycles.
Advantages

• Promotes fairness by achieving greater income averaging (i.e., reducing lumpy income) and reducing premature realization/accrual (but still a problem with any finite accounting period).

• Reduces tax code complexity relating to “rifle shot” solutions.

• Reduces administrative burden on government.

• Reduces financial costs of preparing tax returns and obtaining professional advice.

• Reduces opportunity (time) costs of preparing tax returns.
Disadvantages

- Could cause complexities at the state level if states do not follow suit.
- Changes in law could take longer to effect (e.g., raising or lowering tax rates).
- Poses greater creditor risk for the government.
  - Could be alleviated through expanded withholding regimes and informational return requirements
- There are upfront administrative costs of implementing new regime.
- Requires restructuring the rate schedules and rethinking the dollar and percentage thresholds.
Recommendations
Recommendations

• NOL Carryback: Inappropriate to repeal carryback.
• NOL Carryforward: Inappropriate to limit carryforward to 80%.
• CL Carryback: Individuals should have a 3-year carryback period as well.
• CL Carryforward: Corporate carryforward period of 5 years is too short.
• CL Limitation: Inappropriate for corporations due to lack of preferential rate and no step-up at death.
Recommendations (cont’d)

- Averaging: no reason to return to income averaging for individuals because rates not very progressive.
- Indexing: appropriate for corporations due to lack of capital gains preference; arguably not for individuals.