

ORGANIZATIONAL CAPITAL: A COMMENT TO PROFESSOR KAHNG

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In her article, *Taxation of Intellectual Capital*, Professor Lily Kahng has proposed to capitalize the costs of research and development, and worker training and amortize those costs over a tax life, provisionally set at five years.¹ She would capitalize one half of the cost of advertising and top management compensation and similarly amortize the costs over five years. Professor Kahng cites the quip, attributed to Keynes, that “it is better to be imprecisely right than precisely wrong.”² The capitalization of research, development and worker training, and half of advertising and executive compensation aim to be imprecisely right.

Professor Kahng’s proposals are good and important. Tax does harm because it affects competing investments in dramatically different ways. A tax system that reduced all pretax returns uniformly would, under most circumstances and estimates, increase the amount invested or leave it substantially unaffected.³ The primary harm from tax arises because some investments bear no tax or even a negative tax that increases their return, some investments bear tax higher than statutory tax rates, and some investments are in between. The differing effects of tax on returns shifts investment away from the real pretax demand to inferior investments.

Professor Kahng does not go far enough, however, because her proposals do not capture enough of the value of the corporation as a whole, its organizational advantages. To reach a level playing field for all investments, the organizational advantages of publically traded corporations need to be brought into tax, and that would require that the going concern or goodwill value of the corporation as a whole be brought into tax.

Intangibles lead to disparate effects of tax on returns because costs of intangible investments are invisible for tax. Federal income tax allows expensing, an immediate deduction, for the costs of creating or enhancing the value of an intangible investment. Expensing means that tax does not

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1. 66 FLA. L. REV. 2229, 2274–75 (2014).

2. *Id.* at 2273.

3. A uniform reduction in investment return usually increases investment. *See, e.g.*, Jane G. Gravelle & Donald J. Marples, *Tax Rates and Economic Growth*, CONG. RES. SERV., at 6–7 (Jan. 2, 2014) (reviewing studies and concluding that the savings reaction to taxes were small in magnitude and uncertain in direction); Jonathan Skinner & Daniel Feenberg, *The Impact of the 1986 Tax Reform Act on Personal Saving*, National Bureau of Economic Research Working Paper No. 3257, at 17 (1990) (describing a consensus in the economic literature that any positive response of savings to an interest rate increase is “fragile and fleeting” and that overall reaction of savings to greater after-tax returns has been negative in the postwar period).

reduce the pretax return from the investment.⁴ On the other side of the spectrum, for some investments, tax maintains an adjusted basis equal to or in excess of the remaining value of the investment. For those investments, tax reduces the pretax return by an amount equal to or exceeding the statutory tax rate.⁵ There is a proration rule under which an adjusted basis equal to half of value entails that the economic tax rate is half of the statutory tax rate.⁶ Thus for corporations valued by the market as half intangible values and half assets reflected in adjusted basis, the real impact of tax is to reduce pretax return by half the statutory corporate tax rate. To give some examples, Google, Microsoft and game developers have low bases, and low effective tax rates. Macy's, which the market values at under the total adjusted basis for all its assets, has an effective tax rate over the statutory tax rate. Walmart and Dell Computer, with both assets with basis and intangibles, have effective tax rates near half the statutory tax rate.⁷ The disparate impact of tax, according to what proportion of value is in expensed intangible, creates an uneven playing field giving relative advantages and punishments without regard to the underlying merits, that is, the subsidy-worthiness or penalty-worthiness of the underlying investment. That disparate effective tax rate distorts investment away from real value and causes harm.

For publicly traded corporations, we can see the intangible investments because the smart market sees their value in the daily valuation of overall stock price. The market price is the summation of millions of dollars of research by buyers and sellers acting intensely in their own self-interest. If anyone can see an error in valuation, they can make money on the

4. The seminal piece is Cary Brown, *Business-Income Taxation and Investment Incentives*, in *INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSON*, 300 (1948). For one lawyer's explanation of the idea, see Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 1989 U. ILL. L. REV. 1019 (1990). Assume, to illustrate the point, that TP1 makes \$100 income, pays tax at rate t and so has $\$100*(1-t)$ to invest. TP1 invests at rate R for n years and gets $\$100*(1-t)*(1+R)^n$ pretax. If the profit is tax-exempt, then $\$100*(1-t)*(1+R)^n$ is also TP1's post-tax return. Now assume that TP2 avoids tax on the \$100 investable income by deducting the \$100 in the year when the investment is made. TP2 thus does not have \$100 reduced by tax and thus can make a \$100 investment, and will get $\$100*(1+R)^n$ back pretax. TP2 has no basis, however, so tax at t leaves him with $\$100*(1+R)^n*(1-t)$, which is the same thing as TP1 achieved. As long as it is constant, and the amount invested is sensitive to upfront tax, it does not matter whether the tax factor $(1-t)$ is at the beginning or end of the formula.

5. The underlying logic of identifying internal rate of return is Samuelson depreciation, applied uniformly. See generally Paul Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604 (1964). See also Calvin H. Johnson, *Measure Tax Expenditures by Internal Rate of Return*, 139 TAX NOTES 273 (Apr. 15, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2253291.

6. See generally Calvin H. Johnson, *The Effective Tax Ratio and the Undertaxation of Intangibles*, 121 TAX NOTES 1289 (Dec. 15, 2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1315477.

7. *Id.* at 1295. The computations were made as to market prices in July and August of 2008.

mispricing. News is thus reflected in price almost instantaneously.⁸ The market can be misled, there may be bubbles, and market prices fluctuate. The value depends on future income, and the future, alas, is very hard to predict. Still the smart market creates a better description of the economic situation of the firm than any existing tax or nontax accounting system, both as to capital and economic income. Hulten and Hao find that accounting assets represent only 31% of the market value determined by stock quotes, so it follows that 69% of all capital is invisible to tax and GAAP accounting.⁹ On average nationally, only 31% of corporate capital bears the corporate tax. Investments in self-developed intangibles, whatever their nature, are clear to the market, but they are dark matter, invisible to accounting.

Current law could be improved in incremental ways. Professor Kahng's proposal to capitalize R&D and half of advertising and executive compensation for a five-year tax life, for instance, is a bold and constructive proposal. Still, incremental improvements leave untouched the biggest intangibles, related to organizational capital.

For a large range of businesses, especially big business and publicly traded entities, the most important intangible is the organizational advantages of the firm as a whole. Business historian Alfred Chandler has argued that the first businesses in the nineteenth century that combined the new mass production machines with mass distribution, organized by professional managers, drove down the price, drove out all the artisan competition, became a monopoly and remain dominant in their field 150 years later.¹⁰ It was the organizational advantages of big business that dominated immediately. Firms like Apple, Google and Microsoft were first movers within their fields and remain innovation factories, valuable beyond their specific products. Fair, accurate and neutral tax accounting would bring their organizational capital into tax. The failure to tax their organizational capital means their primary advantage is not taxed.

Sometimes the organizational advantage comes directly from public trading. A publically traded corporation can assemble a large mass of capital from public investors because any investor can bailout quickly. Some enterprises cannot go forward without the amassing of that

8. See, e.g., Burton G. Malkiel, *Is the Stock Market Efficient?*, 243 *SCIENCE* 1313, 1317 (1989) (answering—largely—yes); Kenneth A. Froot & Andre F. Perold, *New Trading Practices and Short-Run Market Efficiency*, Nat'l Bureau of Econ. Research Working Paper No. 3498 (1990) (arguing news is reflected in stock price within 15 minutes).

9. See Charles R. Hulten & Xiaohui Hao, *What is a Company Really Worth? Intangible Capital and the "Market to Book Value" Puzzle*, Nat'l Bureau of Econ. Research Working Paper No. 14548, 3 (2008).

10. See generally Alfred D. Chandler, *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* (1977); Richard R. John, *Elaborations, Revisions, Dissents: Alfred D. Chandler, Jr.'s, "The Visible Hand" after Twenty Years*, 71 *BUS. HISTORY REV.* 151 (1997) (reviewing Chandler's impact).

substantial capital, and those enterprises tend to be the most profitable businesses, with the highest entry barriers protecting them from competition.

The economic harm caused by ignoring the biggest intangibles, the organizational capital, is serious enough that it should force a mark to market system, taxing the corporation by looking to the market price for its stock.¹¹ Even if the tax system does not reach directly to mark all assets to market value based on their stock price, the public market can be used to critique tax accounting decisions. A tax accounting method that makes adjusted basis come closer to market value for the whole company is a superior to a method that leaves the adjusted basis of all the assets further from the fair market value.

Reliance on the smart market for a tax accounting leaves the problem of what to do about business not traded on a public market. If there is no public market, there is no smart market price, easy to find and superior to accounting. If the organizational advantage of a corporation is all in the public trading—which is an important explanation of a great deal of organizational capital—, then the lower tax on firms that do not have access to the public target is tolerable even correct. Still, we should do more to reach the organizational capital in non-publically traded firms perhaps by imitating publically traded company results. The public market, for instance, implies longer lives for intangible assets, and those lives should be applied to nonpublically traded businesses as well.

Distortions by reason of tax extend beyond the expensing of intangibles, but mark to market will also reduce perhaps even dissolve the distortions. An interest deduction, for instance, is compatible only with a system in which adjusted basis equals value; combining the interest deduction with the expensing of intangibles is a subsidy, that is, tax increases the return from the investment,¹² whereas the system overall is dedicated to raising revenue without penalty or subsidy. Our international taxation rules commonly allow the costs of intangibles to be deducted against domestic income and then the revenue stream is allocated to foreign subsidies which are exempt from U.S. tax until the revenue is

11. Among the [persuasive] proposals for taxing corporations based upon market value of their shares, see generally, Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 *TAX L. REV.* 265 (1995); David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 *TAX L. REV.* 95 (1999); Calvin H. Johnson, *Replace the Corporate Tax with a Market Capitalization Tax*, 117 *TAX NOTES* 1082 (Dec. 10, 2007), <http://ssrn.com/abstract=1517925>; Eric Toder & Alan D. Viard, *Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax*, *TAX POLICY CENTER* (Apr. 2014), <http://www.taxpolicycenter.org/UploadedPDF/413090-major-surgery-needed.pdf>; Martin Sullivan, *Can Marking Stock to Market Replace the Corporate Tax?*, *TAX NOTES*, Apr. 14, 2014, p. 139 (2014 TNT 71-1).

12. See, e.g., Calvin H. Johnson, *Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation*, 61 *TEXAS L. REV.* 1013 (1983).

repatriated to the U.S. parent, if ever.¹³ When R&D credits and exclusions of domestic production are added to expenses, the whole tax system produces a negative tax that can double the return from making computer games, probably in error.¹⁴ Capitalization of intangibles would improve all these distortions, and indeed as a logical matter, capitalization of costs of intangible investments seems forced by interest deductions, credits and diversion of revenue overseas. Outside the borders of intangibles, investments in oil and gas, homes and debt-financed bonus depreciation get negative tax that adds to the pretax value.¹⁵ The depreciation deductions from bonus depreciation reduce the effective tax to a quarter of the statutory tax rate.¹⁶ Reaching and taxing organizational capital will, however, also reach the disparity between basis and value, however produced, and reduce the distortions beyond the borders of intangibles strictly defined.

13. Staff of the Joint Comm. on Taxation, 111th Cong., JCX-37-10, Present Law and Background Related to Possible Income Shifting and Transfer Pricing 106 (2010), <https://www.jct.gov/publications.html?func=startdown&id=3692> (discussing planning under which corporation performs deductible research work in United States, but the rights to exploit the intangible property are transferred to and taxable in a low-tax jurisdiction).

14. Calvin H. Johnson, *Capitalize Costs of Software Development*, 124 TAX NOTES 603 (2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1516809 (arguing that expensing, R&D credit and exclusion as to domestic production better than double the pretax return); Calvin H. Johnson, *R&D Credit: Intelligence is Better than Random* (Letter to the Editor) (2015), <http://www.utexas.edu/law/faculty/calvinjohnson/nsf-instead-of-rd-credit.pdf> (arguing resources supporting research would be far better spent by the National Science Foundation).

15. Calvin H. Johnson, *Accurate and Honest Tax Accounting for Oil and Gas*, 125 TAX NOTES 573 (2009).

16. Calvin H. Johnson, *Depreciation Policy During Carnival: The New 50 Percent Bonus Depreciation*, 100 TAX NOTES 713 (2003), <http://www.utexas.edu/law/faculty/calvinjohnson/DepreciatonduringCarnival.pdf>.