Explaining the GAAP between Book and Taxable Income

A recent study identified dozens of large companies that paid no income taxes in 2020. While such studies get headlines and may seem shocking, the reality is much more mundane: taxable profits (or losses) are determined by tax laws, whereas book profits (or losses) are determined by accounting standards. There are real, legitimate reasons why tax laws differ from accounting standards, which can result in book profits but tax losses for a given company in a given year.

- **Tax laws and accounting rules are not the same—Congress writes tax laws and accountants write accounting rules**

Book income refers to the income that a company reports on its publicly filed financial statement and is defined using Generally Accepted Accounting Principles (GAAP). The Financial Accounting Standards Board (FASB) sets rules and guidelines with the purpose of creating a standard by which investors can evaluate different firms.

Taxable income refers to the amount of income that a company reports on its tax return. The rules defining taxable income were designed by members of Congress to raise revenue for government activities and encourage or penalize certain behaviors.

- **Businesses don't use "loopholes," they follow the rules enacted by Congress**

Much like homeowners who take the mortgage interest deduction or parents who take the child tax credit, businesses utilize deductions and credits that Congress has enacted to encourage or discourage behavior.

For instance, Congress enacted accelerated depreciation to incentivize investment, which means when a business buys a machine or builds a factory, tax rules allow for faster and larger upfront deductions than allowed under accounting rules. Accelerated depreciation leads to short-term gaps between book and taxable income over the period when the tax deductions are larger. Business tax credits like the tax credit for research & development (R&D) costs also lead to gaps in taxable and book income.

If some corporations paid little to no income taxes in a given year due to depreciation deductions or the R&D tax credit, the only way they benefited from such provisions was by investing in capital or performing R&D, economically beneficial activities recognized by tax rules Congress enacted.

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- **Tax rules were written to smooth out effects of business cycles**

If some corporations paid zero corporate income taxes because they were carrying forward past losses, it should be seen as a normal feature of the U.S. tax code, not a cause for concern. Deductions for carried-forward losses ensure firms are taxed on profitability over time and not penalized for losses that don't align with calendar years. Tax losses can be carried forward for an unlimited number of years (backward for two years) with some other limitations, so many companies could be carrying forward losses from the financial crisis or other company-specific downturns.

- **There is symmetry in the tax code: A deduction for one is a tax liability for another**

Timing differences of when stock-based employee compensation is deducted from book versus taxable income contribute to book-tax gaps as well. But what is deducted for the corporation is taxable for the employee receiving it. A full analysis must recognize that recipients of stock-based compensation will pay personal income taxes on that income.

In the time between when the compensation is issued and deducted from book income and when it vests for the employee and is deducted from taxable income, the stock value may have changed. Book income is greater than taxable income if the stock value has increased when vested, and vice versa if the stock value has declined.

- **Big companies are audited at the highest rates and Congress keeps an eye on corporate refunds**

The largest corporations have relatively high audit rates—of the 619 companies with assets over $20 billion in 2019, 50 percent were audited by the IRS compared to the overall corporate audit rate of 0.7 percent.[1] Further, the Joint Committee on Taxation (JCT) must review any C corporation refunds above $5 million.[2]

- **Large companies pay taxes in other countries too**

Foreign profits also create a wedge between taxable income and book income, as the federal corporate income tax applies to a portion of foreign income under the Tax Cuts and Jobs Act's base erosion and profit shifting guardrails, such as the tax on global intangible low-taxed income (GILTI).

- **Take the long view: A multiyear horizon is necessary to accurately analyze corporate taxes**

A one-year snapshot of corporate tax situations paints an inaccurate picture of the taxes paid by corporations. Provisions like accelerated depreciation cause short-term gaps in book and taxable income due to timing differences, but over the life of an asset the same nominal deductions are taken for both calculations. Deductions for past losses help smooth out tax liability over time to avoid penalizing companies with volatile earning patterns.

Over a multiyear horizon, timing differences between book and tax income largely disappear, making the two measures more consistent.

1 Internal Revenue Service Statistics of Income, "Table 17b Examination Coverage: Recommended and Average Recommended Additional Tax After Examination, by Type and Size of Return, Fiscal Year 2019," https://www.irs.gov/statistics/compliance-presence.

2 The Joint Committee on Taxation, "Refund Review," https://www.jct.gov/operations/refund-review/.