APPENDIX 1: METHODOLOGY

This study is an in-depth look at corporate taxes paid in 2018. It is similar to a series of widely-cited and influential studies by Citizens for Tax Justice and the Institute on Taxation and Economic Policy, starting in the 1980s and most recently in 2017. This report covers 379 profitable Fortune 500 corporations and analyzes their U.S. profits and corporate income taxes in 2018. In this one year, these companies reported $760 billion in pretax U.S. profits, and, on average, paid tax on just over half that amount.

1. Choosing the Companies

This report is based on corporate annual reports to shareholders and the similar 10-K forms that corporations are required to file with the Securities and Exchange Commission. We relied on electronic versions of these reports from the companies' websites or from the SEC website.

As we pursued our analysis, we gradually eliminated companies from the study based on two criteria: either (1) a company lost money in 2018 or (2) a company's report did not provide sufficient information for us to accurately determine its domestic profits, current federal income taxes, or both. This left us with the 379 companies in our report.

The total net federal income taxes reported by the 379 companies in this study amounted to about 40 percent of all net federal corporate income tax collections in fiscal year 2018.

2. Method of Calculation

Conceptually, our method for computing effective corporate tax rates is straightforward. First, we determined a company's domestic profit and then subtracted current state and local taxes to determine net U.S. pretax profits before federal income taxes. We then calculated a company's federal current income taxes. Current taxes are those that a company is obligated to pay during the year; they do not include taxes "deferred" due to various federal "tax incentives" such as accelerated depreciation. Finally, we divided current U.S. taxes by pretax U.S. profits to determine effective tax rates.[7]

A. Issues in measuring profits.

The pretax U.S. profits reported in the study are generally as the companies disclosed them. In a few cases, if companies did not separate U.S. pretax profits from foreign, but foreign profits were obviously small, we made our own geographic allocation, based on a geographic breakdown of operating profits minus a prorated share of any expenses not included therein (e.g., overhead or interest), or we estimated foreign profits based on reported foreign taxes or reported foreign revenues as a share of total worldwide profits.

Many companies report "noncontrolling interest" income, which is usually included in total reported pretax income. This is income of a subsidiary that is not taxable income of the parent company. When substantial noncontrolling income was disclosed, we subtracted it from U.S. and/or foreign pretax income.

Where significant, we adjusted reported pretax profits for several items to reduce distortions. In the second half of 2008, the U.S. financial system imploded, taking our economy down with it. By the fourth quarter of 2008, no one knew for sure how the federal government's financial rescue plan would work.

Many banks predicted big future loan losses and took big book write-offs for these pessimistic estimates. Commodity prices for things like oil and gas and metals plummeted, and many companies that owned such assets booked "impairment charges" for their supposed long-term decline in value. Companies that had acquired "goodwill" and other "intangible assets" from mergers calculated the estimated future returns on these assets, and if these were lower than their "carrying value" on their books, took big book "impairment charges." All of these book write-offs were non-cash and had no effect on either current income taxes or a company's cash flow.

As it turned out, the financial rescue plan, supplemented by the best parts of the economic stimulus program adopted in early 2009, succeeded in averting the Depression that many economists had worried could have happened. Commodity prices recovered, the stock market boomed, and corporate profits zoomed upward. But in one of the oddities of book accounting, the impairment charges could not be reversed.

Here is how we dealt with these extraordinary non-cash charges, plus "restructuring charges," that would otherwise distort annual reported book profits and effective tax rates:

i. Smoothing adjustments

Some of our adjustments simply reassign booked expenses to the years that the expenses were actually incurred. These "smoothing" adjustments avoid aberrations in one year to the next.

"Provisions for loan losses" by financial companies: Rather than using estimates of future losses, we generally replaced companies' projected future loan losses with actual loan charge-offs less recoveries. Over time, these two approaches converge, but using actual loan charge-offs is more accurate and avoids year-to-year distortions. Typically, financial companies provide sufficient information to allow this kind of adjustment to be allocated geographically.

"Restructuring charges": Sometimes companies announce a plan for future spending (such as the cost of laying off employees over the next few years) and will book a charge for the total expected cost in the year of the announcement. In cases where these restructuring charges were significant and distorted year-by-year income, we reallocated the costs to the year the money was spent (allocated geographically).

ii. "Impairments"

Companies that booked "impairment" charges typically went to great lengths to assure investors and stock analysts that these charges had no real effect on the companies' earnings. Some companies simply excluded impairment charges from the geographic allocation of their pretax income. For example, Conoco-Phillips assigned its 2008 pretax profits to three geographic areas, "United States," "Foreign," and "Goodwill impairment," implying that the goodwill impairment charge, if it had any real existence at all, was not related to anything on this planet. In addition, many analysts have criticized these non-cash impairment charges as misleading, and even "a charade."[8] Here is how we treated "impairment charges":

a. Impairment charges for goodwill (and intangible assets with indefinite lives) do not affect future book income, since they are not amortizable over time. We added these charges back to reported profits, allocating them geographically based on geographic information that companies supplied, or as a last resort by geographic revenue shares.

b. Impairment charges to assets (tangible or intangible) that are depreciable or amortizable on the books will affect future book income somewhat (by reducing future book write-offs, and thus increasing future book profits). But big impairment charges still hugely distort current year book profit. So as a general rule, we also added these back to reported profits if the charges were significant.

c. Caveat: Impairments of assets held for sale soon were not added back. All significant adjustments to profits made in the study are reported in the company-by-company notes.

B. Issues in measuring federal income taxes.

The primary source for current federal income taxes was the companies' income tax notes to their financial statements. The tax note includes each company's best assessment of its current federal income tax bill for 2018. In general, the numbers included in our report are identical to "current federal income tax" as reported by each company.[9] However, 2018 tax disclosures present a special challenge for the use of these data. In late December of 2017, the newly-enacted tax law passed by Congress imposed a one-time "deemed repatriation" tax on companies' accumulated prior foreign profits. Companies included the estimated value (if any) of this tax in their current income tax for 2017, because accounting rules required immediate recognition of this expense even if it wasn't paid immediately. In most cases, this did not affect the 2018 data used in our report. But there were two situations in which the transition tax required an adjustment to our data.

First, some companies in our sample have fiscal years that overlap mostly, but not completely, with the calendar year. For companies with fiscal years ending in (for example) October, the 2018 annual report covers a time period including late December 2017, which means the transition tax is included in 2018 current income tax and must be subtracted.

Second, some companies with conventional fiscal years that follow the calendar year made second-round re-estimates of the transition tax in 2018. (A special Financial Accounting Standards Board (FASB) rule, in a nod to the very short period of time companies were given to assess the impact of the 2017 tax cuts before the end of their 2017 fiscal year, gave companies latitude to make adjustments their original estimates in the following year, and many companies did so.) In many cases, the transition tax was adjusted downward, making current federal income tax for 2018 appear lower than it really was. In a smaller number of cases, the transition tax was adjusted upwards, making current federal income tax related to 2018 income appear larger than it really was.

In each of these cases, current federal income tax for 2018 should not include the effect of the transition tax or the transition tax adjustment. The transition tax is not related to U.S. income earned during 2018 but is associated with foreign income earned in an indeterminate year, usually before 2018. We adjusted reported current federal income tax, where necessary, to exclude the effect of the transition tax or transition tax adjustment. When companies disclosed the existence of a transition tax adjustment but did not disclose its size, we eliminated that company from the sample because it wasn't possible to determine true 2018 income tax liability.

C. Negative tax rates

A "negative" effective tax rate means that a company enjoyed a tax rebate. This can occur by carrying back excess tax deductions and/or credits to an earlier year or years and receiving 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. If and when these "uncertain tax benefits" are recognized, they reduce a company's reported current income tax in the year that they are recognized. See the appendix on page 24 for a fuller discussion of "uncertain tax benefits."

D. High effective tax rates

Some of the companies in our study report effective U.S. federal income tax rates that are higher than the 21 percent official corporate tax rate. This phenomenon 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 are continuing to increase or maintain their investments in plant 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).

E. Industry classifications

Because some companies do business in multiple industries, our industry classifications are far from perfect. We generally, but not always, based them on Fortune's industry classifications.