Appendix:

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 taxes.

Some analysts and journalists, along with some corporations, have complained 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 complaint is mostly incorrect. In fact, "current income taxes," with a sometimes important downward adjustment that we make for "excess stock option tax benefits," are a good assessment of companies' tax situations, 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.[21]

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 (after adjusting for excess stock option tax benefits) 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 SEC and the tax return isn't usually filed until September. When the 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 is minimal (especially because we look at the rates over a period of years). 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 make two main points.

A. Excess stock option tax benefits: The first, easily dismissed complaint is that "current income taxes" do not include some of the tax benefits that corporations enjoy when employees exercise stock options. That is certainly true. But our study does subtract those "excess stock option tax benefits" from current income taxes in the tax results we report.

B. Dubious tax benefits: A more interesting, but also flawed argument against the use of current income taxes (less stock option tax benefits) involves the accounting treatment of dubious tax benefits that companies claim on their tax returns but are not allowed to report on their books until and if these claimed tax benefits are allowed.

Dubious tax benefits, officially known as "uncertain tax positions" and "unrecognized tax benefits," are tax reductions that corporations claim when they file their tax returns but which they do not expect to be allowed by the IRS or other taxing authority.

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[21]Companies also explain in their tax footnote why the income tax provision isn't exactly 35% (the 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 19.7%. But this disclosure is a reconciliation of their *worldwide* effective rate, based on the total of current *and deferred* taxes, and doesn't tell you much, if anything, about what they are currently paying in U.S. taxes.

For example, suppose a corporation on its 2005 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 2005 that it reports to shareholders will be $1,000 million, the amount that the corporation expects to actually owe in income taxes.[22]

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

1. More often than not. Suppose that, as the corporation's tax staff predicted, the IRS in 2010 disallows the $300 million in dubious tax benefits claimed on the company's 2005 tax return. In this case, the $1,000 million in reported current income tax for 2005 will turn out to have been correct. In 2010, 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 2010 payback in its 2010 annual report to shareholders, since it had already reported it as paid back in 2005.

2. Occasionally. Suppose instead that to the surprise of the corporation's tax staff, the IRS in 2010 allows some or part of the $300 million in dubious tax benefits claimed back in 2005. In this case, the corporation will reduce its 2010 "current income tax" reported to shareholders by the allowed amount of the dubious tax benefits previously claimed on the corporation's 2005 tax return.

But, argue some analysts, isn't the right answer to go back and reassign the eventually allowed dubious tax benefits to 2005, 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 2010, 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 2005 tax return is the same as the corporation receiving an unexpected tax refund in 2010.

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 you 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 2010 tax windfall ought to be reassigned to 2005, 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.[23]

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[22]Dubious tax benefits are not booked as either a current or a "deferred" tax benefit until and if they lose their dubiousness. In its 2010 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 unrecognized tax benefits ("UTBs") 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 2010 10-K, p. F8 (pdf p. 117).

[23]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 not allowed (which also

C. A final point here, regarding a potentially useful, but currently almost useless measure called "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.[24] Unlike current taxes, however, cash income taxes paid subtracts dubious tax benefits that are likely to be reversed later (and add those dubious tax benefits if and when they are later reversed).

"Cash income taxes paid" is sometimes interesting, but at this point in time, 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, that's a fatal defect.[25]

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.

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 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.

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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.

[24]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 unusually 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.)

[25]An interesting point regarding worldwide "cash income taxes paid" is that in the cases we have examined, over time, they are usually very similar to worldwide "current income taxes" (less stock option tax benefits). The relatively small exceptions are generally in the case of companies that are very aggressive in claiming dubious tax benefits year after year. Since it takes time for the tax authorities to disallow these dubious tax benefits, worldwide cash taxes paid over time by such companies are typically somewhat lower than "current income taxes" (less stock option benefits).

For example, from 2001 to 2010, General Electric's worldwide cash income taxes paid were 13 percent less than its worldwide current income taxes. Verizon's worldwide cash income taxes paid were 10 percent less than its worldwide current taxes. And Exxon Mobil's worldwide cash income taxes paid were 10 percent less than its worldwide current taxes.

Since "cash taxes paid" are presented only on a worldwide basis, we usually cannot tell whether these and other similar companies' U.S. cash taxes paid are noticeably less than their current U.S. taxes. But it does suggest that our use of "current income taxes" (less stock option tax benefits) may slightly overstate the income taxes that U.S. corporations actually pay on their U.S. profits over time.

An Example:
General Electric, Current Taxes, Cash Taxes & Uncertain Tax Benefits

When a brilliant article by David Kocieniewski in the *New York Times* in May of this year exposed GE as a champion tax dodger, the company begged to differ. "In 2010," said GE, pathetically, "we paid a small amount in federal income taxes."

According to GE, the New York Times had counted as "tax benefits" in 2010 (leading to a stated huge negative tax in that year), tax reductions that the company had actually received in earlier years. GE said it had not revealed those earlier tax benefits on its books in the earlier years because it had expected that the IRS would disallow GE's improbable claims, and thus GE expected to be required to pay the money back later (with interest).

But as it turned out, GE implied, in 2010 the IRS decided that GE could get to keep some of the unpaid income taxes that GE had expected to have to pay back. So, under standard accounting rules, GE booked the tax benefits in 2010. At least this seems to be GE's story.

Even if true, of course, that meant that GE really did get the tax breaks. It just hadn't bothered to tell anyone about them until 2010. Which is arguably quite reasonable, since GE expected it would have to pay the money back. Counting the tax breaks as received in 2010 (as "current" taxes do) makes sense, because that's the year that GE was really entitled to keep the money.

In any event, a frantic GE (along with some grumpy reporters) argued that the *Times* would have been better advised to look at GE's "cash income taxes paid" rather than its "current" federal income taxes. The problem, however, is that companies do not break down their "cash income taxes paid" between U.S. and foreign taxes. That makes "cash income taxes paid" pretty much useless in measuring what companies actually pay to the U.S. government.

Except for one thing. Companies are required to keep track, in a confusing way, of their "uncertain tax benefits." These are taxes that the companies did not pay, but expect to have to pay in the future once various governments audit their tax returns. These "UTBs" are almost never broken down geographically. But in its 2010 report, GE admitted that all or almost all of its UTBs reflect U.S. federal income taxes not paid. (The non-US-federal portion of the UTBs, GE said, are not "material.")

Since over time, the difference between worldwide "current" income taxes and "cash" income taxes is almost entirely due to "uncertain tax benefits," this admission by GE allows a diligent analyst to find out something very interesting about GE's federal income taxes (if one thinks that "cash income taxes paid" is the best measure).

Over the past 10 years (2001-10), GE's reported that its total worldwide "cash" income taxes paid have been $3.3 billion less than it reported in total federal, state and foreign "current" income taxes. Meanwhile, GE says that at the end of 2010, its worldwide "unrecognized tax benefits" totaled at least $4.1 billion.

If, as GE seems to say, all or almost all of that $4.1 billion reflects unrecognized *U.S. federal* tax benefits, and one subtracts the $4.1 billion from the $2.6 billion in "current" federal income taxes that GE reported over the 10 years (already a tiny 3.1 percent U.S. federal 10-year tax rate), here's what one finds:

From 2001 through 2010, GE's U.S. net federal cash income taxes paid appear to have been less than zero!

So, if we accept GE's suggestion to look deeper, it seems that the *New York Times* may have slightly *understated* the vast scope of GE's tax avoidance over the last decade. But the *Times* certainly got the gist absolutely right. Or, if one thinks that uncertain tax benefits shouldn't be counted until they're actually allowed (our position), then the *Times* got the story perfect.