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Beyond the Headlines: What Do Corporations Pay in Income Tax?

By
William McBride
Economist
Tax Foundation

Introduction

A number of recent news stories and think tank reports have drawn attention to the amount of income taxes paid by large corporations. For example, a recent report by Citizens for Tax Justice claimed that the financial statements of 12 large companies showed that eight paid no federal corporate income taxes between 2008 and 2010, and as a group, their effective federal corporate rate was -1.5 percent.[1] Similar news stories by the *New York Times* have focused on the ability of a few large companies, particularly General Electric, to take advantage of various credits and deductions in the corporate tax code.[2]

Key Findings

- *While the corporate tax code – like the individual tax code – is complicated by too many credits and deductions that benefit a narrow set of taxpayers at the expense of the many, recent reports of large corporations avoiding their "fair share" of taxes are misleading.*
- *IRS data on millions of actual corporate tax returns shows that the effective U.S. federal corporate tax rate has averaged 26 percent between 1994 and 2008.*
- *The effective U.S. federal corporate tax rate differs considerably across sectors, but much of this variance is explained by the mixture of U.S. and foreign income, foreign taxes paid, and foreign tax credits claimed, which merely prevents double taxation of foreign profits.*
- *Foreign taxes explain most of the difference between U.S. statutory and effective rates. The overall effective corporate income tax rate on the worldwide income of U.S. corporations, inclusive of foreign taxes paid on foreign income, is between 32.1 and 33 percent, which is close to the statutory rate of 35 percent.*
- *The largest corporations pay the lion's share of taxes. In 2008, the 1,937 largest companies were responsible for 68 percent of corporate tax revenue.*

1 Bob McIntyre and Anne Singer, "Twelve Corporations Pay Effective Tax Rate of Negative 1.5% on $171 Billion in Profits; Reap $62.4 Billion in Tax Subsidies," Citizens for Tax Justice, June 1, 2011. http://ctj.org/ctjreports/2011/06/twelve_corporations_pay_effective_tax_rate_of_negative_15_on_171_billion_in_profits_reap_624_billion.php

2 See David Kocieniewski, "U.S. Business Has High Tax Rate but Pays Less," *New York Times*, May 2, 2011 and "G.E.'s Strategies Let it Avoid Tax Altogether," *New York Times*, March 24, 2011. http://www.nytimes.com/2011/05/03/business/economy/03rates.html?_r=2 http://www.nytimes.com/2011/03/25/business/economy/25tax.html?_r=3&hp=&%2359;=&pagewanted=all

Table 1

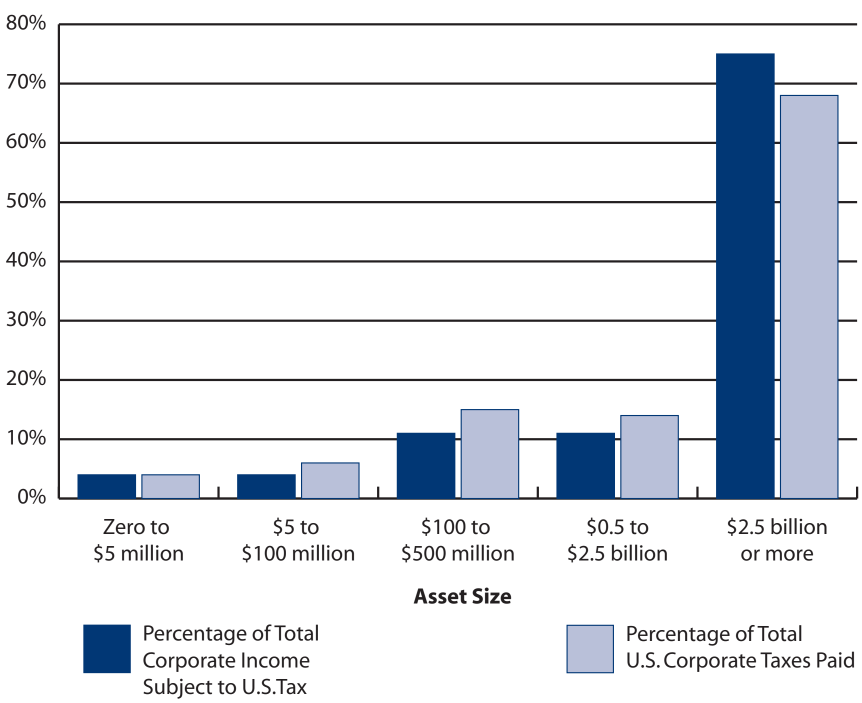
Summary Data on All Active Corporate Returns for 2008, Including Both C and S-Corporations.

		Asset Size				
	All Returns	Zero to $5 Million	$5 to $100 Million	$100 to $500 Million	$0.5 to $2.5 Billion	$2.5 Billion or More
Number of returns	5,847,221	5,679,895	143,481	169,408	6,235	2,582
Income Subject to Tax ($Billions)	$978	$37	$43	$109	$108	$737
U.S. Income Tax After Credits ($Billions)	$229	$10	$14	$35	$32	$156
Effective U.S. Federal Tax Rate	23.4%	26.6%	32.5%	31.7%	29.6%	21.2%
Percentage of Total Corporate Income Subject to U.S.Tax	100%	4%	4%	11%	11%	75%
Percentage of Total U.S. Corporate Taxes Paid	100%	4%	6%	15%	14%	68%

Source: IRS Statistics of Income: Table 2--Balance Sheet, Income Statement, and Selected Other Items, by Size of Total Assets. http://www.irs.gov/taxstats/article/0,,id=170544,00.html

Figure 1

Share of U.S. Corporate Income and U.S. Taxes Paid, by Asset Size, 2008



Note: This includes all active corporate returns.
Source: IRS Statistics of Income: Table 2--Balance Sheet, Income Statement, and Selected Other Items, by Size of Total Assets. http://www.irs.gov/taxstats/article/0,,id=170544,00.html

To many Americans, such reports are an indication that the tax code is riddled with preferences that allow large corporations to avoid "paying their fair share" of taxes. To be sure, the corporate tax code – like the individual tax code – is complicated by too many credits and deductions that benefit a narrow set of taxpayers at the expense of the many. But as is often the case in tax discussions, anecdotes do not tell the whole story.

A review of actual IRS corporate tax return data shows that while the largest corporations in America (those with assets larger than $2.5 billion) represent a tiny fraction of all corporations, they pay an overwhelming share of all federal corporate income taxes. And while the more sensational reports focus on the low effective tax rates paid by a few companies – at least according to their financial statements – the IRS data shows that the effective U.S. tax rate for all corporations averaged 26 percent between 1994 and 2008.

The effective U.S. tax rate varies across years, ranging from 27.5 percent in 1999 to 22.8 percent in 2008. It also depends on industry and company size, with small, domestically based corporations paying close to the statutory rate of 35 percent and large, multinational corporations (MNCs) paying a lower effective U.S. rate. However, when foreign taxes are included, the overall tax rate on large MNCs is also close to the U.S. statutory rate of 35 percent. Averaged for all corporations in 2007, the overall effective corporate tax rate was between 32.1 and 33 percent.

Effective U.S. Corporate Income Tax Rate

Table 1 provides summary statistics for the 2008 (most recent) IRS data, which is comprised of 5.8 million corporate tax returns, the majority of which are S-corporations that pay their income taxes on their individual tax returns. Of the 5.8 million, 97 percent are small firms and have assets between zero and $5 million. Just 2,582 are large firms, with assets above $2.5 billion.

As is often the case in tax discussions, anecdotes do not tell the whole story.

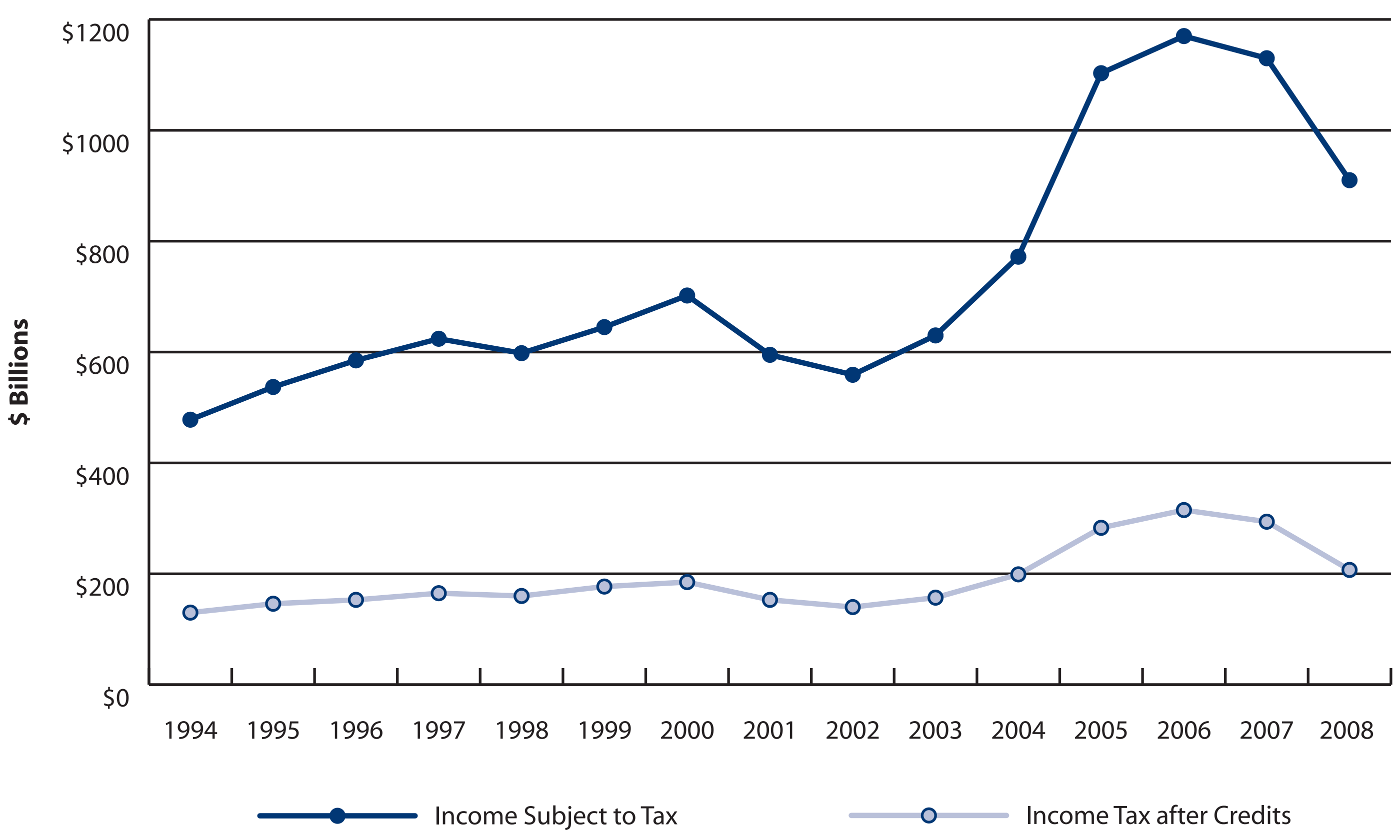
In 2008, a particularly low year for corporate income and tax revenues, total reported income for all firms was $978 billion. As Figure 1 illustrates, the largest firms earned 75 percent of taxable corporate income (86 percent if we include firms with assets above $500 million). Total federal corporate income taxes paid for all firms was $229 billion. Large firms paid 68 percent of this (82 percent if we include firms with assets above $500 million). Of the 2,582 largest firms, 25 percent were unprofitable and thus paid no income tax, leaving 1,937 responsible for 68 percent of corporate revenues.

While the average effective tax rate for all firms in 2008 was 23.4 percent, it was 32.5 percent for companies with assets of $5 million to $100 million, and 31.7 percent for companies with assets between $100 million and $500 million. For a variety of reasons, the largest companies had an effective tax rate on U.S. income of 21.2 percent in 2008, the lowest in many years.

The main reason is that this effective rate counts only income taxes paid to the

Figure 2

Income Subject to Tax and U.S. Corporate Income Tax after Credits, 1994 to 2008

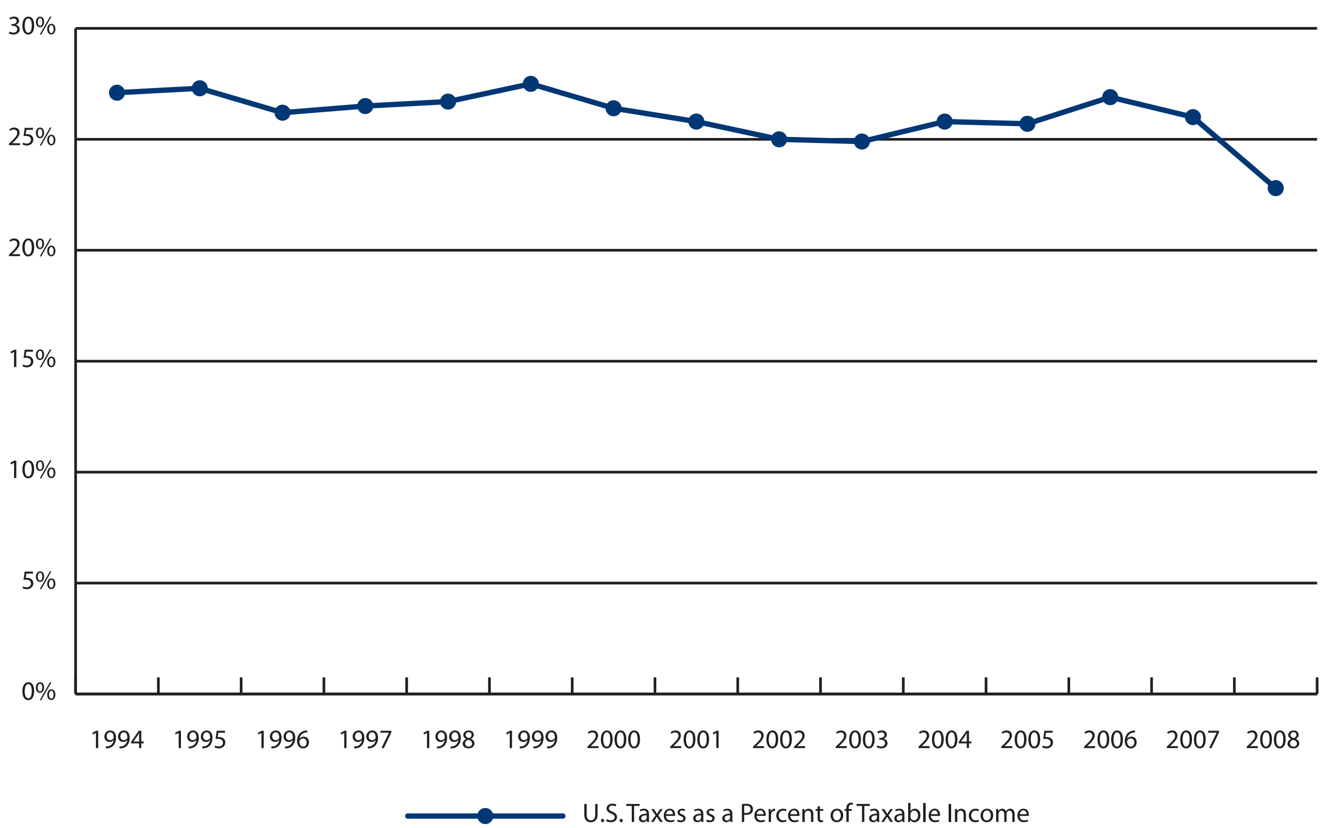


Note: This is restricted to 1120 C-Corporation filings. Source: IRS Statistics of Income: Table 17--Balance Sheet, Income Statement, Tax, and Selected Other Items, by Major Industry.
Source: IRS, http://www.irs.gov/taxstats/article/0,,id=170726,00.html

IRS, and not income taxes paid to foreign countries (or to U.S states, for that matter). The foreign taxes distinction matters more for larger companies, as they tend to pay a large and growing share of their taxes abroad. More precisely, foreign taxes paid by U.S corporations were about $100 billion in 2007, and IRS schedule M-3 indicates that a little over 90 percent of foreign income is attributable to this group of largest corporations.[3] Therefore, the overall (but excluding state and local) corporate income tax burden on large companies is about $90 billion more than stated in Table 1, totaling about $246 billion. This brings their overall effective tax rate, i.e. domestic and foreign income taxes paid divided by income, to about 33 percent, in line with smaller companies, and just slightly lower than the statutory rate of 35 percent.

Figure 2 shows IRS data on the total amount of taxable income and U.S federal income tax paid by all corporations between 1994 and 2008. Generally, both income and taxes paid fluctuate with the economy. In nominal terms, taxable income peaked along with the dot com bubble in 2000, at $702 billion, and then fell with the dot com bust to $556 billion in 2002. As Figure 3 shows, the effective U.S. tax rate, also measured during this period, peaked at 27.5 percent in 1999 and fell steadily to 24.9 percent in 2003.[4]

Figure 3
Effective U.S. Corporate Income Tax Rate, 1994 to 2008



Note: This is restricted to 1120 C-Corporation filings. Source: IRS Statistics of Income: Table 17--Balance Sheet, Income Statement, Tax, and Selected Other Items, by Major Industry.
Source: IRS, http://www.irs.gov/taxstats/article/0,,id=170726,00.html

3 See Appendix A for more on measures of foreign income, foreign taxes, and IRS Schedule M-3.

In the ensuing economic boom from 2002 to 2006, taxable income doubled from $559 billion to $1.2 trillion, as did tax revenue, from $140 billion to $315 billion. The effective rate climbed from 25 percent to 26.9 percent.

The most recent recession began taking its toll in 2007 and income decreased further in 2008 to $910 billion. Taxes paid followed the same trajectory, dropping to $294 billion in 2007 and $207 billion in 2008. The effective rate also declined during this period to 22.8 percent in 2008, in large measure because of an uptick in the amount of foreign income and foreign tax credits claimed by large firms, relative to domestic income.[5] The average effective tax rate over the entire period from 1994 to 2008 is 26 percent.

Foreign Income, Foreign Taxes Paid, and the Foreign Tax Credit

The U.S. imposes tax on the worldwide income of U.S. corporations. To avoid double taxation of the same income, i.e. once by the foreign country and then again by the U.S., U.S. law provides a credit for foreign income taxes paid. Most countries protect their multinational corporations from double taxation by using a territorial tax system, which only taxes companies based on their domestic profits. In contrast, the U.S. uses a credit system. When U.S. companies repatriate foreign earnings, U.S. law provides a foreign tax credit (FTC) for any taxes paid to foreign countries. It then taxes those foreign earnings based on the degree to which the U.S. statutory rate exceeds the foreign statutory rate. Further, subject to exceptions for non-operating passive income, U.S.-owned foreign incorporated companies may defer repatriation and thereby avoid additional U.S. tax by reinvesting profits abroad.[6]

Because the FTC is a fairly good proxy for foreign taxes paid on repatriated foreign income, it is safe to say that the overall effective corporate tax rate, in terms of foreign and U.S. federal taxes paid, is close to the statutory rate of 35 percent, i.e. within 1 or 2 percentage points. The overall effective rate could be more than 35 percent for companies operating in countries with a statutory rate that exceeds 35 percent.

Appendix A provides a description of common measures of the foreign earnings of U.S. companies, the tax paid on those earnings to foreign countries, and the foreign tax credit granted by the IRS when those foreign earnings are repatriated. Measures of foreign income vary considerably across methods

4 In calculating effective rates, many researchers use "book profit" from financial statements, in part because they do not have access to company tax returns. Book and tax profits differ for a multitude of reasons, one of which is that tax profit, i.e. income subject to tax, reflects "above the line" tax preferences. Appendix B shows aggregated data from IRS Form 1120, where some of these tax preferences are listed under deductions. Many are industry specific, such as the Domestic Production Activities Deduction, which primarily affects manufacturers. Thus, the difference between book and tax profits will depend upon the industry. However, such industry-specific tax deductions amount to a tiny fraction of all deductions, less than 1 percent, and other generally applicable tax deductions, such as that for Charitable Contributions, are similarly minute. A more important difference between book and tax profits results from differing treatments of depreciation, which is tax deductible. Depreciation typically represents between 2 and 3 percent of tax deductions. For more on the differences between tax and book accounting, see David Logan, "Three Differences Between Tax and Book Accounting that Legislators Need to Know", *Tax Foundation Fiscal Fact* No. 277, July 27, 2011. http://www.taxfoundation.org/publications/show/27488.html

5 See Figures 5 and 6 in Appendix A.

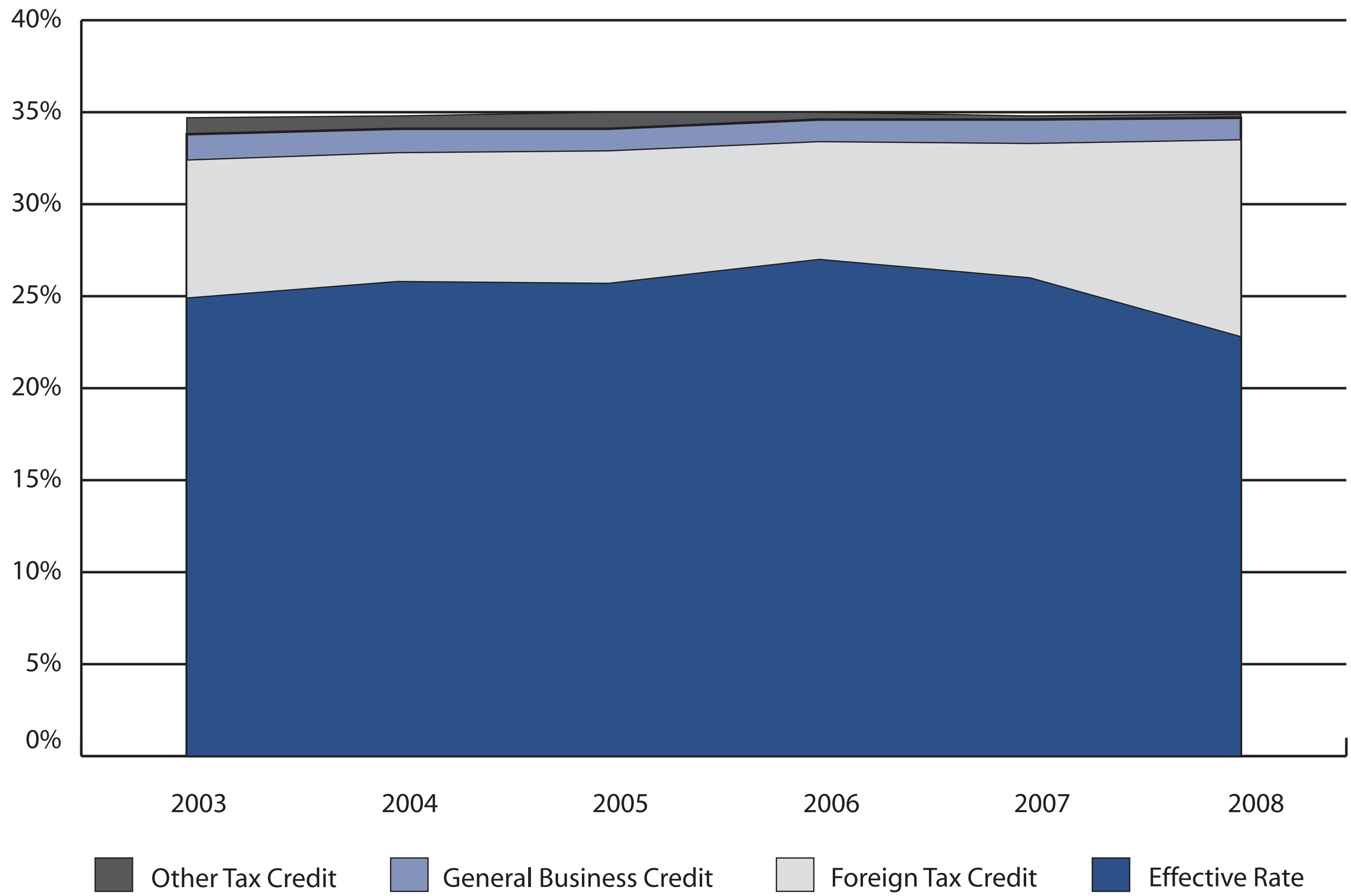
6 U.S. companies operate abroad either through branches or foreign incorporated entities. If the U.S. company operates through a branch, its income is immediately subject to U.S. tax. If through a foreign corporation, income is not subject to U.S. tax until a dividend is paid. For more on deferral, see Robert Carroll, "The Importance of Tax Deferral and A Lower Corporate Tax Rate," *Tax Foundation Special Report* No. 174, February 19, 2010. http://taxfoundation.org/news/show/25842.html

and years, causing variance in the effective foreign tax rate, but the estimates range from about 14 percent to 35 percent and typically are around 25 percent. In most years the foreign tax credit is slightly less but close to foreign taxes paid. This is because the FTC is limited to foreign taxes paid at or below the U.S. statutory rate, and some countries have higher statutory rates than the U.S. Also, the FTC will not perfectly match foreign taxes paid in any year due to the fact that FTCs can be carried back one year and forward 10 years to reflect differences in the timing of the recognition of U.S. and foreign income.

Foreign tax credits have increased along with foreign income as multinational corporations, particularly in the mining and manufacturing sectors, have expanded real and financial activity abroad to take advantage of emerging markets and low-tax jurisdictions. This trend accelerated in both 2007 and 2008, which is partly explained

Figure 4

Contribution of Various Credits in Reducing Effective U.S. Corporate Income Tax Rate, as a Share of Taxable Income



Note: This is restricted to 1120 C-Corporation filings.
Source: IRS Statistics of Income: Table 17--Balance Sheet, Income Statement, Tax, and Selected Other Items, by Major Industry. http://www.irs.gov/taxstats/article/0,,id=170726,00.html

7 Robert Carroll, "Comparing International Corporate Tax Rates: U.S. Corporate Tax Rate Increasingly Out of Line by Various Measures," *Tax Foundation Fiscal Fact* No.143, August 28, 2008. http://taxfoundation.org/research/show/23561.html. See also Scott Hodge, "KPMG Study Finds U.S. Corporate Tax Rate Higher Than Every Global Region," *Tax Foundation Fiscal Fact* No. 145, September 17, 2008. http://taxfoundation.org/research/show/23621.html See also Scott Hodge, "U.S. Multinationals Paid $100 Billion in Foreign Income Taxes According to Most Recent IRS Data," *Tax Foundation Fiscal Fact* No. 267, April 26, 2011. http://www.taxfoundation.org/research/show/27234.html. The 33 percent number comes from IRS Form 1118 statistics.

by the fact that 23 countries, including Canada, the UK, and Germany, reduced their corporate rates between 2007 and 2008, representing over 33 percent of foreign taxes paid by U.S. companies.[7]

Foreign Taxes Explain Much of the Difference Between U.S. Statutory and U.S. Effective Rates

The FTC represents far and away the largest credit, as shown in Figure 4, which depicts the contribution of various credits in reducing the effective U.S. rate.[8] The FTC explains almost the entirety of the difference between the statutory rate of 35 percent and the effective rate of roughly 25 percent over this period, all but about 1 or 2 percentage points. The general business credit is relatively minor, and contains a multitude of items, including the regular investment credit, welfare-to-work credit, low-income housing credit, research activities credit, Indian employment credit, etc. The "other" category contains still more minor credits, such as the prior year minimum tax credit and the nonconventional source fuel credit.

Table 2

Calculation of Overall Effective Tax Rate (ETR) on the Worldwide Income of U.S. Corporations, 2007

Sources Shown in Parentheses	Dollar Amounts in $ Thousands
U.S. Non-Deferred Taxable Income (IRS 1120)	$1,129,996,905
Deferred Income (IRS Schedule M-3)	$85,688,641
Total Worldwide income (Sum of deferred and non-deferred income)	$1,215,685,546
Share of Worldwide Income Deferred	7.0%
Share of Worldwide Income Non-Deferred	93.0%
Foreign Tax Credit (IRS 1120)	$82,756,556
U.S. Income Tax after Credits (IRS 1120)	$293,575,861
Overall ETR on U.S. Non-Deferred Taxable Income (FTC plus U.S. Income Tax/U.S Non-Deferred Taxable Income)	33.3%
Foreign ETR on Deferred Income (IRS 5471)	16.1%
Foreign ETR on Deferred Income (BEA)	28.7%
Overall ETR on Worldwide Income (IRS 5471)	32.1%
Overall ETR on Worldwide Income (BEA)	33.0%

Table 3

Contribution of Various Credits in Reducing Effective U.S. Federal Corporate Income Tax Rate, as a Share of Taxable Income, 2008

	All Sectors	Mining	Manu-facturing	Educational Services	Finance and Insurance
Statutory U.S. Federal Rate	35.0%	35.0%	35.0%	35.0%	35.0%
- Foreign tax credit	-10.7%	-14.5%	-16.9%	-0.3%	-2.9%
- General business credit	-1.2%	-0.2%	-1.2%	-0.1%	-0.7%
- Other tax credit	-0.2%	-0.7%	-0.1%	0.0%	0.0%
Effective U.S. Federal Rate=	22.8%	20.2%	16.8%	34.0%	32.5%

Note: This is restricted to 1120 C-Corporation filings.
Source: IRS Statistics of Income: Table 17--Balance Sheet, Income Statement, Tax, and Selected Other Items, by Major Industry. http://www.irs.gov/taxstats/article/0,,id=170726,00.html

Because the FTC is a fairly good proxy for foreign taxes paid on repatriated foreign income, it is safe to say that the overall effective corporate tax rate, in terms of foreign and U.S. federal taxes paid, is close to the statutory rate of 35 percent, i.e. within 1 or 2 percentage points. The overall effective rate could be more than 35 percent for companies operating in countries with a statutory rate that exceeds 35 percent.

There is an additional tax burden on multinational corporations, which the IRS data does not fully reflect.

More precisely, this is the overall effective corporate tax rate on domestic and repatriated foreign income, since it does not include deferred foreign income or the foreign taxes paid on that income. In 2007, it was 33.3 percent, as shown in Table 2. Deferred income is not technically part of the U.S. tax base, so it does not belong in a calculation of U.S. effective rates. However, it arguably

8 See Appendix B for a (partial) aggregated IRS Form 1120 from 2008, showing receipts, deductions, income subject to tax, statutory taxes applied to that income, tax credits, and taxes after credits. Incidentally, notice that "taxes paid" under deductions is larger than "income tax after credits," indicating that the total tax burden on corporations, inclusive of sales, property, payroll and other taxes, is more than double the corporate income tax burden alone.

9 Based on aggregated IRS Schedule M-3 data, deferred income in a typical year represents between 5 and 10 percent of non-deferred IRS taxable income ($45 billion in 2004, $117 billion in 2005, $95 billion in 2006, and $86 billion in 2007).

does belong in a calculation of overall effective rates. Table 2 shows calculations of the overall effective tax rate on the worldwide income of U.S. corporations, i.e. including both deferred and non-deferred foreign income. In 2007, deferred income represented 7 percent of the worldwide income of U.S. corporations.[9] Applying to this deferred income the two measures of foreign effective rates on foreign income that are discussed in Appendix A, and then creating a weighted average of effective rates on deferred and non-deferred income, yields an overall effective tax rate on worldwide income of between 32.1 and 33 percent.[10]

Effective U.S. Tax Rate, Along with Foreign Taxes Paid, Varies Across Industry

Although the effective U.S. tax rate for all corporations has been roughly 26 percent for many years, the rate varies substantially across industries and sectors. For example, Table 3 shows how the various credits lowered the statutory rate to the effective rate for the mining, manufacturing, educational services, and finance and insurance sectors in 2008.

Mining and manufacturing are sectors that earn a relatively large share of their profits abroad, increasing their foreign taxes and FTCS. The FTC also explains why these sectors have relatively low effective U.S. tax rates – that is, they have income in their U.S. tax return that does not bear U.S. tax because it has already borne foreign tax. In fact, these are the two sectors with the lowest effective tax rates, as can be seen in Table 4, which shows effective U.S. rates for all sectors. In contrast, educational services is one of many sectors that has an effective tax rate close to the statutory rate of 35 percent, and this is mainly because almost all their profits are earned domestically, so their use of the foreign tax credit is vanishingly small, as indicated in Table 3. Table 3 also shows the finance and insurance sector, which has an above average effective tax rate of 29.9 percent (shown in Table 4), the result of their relatively low use of the FTC.

Table 4

Effective U.S. Corporate Income Tax Rates by Sector, 2003 to 2008

	2003	2004	2005	2006	2007	2008	Avg.
All Industries	24.9%	25.8%	25.7%	27.0%	26.0%	22.8%	25.4%
Agricultural, forestry, fishing and hunting	27.2%	29.5%	29.2%	28.7%	28.6%	27.2%	28.4%
Mining	20.4%	24.6%	24.5%	24.5%	20.9%	20.2%	22.5%
Utilities	27.3%	30.7%	29.2%	29.7%	30.4%	32.4%	29.9%
Construction	31.8%	32.4%	32.4%	32.1%	31.0%	30.2%	31.6%
Manufacturing	18.2%	19.9%	20.1%	22.3%	20.9%	16.8%	19.7%
Wholesale and retail trade	31.5%	31.4%	31.5%	31.4%	32.6%	31.3%	31.6%
Transportation and warehousing	29.7%	31.8%	30.7%	31.5%	31.1%	31.8%	31.1%
Information	25.8%	27.9%	29.8%	31.3%	29.5%	26.0%	28.4%
Finance and insurance	29.6%	29.0%	28.7%	29.2%	30.1%	32.5%	29.9%
Real estate and rental and leasing	30.7%	31.3%	32.0%	33.4%	32.6%	31.3%	31.9%
Professional, scientific, and technical services	27.3%	29.0%	29.0%	29.0%	27.3%	29.7%	28.5%
Management of companies (holding companies)	27.9%	28.4%	28.3%	28.5%	27.4%	24.8%	27.6%
Administrative, support, waste management, remediation services	28.0%	26.0%	30.3%	27.9%	29.3%	28.4%	28.3%
Educational services	32.5%	33.2%	33.9%	33.4%	33.3%	34.0%	33.4%
Health care and social assistance	33.3%	33.6%	33.2%	32.8%	32.1%	33.3%	33.0%

Note: This is restricted to 1120 C-Corporation filings.
Source: IRS Statistics of Income: Table 17--Balance Sheet, Income Statement, Tax, and Selected Other Items, by Major Industry. http://www.irs.gov/taxstats/article/0,,id=170726,00.html

10 Note also that this does not count state and local corporate taxes in the U.S., which add on average about 4 percent. Therefore, the true overall effective rate for U.S. companies is between 36 and 37 percent and can exceed that for companies operating in high-tax countries.

None of this counts U.S. state and local corporate taxes, which add about 4 percent, for a total effective corporate tax rate of about 37 percent on U.S. companies.

Conclusion

Using IRS data on millions of actual corporate tax returns, we find the effective U.S. federal corporate tax rate has averaged 26 percent between 1994 and 2008. The rate differs considerably across sectors, but much of this variance is explained by the mixture of U.S. and foreign income, foreign taxes paid, and foreign tax credits claimed, which merely prevents double taxation of foreign profits. In other words, there is an additional tax burden on multinational corporations, which the IRS data does not fully reflect. The overall effective corporate income tax rate on the worldwide income of U.S. corporations, inclusive of foreign taxes paid on foreign income, is between 32.1 and 33 percent, which is close to the statutory rate of 35 percent. U.S. industries with little to no foreign earnings are taxed by the IRS at a rate that is close to 35 percent. None of this counts U.S. state and local corporate taxes, which add about 4 percent, for a total effective corporate tax rate of about 37 percent on U.S. companies. Lastly, we find that the largest corporations pay the lion's share of taxes. In 2008, the 1,937 largest companies were responsible for 68 percent of corporate tax revenue.

Appendix A: The Difficulties of Defining and Measuring the Foreign Income of U.S. Corporations

There are a number of techniques researchers have used to calculate the foreign income of U.S. corporations, each of which has its drawbacks. Fundamentally, the problem is definitional, in that there is no single agreed upon best way to ascribe the activities of multi-national entities along national lines. For example, does a 10 percent share in a foreign-controlled corporation constitute ownership, or does a 50 percent share? Even if these definitional issues could be resolved, there would be the very difficult problem of measurement, since these business entities report various parts of their activities to multiple authorities in accordance with their requirements. Further, these business entities often have multiple tiers of ownership, whereby one foreign entity partially owns another and both are partially owned by a U.S. corporation, creating the problem of double counting of foreign income by U.S. authorities.

One technique is based on IRS form 5471 for controlled foreign corporations (CFCs), which U.S. corporations are required to file if they own a controlling share in a foreign corporation. The IRS provides statistics on those CFCs which are majority-owned by a U.S. corporation.[11] The most recent data is from 2004 and 2006. As many researchers have acknowledged, this method double counts income earned by lower-tier CFCs that is distributed to higher-tier CFCs in the form of dividends.[12] Thus, effective rates based on this technique represent an under-estimate.

11 See, for example, Rosanne Altshuler and Harry Grubert, "Governments and Multinational Corporations in the Race to the Bottom," *Tax Notes*, February 27, 2006, pp. 979-992. The data can be found on the IRS website: http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282,00.html.

12 "U.S. Multinational Corporations: Effective Tax Rates Are Correlated with Where Income is Reported," Government Accountability Office, August 2008. http://www.gao.gov/new.items/d08950.pdf.

Another technique is based on Bureau of Economic Analysis (BEA) survey data on direct investment earnings of majority-owned foreign affiliates (MOFAs).[13] This technique excludes income from equity investments, thus avoiding the problem of double counting of income earned by lower-tier and higher-tier MOFAs. However, by excluding investment income, it represents an under-estimate of total income. As a result,

Figure 5

Foreign Earnings of U.S. Corporations, 2003 to 2008

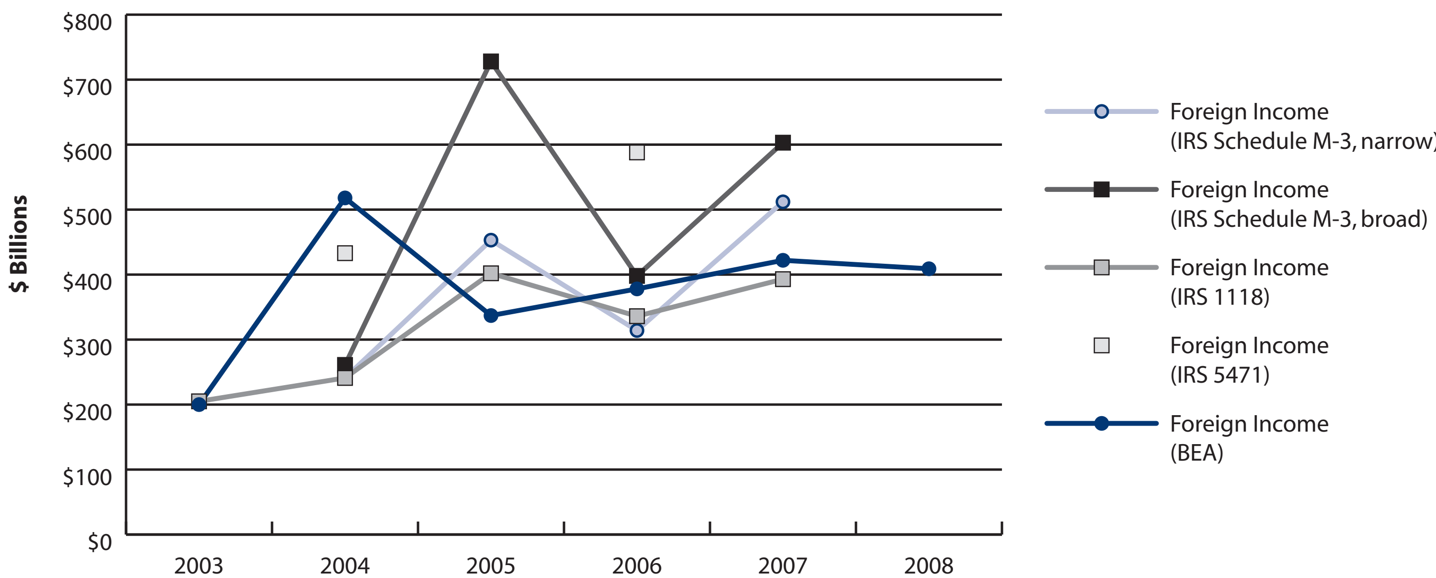
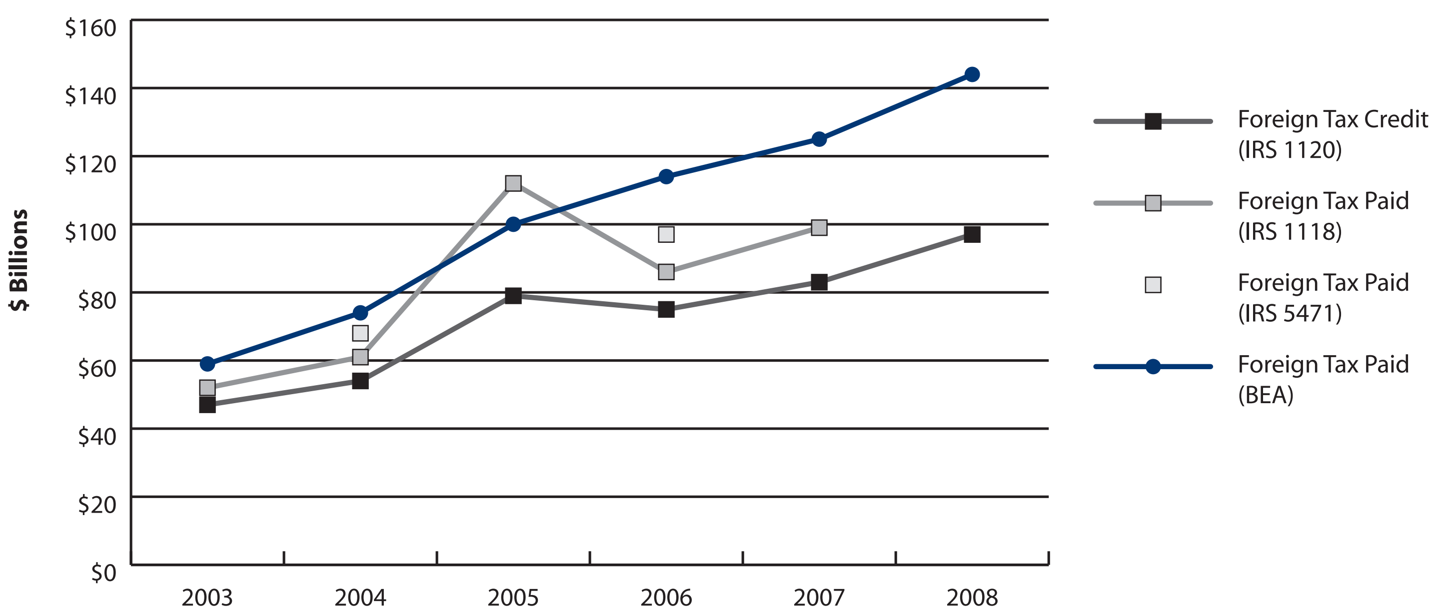


Figure 6

Foreign Taxes Paid and Foreign Tax Credits Received by U.S. Corporations, 2003 to 2008



13 See, for example, Martin A. Sullivan, "U.S. Multinationals Paying Less Foreign Tax," *Tax Notes*, March 17, 2008. The data can be found on the BEA website: http://www.bea.gov/scb/account_articles/international/iidguide.htm#USDIA.

effective rates based on this technique represent an over-estimate.

In a report from 2008, the Government Accountability Office (GAO) outlined these two widely accepted techniques, and used 2004 data to estimate the foreign effective tax rate on foreign income.[14] The technique based on IRS 5471 data produced a foreign effective rate of 16.1 percent, while the technique based on BEA survey data produced a foreign effective rate of 28.7 percent. The two techniques differ primarily in their estimate of foreign income, as shown in Figure 5.

The GAO report also develops a new technique for estimating U.S. effective tax rates on the domestic and foreign income of U.S. corporations, i.e. corporate taxes paid to the U.S. divided by measures of domestic and foreign income. This is based on IRS schedule M-3, which, beginning in 2004, all U.S. corporations with assets of $10 million or more are required to file. It provides a more detailed reconciliation of corporate book and tax income than was previously available, and as such can be used to calculate effective rates based on book income. Based on 2004 data, the GAO finds a U.S. effective tax rate on domestic income of 25.2 percent, but with considerable variance, such that a large share of companies pay less than 5 percent while another large share of companies pay more than 50 percent. The GAO finds the U.S. effective tax rate on foreign income ranges from 3.9 to 4.2 percent. It is exceedingly low because the numerator only counts taxes paid on repatriated foreign income, which is reduced by both the foreign tax credit and deferral, while the denominator counts all foreign income. The main limitation of this estimate of foreign income, as with other available sources, is the issue of double counting income earned by lower-tier and higher-tier foreign affiliates. The GAO addresses this by providing a range of measures of foreign income, and hence a range of effective tax rates, from a broad measure including equity and dividend income to a narrow measure excluding equity and dividend income. These measures of foreign income are shown in Figure 5 along with the other IRS and BEA based measures of foreign income.

Finally, the IRS provides another measure of foreign income from IRS form 1118, which is filed by corporations seeking a foreign tax credit.[15] It is also shown in Figure 5.

The lowest measure of foreign income in three of the six years presented in Figure 5 is from IRS form 1118. However, in most

Table 5

IRS Form 1120, Aggregated for All C-Corporations, 2008

Item	$ Thousands
Number of returns	**835,462**
Total receipts	**14,469,662,082**
Total deductions	**13,577,021,884**
Cost of goods sold	8,311,044,840
Compensation of officers	146,871,570
Salaries and wages	1,242,140,803
Repairs	91,587,374
Bad debts	116,206,012
Rent paid on business property	200,404,483
Taxes paid	243,517,189
Interest paid	689,092,864
Charitable contributions	11,638,321
Amortization	98,784,920
Depreciation	403,470,842
Depletion	15,805,592
Advertising	148,234,509
Pension, profit-sharing, stock, annuity	94,990,941
Employee benefit programs	182,291,323
Domestic production activities deduction	18,352,565
Net loss, noncapital assets	14,881,597
Other deductions	1,547,706,138
Total receipts less total deductions	892,640,198
Constructive taxable income from related foreign corporations	129,198,016
Net income	**1,011,206,962**
Income subject to tax	**910,056,404**
Total income tax before credits	316,999,413
Income tax	315,406,966
Alternative minimum tax	1,466,971
Foreign tax credit	97,026,129
General business credit	10,709,768
Prior year minimum tax credit	1,675,039
Total income tax after credits	**207,440,305**

14 "U.S. Multinational Corporations: Effective Tax Rates Are Correlated with Where Income is Reported," Government Accountability Office, August 2008. http://www.gao.gov/new.items/d08950.pdf

years it tracks fairly closely the narrow measure of foreign income from Schedule M-3 as well as the BEA measure. The remaining two measures, i.e. the broad measure from Schedule M-3 and the measure from IRS form 5471, are generally much higher and in some cases about twice as high. The large variance of these measures, both among those that are widely accepted (5471 and BEA) and among those that are not, indicates there is no single best way to estimate foreign income.

In contrast, the three measures of foreign taxes paid shown in Figure 6, i.e. from IRS form 1118, form 5471, and the BEA, are fairly close together. Thus, measures of effective foreign tax on foreign profits vary mainly because of variance in measures of foreign income.

Lastly, Figure 6 shows that the foreign tax credit, as measured by IRS statistics on form 1120, represents a reasonable proxy for foreign taxes paid.[16] In most years the foreign tax credit is about 10 to 20 percent less than any measure of foreign taxes paid. This is because the FTC is limited to foreign taxes paid at or below the U.S. statutory rate, and some countries have higher statutory rates than the US. Interestingly, the gap between the two has been growing in recent years, suggesting the IRS has expanded certain limitations, such as the degree to which certain foreign fees and royalties count as foreign taxes.

Appendix B: IRS Form 1120, Aggregated for All C-Corporations, 2008

Table 5 shows a (partial) spreadsheet of IRS aggregated Form 1120, which the IRS requires of every C-Corporation. First, income is determined by subtracting total deductions, so-called above-the-line tax preferences, from total receipts. The largest deduction is for cost of goods sold. Notice also that "taxes paid," comprised of payroll, sales, property and other taxes, is one of the larger deductions, and in fact is larger than corporate income taxes, at $244 billion versus $207 billion. Net income also includes "constructive taxable income from related foreign corporations," and is reduced further to "income subject to tax" by certain "statutory special deductions," consisting mainly of the net operating loss deduction and the dividends received deduction. The 35 percent statutory rate is then applied to income subject to tax, equaling $315 billion and added to the alternative minimum tax for a total tax liability. Finally, this tax liability is reduced by various tax credits, so called below-the-line preferences, the largest of which is the foreign tax credit, to arrive at total income tax after credits.

15 Data source: IRS Statistic of Income. Table 3 -- U.S. Corporation Income Tax Returns with a Foreign Tax Credit: Foreign Income, Deductions, and Taxes Reported on Form 1118. http://www.irs.gov/taxstats/bustaxstats/article/0,,id=210075,00.html

16 Data source: IRS Statistics of Income: 1) Table 17--Balance Sheet, Income Statement, Tax, and Selected Other Items, by Major Industry. http://www.irs.gov/taxstats/article/0,,id=170726,00.html

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Tax Foundation
National Press Building
529 14th Street, NW, Suite 420
Washington, DC 20045-1000

(202) 464-6200

www.TaxFoundation.org
TF@TaxFoundation.org