Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives

***Abstract** - This paper offers an overview of the issues raised by disclosure of corporate tax return information by providing current and historical perspectives from the fields of accounting, economics, and law. It reaches a number of conclusions. First, we are concerned that disclosure of the entire corporate tax return could cause companies to dilute the information content of these returns, hampering tax enforcement, and might, even in diluted form, reveal proprietary information that could provide a competitive advantage to those companies that are not required to make such a disclosure. For this reason we do not support full disclosure.*

The case for considering limited public disclosure of corporate tax return information—revealing a small number of bottom–line items or an expanded reconciliation between tax and book concepts of income—rests on the fact that it would contribute to the transparency of the tax system by clarifying the tax payments of corporations in and of themselves, relative to other corporations, and relative to the income they report on their financial statements. The greater transparency could have several beneficial effects. First, it could put pressure on legislators to improve the tax system. Second, it could induce corporations to resist aggressive tax reduction strategies if they fear that disclosure of their low tax payments would trigger a negative consumer response; whether it would provoke negative investor response is less clear, as more transparency could conceivably induce a race to the bottom of low tax liability. Finally, it could contribute to better functioning of financial markets if it sheds new light on the information presented in financial statements.

We find the case for limited disclosure to be compelling enough that we look forward to the next step of considering the best form of disclosure and the details of its implementation.

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INTRODUCTION

On July 8, 2002, while attention was still focused on alleged corporate misdeeds of Enron, WorldCom, and other major U.S. corporations, Senator Charles Grassley (R–IA), then the ranking member and currently the chairman of the Senate Finance Committee, wrote a letter to the Securities and Exchange Commission (SEC) and Treasury Department raising the question of whether government regulators and the public might benefit if corporate tax returns were made public. Specifically, Grassley asked whether corporate governance would be improved if corporations' tax returns were available to the SEC and whether shareholders and employees would benefit if tax returns were publicly available. Ultimately, both the SEC and Treasury responded to Grassley's letter largely by rejecting the idea of broad public disclosure of full corporate tax returns. Many of the key issues surrounding this public disclosure debate are examined in detail in the other papers prepared for this conference. This paper offers an overview of the issues by providing current and historical perspectives from the fields of accounting, economics, and law.[1]

Grassley's suggestion of making corporate tax returns public, coupled with the negative response by the SEC and the Treasury Department, prompted much discussion among scholars, tax practitioners, government policymakers, and the media. For example, Rep. Lloyd Doggett (D–TX) introduced a bill in April, 2003, that would provide for public disclosure of certain corporate tax return information (U.S. Congress, 2003). Specifically it would require every corporation to electronically file, along with its tax return, a report that the IRS would make publicly available as a searchable database. The report would detail the amount of corporate taxable income and income tax shown on the return, the amount of federal income tax expense on the company's annual report, the company's adjusted book income, and certain items causing the discrepancy between tax and book income.[2]

Supporters of disclosure of corporate tax return information argue that it could aid government regulators in policing corporations, generally improve the functioning of financial markets, deter aggressive tax planning and, more generally, encourage tax compliance. By shedding light on the details of corporate tax payments, it could also promote sensible tax reform. We evaluate these arguments, as well as arguments against disclosure. However, we first give insight into the background of this debate by describing the political and economic context for Grassley's letter and the reactions it received and by summarizing the history of tax return disclosure.

During our evaluation of the claims made by those on both sides of the disclosure debate, we consider the possibility of making corporate tax returns public in their entirety, but primarily focus on other forms of disclosure. One such form of disclosure is to make public only certain portions of corporate tax returns or, alternatively, to disclose only the bottom line tax liability of each corporation. In his letter to the SEC, Grassley allowed for this possibility by suggesting that "a summary version" of returns be made available to government regulators and the public. A related alternative is to make public the Schedule M–1 (or a summary version), the tax return schedule that reconciles taxable income with the accounting earnings that are computed for financial reporting purposes. Grassley himself raised this possibility in a second letter to the SEC and Treasury Department, and some legal and academic commentators have also suggested that an expanded version of the current Schedule M–1 be made a public document (Kleinbard and Canellos, 2002; Mills and Plesko, 2003). A third alternative, mentioned by then–Treasury Secre-

[1] The text of Grassley's letter can be found in *Tax Notes Today* (2002a). Grassley's letter of October 7, discussed below, can be found in *Worldwide Tax Daily* (2002b). Many of the issues we discuss were raised in a state income tax context in the lively interchange between Pomp (1994, 1995) and Strauss (1993, 1995), reacting to the Massachusetts deliberations on disclosure discussed in Tannenwald (1993).

[2] The bill also calls for the Treasury Department, Joint Committee on Taxation, House Ways and Means Committee, and Senate Finance Committee to conduct a study of corporate tax shelter activity and to publish a report including recommendations (if any) for requiring additional information on the reconciliation of book and tax income and for publicly disclosing additional corporate tax return information.

tary Paul O'Neill in his reply to Grassley, is to improve the tax reporting on a company's financial statements, either through voluntary disclosure by firms or through mandate by the Financial Accounting Standards Board (FASB) or the SEC. Finally, a broader policy response to the concern over opaque financial and tax reporting would be to make taxable income more closely conform to accounting income. Which, if any, of these alternatives constitutes good policy depends in part on the goals of increased disclosure, an issue that this paper will address.

POLITICAL AND ECONOMIC CONTEXT

Grassley wrote his letter during a time of widespread concern over corporate business and accounting practices. His letter specifically mentioned WorldCom which, news stories had just revealed, inflated its cash flow by $3.9 billion for 2001 and the first quarter of 2002 by recording ordinary expenses as capital expenditures (estimates that would increase later that summer). WorldCom was not the only company making news for accounting problems. Other big news stories at the time of Grassley's letter were that Xerox had improperly reported $6.4 billion in revenue over the past five years and that Andersen, WorldCom's auditor, as part of an ultimately unsuccessful effort to save its own existence, claimed WorldCom officials failed to disclose information necessary for Andersen to have noticed its improper books.

The Bush administration initially resisted efforts to support broad legislation targeted at corporate abuses. Congress, however, passed legislation aimed at curbing and punishing corporate fraud. The bill established a regulatory board appointed by the SEC to oversee the accounting industry, created new legal standards for prosecuting corporate wrongdoing, required top management to certify their firms' financial statements and internal controls, set forth long prison sentences for executives convicted of fraud, and gave new protections to corporate whistleblowers. Although the administration had initially opposed the legislation, amid much fanfare Bush signed into law the Sarbanes–Oxley bill on July 31, 2002.

Although the corporate wrongdoing that received publicity mostly involved business and accounting issues, tax matters did arise. In the collapse of Enron, for example, it was revealed that the company had set up hundreds of Cayman Islands subsidiaries, in part for tax purposes. While it was not known whether Enron had actually engaged in illegal tax behavior, the Senate Finance Committee and later, at the Finance Committee's request, the Joint Committee on Taxation, investigated the methods Enron used to cut its U.S. tax bill. At about the same time, news stories revealed that other energy companies such as Halliburton and Baker Hughes themselves were organized in tax havens or planned to move to a tax haven. The reporting of these planned moves was part of an intense focus on an increasingly common transaction known as an inversion, a tax–motivated transaction in which a U.S. company first sets up a tax haven entity and then becomes a subsidiary of that entity. Stanley Works, a Connecticut–based tool company, canceled its planned inversion after being the target of much ire from Congress, unions, the media, and the Connecticut attorney general. Congress has considered various bills intended to stop the practice of inversions, but no legislation has been enacted to date.[3]

One underlying concern was that at the same time companies were overstating their revenues for financial accounting purposes, they were understating their income for tax purposes. Although the

[3] See McKinnon (2002), Desai and Hines (2002) and Cloyd, Mills, and Weaver (2003).

accounting for stock options explains part of the widening spread between aggregate book and taxable income in recent years,[4] at least two other concerns have been raised. First, the government and many practitioners and academics have argued that corporate tax shelters may have been one of the causes of a large and growing erosion of the corporate tax base (Desai, 2002). Bankman (1999, p. 1776) argued that it was "virtually certain" that annual investments in corporate tax shelters totaled tens of billions of dollars. The U.S. Treasury Department (1999) agreed with private estimates that corporate tax shelters might cost the U.S. government $10 billion each year in lost revenues and provided extensive evidence that corporate tax shelters were proliferating. In the background is the fact that corporate tax revenues as a percentage of gross domestic product (GDP) have been flat over the short run—even as corporate profits on the books were increasing rapidly—and declining over the long run. In each year from 1995 through 2000, corporate tax revenues amounted to 2.0 to 2.2 percent of GDP. These figures represented a decline from 2.8 percent in 1973 and 1977, 4.2 percent as late as 1967, and 6.1 percent in 1952, the highest percentage since World War II (see Office of Management and Budget website). Undoubtedly other factors, such as legislated changes in the tax rate and base, have contributed to this long–run decline, but there is also a widespread perception that more aggressive tax avoidance behavior is a contributing factor.

The SEC's and Treasury Department's responses to Grassley's letter were largely negative.[5] Then–SEC chairman Harvey Pitt wrote that any benefits from making corporate tax returns available to the SEC would be "marginal at best." According to Pitt, the SEC's enforcement staff can already obtain tax returns directly from companies, and such tax return information helps in regulation only in a "limited number of circumstances." Moreover, Pitt wrote, the tax disclosure in companies' financial statements is more beneficial in helping investors understand a company's tax situation than would be providing public access to tax returns.

Then–Treasury Secretary O'Neill responded to Grassley by asserting that "there is a potential for great harm to both corporations and federal tax administration if corporate tax returns or portions thereof are made publicly available." The SEC would not benefit from having access to corporate tax returns, according to O'Neill, because much information in the returns is irrelevant to the SEC. Neither would the public benefit if corporate tax returns were public, because their complexity would cause confusion and subject corporations to "misinformed, inexpert analysis." O'Neill did allow, however, that other alternatives might improve tax and financial reporting: the Schedule M–1, which is filed with corporate tax returns and reconciles tax and accounting income, could be improved, the tax disclosure in financial statements could be changed, and some

4 Recently a number of companies have chosen to expense their stock options, but historically stock options produced no expense for book purposes, while they created a corporate deduction at exercise for the difference between market price and strike price. This accounting difference widens the spread between book and taxable income during periods of rising stock prices, such as seen in the late 1990s. For further discussion, see Graham, Lang, and Shackelford (2003).

5 Interestingly, although Bush administration officials opposed disclosure of corporate tax return information, the Bush administration's dividend exclusion proposal in early 2003 might have revealed information about the amount of tax a corporation had paid. The proposal made dividends excludable from corporate income only to the extent the dividends were paid from income on which corporate tax had been paid. Every corporation paying dividends was therefore required to keep an account showing its "excludable dividend amount." Because this account would have been based on the amount of corporate taxes paid, under some circumstances an interested party might have been able to work back from the excludable dividend amount to determine the amount of a corporation's tax liability.

of the differences between book and tax accounting could be eliminated.

In response to the SEC's and Treasury's letters, Senator Grassley on October 7, 2002 wrote a letter to President Bush asking that the Bush administration "consider whether more aggressive action is warranted to require improved disclosure of the differences in financial statement (book) income and the tax return income reported by publicly traded corporations." We address this question below and begin by providing some historical background relevant to the debate surrounding the public disclosure of tax returns.

HISTORY OF PUBLIC DISCLOSURE OF TAX RETURNS

At several times since the Civil War, tax information has been available to the public. Moreover, it was not until 1976 that the IRS was barred as a general matter from disclosing tax returns to other government regulators. In this section we discuss the history of public disclosure of returns and describe current Internal Revenue Code rules governing the confidentiality of returns.

The Civil War Income Tax

Before the Civil War, the United States relied chiefly on land sales and tariffs for federal revenues. Amid concern that these revenue sources would prove inadequate for financing the war, Congress enacted the country's first federal income tax by passing the Revenue Act of 1861 and increasing the tax rate in 1862 and 1864. The Civil War revenue acts included publicity features. The wording of the 1861 act suggested that tax assessment information was public, but because collection efforts were minimal, this act never truly took effect. The 1862 act permitted the public to examine the names of taxpayers and the amounts of their tax liabilities. Notices and newspaper advertisements informed the public about its right to access this taxpayer information. Tax assessors were required to determine what was to be taxed and to compile assessment lists. These lists were posted in public places, and advertisements were used to tell the public about them. Pomp (1993, p. 380) argues that the purpose of these publicity features of the 1862 act was chiefly to notify taxpayers that they owed taxes because the federal tax administration remained small.[6]

Publicity became more widespread with the Revenue Act of 1864. Like the 1862 act, the 1864 statute provided that tax lists were to be public. Now newspapers started to publish lists of taxpayers, their reported incomes, and the amounts of taxes they paid. In 1870, however, a new commissioner of the Bureau of Internal Revenue barred assessors from providing tax lists for publication and a statute from Congress prohibited the publication of all or any part of an income tax return. The public, however, was still permitted to inspect returns. In 1871, the income tax was allowed to expire by its terms, in part, according to Pomp (1993), because of privacy concerns. In 1894, when a new income tax was passed, but never put into practice, Congress specifically barred government officials from making public any part of any income tax return.[7]

The 1909 Corporate Excise Tax

Publicity of corporate tax returns first became a major issue during the debates over the precursor to the current corporation income tax, the Corporate Excise Tax

[6] Our discussion of the Civil War disclosure provisions draws heavily on Pomp (1993).

[7] As we discuss below, the Supreme Court in *Pollock v. Farmers Loan & Trust Co.* concluded that the 1894 income tax was unconstitutional.

of 1909, which imposed a one–percent tax on the net income of corporations.[8] Although proponents of the tax advocated passage because they sought to raise revenue, many viewed the statute as a tool of corporate regulation. President Taft, in particular, supported the tax as a way to further his agenda of regulating corporations. Taft believed that by taxing corporations and making returns public, the government would enable regulators and the public to learn details about the business transactions and profits of corporations. This knowledge would, according to Taft, constitute "a long step toward that supervisory control of corporations which may prevent a further abuse of power" (quoted in Kornhauser (1990), p. 113). Taft and other proponents of publicity held these views in part because public reporting of any sort of corporate information was inconsistent and limited; disclosure of corporate tax return information, according to one commentator, "promised to be the most consistent and comprehensive source of corporate information" (Thorndike, 2002, p. 324). After much debate, the corporate excise tax in its final form provided that tax returns under the statute were to be filed with the Commissioner of Internal Revenue and constituted public records.[9]

The statute's enactment did not, however, end the publicity debate: opponents of publicity engaged in a campaign to weaken the publicity feature. In 1910, the Commissioner of Internal Revenue ruled that because Congress had not specifically appropriated money for public inspection of tax returns, the returns would be treated as confidential. Congress responded to this ruling by appropriating the staggering sum of $25,000 for classifying, indexing, and exhibiting tax returns, but provided that "returns shall be open to inspection only upon order of the President under rules and regulations to be prescribed by the Secretary of the Treasury and approved by the President." Under an executive order of President Taft, the Treasury Department issued regulations providing access to corporate tax returns in two ways. First, shareholders of a company could apply for permission to inspect the tax returns of the company by describing the rationale for inspection, which would be granted at the discretion of the Treasury. Second, all persons were permitted to inspect a corporation's returns if the corporation's stock was listed on a public exchange or was advertised in the press or offered for public sale by the corporation, but individuals could only inspect returns at the office of the Commissioner of Internal Revenue.

Public Disclosure in the 1920s

The Revenue Act of June 2, 1924 made public disclosure the rule for both individual and corporate taxpayers. Advocates of disclosure argued that publicity would discourage evasion and improper business conduct. Robert Howell, Republican senator from Nebraska, argued that "secrecy is of the greatest aid to corruption" and contended, "[T]oday the price of liberty is not only eternal vigilance [sic] but also publicity" (quoted in Leff, (1984), p. 67). That statute made public not the tax returns themselves, but rather the names and addresses of individuals and corporations filing returns along with their respective tax pay-

[8] Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 11, 116. The U.S. Supreme Court had held in *Pollock v. Farmers Loan & Trust Co.*, 157 U.S. 429, *reh'g. granted*, 158 U.S. 601 (1895), that the 1894 federal income tax was unconstitutional, and as of 1909 no constitutional amendment had been enacted to permit an income tax. Proponents of the 1909 tax argued that it was constitutional because it was not an income tax, but rather a tax on the privilege of doing business in corporate form. The Supreme Court validated this view in 1911 in *Flint v. Stone Tracy Co*., 220 U.S. 107, 161 (1911), when it concluded that the 1909 tax was constitutional.

[9] Act of Aug. 5, 1909, ch. 6 § 38(3), 36 Stat. 11, 116.

ments.[10] Before the 1924 elections, newspapers across the country published the names and tax payments of large companies, celebrities, and local residents. The *New York Times* filled pages with lists showing the amounts of tax paid by thousands of people, and ran stories listing the names of prominent New Yorkers who had paid no income tax.

President Coolidge and his Treasury secretary, Andrew Mellon, vigorously opposed making tax return information public. They and other opponents of publicity argued that disclosure gave hucksters access to names of wealthy taxpayers to target for scams, compromised business secrecy, and proved useless, and perhaps harmful, to tax administration and collection efforts. With the passage of the Act of Feb. 26, 1926, the law was changed so that only the names and addresses of taxpayers, and not their tax liabilities, were public.[11]

Revenue Act of May 10, 1934

A 1934 Senate Committee on Banking and Currency investigation of financial institutions motivated by the 1929 stock market crash revealed that many owners of those institutions had paid no income tax in the years since the crash. This revelation led to a move in Congress to have a publicity provision inserted in the 1934 Revenue Act. The act did not make entire tax returns public, but it did require individuals and corporations to attach to their returns a form, dubbed the "pink slip," that would become a public record. This pink slip contained the taxpayer's name, address, gross income, amount of deductions, net income, and tax liability.

The pink slip provision generated intense controversy. Proponents of publicity made a range of arguments: making tax information public would help Congress close loopholes that permitted tax avoidance; publicity would help keep tax administration honest by preventing officials from favoring high–income taxpayers; publicity was necessary if the tax rules were to be *seen as* fair; and if wealthy taxpayers knew tax information was public, they would not engage in transactions that would reduce their tax liability.[12] Opponents argued that publicity was an invasion of privacy and, in the case of companies, would give competitors valuable proprietary information.[13] This argument generally focused on small businesses rather than large corporations, perhaps because opponents aimed to have their appeals seen as populist. The campaign to repeal the pink slip provision began in earnest in February 1935, one month before income tax returns were due, when Raymond Pitcairn, an heir of the Pittsburgh Plate Glass Company and chairman of a conservative group called the Sentinels of the Republic, organized the distribution of hundreds of thousands of copies of the pink slip and of green protest stickers. The campaign urged people—many of whom were not affected by the pink slip provision—to send these mock pink slips to their representatives in Congress and to send letters and telegrams opposing disclosure. Congress passed a

[10] Revenue Act of June 2, 1924, ch. 234, § 257(b), 43 Stat. 293 (1924).

[11] Act of Feb. 26, 1926, ch. 27, § 257(e), 44 Stat. 9, 52. Permitting names and addresses to be disclosed, instead of simply abolishing publicity entirely, was intended to placate supporters of disclosure. (Pomp, 1993, pp. 396–7).

[12] On this last point, Robert LaFollette, Jr. argued that if a person "knows that his return is a matter of public record, he will hesitate a long time before he will resort to any device designed to relieve him of his fair share of the tax" (Leff, 1984).

[13] Senator Louis Murphy (D–IA) argued: "We are so insensate to the finer feelings of people, so wantonly ruthless, that we have taken the curtains and shades from the homes of our taxpayers and pulled out the walls of the bathroom to assure that the Peeping Toms shall have full and unobstructed opportunity to feast their eyes on the 'pink slip.'" Leff (1984, pp. 70–1)

statute that repealed the pink slip provisions, and President Roosevelt signed the bill into law before the publicity provisions requiring disclosure came into effect.[14] No similar disclosure provision has been implemented since at the federal level.

Disclosure at the State and Local Level

At various times many state governments have made tax returns public documents open for review. In *Flint v. Stone Tracy Co.*,[15] the case in which the U.S. Supreme Court concluded that the 1909 Corporate Excise Tax was constitutional, the court cited the policies of several states as support for its holding that the publicity feature of the 1909 statute did not violate the Fourth or Fifth Amendment. The court described the rules of Connecticut, New York, Maryland, Pennsylvania, and New Hampshire that generally required property tax lists to be available for inspection at the offices of town clerks or at other public places.[16] Property tax information, of course, typically remains public today, and many municipalities allow access to that information on the Internet.

At least five states—Arkansas, Massachusetts, North Carolina, West Virginia, and Wisconsin—provide some form of public disclosure of state income tax information. Wisconsin first provided for public disclosure of corporate income tax returns in 1923, while Massachusetts, West Virginia, and Arkansas enacted public disclosure rules in the early 1990s. Under the Massachusetts law, which was enacted in 1993, certain banks, insurance companies, and publicly traded companies doing business in Massachusetts are required to file annual reports that generally includes its name, the address of its principal office, Massachusetts taxable income, total Massachusetts excise tax due, non–income excise tax due, gross receipts or sales, either gross profit or credit carryovers to future years, income subject to apportionment, and the amount of each credit taken against the excise tax due.[17] The Secretary of State is required to maintain those reports and to make them available for public inspection on request, but only after expunging the names and addresses of the companies.[18]

The West Virginia, Arkansas, North Carolina, and Wisconsin laws are more limited in scope than the Massachusetts rules. The West Virginia and Arkansas laws authorize the disclosure of the names of taxpayers who receive certain tax credits or rebates and the amounts of those credits, but do not authorize the disclosure of total

[14] This episode is described in Kornhauser (2002) and Leff (1984).

[15] 220 U.S. 107 (1911).

[16] *Flint v. Stone Tracy Co.*, 220 U.S. at 176.

[17] A.L.M. G.L. ch. 62C, § 83(c) (2002).

[18] Massachusetts General Laws chapter 62C, § 83(n). As originally enacted, the law did not provide that the Secretary of State would expunge from the public reports the names and addresses of taxpayers, but an amendment to the law that was made before the law took effect kept taxpayers' names and addresses confidential (Pomp, 1993, p. 417) Before the Massachusetts law was enacted, the Massachusetts legislature commissioned a study of the issue of business tax disclosure. A paper prepared for the Massachusetts Special Commission on Business Tax Policy by Robert Tannenwald, who was research director of the commission, considers the arguments for and against disclosure of tax return information. Proponents of public disclosure, according to the paper, argued among other things that disclosure would promote fairness in the tax rules, encourage informed debate about business tax policy, and increase taxpayer compliance. Opponents argued that public disclosure would force businesses to divulge sensitive information, discourage voluntary compliance by violating confidentiality, and confuse rather than clarify public debate about tax policy. As will be seen, these arguments overlap with the claims that have been made in response to current disclosure proposals. Interestingly, although this report concludes that the Massachusetts disclosure rules might increase the perception that the state was unfriendly to business, it also argues that public disclosure of tax return information would not necessarily give companies access to sensitive information about their competitors that they did not already have. See Tannenwald (1993).

tax liability.[19] The North Carolina law requires the Department of Revenue to publish, among other related items of information, the names of taxpayers who claim certain job development and research and development credits as well as the amounts of credits they claim.[20] The Wisconsin law requires the state's Department of Revenue to furnish to a person who requests the information the amount of state income tax, franchise tax, or gift tax reported by an individual or corporation if the request satisfies the following conditions: the individual seeking the information must be a Wisconsin resident, must pay a four–dollar fee per return from which information is sought, and must prove his identity and sign a statement disclosing his address and the reason for making the request.[21]

The Experience in Other Countries

Among OECD countries, we found that only Japan, Norway, Sweden, and Finland permit some form of public access to the information in the corporate tax return. In Japan, the amount of taxable income is publicly released if the corporation reports more than 40 million yen (approximately $332,000) in taxable income. In 2000, approximately 70,000 corporations reported sufficient taxable income to require disclosure. None of the components of taxable income (revenues, cost of goods sold, interest, etc.) is made publicly accessible.

Taxable income is released publicly for all Swedish companies, and both taxable income and the tax liability are publicly available in Norway.[22] However, if a company reports a tax loss, the amount of the loss is not reported. Instead, the tax authorities disclose a zero taxable income amount. None of the components of taxable income is made publicly accessible. In contrast, Finland provides public access to a database that contains information about ordinary taxable income, capital income, and total taxes payable, among other items. Reconciliations between tax and book numbers are also made public for Finnish corporations.

In certain countries, there is public disclosure of information about tax evaders. For example, under Greek law the presentation of a new budget is accompanied by the names of tax evaders in the previous year compiled by the finance ministry. In New Zealand the Commissioner of Inland Revenue regularly releases a document entitled "Tax Evaders Gazette" that lists those taxpayers who have been prosecuted or had penal tax imposed for evading their taxation obligations; as of April 1997 the Commissioner is able to also publish the names of those taxpayers involved with "abusive tax avoidance." The Canadian Customs and Revenue agency compliance strategy includes publicizing court convictions for tax fraud. In Ireland, a list of tax defaulters was formerly published on an annual basis in the Revenue Commissioner's Annual Report, but recently the lists are published on a quarterly basis in *Iris Oifigiuil* (the official newspaper of record in Ireland in which several legal notices, including insolvency notices, are required by law to be published) and are reported in the national and local newspapers. According to the tax agency, this measure "aims to raise the profile of compliance and provide a continuous deterrent to other potential tax evaders. Frequently, taxpayers make a full disclosure of irregularities to auditors at the commencement of an audit to avoid the possibility of being published for tax

[19] W. Va. Code § 11–10–5s(b)(1) (2003); A.C.A. § 26–18–303(b)(11) (2002). The West Virginia rules require disclosure of a dollar range for the amount of a tax credit received (e.g., $250,001 to $500,000, rather than the exact amount).

[20] N.C. Gen. Stat. § 105–129.6(b) (2003).

[21] Wisconsin Statutes § 71.78 (2002).

[22] In Norway the information is accessible on the Internet for both corporations and individuals.

offences." Moreover, the well–publicized quarterly list is "more likely to be spotted by suppliers, customers, business associates and friends." Although such practices are not now generally permitted for the U.S. income tax, in July 2002, the IRS filed suit against accounting firms KPMG and BDO Seidman claiming the firms withheld documents, including the names of participants, relating to tax shelters the IRS is investigating. Referring to the documents already submitted by KPMG, the IRS made public a list of prominent investors that are under examination. While the IRS has occasionally in the past made public the names of tax offenders, none of the named tax shelter participants had been accused of any wrongdoing.

Disclosure of U.S. Tax Returns in Special Contexts[23]

Tax–exempt organizations are often involved in both exempt activities and taxable activities (i.e., for–profit activities unrelated to the organization's exempt purpose). Form 990–T, the nonprofit's income tax return (for income from unrelated, for–profit activities), is not publicly available.[24] However, Form 990, an annual information return that must be filed by all tax–exempt organizations, except federal agencies, religious bodies, organizations with gross receipts less than $25,000, and private foundations (who file a 990–PF), is publicly available. Form 990 contains financial data (an income statement and a balance sheet) which aggregates both the taxable and tax–exempt activities of the not–for–profit. Since 1999, tax–exempts have been required to make publicly available their three most recent Form 990s. Page format and computer–readable IRS 990 data are now available from the National Center for Charitable Statistics (NCCS).[25]

Although Form 990 is primarily a financial reporting tool, rather than an income tax return, it does contain two pieces of information related to a nonprofit's taxable activities. Part VI on page 5, item 78b asks whether a 990–T was filed. Part VII on page 6, item 104b reports the amount of taxable revenues nonprofits earn. Both of these items are included in the public–use sample of 990s. Badertscher and Yetman (2003) report that many nonprofits report less taxable revenues on the publicly available 990 than they report on confidential 990–T.

Property and casualty insurers are required to file publicly available "annual statements" with the insurance department in the state in which they are licensed to sell insurance. State regulators use the annual statements to assess the insurer's solvency. The statement is prepared in accordance with statutory accounting practices (as opposed to generally accepted accounting principles (GAAP)). These statutory accounting practices have developed over time through insurance laws, regulations and administrative rulings. Although the tax returns for property–casualty insurers are not publicly available, the federal computation of taxable income begins with net income reported in the annual statement. Aside from a few adjustments (e.g., municipal bond interest is included in income for regulatory purposes, but not for tax

[23] We describe below public access to the annual information returns of tax–exempt organizations and the annual statements of insurers. One other area of tax return disclosure merits brief mention. Since the 1970s, U.S. presidents have voluntarily made their income tax returns public. The nonprofit organization, Tax Analysts, has posted PDF versions of these tax returns (and the returns of President Franklin D. Roosevelt) on the web site of its Tax History project (http://taxhistory.tax.org/Presidential/default.htm).

[24] A 2000 Joint Committee on Taxation study, however, concluded that the 990–T should be made publicly available, although no such action has been undertaken. (Joint Tax Committee, 2000)

[25] The NCCS web page, www.nccs.urban.org, contains information on obtaining data. Computer readable data is available for the period 1982–1998 at no cost to researchers.

purposes), taxable income closely approximates net income per the annual statement.[26] This contrasts with the often–widespread differences that we observe between taxable income and GAAP net income. Consequently, although the tax returns filed by property–casualty insurers are not publicly available, public access to the annual statement effectively means that property–casualty taxable income can be estimated with considerable precision.

Internal Revenue Code Confidentiality Rules

As we have described, specific publicity rules enacted in 1862, 1864, 1909, 1924, and 1934 provided for disclosure of one sort or another. More generally, from the enactment of the Revenue Act of 1913, the first tax statute enacted after a federal income tax was made constitutional by the ratification of the Sixteenth Amendment until 1976, income tax returns were classified as public records. What precisely this public classification meant in practice varied over time with changes in the rules governing publicity. Over the entire period, the President, through executive order and Treasury regulations, controlled access to tax returns. Generally, people who could access tax returns included individuals with a material interest in the returns, the heads of government departments upon written request, and officials involved in legal proceedings on behalf of the U.S. government. The public classification also meant that from 1917 until 1966, the IRS maintained lists of all individuals who filed tax returns; these lists were open to public inspection. From 1966 until 1976, the law permitted the IRS to respond to inquiries about a taxpayer by stating whether the taxpayer had filed a return for a particular period.

The shift in 1976 to making tax returns confidential came in response to allegations that the Nixon administration had improperly used tax return information against its political opponents. The Tax Reform Act of 1976 consequently eliminated executive branch control over tax return disclosure.[27] Thus, confidentiality as a general rule is a relatively recent phenomenon.

Since 1976 the principal rules governing confidentiality and disclosure have been in section 6103 of the Internal Revenue Code.[28] Under these rules, IRS officials, other federal government employees, state government employees, and certain others who have access to returns and return information are forbidden from disclosing the information except under the limited circumstances set forth in section 6103. Individuals who unlawfully disclose returns or return information face civil and criminal penalties.

Section 6103 contains many exceptions to the general rule of confidentiality. First, shareholders of a corporation who own one percent or more of the outstanding stock of the corporation may inspect the corporation's return by making a written

[26] Other primary differences involve discounting loss reserves, increases in unearned premiums, and inclusion of anticipated salvage and subrogation.

[27] Joint Committee on Taxation, 2000, pp. 246, 249–56.

[28] The Freedom of Information Act and the Privacy Act may also be relevant in some circumstances in determining whether disclosure of tax returns is permitted (or required). The Freedom of Information Act provides a statutory right to access government information, but courts have concluded that tax returns or return information that is confidential under section 6103 cannot be disclosed under the Freedom of Information Act. Nonetheless, individuals seeking to access non–return information arguably made confidential under section 6103—documents such as IRS rulings and guidance—have used the Freedom of Information Act to compel disclosure. The Privacy Act regulates the collection, use, dissemination, and maintenance of personal information about individuals by federal agencies. The act generally prohibits the disclosure of an individual's records without the individual's consent unless the disclosure is for a routine use. Disclosure under section 6103 is generally considered a routine use (Joint Committee on Taxation, 2000, pp. 3–5).

request to the IRS. However, it is a felony for one–percent shareholders to disclose to other persons tax return information they obtain from the IRS. Second, returns and return information may be disclosed to certain government employees for tax administration purposes. Returns and return information may be disclosed to state tax officials for the purpose of administering state tax laws (and likewise from the states to federal administrators). Officials in the Departments of Justice and Treasury may gain access to tax returns and return information in matters involving tax administration. Justice Department officials are permitted this access only in the context of grand jury investigations and federal or state judicial or administrative proceedings. The rules governing access by Treasury and Justice officials generally permit return disclosure only when information on the return is specifically at issue in the work of the officials accessing the information. Consequently, although confidentiality of return information is the general rule, government officials outside the IRS can obtain tax return information while performing tax enforcement, collection, and other administrative functions.

Third, disclosure is permitted in non–tax criminal investigations. To obtain taxpayer return information in these criminal investigations, a government attorney must submit an application to a federal judge or magistrate. Federal agencies can obtain tax information about a taxpayer that was filed by a third party such as the taxpayer's bank or employer without getting a court order by submitting a written request to the IRS. The rules permitting disclosure of tax return information in the course of non–tax criminal investigations enable Justice Department officials conducting criminal securities law investigations to access taxpayers' returns.[29] The Justice Department in fact regularly requests and obtains tax returns for non–tax purposes. In 1975, eighteen federal agencies by individual request obtained 29,385 tax returns for non–tax purposes, and more than 97 percent of these returns went to the Justice Department for law enforcement purposes unrelated to tax administration (Darby, 1998, p. 580). Although the SEC lacks the ability to obtain taxpayers' returns from the IRS, the SEC does request tax return information directly from taxpayers when the information is relevant to a civil investigation (McLucas, 1997, p. 94). The fact that government regulators already can obtain tax return information in both tax and non–tax situations may make the argument for disclosure of corporate tax returns within the government less compelling.

WHY SHOULD CORPORATE TAX RETURNS (OR RETURN INFORMATION) BE PUBLIC?

Proponents of public disclosure of corporate tax return information argue that disclosure will aid government regulators, improve the functioning of the financial markets, promote increased tax compliance, and increase political pressure for a good tax system. We now critically address these arguments and follow this discussion by considering the counterarguments.

Aid Government Regulators

One rationale for making corporate tax returns public is to improve government regulation of corporations. Senator Grassley raised this point in his July 8 letter to the SEC and Treasury, asking whether making corporate tax returns

[29] The Justice Department, not the SEC, has the authority to prosecute criminal cases. Accordingly, the SEC handles civil cases itself and refers possible instances of criminal securities law violations to the Justice Department. (McLucas, 1997, p. 94; SEC Internet home page)

available to the SEC would help government efforts to police corporate governance and to ensure that companies file accurate financial reports. Two ideas underpin this argument. The first idea is that corporations need to be better policed. Although there is controversy about how best to respond to the many recent examples of corporate wrongdoing, it is hard to deny that at some level corporate governance performed poorly in some cases. The second key idea is that the information now available to government regulators, both those officials engaged in administering the tax laws and officials at the SEC, is inadequate, and corporate tax returns could serve as a useful tool to government officials in their efforts to regulate companies.

We do not find this argument to be compelling. In administering the tax laws, officials at not only the IRS and Treasury Department but also at the Justice Department already can, as was explained earlier, access corporate tax returns. In non–tax regulatory work as well, government employees can access tax returns; as was described above, SEC officials can and do obtain corporate tax returns from companies subject to civil investigations, and Justice Department lawyers obtain tax returns from the IRS in criminal securities law cases. Furthermore, administering the securities laws demands a different substantive focus from administering the tax laws and so it is not clear that studying corporate tax returns typically is useful in securities regulation. We share the view expressed by the Tax Executives Institute (TEI), an organization of business executives who are responsible for tax matters, that disclosure of corporate tax returns is not a well–targeted solution to the problem of facilitating SEC regulating activities.[30] In their words,

> If the current exceptions in [Internal Revenue Code] section 6103 are not broad enough to permit the SEC to enforce the country's securities regulations or otherwise inhibits investigation of corporate reporting practices, the proper course would be to consider an additional limited exception to section 6103 authorizing the SEC's expedient access to a company's tax returns (or portions thereof, including, for example, Schedule M–1 of the Form 1120) (2002).

Recall that supporters of the original Corporate Excise Tax of 1909 viewed the statute, and in particular its publicity provision, as a tool for regulating companies. But at the time the tax was enacted, the federal government, state government, and public had little information about large corporations other than quasi–public companies such as railroads and financial institutions. Some large publicly–traded corporations often went for years without publishing financial reports or holding annual meetings, and some states did not require publicly–traded companies to submit financial reports to officials or stockholders. The modern federal regime of securities regulation did not get started until 1933. In this earlier context, it is understandable that even the limited information provided by sparse corporate tax returns could be seen as a useful regulatory device.

In the current context, by contrast, the argument that corporate tax returns should be made public so that government officials outside the IRS can better

[30] Another policy is to mandate improvements in financial reporting. In particular, the tax footnote in financial statements, which is intended to provide a better understanding of a company's tax accounting and to explain the difference between a company's actual tax expense and the expense that would be incurred at the statutory tax rate, could be improved. Harvey Pitt conceded that the tax footnote is "selective." (2002) And O'Neill wrote that "changes may . . . be appropriate to the tax footnote in the information provided to the SEC. . ." (2002) Although a thorough discussion of this option is outside the purview of this paper, another paper in this conference, Hanlon (2003), addresses this issue in some detail.

perform corporate governance is not persuasive. It ignores the fact that non–tax officials already have access to ample information, including in many circumstances corporate tax returns, and fails to recognize that securities and financial regulation involve different substantive considerations from tax administration. If improved non–tax regulation by government officials is the objective, other solutions hold more promise, such as authorizing limited disclosure of returns by the IRS to the SEC in the context of civil securities law investigations.

Improve the Functioning of the Financial Markets

A second argument for disclosing corporate tax return information is that it would help the financial markets to function more efficiently by improving the quality of financial reporting. This rationale is, in a sense, a generalization of the argument that it will aid the SEC in its objective of protecting investors by policing the integrity of the securities markets. Arguably, public disclosure of corporate tax returns could help the financial markets even if it did not aid the SEC.

Consider for the sake of discussion that some companies now undertake misleading financial reporting in part because the public, not just the SEC, has little outside information against which to judge financial statements. If corporate tax returns were public, interested individuals could compare the contents of the returns with the information reported in the financial statements and, so the argument goes, could more easily catch inaccuracies in financial reporting. In sum, the additional information provided in the calculation of income tax could help in assessing the financial health of the company.

To be sure, comparing financial statements with tax returns would be, in the words of TEI," a time consuming and complex challenge" (2002) because corporate tax returns are long, complicated documents and because tax reporting and financial accounting have different sets of rules and objectives. One important way in which tax reporting and financial reporting differ is in their consolidation principles; tax rules generally require 80 percent common ownership for consolidation, while the accounting rules generally demand only 50 percent, and accounting rules require consolidation of foreign–controlled entities, while tax rules do not permit consolidation. For these reasons, TEI asserts that public disclosure of corporate tax returns "poses great potential for confusing rather than enlightening investors" (2002).

It is indisputable that many corporate tax returns are lengthy and complex, and that tax and financial reporting differ from one another in their governing rules and goals. But given sufficient time and resources and the incentive to invest those resources, we believe that experts could compare tax return information with financial statements to gain insight into the company's situation that could not be garnered from financial statements by themselves.[31] Moreover, if companies know that investors and other interested indi-

[31] For example, one area where tax return disclosure could lead to better understanding of the financial reports involves the accounting for income taxes. In the computation of tax expense for the books, firms establish a valuation allowance if they anticipate net operating losses (or other tax benefits) expiring unutilized. Several studies (e.g., Miller and Skinner (1998) and Schrand and Wong (2003)) have investigated whether firms manipulate the valuation allowance to manage earnings by increasing the allowance when earnings are strong and decreasing it when earnings are weak. The conclusions have been mixed. Access to the corporate tax returns could enable investors to know the actual current and past tax payments and independently access whether the valuation allowance, and thus book income, is managed.

viduals and organizations will scrutinize tax return information alongside their financial statements, they may be encouraged to provide fuller financial information than they now do.

Thus, we are not convinced that disclosure of tax return information would prove useless or, even worse, "confusing." More to the point is whether the objective of improving the flow of information could be achieved short of making entire corporate tax returns public. The problem with disclosing entire corporate tax returns is, as Kleinbard and Canellos (2002) have written, that "corporate tax returns can run into the thousands of pages, and on their face will show wildly different numbers than the GAAP financial statement, simply as a result of differences in consolidation principles." Much of this information likely would not be useful and, as we discuss later, may provide proprietary information to competitors. A possible compromise would be to disclose only a portion of the tax return, such as the first four pages of Form 1120.

Another intriguing alternative to making public entire corporate tax returns is to expand the Schedule M–1 to the corporate tax return and make this a public document. Recall that the Schedule M–1 reconciles book income for financial reporting purposes with income for tax purposes. The existing Schedule M–1 is a short document that groups together the effects of various transactions and reporting items and therefore does not permit an understanding of book–tax differences at any meaningful level of detail.[32] However, if Schedule M–1 were expanded so that interested parties could use the schedule to understand in detail the sources of variation between tax and book income, this expansion might achieve the objective of improving the flow of information.

Kleinbard and Canellos (2002) and Mills and Plesko (2003) have recently proposed comprehensive schemes of book–tax reconciliation. Under the Kleinbard and Canellos proposal, a publicly–held corporation's Schedules M and L and its financial statement income tax disclosure are conformed into a single public financial statement–tax reconciliation schedule that is filed with the corporation's tax return in lieu of the current Schedule M and also included in the corporation's financial statements.[33] The single financial statement–tax reconciliation schedule would "follow a detailed set of rules as to how reconciliation entries are presented, beginning with consolidation adjustments, and then moving to items of revenue, expense, and so on, down to actual cash tax payables to taxing authorities" (Kleinbard and Canellos, 2002, p. 1000). Mills and Plesko's (2003) proposed Schedule M–1 requires that companies filing consolidated tax returns provide the information needed to link those returns to the financial reports of the related consolidated financial reporting entities.

Enhanced public disclosure through an improved book–tax reconciliation schedule is not the only way to improve the information content of financial reports. As mentioned earlier, another approach is to make book accounting correspond more

[32] The only accounts specifically detailed on the Schedule M–1 are net income (loss) per books, federal income tax per books, excess of capital losses over capital gains, depreciation, charitable contributions, travel and entertainment, and tax–exempt interest (see Mills and Plesko, (2003)).

[33] Schedule M in this context refers to the Schedule M–1. There are actually two schedules on the U.S. corporate tax return with the letter M—Schedule M–1 and Schedule M–2. The Schedule M–1 is, as we have described, the book–tax reconciliation. Schedule M–2 provides a breakdown of unappropriated retained earnings shown on a company's financial statements. The Schedule L mentioned by Kleinbard and Canellos (2002) provides balance sheet information from a company's books. The Schedule M–1 (M–2) focuses on the income statement (statement of retained earnings).

closely with tax accounting. Others have advocated reducing or eliminating differences between book income and taxable income definitions.[34]

One advantage of reducing the differences between the definitions of book income and taxable income is that tax compliance is facilitated when the tax base is already constructed for non–tax reasons. Capital markets, consumers, government regulators, employees, suppliers, and others value reliable measures of profitability. Compliance with the income tax system is facilitated when taxable income is tightly linked to the private information of accounting earnings that taxpayers already have an incentive to compile.[35] However, a difficulty with moving toward book–tax conformity is determining which method should be changed. Different accounting for book and tax arose naturally because users of financial statements and the government's taxing authority need different information about a company. GAAP accounting is designed to provide a fair and accurate assessment of a firm's financial condition. Tax accounting is designed to produce a verifiable tax base and, in some cases, to provide incentives to firms for undertaking particular activities (e.g., Accelerated Cost Recovery System (ACRS) depreciation).

To illustrate the difficulty of imposing conformity, suppose the financial statements were prepared in accordance with the tax code. Many accruals that accountants make to reflect current economic reality better would be eliminated. For example, consider bad debt expense. Under GAAP accounting, firms are required to estimate the proportion of sales that will ultimately become uncollectible and reduce profits and the associated asset account to estimated net realizable value. If firms were required to wait until debts actually became uncollectible to reduce profits and assets (as required under current tax law), then profits and assets would be overstated in the period of sales. In addition, one of the costs associated with generating profits (bad debt expense) would not be properly "matched" to the associated revenue, so the period of sale would appear unusually profitable while subsequent periods would bear the brunt of the expenses. In addition, this method would skew managerial incentives because an easy way to artificially boost this year's profit and asset values would be to sell large quantities of product to buyers with poor credit prospects, leaving the bad debt expense to appear in a subsequent period. Under GAAP, that strategy is mitigated because auditors perform careful assessments of receivables to ensure sufficient allowances are provided so that asset values are not overstated.

Similarly, consider depreciation schedules. Suppose that the government wishes to encourage corporate investment by accelerating depreciation. If financial accounting were linked to tax accounting, corporations with substantial new investment would suddenly appear less profitable, not because of any changes in economics but simply because of a governmental move to encourage investment. Similarly, this approach would eliminate any insights that the managers and auditors might have about the deterioration of property, plant and equipment in a particular firm's context. For example, take airlines. Most wear and tear on a plane is caused by takeoffs and landings, so planes

[34] See, e.g., Engler (2001) and Yin (2001). For an alternative perspective, Hanlon, Kelly, and Shevlin (2003) contend that having both book income and taxable income maximizes the information content for capital market participants. Furthermore, they find that their measure of imputed taxable income, though informative to capital market participants, is less informative than the current GAAP mandated disclosures.

[35] We thank Eugene Steuerle for making this point in his discussion of our paper at the conference. This concern becomes less germane to the extent that the tax system moves away from an income base toward a consumption base.

used in short–haul routes have shorter expected useful lives and are depreciated more quickly under GAAP. If financial accounting were tied to tax accounting, those differences would be ignored and, presumably, the capital markets and other users of financial statements would suffer a loss in the quality of information.[36]

Alternatively, suppose firms were taxed on book income. GAAP accounting relies heavily on judgments to produce the best assessment of a firm's financial condition. For example, GAAP accounting requires an assessment of numerous factors in determining a company's annual pension expense. These factors are subject to considerable discretion, and reasonable people can disagree. Conversely, tax accounting provides a deduction when cash is contributed to a pension. The advantage of tax accounting in the pension area for computing the tax base is that the deduction can be independently verified and is subject to no judgment in amount or timing. In short, using GAAP accounting to compute taxable income would create an administrative nightmare and greatly increase firms' ability to manipulate their tax payments.

A good example of the effects of linking tax and financial accounting is the last–in, first–out (LIFO) conformity rule, which requires a firm to use LIFO for financial accounting if it uses LIFO for tax and represents one of very few cases in which tax and financial reporting are currently linked. As a consequence, many firms use LIFO for financial reporting.[37] This choice significantly understates their inventories on the balance sheet and reduces profits in periods of rising prices. As a consequence, financial statements must carry a footnote that discloses the effect of the first–in, first–out (FIFO) value of inventories. It is up to the user to use that footnote to restate the reported balance sheet and income statement to a FIFO basis to capture economic reality better and allow comparison to other firms.

One rebuttal to this argument could be that book and tax accounting do conform (or have historically) in many countries, typically non–Anglo nations, such as Germany. However, the reason is that for many continental European countries, where conformity exists, diffuse equity has not traditionally been an important source of capital, so it was not deemed cost–effective to require that firms keep two sets of books.[38] In the United States and the United Kingdom, which have a long tradition of diffuse equity ownership, separation of ownership and control increase agency problems, which have led to increased demand for high quality accounting information. A long series of papers in financial accounting (e.g., Hung (2000)) has examined cross–country differences in accounting information, and has consistently concluded that the usefulness of accounting information is nega-

[36] In fact, very small, privately–held businesses occasionally do use tax accounting rules to construct their financial statements to avoid these additional costs. However, the GAAP–based financial statements maintained for publicly–traded firms and universally used by sizable privately–held firms have developed over decades in response to users' need for information.

[37] Ball (1972), Hand (1993), Dhaliwal, Frankel and Trezevant (1994) and Hunt, Moyer and Shevlin (1996), among many others, find that some companies behave as though the benefit of lower taxes and, therefore, increased cash flow from LIFO (during times of rising prices) dominates the cost of reduced reported earnings, while other companies forgo the opportunity to lower taxes if it comes at the expense of lower reported net income. Forgoing some reported accounting earnings to mitigate taxes or willingly paying additional taxes to gain higher earnings is a phenomenon that is not restricted to the LIFO conformity rule. Matsunaga, Shevlin and Shores (1992) find the same trade–offs with incentive stock options; Engel, Erickson, and Maydew (1999) with hybrid securities; Collins, Shackelford and Wahlen (1995) in the banking industry; and Erickson, Hanlon, and Maydew (2003) in recent SEC fraud cases. For a more thorough review of this literature, see Shackelford and Shevlin (2001).

[38] The implicit assumption was that providers of capital like banks, large stockholders and governments would have more direct access to the company's finances and would not rely on public disclosure for information.

tively related to the extent of tax–book conformity. Not surprisingly, as countries like Germany increase their reliance on equity markets, we observe a de–linking of book and tax accounting.

From 1987 to 1989, the United States experimented with linking taxable income and book income. For firms subject to the alternative minimum tax (AMT), book income was a component of taxable income. Several studies (Gramlich, 1991; Dhaliwal and Wang, 1992; Manzon, 1992; Choi, Gramlich, and Thomas, 2000) attempted to determine the impact of this linkage on the quality of accounting earnings. That is, did firms adjust their accounting earnings downward or shift them to non–linkage years to reduce taxes? In their review of this literature, Shackelford and Shevlin (2001) concluded that there is little evidence to support AMT–driven income shifting.

Promote Tax Compliance

A third argument for disclosure of corporate tax return information is that it could increase tax compliance, either by discouraging outright evasion or because companies might become less inclined to take aggressive tax positions such as tax shelters that are arguably within the rules.[39] Disclosure of corporate income tax return information might reduce outright evasion and aggressive tax avoidance for two reasons. The first reason is that corporate officials might be concerned that if it were revealed that the company's taxable income was suspiciously low, the discovery could yield an adverse public reaction. Some company officials might feel ashamed at being officers of companies revealed to be less than good corporate citizens. More importantly, they might fear an adverse impact on the company's bottom line because their business relies on their customers' trust that they are good public citizens.

To be sure, many corporations do care about their public image. One indication of this concern is the $9.05 billion of corporate charitable giving in 2001, as estimated by the American Association of Fundraising Counsel; presumably one motivation for corporate charitable giving is to bolster consumer loyalty and ultimately sales.[40] Often companies explicitly and publicly link sales to their charitable gifts. Moreover, there is abundant anecdotal evidence that some consumers will boycott products of companies they perceive to be behaving unethically, as in the Nike sweatshop controversy, and that these companies will change their policies in part to forestall such boycotts. According to a survey of 2,594 adult Americans done by Hill and Knowlton (2001) in the spring of 2001, 79 percent of Americans said they consider good corporate citizenship when deciding whether to buy a company's product, and 71 percent consider citizenship in deciding whether to buy a particular company's stock. There is, however, no conclusive evidence linking company performance to these consumer perceptions. Nor is it at all clear how information from corporate tax returns would affect public perceptions about those aspects of corporate citizenship that consumers care about.[41] Companies might also fear that a hostile public response

[39] Supporters of the pink–slip provision of the 1934 Revenue Act made a similar argument: if taxpayers knew their tax returns were public, advocates argued, they would not engage in transactions that reduced their tax liabilities even if those transactions were legal (Kornhauser, 2002, p. 746).

[40] Presumably this motivation applies most heavily to companies that sell to consumers rather than other businesses.

[41] For example, there is some indication that consumers prefer local causes to national ones, prefer disaster relief or curing diseases to other causes, and that they respond more positively when the tactics used prompt attributions of genuine altruism on the part of the firm (Ellen, Mohr, and Webb, 2000). The dutiful payment of federal taxes does not obviously fit these characteristics.

might be accompanied by a harsh government response; government contracts could be threatened, or punitive legislation might be enacted.[42] This last fear would be rooted in recent history; the Homeland Security Act of 2002 included a provision banning the new Department of Homeland Security from entering into contracts with companies that have engaged in inversion transactions that are largely motivated by the tax savings they generate.[43]

However, it is conceivable that publicity could increase pressure on corporate tax managers to *reduce* their companies' tax bills.[44] The increased pressure would come from the fact that making corporate tax returns public will allow the shareholders, and CEOs acting in their interest, to benchmark their company's actual tax rate against the actual tax rates of the company's competitors and possibly also to determine in detail the reasons for any divergence in these rates.[45] This benchmarking would facilitate the drafting of more precise employment contracts for corporate tax managers, and could exacerbate a corporate "race to the bottom" of tax rates.

Disclosure of corporate tax return information might encourage increased compliance for a second, less direct, reason. Disclosure might facilitate the reconciliation of major differences between book and tax, either because these reconciliations are provided by the company itself or because they are computed by interested parties, such as the business press or academics. These reconciliations could aid the IRS in detecting corporate tax evasion. As a result, companies might be more hesitant to engage in aggressive tax planning. For example, an expanded book–tax reconciliation might highlight a tax shelter transaction; whereas under current policy, the transaction likely would not be separately disclosed in the tax footnote of the financial statements nor detailed in the Schedule M–1.

One empirical study is relevant to this issue. Rice (1992) examined data from the special 1980 Taxpayer Compliance Measurement Program study of corporations with assets between $1 and $10 million, and found that compliance was positively related to being publicly traded and in a highly regulated industry, suggesting that characteristics that assure public disclosure of information also tend to encourage better tax compliance. Tannenwald (1993) disputes this conclusion, though, asserting that a publicly–traded company might be more likely to comply because it is more likely to have managers who are independent of its owners, and are therefore less fearful of commingling the owners' personal affairs with those of the corporation.

Increase Political Pressure for Good Tax Policy

A fourth argument for public disclosure of corporate tax returns is that disclosure

[42] This argument is made in Slemrod (2002).

[43] Section 835, Public Law 107–296, 107th Congress, 2nd Session. The provision was seriously weakened by a requirement that the secretary of the department waive the ban if the waiver is required in the interest of homeland security, or to preserve American jobs, or to prevent the government from incurring additional costs.

[44] The possibility for lower tax payments resulting from disclosure is similar to Harris and Livingstone's (2002) finding that, following 1993 legislation that disallowed a deduction for executive compensation in excess of $1 million, firms with lower levels of compensation increased executive pay up to the $1 million limit. In other words, in the same way that the $1 million limit clarified the standard for executive pay, disclosure of tax returns may inform firms of opportunities or expectations that are currently more difficult to verify.

[45] See Crocker and Slemrod (2003) for a model of corporate tax evasion and enforcement in the context of a principal–agent model in which there are penalties for detected tax evasion to both the corporation and the chief tax officer, and the tax officer has private information about the availability of legal tax avoidance possibilities.

would help increase political pressure for good tax policy. As Hanlon (2003) discusses, the information presented on financial statements is generally not sufficient to pin down a corporation's annual tax liability or payments. Disclosure would ensure that a verifiable and, to some extent, comparable number is in the public domain. If the company believes that the disclosed number is misleading about its true tax situation, it would have the opportunity of releasing further explanatory information.

According to this argument, if, for example, certain corporations' tax liabilities were seen as too low relative to some norm, if certain corporations were viewed as engaging in improper tax–motivated behavior, or if tax rules were seen as unreasonably favoring certain corporations, politicians might feel pressure to make changes in tax rules or administration. The tax system, under this view, might be more responsive to public concerns. There is some historical support for this view. Pomp (1995) notes that, according to Rep. Dan Rostenkowski (D–IL), the former chair of the House Ways and Means Committee, the public outcry that resulted from disclosure by Citizens for Tax Justice of nominal federal income taxes paid by some of the largest corporations in the country was one of the keys to the passage of the Tax Reform Act of 1986. Tannenwald (1993) argues that a report by the Wisconsin Action Coalition based on disclosure of the state income tax liabilities of the 40 largest corporations sparked a debate about whether Wisconsin should adopt a minimum corporate tax.

If this responsiveness increases a public perception that the tax system is fair, there could be at least two potential benefits. First, in a democracy, respect for rules and administration is a good in and of itself since governmental legitimacy depends on this respect. Second, a public perception of fairness might increase voluntary compliance with the tax laws. Of course, these arguments could be reversed if disclosure eroded public confidence in the fairness of the tax system or in whether it preserved taxpayers' privacy.

ARGUMENTS AGAINST PUBLIC DISCLOSURE

Opponents of making corporate tax returns public argue that public disclosure violates the established norms of confidentiality and privacy and that it would create confusion and misinformation about corporate activities. We address both of these arguments below and also discuss three other potential objections to disclosure: one legal, one based on concerns over government power, and one possible unintended consequence.

Disclosure Violates Confidentiality

Opponents of public disclosure contend that it would violate a central feature of the tax laws: the confidentiality of tax return information. According to this view, breaching confidentiality would be unwise for two reasons. The first reason, which is more related to compliance than confidentiality, is that disclosure will cause companies to *say less* and therefore *pay less*. TEI made this argument in its comments to the Treasury Department and SEC and thereby turned upside down the argument for disclosure based on *increased* compliance. It wrote, "[T]he scope of information required by the Internal Revenue Code is at once daunting and extraordinarily sensitive, and the willingness of taxpayers to disclose confidential information is strengthened by assurances that their privacy interests will be safeguarded by the government" (2002). If a company's tax managers know that the information they include in the company's tax returns will be made public, this arguments goes, the managers will withhold sensitive information. The company's tax compliance will therefore decrease either directly—through simple understatements on the tax return—or indirectly as a result of the IRS's inability to correctly assess tax liability due to a lack of necessary information reporting.

Another argument is that public disclosure would reveal valuable and otherwise private business information to firms' competitors. In its comments to the Treasury Department and SEC, TEI (2002) sets forth several examples of business items that are required to be disclosed on tax returns and that, according to TEI, will be of great use to a company's competitors. Those items include the nature, sources, and character of a company's revenues and expenses, details about a company's legal structures, sales, licensing, and leasing revenues by legal entity and jurisdiction, advertising and other selling expenses, and the nature and location of a company's manufacturing costs by functional type.

To the extent that the increased disclosure is universal, it could place a competitive disadvantage on those firms that have relatively more valuable proprietary information. To the extent that the disclosure is not universal (e.g., only for U.S.–resident public corporations above a certain size), it could offer an advantage to those companies that are not subject to the disclosure requirements. In any event, it would reduce the incentive to invest in activities whose return depends in part on their proprietary nature.[46]

In fact, the loss of proprietary information was a primary objection in the 1930s to the original mandated financial disclosures for publicly–traded companies, and is raised in recent times for almost every new financial statement disclosure. This objection is undoubtedly true. There is no ability to disclose information about a company without losing the proprietary nature of that information. Moreover, we do not observe companies voluntarily releasing their tax returns. So it is reasonable to assume that firms judge any benefits of disclosing their tax returns as less than the loss of proprietary information contained in the tax returns.

Although it is undeniable that public disclosure of corporate tax returns would entail a loss of some business secrecy, the extent to which companies would be disadvantaged by the disclosure of proprietary information is uncertain and would vary from business to business and industry to industry. Also, one could raise the objection that tax return disclosure would compromise business secrets about any form of disclosure, including the existing regime of extensive financial reporting. Whether this incremental loss of confidentiality from full corporate tax return disclosure outweighs the possible benefits of disclosure is impossible to quantify.

Undoubtedly full disclosure of corporate tax returns would substantially change what is revealed in the document, but how much this disclosure would compromise IRS enforcement efforts is unknown, as is the extent of competitive disadvantage caused by non–uniform coverage or impact of the disclosure requirements. We do, however, take these objections seriously and are persuaded that full disclosure of corporate tax returns is not advisable. Yet these arguments are not persuasive when applied to more limited disclosure of either a few bottom–line items from the tax return, as in the legislation of the 1920s and 1930s, or to some form of expanded book–tax reconciliation.

Disclosure Could Create Confusion

Opponents of public disclosure of corporate tax return information also argue

[46] It is not completely clear that it is bad policy to reduce investment in activities whose return depends on secrecy, given that information is a public good. Moreover, some proprietary information, such as the details of tax shelter arrangements, might reside with outside lawyers and accountants, and not with the taxpayers. Reducing the return to investing in this sort of information could very well be good public policy.

that because returns are so lengthy and complicated, disclosure might generate confusion about corporate activities and accounting and tax practices. TEI (2002) writes, "Given the scope and degree of differences in tax and financial accounting requirements, public disclosure of corporate tax returns poses great potential for confusing rather than enlightening investors." In his reply to Grassley, Paul O'Neill stated that,

> We have serious concerns that public disclosure of large corporate returns would cause considerable confusion among the public and would subject corporations to misinformed, inexpert analysis of their finances and operating practices. Such confusion and misanalysis could lead to unfounded loss of faith in a corporation, which could significantly (and inappropriately) damage that corporation's standing among investors (2002).

Several arguments can be made against this objection. First, "misinformed, inexpert analysis" of corporations' finances and activities is already widespread, and it is not all clear whether the release of corporate tax returns would add to existing confusion. Second, the fact that the disclosure of tax returns would result in confusion and poor analysis is not necessarily an argument against disclosure. If the confusion is rooted in complex tax rules and myriad book–tax differences, the proper response might be not to resist increased disclosure, but rather to address the problems of complexity. More broadly, transparency and full information can cause problems but are essential elements of a well–functioning economy. This argument against corporate tax return information disclosure based on the worry over misinformed analysis can quickly turn into an argument against all sorts of disclosure, but restrictions on disclosure would at some point have pernicious effects. Apparently the demand for information provides sufficient compensation for financial experts to overcome the confusion and garner insights from the financial statements. Surely tax experts would be able in many cases to overcome the complexity and translate the tax return data into usable information for a broader audience. Finally, this argument applies with much less force to the limited disclosure proposals that we believe, on other grounds, have the most merit.

Legal Arguments

Is public disclosure of corporate tax return information unconstitutional? One could argue that this policy would violate Fourth Amendment protections against unreasonable searches and seizures. The Supreme Court, however, dismissed this claim in *Flint v. Stone Tracy Co.,* the case in which it concluded that the 1909 Corporate Excise Tax was constitutional. We know of no subsequent federal case in which a taxpayer successfully argued against disclosure of tax return information based on the Fourth Amendment.

In later cases, courts have considered whether the disclosure of tax return information, not to the public at large, but to the government itself or in judicial proceedings, violates taxpayers' constitutional rights. The Supreme Court has addressed two related Fifth Amendment issues: first, whether the Fifth Amendment privilege against self–incrimination bars the government from requiring a taxpayer to file a return that shows income from illegal activities and second, whether the government violates a defendant's Fifth Amendment rights in a non–tax criminal prosecution by introducing the defendant's tax returns as evidence of the defendant's unlawful conduct. On the first issue, the Supreme Court in *U.S. v. Sullivan*[47] concluded that a taxpayer could

[47] 274 U.S. 259 (1927).

not refuse to file a tax return on the ground that his tax return would reveal income from illicit liquor sales (during Prohibition) and thereby subject him to criminal prosecution. On the second issue, the Supreme Court nearly fifty years later in *Garner v. United States*[48] concluded that the government did not violate a criminal defendant's Fifth Amendment rights by introducing into evidence the defendant's tax return to show that the defendant had engaged in illegal gambling activities. The court argued that the taxpayer could have invoked the Fifth Amendment's privilege against self–incrimination and not revealed on his tax return the source of his income. The taxpayer then, of course, might have faced IRS proceedings for failing to file a complete return.

Although the decisions in *Garner* and *Sullivan* do not specifically address whether the *public* disclosure of tax returns raises constitutional concerns, the decisions reflect a balancing of interests in which the government's need to administer the tax laws (or to prosecute non–tax crimes) has trumped individuals' privacy desires. More broadly, this balancing of interests can be seen in the historical and current legislative approach to tax return publicity. As we described earlier, from 1913 until 1976 income tax returns were treated as public records, and the executive branch controlled access to tax returns. Since 1976, income tax returns have been classified as confidential, but this confidentiality may be breached in certain circumstances. Based on the Supreme Court's decisions involving tax return disclosure and on the fact that the longstanding legislative policy of permitting limited disclosure has not been overturned, we believe that it would be difficult to make a successful constitutional argument against the public disclosure of corporate tax returns. It is, though, outside the scope of this paper to consider at length hypothetical constitutional claims against corporate tax publicity.

If public disclosure of corporate tax returns is not unconstitutional, any legal arguments against disclosure must be legal policy arguments about why disclosure is unwise. One policy argument might be the following: making corporate tax returns public would overturn more than twenty–five years of accumulated jurisprudence and legal practice under Internal Revenue Code section 6103. This argument by itself lacks force. That is to say that in order to be persuasive, the argument must spell out an independent reason why overturning established legal rules is a problem. Ultimately, then, any satisfactory argument against public disclosure of corporate tax returns will be made only on non–legal grounds.

Too Much Ammunition to the Federal Government

Another argument against corporate tax return disclosure—not to the public generally, but to the SEC and other agencies—is that making returns available to government officials outside the IRS will give an already powerful federal bureaucracy an excessive amount of information to use against taxpayers. The problem with this argument is that the incremental information is probably not substantial. The SEC collects regular and detailed financial reports from public companies, the Justice Department can access tax returns from the IRS by obtaining a judicial order, and the SEC can obtain tax returns directly from companies the Commission is investigating. Moreover, large corporations now have significant resources that they can deploy against the increased power of government. As we described above in the context of business confidentiality, concerns about privacy and government interference traditionally have

[48] 424 U.S. 648 (1976).

been raised against disclosure of individual, not corporate, information. This focus was certainly the case in 1934. The privacy concerns raised by disclosure of individual tax information become less resonant when corporate disclosure is at issue.

Possible Unintended Behavioral Responses to Disclosure

A final argument against corporate tax return disclosure is that it raises the cost of doing business in a form that is subject to disclosure. Suppose, for example, that disclosure is restricted to companies that are subject to SEC regulatory oversight, i.e., companies that are traded on public exchanges. Since no publicly–traded companies currently disclose their tax returns or significant tax return information, we can assume that managers believe that the costs of such disclosure outweigh the benefits. If disclosure were mandated for public companies, some of them might choose to withdraw from the public capital markets, rather than release their tax information. This withdrawal could consequently increase the cost of obtaining capital.

Similarly, if disclosure were limited to tax returns for C corporations (both public and private), this regulation could lead to liquidation and reformation of businesses as partnerships or other flow–through entities that would not be subject to disclosure. Likewise, if disclosure were mandated for all U.S.–domiciled businesses, then the cost of locating in the United States would increase compared with other countries. This relative increase could provide a competitive advantage to foreign companies and result in companies relocating outside the United States. In short, it is impossible to mandate full tax return disclosure for all businesses in the world. If disclosure is costly, then some business will respond to disclosure by operating in alternative, presumably suboptimal forms, in order to avoid the disclosure requirement.

Another possible unintended consequence of disclosure could be a decline in the quality of accounting earnings. This consequence could occur because companies might respond to disclosure by reducing the cushion allowance that they include in the tax expense account for their financial statements. The cushion allowance is the added tax provision that companies book to ensure adequate reserves in the event that their tax liability increases in subsequent years following an audit by the taxing authorities. For example, a company could file a tax return showing a $100 tax liability. However, because it is aware that some of the positions that it has taken are subject to alternative interpretations, it may book a tax expense of $125. Then, in future years, if the IRS audits the return and the tax liability increases, the company has up to $25 of reserves to offset the adjustment, reducing the likelihood that prior earnings require restatement. In other words, the financial statements recognize the full expected cost of taxes in the year that the financial statements are filed, even though cash payments may be deferred into the future.

With disclosure, it might be possible to determine a company's cushion. If the company believed that knowledge of a large cushion would signal to the IRS that an aggressive position has been taken, managers might respond by decreasing the cushion. If so, earnings could become more volatile as adjustments are needed in future years to cover inadequate tax provisions in the past. Of course, the actual expected future tax liability that an accurate cushion would reflect would fall to the extent that companies respond by reducing aggressive tax avoidance strategies.

CONCLUSIONS

Twice in the history of the modern U.S. income tax, Congress passed legislation requiring disclosure of information from the tax returns of corporations (and individuals). In one case, the law was repealed before it took effect, but disclosure of a limited number of items was the law during the tax years 1923 and 1924. In the wake of concern about corporate accounting abuses and aggressive tax avoidance, the issue of disclosure has recently been revived by a prominent senator and others.

Our review of the accounting, economic, and legal issues has led us to a number of tentative conclusions. First, we are concerned that disclosure of the entire corporate tax return could cause companies to dilute the information content of these returns, hampering tax enforcement, and might, even in diluted form, reveal proprietary information that could provide a competitive advantage to those companies that are not required to make such a disclosure. For this reason we do not support full disclosure. However, this argument applies neither to proposals for disclosure of total tax liability alone, or along with a small number of bottom–line items, nor to an expanded, public reconciliation between tax and book concepts of income. We are persuaded that proposals of this sort would not compromise proprietary information, unduly add to the information available to government regulatory agencies, or sow confusion about the financial status of the affected companies.

The case for considering limited public disclosure of corporate tax return information rests on the fact that it would contribute to the transparency of the tax system by clarifying the tax payments of corporations in and of themselves, relative to other corporations, and relative to the income they report on their financial statements. Tax information on financial statements does not currently reveal tax liability in most cases. The greater transparency could have several beneficial effects. First, it could put pressure on legislators to change the tax system so that it better conforms to the tax system that citizens of the United States want to have. Second, it could induce corporations to resist aggressive tax reduction strategies if they fear that disclosure of their low tax payments would trigger negative consumer response; whether it would provoke negative investor response is less clear, as more transparency could conceivably induce a race to the bottom of low tax liability. Finally, it could contribute to better functioning of financial markets if it sheds new light on the information presented in financial statements.

By definition, increasing disclosure means that some information that is now private becomes public. We believe there is no constitutional obstacle to forgoing the privacy of this information, and so the case must be made on the basis of whether there are overriding societal benefits. We find this case to be compelling enough that we look forward to the next step of considering the best form of disclosure and the details of its implementation.

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