

# AMERICAN JOURNAL OF TAX POLICY ARTICLES SENT TO TREASURY.

NOV. 10, 1989

## ===== SUMMARY =====

ABSTRACT: Samuel P. Guyton, President of the American College of Tax Counsel, Nashville, Tenn., has provided a brief summary of three articles in the American Journal of Tax Policy concerning the source of "time value of money tax arbitrage," the "in lieu of credit" allowed by section 903, and the tension created in the tax law between objective and subjective standards.

SUMMARY: Samuel P. Guyton, President of the American College of Tax Counsel, Nashville, Tenn., has provided a brief summary of three articles appearing in the current issue of the American Journal of Tax Policy. Professor Charles Terry's article analyzes the source of "time value of money tax arbitrage." Professor Karen Moore writes on the "in lieu of credit" allowed by section 903. The third article discusses the tension created in the tax law between objective and subjective standards, using examples from the United States, Great Britain, and France.

## ===== FULL TEXT =====

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November 10, 1989

Mr. Kenneth Gideon  
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MISC

Dear Ken:

You will be receiving Volume 7, No. 2 of the American Journal of Tax Policy under separate cover.

Three articles in this issue of the Journal, we feel, make a substantial contribution to the analysis of major issues in income tax law. A summary of these articles is enclosed. An article authored by Charles Terry analyzes the source of "time value of money tax arbitrage", and suggests solutions to issues which are raised.

Addressing the "in lieu of credit" allowed by Section 903 of the Internal Revenue Code, Karen Moore's article advocates repeal of this section and recommends reconsideration of the foreign tax credit.

The winner of the second prize in the student writing contest discusses the tension created in the tax law between objective and subjective standards and uses examples from the United States, Great Britain and France to illustrate his points.

It is hoped you will find this issue of the Journal and the enclosed summary to be informative.

Sincerely,

Samuel P. Guyton, Chairman

SPG:rmr  
Enclosure

SUMMARY OF ARTICLES  
IN VOL. 7, NO. 2 OF  
THE AMERICAN JOURNAL OF TAX POLICY

Professor Charles Terry's article analyzes the source of "time value of money tax arbitrage." A taxpayer who borrows funds to buy an investment may have a greater return after taxes than before taxes because of the time value of the tax savings. To analyze this phenomenon, he considers the present value of the cash flows in an economically neutral investment, *i.e.*, an investment in which the cost of the borrowing exactly equals the return on the investment. Using a series of examples based on an economically neutral investment, he shows that the source of tax arbitrage in a leverage-financed financial asset arises from the deduction of interest on the borrowing before the income from the investment is reported. Developing the examples further, he shows that tax arbitrage in a leverage-financed depreciable asset arises both from deducting interest on the borrowing before reporting the asset income and from allowing depreciation on basis that does not represent a cash investment. He shows how the problem might be solved by requiring cash basis tax accounting for leverage-financed investments or by limiting deductions for interest to the income from the asset and deductions for depreciation to the taxpayer's cash investment in the asset. He concludes with a consideration of the systemic effects of the availability of tax arbitrage. Although this article is long and difficult, we believe that it throws new light on the origin of tax arbitrage and methods to prevent it.

Professor Karen Moore writes on the "in lieu of credit" allowed by section 903. She advocates the repeal of this section for two reasons. First, economic studies suggest that foreign taxes of the sort allowed to be credited under section 903 are in fact shifted to customers. Since the rationale for allowing a credit for these taxes is that they duplicate the federal income tax, the credit is not justified if taxpayers are in fact able to shift the tax. Second, the Service's present generous interpretation of the kind of taxes that qualify for the credit under section 903 may undercut its attempt to limit the creditability of various exactions by foreign governments under the foreign tax credit. We believe that this article is significant not only because it is one of the few scholarly considerations of the in lieu of credit, but also because it suggests that the time is ripe for a reconsideration of the foreign tax credit itself.

Finally, the winner of the second prize in the student writing contest (an LL.M. student) addresses the tension in the tax law between objective standards that are easy to administer (and for both tax authorities and taxpayers to abuse) and subjective standards that provide equity at the cost of uncertainty. The author uses examples from the United States, British, and French tax systems to illustrate his discussion.