REPORT #668

TAX SECTION

New York State Bar Association

Opposition of the NYSBA to the Budget Summit

October 4, 1990

Table of Contents

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The Honorable Lloyd Bentsen
Chairman
Senate Committee on Finance
205 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Dan Rostenkowski
Chairman
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Messrs. Bentsen and Rostenkowski:

I am writing to express the strong opposition of the Tax Section of the New York State Bar Association to the budget summit agreement proposal to deny deductions for interest paid by corporations on Federal income tax deficiencies.

Our opposition rests on three principal grounds. First, this proposal imposes an additional very significant penalty for being wrong about a tax question. Taxpayers frequently take incorrect positions simply because the law is unclear and there is no adequate guidance as to the correct answer to that question. Second, the proposal will be disruptive of the present audit and litigation processes. Third, its major burden will fall on small corporations and corporations which are financially weak and place them at a distinct disadvantage as against their U.S. and foreign competitors. This last result seems particularly bizarre in light of the budget agreement proposals aimed at providing tax incentives for investment in qualified small corporations.

Turning to questions of basic rationale, we believe that interest on tax deficiencies is just as much a business expense as interest corporations pay on their other debts. In this respect, it is sharply distinguishable from interest on deficiencies paid by noncorporate taxpayers, which has generally been nondeductible since 1987. Such interest is generally a personal expense; interest paid by a corporate taxpayer is an expense of carrying on its business.

Just as significantly, it must be recognized that a very large percentage of corporate tax deficiencies result from difficulty in interpreting and applying the myriad new, highly complex Code provisions enacted since 1981. Corporations must interpret and apply those provisions at their peril, frequently with virtually no guidance in the form of regulations or other meaningful Service pronouncements. For example, one report we are now preparing addresses proposed regulations relating to Section 461(h), which appeared six years after that provision was enacted. Other deficiencies may be the result of reversals of longstanding judicial precedent upon which the Service and taxpayers and their advisers have relied for years. For example, in 1988 the Supreme Court's Arkansas Best decision reversed the generally accepted interpretation of the Corn Products case decided by that court in 1955. On Monday last it was disclosed that the Service has suspended a project aimed at providing guidance as to the effects of this reversal.

In the face of these uncertainties, the budget proposal would, in the case of a corporation paying an overall effective state and local tax rate of 40 percent, raise the deficiency interest rate to the equivalent of 18 percent on a pre-tax basis. This is a rate of return higher than many, if not most, U.S. corporations realize on their capital. This, combined with the risk of the substantial understatement penalty, would make the potential cost of tax deficiencies intolerable.

We are particularly concerned by the effect an 18 percent pre-tax rate of interest will have on both tax administration and tax litigation.

For seventy-seven years the tax audit system has rested primarily on the ability of the Service and taxpayers to resolve the vast majority of disputes in the audit process or in appelate division settlement negotiations. Unfortunately, it is not uncommon for audits of corporate tax returns to take many years; in some cases returns are open for ten years or more after they are filed. Many, if not most, of these delays result from the shortage of Service personnel and the necessity to provide Service personnel with answers for information requests as an audit progresses.

If interest on corporate, tax deficiencies becomes nondeductible, corporations are simply going to refuse to extend the statute of limitations in any case where there is potential for any significant tax deficiency. This will put enormous stress on the Service's audit and litigation capability, which is already stretched thin.

The proposed interest disallowance will also undermine the litigation process that has been in force since 1924 by forcing corporations to pay pre-tax liabilities and then sue for refunds in the district courts or claims court.[*] This would shift the burden of most tax litigation from the Tax Court, with its high degree of technical expertise, to the claims court and the already overburdened district courts.

At the very minimum, we urge that any legislation denying deductions for interest on corporate tax deficiencies also extend the jurisdiction of the United States Tax Court to refund claims and in other respects as we urged in our August 1988 report on the jurisdiction of the Tax Court, a copy of which is attached.

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[*] The fact that a taxpayer may litigate in the Tax Court in the case of a tax paid after a deficiency notice has been mailed will be of little benefit in many cases since the interest paid with the tax would be nondeductible and would represent amounts accrued over several years before the case reached the deficiency stage. The statement in the agreement summary that appropriate relief will be granted where "there has been an extraordinary delay in the issuance of a statutory notice of deficiency or assessment beyond the control of the taxpayer" would generally be of no avail since audits which take several years to complete are ordinary, not extraordinary. It is also quite typical for the litigation of a tax case to take several years.

It is also worth noting that denying a deduction for interest on corporate tax deficiencies would impose very different economic costs on different corporate taxpayers. Thus, it would have little or no effect on foreign corporations that are not entitled to deduct interest but may be able to deduct such interest in their home countries, and on U.S. taxpayers that are unable to utilize interest deductions because of net operating losses or excess foreign tax credits. Further, it in effect discriminates between financially strong corporations that can borrow at reasonable interest rates to prepay potential tax liabilities and deduct the resulting interest costs and other corporations, such as small businesses, with more limited credit. Faced with the alternative of interest disallowance, these latter corporations could be under substantial pressure to settle cases on a less favorable basis than their legal positions warrant.

Thus, the net effect of the proposal will be to put small corporations and corporations with lesser financial resources at a distinct disadvantage as against their U.S. and foreign competitors. This result seems totally inconsistent with the budget agreement proposals to provide tax incentives for investment in qualified small corporations.

All in all, we find this an extremely unsound proposal which should be rejected. We note that it is expected to raise $1.4 billion in 1991 and $3.9 billion over the five years 1991-1995. If these budgeted amounts must be raised from corporate taxpayers, we are confident that there are ways of raising these same amounts that would operate in more equitable manner.

Very truly yours,

Arthur A. Feder
Chair

Enclosure

cc with enclosure:

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