RECONCILIATION ITEMS:

Analysis of 2016 tax reconciliation items among S&P 500.

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Introduction

The statutory tax rate for U.S. corporations is 35 percent. In reality, however, many companies pay taxes at rates considerably lower than that. For example, in a previous Calcbench research report, we found that the S&P 500 paid taxes at an average rate of 22.8 percent, 2012-2016.

Corporations achieve those lower tax rates through deductions and credits allowed under the tax code and via other tax management strategies. In their annual reports, they must reconcile those lower effective tax rates back to the statutory rate of 35 percent. Essentially, they must show investors their math.

This report examines how the S&P 500 reconciled their effective tax rates for 2016, to uncover typical patterns and to quantify the dollars involved in companies' reconciliation efforts.

We found five common reconciling items that affected corporate taxes owed:

- State and local taxes
- Research and development credits
- Foreign operations (for example, the "Irish subsidiary")
- Share-based compensation effects
- Domestic manufacturing credits

Altogether, those five items accounted for $49.7 billion in deductions and other adjustments last year, among 428 companies that claimed them.

We must also stress that companies had numerous other factors driving their effective tax rates, and many of those items were firm-specific—tax loss carryforwards, for example; or favorable rulings from the IRS that occasionally let companies report *negative* effective tax rates. Calcbench chose *not* to examine those items for the purposes of this paper. (We may return to firm-specific factors at a later date.)

How Reconciliation Is Reported

Reconciliation of effective tax rates is a diverse science. For example, some companies perform their reconciliation by percentage rates, without reporting dollar amounts of taxes paid. See Figure 1, below.

The reconciliation of federal statutory income tax rate to our effective income tax rate is as follows:

	Year Ended December 31, 2014	2015	2016
U.S. federal statutory tax rate	35.0 %	35.0 %	35.0 %
Foreign rate differential	(12.2)%	(13.4)%	(11.0)%
Federal research credit	(1.8)%	(2.1)%	(2.0)%
Stock-based compensation expense	0.1 %	0.3 %	(3.4)%
Other adjustments	0.0 %	(3.0)%	0.7 %
Effective tax rate	21.1 %	16.8 %	19.3 %

Others do the opposite, reconciling dollar amounts but not percentage rates. See Figure 2, below.

Following is a reconciliation of the income tax expense applying the U.S. federal statutory rate to income before income taxes to reported income tax expense:

	2016	2015	2014
Income tax at the U.S. federal statutory tax rate	$ 1,180.9	$ 976.5	$ 1,050.1
Add (deduct):			
International operations, including Puerto Rico	(313.7)	(565.2)	(344.8)
General business credits	(58.3)	(69.2)	(44.3)
Other	(172.5)	39.5	(51.2)
Income taxes	$ 636.4	$ 381.6	$ 609.8

And some companies report both dollar amounts and percentages. Federal securities law has no specific directive on how to reconcile effective and statutory tax rates, so long as the company can argue that reasonable investors are informed.

To perform our analysis, we first identified the 473 firms in the S&P 500 that reported some kind of tax reconciliation items in 2016. We then culled that list to the 428 firms that turned a profit in 2016, under the theory that only firms making a profit would pay taxes. This is not technically true; under some circumstances firms can operate at a loss *and* pay taxes. Still, those instances are so rare and firm-specific that we narrowed our field to profit-making firms in 2016 only.

Of the 428 firms that we studied…

- **224 reported an effective tax rate (for example, 25 percent);**

- **127 reported reconciliation items in dollar amounts;**
- **122 firms provided both percentages and dollars amounts in detailed breakdowns.**

We then recalculated tax items into dollar terms. For example, if a firm had pretax income of $100 million and claimed an R&D tax deduction of "2 percent," that was calculated as $2 million.

Once we arrived at the dollar amounts of tax reconciliation items reported among the firms, we totaled the value for each of the five primary categories previously mentioned. See Table 1, below.

	Total deductions	Firms	Avg. per firm	% of firms taking
Manufacturing	($5,418,031,126)	118	($45,915,518)	28%
Foreign subsidiary	($55.801,288,376)	270	($206,671,438)	63%
R&D	($3,105,410,177)	64	($48,522,034)	15%
Share-based payment	($2,079,117,620)	36	($57,753,267)	8%
State & Local	$16,705,887,862	367	$45,520,130	86%
TOTAL	**($49,697,959,437)**	428		

Leaders in Each Category

We then ranked the companies that claimed the largest reconciliation items in each of our five primary categories. They are as follows.

Foreign Deductions: Top 10

Company	Adjustment
Apple	-$5,582,000,000
Microsoft	-$3,634,000,000
Johnson & Johnson	-$3,149,000,000
Alphabet (Google)	-$2,657,000,000
Gilead	-$2,616,000,000
IBM	-$2,589,000,000
Cisco Systems	-$1,873,000,000
Merck & Co.	-$1,623,000,000
Facebook	-$1,602,000,000
Amgen	-$1,420,000,000
TOTAL	**-$26,745,000,000**

Share-based Comp. Deductions: Top 10

Company	Adjustment
Alphabet (Google)	-$821,100,000
Facebook	-$751,080,000
Johnson & Johnson	-$365,450,000
3M Co.	-$197,480,000
Procter & Gamble	-$172,340,000
Honeywell	-$128,940,000
Amgen	-$119,120,000
Activision	-$81,000,000
McKesson	-$54,000,000
Kroger	-$46,200,000
TOTAL	**-$2,736,710,000**

R&D Deductions: Top 10

Company	Adjustment
Alphabet (Google)	-$423,000,000
Apple	-$371,000,000
Intel	-$297,530,000
Boeing	-$289,540,000
Bristol Myers Squibb	-$144,000,000
Qualcomm	-$143,000,000
Gilead	-$119,680,000
Lockheed Martin	-$107,000,000
HP	-$90,260,000
Facebook	-$87,630,000
TOTAL	**-$2,072,640,000**

Manufacturing Deductions: Top 10

Company	Adjustment
Apple	-$382,000,000
Microsoft	-$324,090,000
Disney	-$237,890,000
Boeing	-$211,580,000
Intel	-$181,100,000
Altria	-$174,820,000
DTE Energy	-$145,000,000
Time Warner	-$141,000,000
3M Co.	-$126,950,000
Bristol Myers Squibb	-$122,000,000
TOTAL	**-$2,046,430,000**

State and Local Adjustments: Top 10*

Company	Adjustment
Wells Fargo	$1,004,000,000
JP Morgan	$828,860,000
Apple	$553,000,000
Verizon	$461,690,000
Bank of America	$420,000,000
Citigroup	$386,590,000
Comcast	$373,000,000
Berkshire Hathaway	$361,000,000
CVS Health	$354,120,000
Walmart	$348,450,000
TOTAL	**$5,090,710,000**

***Firms get to deduct State and Local taxes and then "add them back"to reconcile the federal effective tax rate. The add-back is the number reported.**

Conclusion

Clearly the dollars taken in tax reconciliation are not trivial amounts of money. In our previous Calcbench report, we identified an "implied tax deficit" among the S&P 500 of more than $159 billion annually, 2012 to 2016— the difference between what those companies should theoretically pay at the 35 percent statutory tax rate, and what they actually paid after various adjustments.
As Congress considers measures for tax reform, lawmakers should consider the size and scope of current tax deductions and credits, and the effect those items have on corporations' tax management strategies.

About Calcbench

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