APPENDIX 2

Why the "current" federal income taxes that corporations disclose in their annual reports are the best (and only) measure of what corporations really pay (or don't pay) in federal income tax

Some analysts and journalists, along with some corporations, have pointed that the "current income taxes" reported by corporations under oath in their annual reports are not a true measure of the income taxes that corporations actually pay. This is narrowly true, in that the precise income tax bill for each company in each year can only be known by the company itself and the IRS tax administrators who process the tax returns. But "current income taxes" do represent the company's best assessment of their tax bill at the time and are the only available measure of what corporations pay in income taxes broken down by payments to the federal government, state governments and foreign governments.

Our report focuses on the federal income tax that companies are currently paying on their U.S. profits. So we look at the current federal tax expense portion of the income tax provision in the financial statements. The "deferred" portion of the tax provision is tax based on the current year income but not due yet because of the differences between calculating income for financial statement purposes and for tax purposes. When those timing differences turn around—if they ever do—the related taxes will be reflected in the current tax expense.[10]

The federal current tax expense is just exactly what the company expects its current year tax bill to be when it files its tax return. If the calculation of the income tax provision was done perfectly, the current tax expense would exactly equal the total amount of tax shown on the tax return. But the income tax provision is calculated in February as the company is preparing its 10-K for filing with the Securities and Exchange Commission (SEC), and the company's tax return isn't usually filed until September. While the company's tax return is prepared over those several months, things will be found that weren't accounted for in the financial statement income tax provision, and numbers that were estimated in February will be refined for the actual return. Those small differences will be included in the following year's current tax expense, but the impact on our calculations should be minimal. If the differences in any one year were material, accounting rules would require the company to restate their prior year financials.

The complaints that "current income taxes" are not an accurate measure of taxes actually paid does contain an important truth that is worth remembering; "current income tax" is almost certainly an inflated estimate of what companies actually pay, because of a concept called "dubious tax benefits."

Dubious tax benefits, officially known as "uncertain tax positions" and "unrecognized tax benefits," are tax breaks that companies claim on their tax returns but are not allowed to report on their financial books until and if these claimed tax benefits are allowed. Securities and Exchange Commission rules require each company to assess the likelihood that each tax break it claims on tax returns will be disallowed on examination by tax administrators. The disclosure was introduced so that policymakers and tax administrators could assess the overall aggressiveness of each company's tax avoidance.

For example, suppose a corporation on its 2018 tax return tells the IRS that it owes $700 million in federal income tax for the year. But the corporation's tax staff believes that on audit the corporation will most likely owe an additional $300 million, because $300 million in tax benefits that the company claimed on its tax return are unlikely to be approved by the IRS. As a result, the corporation's current income tax for 2018 that it reports to shareholders (and that we calculate in our reports) will be $1 billion, the amount that the corporation expects to actually owe in income taxes.[11]

After that, two things, in general, can happen:

More often than not. Suppose that, as the corporation's tax staff predicted, the IRS in 2020 disallows the $300 million in dubious tax benefits claimed on the company's 2018 tax return. In this case, the $1 billion

million in reported current income tax for 2018 will turn out to have been correct. In 2020, when the dubious tax benefits are disallowed, the company will have to pay back the $300 million (plus interest and penalties) to the IRS. Reasonably enough, the corporation will not report that 2020 payback in its 2020 annual report to shareholders, since it had already reported it as paid back in 2018.

Occasionally. Suppose instead that to the surprise of the corporation's tax staff, the IRS in 2020 allows some or part of the $300 million in dubious tax benefits claimed in 2018. In this case, the corporation will reduce its 2020 "current income tax" reported to shareholders by the allowed amount of the dubious tax benefits previously claimed on the corporation's 2018 tax return.

But, argue some analysts, isn't the right answer to go back and reassign the eventually allowed dubious tax benefits to 2018, the year they were claimed on the corporation's tax return? The answer is no, for two reasons:

First, booking the corporation's tax windfall in 2020, the year it was allowed by the IRS, makes logical sense. That's because until the IRS allowed the dubious tax benefits, it was the judgment of the company's tax experts that the company was probably not legally entitled to those tax benefits. In essence, the IRS's allowance of all or part of the dubious tax benefits claimed on the company's 2018 tax return is the same as the corporation receiving an unexpected tax refund in 2020.

It's as if the company had initially borrowed the money from the IRS, but expected to pay it back (with interest). When and if the IRS "forgives" part or all of the "loan," then the company recognizes the tax benefit. Likewise, suppose you borrow money from your employer with the expectation that you'll pay it back. But later, your employer forgives your debt. You didn't have to declare the loan as income when you borrowed the money, but you do have to declare it as income when the loan is forgiven.

Second, even if one believed that the 2020 tax windfall ought to be reassigned to 2018, there is simply no way to do so. That's because corporations do not disclose sufficient information in their annual reports to make such a retroactive reallocation.[12]

An Alternative Measure: Cash Income Taxes Paid

In their annual reports to shareholders, corporations also report something called "cash income taxes paid." Cash income taxes paid is net of stock option tax benefits and does not include "deferred" taxes.[13] Unlike current taxes, however, cash income taxes paid subtracts dubious tax benefits that are likely to be reversed later (and adds those dubious tax benefits if and when they are later reversed).

"Cash income taxes paid" is sometimes interesting, but it is useless for purposes of measuring the federal income taxes that U.S. multinational corporations pay on their U.S. profits. That's because "cash income taxes paid" are not broken down by taxing jurisdiction. Instead, this measure lumps together U.S. federal income taxes, U.S. state income taxes and foreign income taxes. Since most big corporations are multinationals these days, and almost all are subject to both federal and state income taxes, that's a fatal defect.[14]

Even for purely domestic corporations, "cash income taxes paid" is a problematic measure. It often fails to match income in a given year with the taxes paid for that year (since companies don't settle up with the IRS until after a given year is over). The cash payments made during the year include quarterly estimated tax payments for the current year, balances due on tax returns for prior years, and any refunds or additional taxes due as a result of tax return examinations or loss carrybacks. Put another way, any check a company writes during a given fiscal year related to income taxes in any year, in any jurisdiction, will be incorporated into "cash income taxes paid."

To be sure, if "cash income taxes paid" were reported by taxing jurisdiction and better linked with the pretax income in a given year, then this measure could be useful. But as of now, it is not, except in one way: it supports our use of current taxes as a measure of how much in taxes corporations are really paying. If you compare a company's total current taxes (after subtracting the excess stock benefits) to cash taxes paid over a period of years, you will see that they are generally very close. The differences, if any, suggest that the effective rate corporations are paying may be even less than what we've calculated.

ENDNOTES

1 A “negative” effective tax rate means that a company enjoyed a tax rebate. This can occur because a corporation carries back excess tax deductions and/or credits to an earlier year or years and receives a tax refund check from the U.S. Treasury Department. Negative tax rates can also result from recognition of tax benefits claimed on earlier years’ tax returns, but not reported as tax reduction in earlier annual reports because companies did not expect that the IRS would allow the tax benefits.

2 When a corporation pays an effective income tax rate that is higher than the statutory income tax rate, it is usually due to taxes that were deferred in the past but that eventually came due. Such “turnarounds” often involve accelerated depreciation tax breaks, which usually do not turn around so long as companies continue to increase or maintain their investments in plants and equipment. But these tax breaks can turn around if new investments fall off (for example, because a bad economy makes continued new investments temporarily unprofitable).

3 The statutory rate was increased to 35 percent in President Bill Clinton’s 1993 deficit reduction act.

4 Gary Guenther, “Section 179 and Bonus Depreciation Expensing Allowances: Current Law, Legislative Proposals in the 112th Congress, and Economic Effects,” Congressional Research Service, September 10, 2012.

5 Employees exercising stock options must report the difference between the value of the stock and what they pay for it as wages on their personal income tax returns.

6 See, e.g., Ending Corporate Tax Favors for Stock Options Act, S. 1491 (111th Congress).

7 The effective federal income tax rates we report in this study should not be confused with an item that companies include in their annual reports with the unfortunately similar name “effective tax rate.” This latter number is a conglomeration of U.S., state and foreign income taxes, including income taxes paid and income taxes not paid (i.e., deferred). It is meaningless for understanding what companies actually pay in U.S. taxes, and even for purely domestic companies tells us little about the size of the check companies will actually write for income taxes this year.

8 One article describes goodwill impairment charges as “a ludicrous charade” “which everyone and their brothers and sisters dismiss as merely the result of an arbitrary recalculation of an arbitrary calculation.”

9 In past editions of this report we subtracted “excess tax benefits” from stock options (if any), which reduced companies’ tax payments but which were not reported as a reduction in current taxes, but are instead reported separately (typically in companies’ cash-flow statements). Thanks to new accounting rules that took effect in 2016, this step is no longer required because companies are required to include the effect of excess tax payments in their current tax estimates.

10 Companies also explain in their tax footnote why the income tax provision isn’t exactly 21% (the newly reduced U.S. statutory rate) in their “rate reconciliation.” It might show, for example, that “U.S. Business Credits” reduced their total worldwide effective tax rate by 4.4% or that “Tax on Global Activities” reduced their total worldwide effective tax rate by 6.7%. But this disclosure is a reconciliation of their worldwide effective rate, based on the total of current and deferred taxes, and doesn’t necessarily tell you much, if anything, about what they are currently paying in U.S. taxes.

11 Dubious tax benefits are not booked as either a current or a “deferred” tax benefit until and if they lose their dubiousness. In its 2012 annual report, Amgen offers a concise explanation of how dubious tax benefits are treated in financial statements: “We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities based on the technical merits of the position. . . . The amount of UTBs [unrecognized tax benefits] is adjusted as appropriate for changes in facts and circumstances, such as significant amendments to existing tax law, new regulations or interpretations by the taxing authorities, new information obtained during a tax examination, or resolution of an examination.” Amgen 2015 10-K, p. 54 (pdf p. 56).

12 Companies do provide information on the growth or decline in the amount of dubious tax benefits they have outstanding. This info is not provided on a geographic basis, however. Moreover, it does not distinguish between benefits allowed (which reduces the amount of outstanding dubious tax benefits) and benefits disallowed (which also reduced the amount of outstanding dubious tax benefits). For these two reasons, the currently provided information on dubious tax benefits is useless for our goal of measuring U.S. income taxes paid on U.S. profits.

13 Both current and cash income taxes also include refunds of taxes paid in the past if a company “carries back” “tax losses” to earlier years and gets a refund of previously paid taxes. This can occur even if a company reports book profits. Current and cash income taxes also automatically include payments of taxes “deferred” in the past in the relatively unusual occasions when those “deferred” taxes actually come due and are not offset by additional tax deferrals. (“Deferred taxes” are taxes that are not paid in the current year, but may or may not come due in future years).

14 The good news regarding worldwide “cash income taxes paid” is that, over time, they are usually very similar to worldwide “current income taxes.”