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INSIGHT

A Look at Book-Tax Differences for Large Corporations Using Aggregate Internal Revenue Service (IRS) Data

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The 117th Congress may consider policies that would tax *book income*, or income as reported on financial statements. President Biden has proposed a 15% minimum tax on book income. Senator Elizabeth Warren has announced her intent to propose a tax on book income, which would be structured as an add-on tax or surtax.

This Insight examines IRS data on aggregate values of financial statement income ("book income") and income as reported on tax returns for corporations filing IRS Schedule M-3 (corporations with assets of $10 million or more). Corporations file Schedule M-3 to reconcile financial statement income to tax income.

Aggregate IRS Data on Book-Tax Income Differences

Media reports identify companies that report profits, but report no taxes, on publicly available financial disclosure reports (Zoom is one of the latest examples). Publicly traded companies publicly disclose comprehensive financial information on the Form 10-K, which is filed with the Securities and Exchange Commission (SEC). A primary purpose of these reports is to provide potential investors information about the risks associated with investing in the firm. Tax accounting rules are intended to produce a verifiable tax base based on rules that can be implemented and enforced.

Tax payments disclosed on Form 10-Ks may differ from tax payments as remitted to the U.S. Treasury, due to differences in consolidation rules (which determine the reporting entity) and accounting rules (financial accounting or tax accounting). Financial statement income is usually determined using U.S. Generally Accepted Accounting Principles (GAAP), while tax income is determined under the Internal Revenue Code (IRC).

Large corporations—those with assets of at least $10 million—are required to file Schedule M-3 with their corporate tax returns. The first step in reconciling financial statement (book) income to tax income is to address differences in consolidation rules. Different consolidation rules under U.S. GAAP and the IRC

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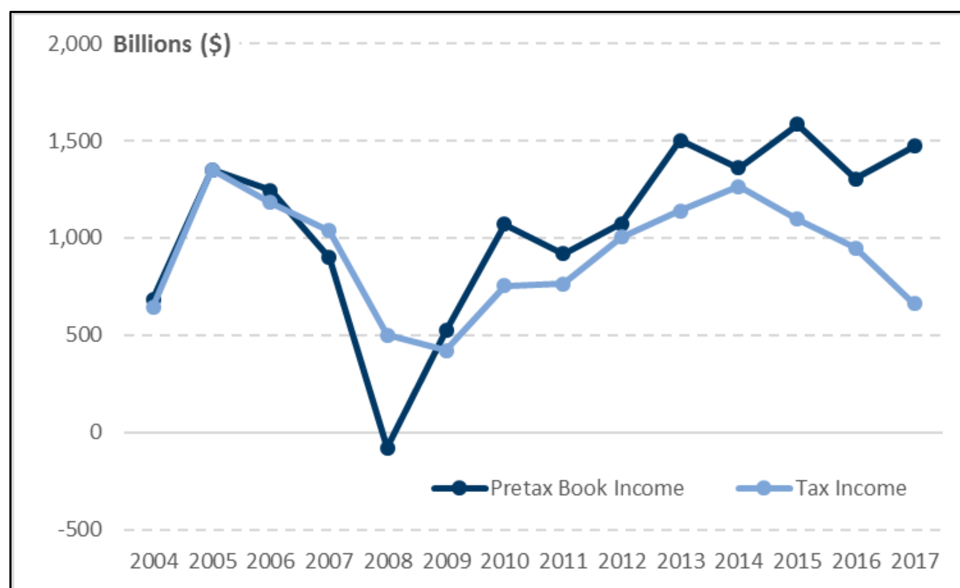
make it such that the reporting entity for the purposes of a financial statement is not necessarily the same as the entity filing a tax return. Schedule M-3s filed in 2017 reported $1,409 billion in worldwide consolidated financial statement net income. Financial statement net income for entities included on U.S. tax returns was $1,324 billion in 2017. Applying tax consolidation rules to all entities allows for an apples-to-apples (same entity) comparison of financial (book) and tax measures of income.

Figure 1 compares aggregate pretax financial (book) income to tax income for corporations filing Schedule M-3, after differences due to consolidation have been removed (other analysis of book-tax differences also uses pretax book income; pretax book income can be found on Part II of the Schedule M-3, while federal taxes are reported on Part III). From 2009 through 2017, aggregate book income reported on corporate Schedule M-3s exceeded tax income. **Figure 2** plots aggregate book-tax differences from 2004 through 2017. Since 2009, corporations filing Schedule M-3, in aggregate, have reported more in financial (book) income than tax income.

Schedule M-3 reconciles book income to tax income *before* adjusting for net operating losses (NOLs) and other special deductions. When deductions exceed receipts, income is negative, and the negative amount a NOL. Income subject to tax—the measure of income to which tax rates are applied—cannot be less than zero, and includes NOLs. In economic downturns, income subject to tax tends to be higher than tax income (the tax income measure reported on Schedule M-3s), since weak economic conditions limit taxpayers' ability to claim losses in the current tax year. At full employment, income subject to tax is often lower than reported tax income as NOL carryforwards reduce income subject to tax. Ultimately, because of NOLs, income subject to tax is smoother over time than tax income.

Figure 1. Aggregate Book Income and Tax Income for Large Corporations

2004-2017

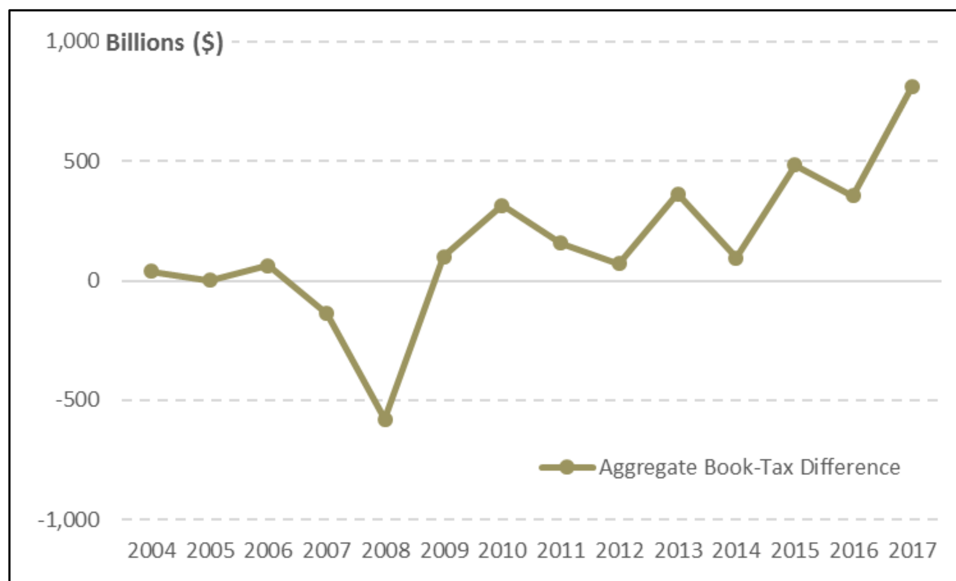


Source: CRS calculations using data from IRS Schedule M-3.

Notes: Pretax book income is financial statement income of corporations filing tax returns that were required to file Schedule M-3 plus U.S. tax expenses. Large corporations are those with assets of $10 million or more filing Form 1120 U.S. corporate income tax returns.

Figure 2. Aggregate Book-Tax Difference for Large Corporations

2004-2017



Source: CRS calculations using data from IRS Schedule M-3.

Notes: Aggregate book-tax difference is aggregate pretax book income less aggregate tax income. Large corporations are those with assets of $10 million or more filing Form 1120 U.S. corporate income tax returns.

Primary Causes of Book-Tax Differences

Differences between book and tax income reflect both differences in income items and differences in deductions. Income items can be larger or smaller for book and tax purposes, and can vary over time. (For example, book foreign-source income reflects distributions out of current and previously taxed income, while tax foreign-source income reflects dividends not already taxed and certain income, called Subpart F, that is taxed whether distributed or not because it is easily shifted.) Interest income is larger for book purposes because of tax-exempt interest. Capital gains are often larger for tax purposes because capital losses are not fully deductible.

Similarly, some deductions can be larger or smaller for book or tax purposes, and these differences can vary over time. Deductions for depreciation and stock options and other forms of equity-based compensation are generally larger for tax purposes. Special rules that allow bonus depreciation or accelerated depreciation for tax purposes, which are often motivated by a desire to encourage investment, are a major factor in explaining book-tax differences.

Some book-tax differences, including those due to depreciation deductions, are temporary. The costs associated with capital investment will be recovered for both book and tax purposes, but there is a timing difference. With bonus depreciation for tax purposes, deductions are taken when investments are made. For book purposes, these costs will be recovered over time. Other differences are permanent. For example, tax-exempt interest payments are included in book income.

The 2017 tax revision (P.L. 115-97, commonly referred to as the "Tax Cuts and Jobs Act") changed the tax treatment of multinationals, which may explain the significant book-tax difference in 2017, the year before many of the law's changes went into effect. Firms may have recognized commitments to larger dividend payments from foreign affiliates for book purposes but delayed paying those dividends until 2018, when dividends became exempt.

The relationship between book and tax income is affected by the business cycle (including the Coronavirus Disease 2019 recession and recovery) and the government's fiscal policy response. During the Great Recession, in 2007 and 2009, aggregate tax income was larger than aggregate book income, leading to negative book-tax differences (**Figure 1** and **Figure 2**). One factor that may partially explain why book-tax differences decline during economic downturns is the treatment of bad debt, which may be recorded on financial statements before being claimed for tax purposes.

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