

The Divergence Between Book and Tax Income

Mihir A. Desai
Harvard University and NBER

October 2002

I am grateful to Alan Auerbach, James Hines, Peter Merrill, Lil Mills, George Plesko, James Poterba and participants at the International Seminar in Public Economics Conference and the Tax Policy and the Economy Conference for helpful comments. Research assistance from Mark Veblen, James Zeitler and Yuming Zou and financial support from the Division of Research at Harvard Business School are gratefully acknowledged.

The Divergence Between Book and Tax Income

ABSTRACT

This paper examines the evolution of the corporate profit base and the relationship between book income and tax income for U.S. corporations over last two decades. The paper demonstrates that this relationship has broken down over the 1990s and has broken down in a manner that is consistent with increased sheltering activity. The paper traces the growing discrepancy between book and tax income associated with differential treatments of depreciation, the reporting of foreign source income, and, in particular, the changing nature of employee compensation. For the largest public companies, proceeds from option exercises equaled 27 percent of operating cash flow from 1996 to 2000 and these deductions appear to be fully utilized thereby creating the largest distinction between book and tax income. While the differential treatment of these items has historically accounted fully for the discrepancy between book and tax income, the paper demonstrates that book and tax income have diverged markedly for reasons not associated with these items during the late 1990s. In 1998, more than half of the difference between tax and book income – approximately \$154.4 billion or 33.7 percent of tax income – cannot be accounted for by these factors. This paper proceeds to develop and test a model of costly sheltering and demonstrates that the breakdown in the relationship between tax and book income is consistent with increasing levels of sheltering during the late 1990s. These tests also explore an alternative explanation of these results – coincident increased levels of earnings management – and finds that the nature of the breakdown between book and tax income cannot be fully explained by this alternative explanation.

JEL Classifications: D33, G30, H25, H26

Mihir A. Desai
Harvard Business School
Morgan 363
Soldiers Field
Boston, MA 02163
mdesai@hbs.edu

1. *Introduction*

Recent trends in the corporate profit base and the tax revenues it generates have drawn considerable attention. In particular, the gap between book income and tax income has reportedly widened over the last decade and corporate tax receipts have been lower than expected. These trends, against the backdrop of a protracted economic expansion over the 1990s, have generated considerable concern over the proliferation of tax sheltering activity by corporations. These concerns have been further amplified by anecdotal evidence on the proliferation of these schemes and high-profile cases associated with large corporations. Estimates of tax sheltering activity have ranged widely depending on the source and methodology employed in generating those estimates.¹

The focus on corporate tax shelters raises several new questions related to the integrity of the corporate tax base. In particular, financial innovations that reduce the costs of, and widen the scope for, recharacterizing income may lead to difficulties in maintaining the corporate tax base. Similarly, the increased importance of legitimate foreign operations for U.S. firms, the attendant transfer pricing opportunities afforded by such operations, and increased competition by jurisdictions for those investments may increase the scope for income shifting. In short, American firms are faced with enhanced opportunities for avoiding or evading corporate taxes through cheaper, more sophisticated, and less transparent mechanisms.

These questions and concerns over the viability of the corporate tax base and the scope of sheltering activity have given rise to varied legislative proposals but limited empirical analysis of the claims associated with increased sheltering activity. Additionally, evidence on sheltering activity that comes from reported book and tax income raises the issue of other differences that might arise between book and tax income and their growing incidence or magnitude. As such, empirical explorations of the nature of sheltering

¹ The concerns regarding the scope and increased incidence of tax shelters can be found in a variety of sources including Bankman (1999), Sullivan (1999a, 1999b, 2000a) and U.S. Treasury (1999). Talisman (1999) and Kies (1999a, 1999b, 1999c, and 2000) provide alternative interpretations of these trends. For a perspective on the variety of instruments associated with sheltering activity, see U.S. Treasury (1999).

activity must jointly investigate the changing nature of book and tax income in order to identify any underlying trends in the gaps that separate them.²

This paper attempts to illuminate recent trends in the corporate profit base in order to highlight the possible aggregate scope of sheltering activity, the other determinants of gaps between book and tax income and their scope for explaining recent trends, and the dynamics of the relationship between tax and book income over the last decade. The evidence provided in the paper demonstrates that the link between book and tax income has broken down over the last decade for two reasons. First, the identifiable factors that have traditionally been associated with the distinction between book and tax income have grown tremendously. In addition to the growing relevance of overseas operations and different measures of depreciation, the paper explores the proliferation of employee stock options (ESOs) and quantifies their impact on the corporate profit base. From 1996 to 2000, net proceeds from the exercise of ESOs for the largest U.S. corporations approximated 27 percent of operating cash flows. These net proceeds appear to be utilized nearly fully as deductions against pretax income for the corporations studied.

Second, the breakdown between tax and book income is not limited to the growth of these traditional distinctions between tax and book income. While the distinctive treatment of these items has historically accounted fully for the difference between book and tax income, the paper demonstrates that book and tax income have diverged markedly for reasons not associated with these items during the late 1990s. In 1998, more than half of the difference between tax and book income – approximately \$154.4 billion or 33.7% of tax income – cannot be accounted for by these historically relevant measures of the discrepancy between tax and book income.

In order to identify the reasons for this breakdown, the paper develops a model of sheltering and then tests that model by exploring the dynamic of the link between tax

² The difficulties in precisely isolating these activities should not be understated. After surveying varied and conflicting estimates of the nature of sheltering activity, JCT (2000) states (p. 16) that “the Joint Committee staff believes that direct measurement of corporate tax shelter activity through macroeconomic data is not possible. Instead, a more instructive approach may be to analyze specific tax shelter transactions that have come to light and evaluate their effect on corporate receipts.” While not disagreeing with this approach, this paper attempts to at least uncover evidence of the underlying trend in sheltering activity and some evidence of the overall scope at the macroeconomic level in order to inform the debate.

income and book income over time and by levels of tax income. The estimates motivated by this model of sheltering provide evidence that the patterns of the deteriorating link between tax and book income are consistent with increased levels of sheltering over the decade. One important alternative hypothesis – that the breakdown of the link between tax income and book income reflects coincident increased levels of earnings management – is also investigated. Measures traditionally associated with different levels of, or motives for, earnings management do not appear to fully explain the distinctive nature of the breakdown of the link between tax and book income in the latter part of the decade. Taken together, the evidence suggests that the large unexplained gaps between tax and book income that have arisen during the late 1990s are at least partly associated with increased sheltering activity.

Section 2 reviews alternative methodologies for understanding the dynamics of corporate profits and their relative merits and recent findings. Section 3 examines the changing relationship between tax and book income as viewed through the lens of aggregated data generated from tax forms where firms reconcile tax and book income. Section 4 reviews in detail the changing nature of employee compensation and its impact on the corporate profit base by exploiting several different sources of data on option exercises. Section 5 of the paper develops a model of sheltering activity and then tests that model through analyses of book and tax income generated from accounting statements over the 1990s with special attention paid to the alternative explanation of earnings management. Section 6 is the conclusion.

2. Previous work and review of alternative methodologies

Efforts to understand the dynamics of corporate profits and tax revenues typically rely on three distinct sources – economy-wide aggregate data taken from national income accounts, reported tax and book income from tax forms, and reported book income and simulated tax income from accounting statements. Each of these sources has distinct advantages and disadvantages in understanding the scope of sheltering activity and, unsurprisingly, yields distinct conclusions. These distinct sources and methodologies also yield the scope for much confusion about their conflicting implications.

National income accounts provide the most aggregate picture of corporate profitability and allow for a disentangling of the different reasons why average tax rates depart from statutory rates. By implementing the procedure proposed in Auerbach and Poterba (1987), Mackie (2000) provides this perspective on recent corporate profitability and the implications for recent tax collections. He documents a reduced average tax rate amid rising corporate profitability and traces through several rationales for this phenomenon. Mackie concludes that this aggregate perspective is unable to illuminate the nature of tax sheltering activity as the basic income measure employed prevents any corresponding measure of what income would have been in the absence of sheltering activity. In other words, typical shelters reduce both income and taxes leaving average tax rates unaffected.³

In order to understand the scope of sheltering activity, the joint reporting of book income and tax income affords the promise of measuring activity reported to shareholders but not reported to tax authorities. Indeed, much of the recent concern over tax shelters reflects the use of Treasury data to construct comparisons between tax income and book income as reported in schedule M-1. The joint reporting of book income and tax income by firms in their tax forms affords the possibility to analyze the gap between the two notions of income and the varied determinants of that gap. The reconciliation between book and tax income in schedule M-1 is, however, of limited detail and, consequently, parsing out alternative explanations of the gap is difficult. Finally, the use of the micro-data is limited given accessibility and the confidentiality requirements imposed by the IRS.⁴ Nonetheless, the aggregate perspective afforded by this reporting along with the ability to analyze true tax income, as opposed to simulated tax income, makes this a valuable source.

Accounting statements can also be used to generate comparisons between book income and simulated tax income. In particular, there is an extensive literature gauging the

³ For a related effort, see Petrick (2001) for a comparison on NIPA profits with S&P 500 profits and a discussion of the compositional reasons why these measures may differ.

⁴ Plesko (2002) provides a detailed reconciliation for 1996-1998 and finds, using a distinct measure of pretax book income and tax net income from Talisman (1999) and the one employed in this paper, that the difference between pretax book income and tax net income grew by 71.9 percent between 1996 and 1998.

reliability of alternative estimates of tax income generated from accounting statements by explicitly comparing them to IRS data on tax income.⁵ These studies then typically go on to study book-tax income differences as generated by the accounting statements to study the nature of permanent and temporary differences in tax accounting. These estimates of book and simulated tax income can also be employed to infer something about sheltering activity as in Manzon and Plesko (2001). Manzon and Plesko (2001) study the gap between accounting-based definitions of tax income and book income and demonstrate that a few measures approximating the demand for tax shelters help explain the cross-sectional variation in these gaps.⁶

As noted by Hanlon and Shevlin (2001), the estimates of book and tax income generated by accounting statements do not encompass the same differences as those generated by viewing differences between book and tax income as reported on tax forms. In particular, deductions associated with the exercise of stock options will not be represented in the gap between book and tax income generated from accounting statements but will show up in the gap generated using tax forms.⁷ In addition to this distinction in reporting of deductions associated with option exercises, any analysis of book income must address potential managerial motives to manage earnings. A large literature has evolved that tries to define, document, and understand the motivation behind earnings management.⁸ While the magnitude and impact of such behavior remains in question, it is conceivable that trends in earnings management could result in systematic variation in book and tax income.

His measure of the aggregate difference between pretax book and tax income as reported by firms is \$159 billion in 1998.

⁵ See Plesko (1999, 2000) and Mills and Newberry (2000) for a discussion of these alternative measures and their relative merits.

⁶ Manzon and Plesko (2001) relate the absolute magnitude of the gap to possible determinants of demand for sheltering activity. They find that dummy variables associated with presence of pretax profits and NOLs help predict the size of the gap in a cross-sectional regression.

⁷ This difference results from the departure from “clean surplus” accounting in the accounting of stock options. In short, tax benefits from exercise of ESOs do not flow through the income statement but are simply transferred to additional paid-in-capital. As a consequence, tax expenses from accounting statements won’t allow for consideration of the deductions associated with exercises. The reporting of these tax benefits associated with employee exercises is continuing to evolve and Hanlon and Shevlin (2001) argue that varied estimates of tax rates make the mistake of inferring tax rates without consideration for the effects of these tax benefits.

⁸ See Dechow and Skinner (2000), Healy and Wahlen (1999) and Schipper (1989) for review articles of this large literature.

The analysis that follows attempts to use the IRS and accounting sources of tax and book income to illuminate the problem of tax shelters. The aggregate view as represented by IRS data is analyzed in section 3 in tandem with an exploration of the impact of ESOs in section 4. The disaggregated view generated by accounting statements is analyzed in section 5 by developing a model of sheltering and then testing it. This analysis also discusses the possibility that earnings management might result in similar empirical patterns and tries to distinguish sheltering activity from earnings management.

3. *Tax Income, Simulated Book Income and Actual Book Income*

Concerns over increased sheltering activities by corporations are typically associated with trends in corporate tax receipts and trends in the gap between tax income and book income employing figures extracted from tax returns. Figure 1a considers the ratio of federal corporate tax receipts to all federal on-budget tax receipts from 1971 to 2001 as reported in OMB (2002). The figure depicts the overall decline in that ratio from nearly 19.7% in 1977 to 10.2% in 2001. Much of the pattern in this ratio for the intervening years can be explained by large legislative changes and general economic conditions. The recent decline, beginning in 1996, is more puzzling given the coincident economic expansion. In particular, this ratio falls from 15.8% in 1996 to 13.5% in 2000 and then, even more dramatically, to 10.2% in 2001.

The relationship between tax and book income as reported in schedule M-1 demonstrates a similarly curious trend. These figures have been employed by the Treasury Department to emphasize the increased incidence and magnitude of corporate tax shelter activity. Figure 1b reproduces a figure from Talisman (1999) that is also related to the figure employed in the Treasury Department's study of corporate tax shelters (U.S. Treasury, 1999). This graph employs data for only those corporations with assets greater than \$1 billion. Inferring a multiple of book income over tax income from that picture illustrates the concern that tax shelter activity has increased over that period. In particular, the ratio of book income to tax income grows to 1.4 from 1.0 over five years. Alternatively, book income exceeds tax income by approximately \$120 billion (in 1992 dollars) by 1996. This figure, and the gap it highlights, has served as the most important

source of data for the debate on corporate tax shelters. Unfortunately, as pointed out by Kies (1999a), there are a number of alternative explanations for this gap that make such a picture inconclusive.

In order to understand the implication of this widening gap for the scope of tax sheltering activity, it is useful to construct a measure of simulated book income that incorporates identifiable sources of that gap. In particular, discrepancies between tax and book income may be attributable to causes unrelated to tax sheltering activity. The evidence in Table 1 and Figure 2 considers the dynamics of tax and book income for firms that have assets greater than \$250 million and isolates the impact stemming from three potential sources of that gap: the differential treatment of depreciation expense on tax and book forms, reinvested earnings abroad, and deductions associated with the exercise of non-qualified stock options. Before analyzing the data, the distinctions between the two sets of data should be emphasized. Figure 1 employs actual tax return data to analyze the gap between actual tax and book income for corporations that have more than \$1 billion in assets and are not S-corporations, RICs, or REITs from 1991 to 1996. In contrast, Table 1 and Figure 2 initially simulate that gap for similar corporations but with a cutoff of \$250 million in assets over the period from 1982 to 2000.

Table 1 provides data, in current dollars, for simulating book income for these corporations and begins with an estimate of tax income comparable to the base in the Talisman picture. In order to analyze the impact of the discrepancy between depreciation expense allowed for tax purposes and that associated with book accounting, Table 1 draws on BEA estimates of the capital consumption allowance (CCA) adjustment which measures the discrepancy between tax measures of depreciation and economic depreciation. This aggregate measure of the discrepancy is scaled by that fraction of depreciation expenses associated with firms over \$250 million in assets. To the degree that economic depreciation is not representative of depreciation associated with historic cost-accounting, and to the degree that this link between accounting and economic depreciation has become more tenuous over time given the changing nature of assets, the evidence in Table 1 likely understates the impact associated with gaps between tax and accounting notions of depreciation. Similarly, Table 1 captures the discrepancy between income

earned by U.S. corporations operating abroad and that income which is repatriated from BEA data on capital flows.⁹ Finally, Table 1 provides data from Execucomp on the aggregate level of option exercises by employees that is discussed in greater detail below. These data are only available for years subsequent to 1992. Tax income from 1999 and 2000 is not yet available but is presumed to stay at 1998 levels in order to facilitate a baseline comparison for 1999 and 2000.

Figure 2 relates the findings of Table 1 in a format comparable to the evidence provided in Figure 1 by translating the figures from Table 1 into 1992 dollars. The bottom line in Figure 2 presents tax income and each line above it adds on an identifiable source of the difference between tax and book income so that the uppermost line represents simulated book income. The evidence provided in Figure 2 indicates several important features of the changing nature of the relationship between book and tax income. First, while gaps between tax and book income were associated with differing notions of depreciation during the 1980s, the role of depreciation differences is now considerably smaller. Nonetheless, recent years feature a renewed distinction between tax and economic notions of depreciation that maps to the tax and book income gap. Second, reinvested earnings abroad, which may reflect both increased foreign activity as well as changed repatriation patterns, are growing in importance and are contributing significantly toward a larger gap.¹⁰ Finally, differing treatment of exercises of ESOs now provides the largest component of the growing gap between tax and simulated book income. By 1998, these three sources comprise 29.0% of tax income. The divergence of simulated book and tax income through the last decade appears to be growing particularly rapidly near the end of the decade. While precisely comparable ratios are not yet available for 1999 and 2000 as tax income is not available, it is clear that these discrepancies – particularly option exercises and reinvested earnings abroad – have grown even more rapidly after 1998.

⁹ These figures are scaled by the annual fraction of FTCs attributable to firms with assets more than \$250 million.

¹⁰ These changed patterns of repatriation may themselves reflect increased levels of relocation of income in response to tax incentives. For a recent study of repatriation patterns and their responsiveness to tax incentives, see Desai, Foley and Hines (2001) and for the use of changed ownership forms in response to international tax incentives, see Desai, Foley and Hines (2002) on indirect ownership of foreign affiliates and Desai and Hines (2002) on expatriations.

While this comparison between tax and simulated book income suggests that these two series have become increasingly distinct during the 1990s for identifiable reasons, it is even more striking how *actual* book income relates to reported tax income and simulated book income. Figure 2 plots actual book income from 1986 to 1998 for this same set of firms with dots.¹¹ From 1986 to 1993, actual book income tracks simulated book income remarkably well with the exception of 1992 when actual book income dips below both simulated book income and tax income. Beginning in 1994, however, actual book income begins to diverge from both tax income and simulated book income in a rapid fashion. This divergence is most acute in 1998 when tax income falls by 10.9%, simulated book income falls by 5.9%, and actual book income rises by 0.8%. By 1998, this divergence results in actual book income being 1.63 times tax income and 1.26 times simulated book income. Indeed, in 1998, more than half of the difference between tax and actual book income – approximately \$154.4 billion or 33.7% of tax income – cannot be accounted for by these sources of the distinction between tax and book income.

This breakdown between both actual book income and tax income and between actual book income and simulated book income can have several alternative explanations. First, the identified sources of differences between tax and book income that have been estimated – particularly the scope of option exercises – could be understated in Figure 2 and Table 1 and these sources could account for an even larger fraction of the difference between tax and actual book income. The following section investigates the actual scope of option exercises in more detail to consider this possibility. Second, alternative discrepancies between book and tax income such as the proliferation of hybrid instruments that provide for deductions to tax income but not book income or the differential treatment of pension earnings could account for some fraction of the gap. Aggregate estimates of such activity suggest that these sources are not likely to be large enough to comprise significant fractions of the unexplained difference between book and tax income.¹²

¹¹ This series was provided by the IRS. Figures for 1989 are only available for all firms so the amounts associated with filers with more than \$250 million in assets is interpolated from similar ratios for 1988 and 1990.

¹² For example, Engel, Erickson and Maydew (1999) study a sample of all trust preferred stock issued between 1993 and 1996 that amounts to \$36 billion of issuances. A current query of the SDC database for all securities classified as MIPS, TOPRS, TRUPS, TRACES or trust preferred of any kind provides for \$73

Third, earnings management, either through the intertemporal shifting of income or through fraudulent book reporting could be associated with this gap. This possibility is investigated further in section 5 but it is worth noting the distinction in the beliefs of practitioners and researchers on the scope of earnings management. In particular, Dechow and Skinner (2000) note “while practitioners and regulators seem to believe that earnings management is both pervasive and problematic, academic research has not demonstrated that earnings management has a large effect on average on reported earnings, or that whatever earnings management does exist should concern investors.” Finally, in contrast to an earnings management explanation that emphasizes the inflation of book earnings, this gap could reflect the artificial underreporting of tax income relative to book income. This hypothesis is investigated through the model developed in section 5.

4. *Changing Trends in Employee Compensation and the Corporate Tax Base*

The large and growing importance of option exercises as a reason that the corporate tax base is shrinking is further explored in Tables 2, 3, and 4. While various studies have considered the incentive and behavioral consequences of options as a form of compensation,¹³ few have considered the consequences associated with the proliferation of option instruments for the corporate tax base.¹⁴ Tax-related studies (e.g., Hall and Liebman (2000) and Goolsbee (2000a, 2000b)) have emphasized the behavior of top executives rather than the impact of these changed compensation instruments on the corporate profit base.

billion of issuance from 1993 to 2001. Given that only the periodic payments of these instruments would be associated with the gap between book and tax income, it seems unlikely that such debt-equity hybrid instruments can account for meaningful fractions of the unexplained difference. As reported widely in the press, Adams (2001) reports that for 30% of S&P 500 companies, pension earnings comprise an average of 12% of pretax income in 2000. Such a figure, if true for *all* companies, would begin to account for a more significant portion of the gap. For example, in 1998, such a ratio could account for 57% of the unexplained difference. Given that firms that report such a figure, and on which such an average ratio is based, are biased toward having material amounts to report and that many firms do not have defined benefit plans which give rise to these differences, such an extrapolation provides an extreme upper bound on the potential for pension accounting to contribute to this difference.

¹³ See Murphy (1999) for an overview or Core and Guay (2001) and Huddart and Lang (1996) for a detailed study of exercise behavior.

¹⁴ Sullivan (2000b), Bear Stearns (2000) and McIntyre (2000) are exceptions – each considers a subsample of up to forty firms in an effort to gauge the overall impact of option exercises on the corporate tax base.

Table 2 provides an overview of option granting and exercise behavior for nearly 2,000 firms from 1992 to 2000 from the Execucomp database.¹⁵ The data provided through Execucomp is limited to the granting and exercise behavior of the top five executives given that mandatory reporting centers on their behavior. However, it is possible to extrapolate to all-employee grants and exercises as firms are required to report the share of total grants that correspond to the grants to the top five executives. While this process is straightforward for grants (as the share for the top five is based on grants), the extrapolation is somewhat more complicated for exercises requiring some additional assumptions.¹⁶

Table 2 provides evidence of several trends in the impact of option granting and exercise behavior on the corporate profit base. First, the remarkable rise in aggregate grants and exercises by the top five officers of these firms over the period has resulted in grant values of over \$16 billion in 2000 to just the top five officers. This corresponds to a tenfold increase over the decade. Second, option granting behavior appears to be deepening within firms at a rapid pace as the share represented by the top five has decreased steadily from 29% in 1994 to 24% in 2000. Finally, the aggregate levels of grant values and exercises across all employees across all firms mushroomed to over \$100 billion, in the case of annual exercises, in 2000 which corresponds to a sixfold increase over the decade. The deepening of the use of incentive instruments in organizations, the

¹⁵ The Execucomp database contains information on various types of compensation for top executives in companies including options granted and exercised to each executive and the percentage these represent of all options granted and exercised, respectively, by all employees each company each year. These data are presented by executive and company, with up to five records (one for each executive) for each company for each year. From these individual executive/company/year records, it is possible to calculate aggregate grants and exercises for the top five executives.

¹⁶ Exercises for all employees were calculated by grossing up the exercises of the top five executives in a year by the average ratio of grants to the top five over grants to all employees for the sample period. If this average proved particularly low, this estimate was recalculated using a ratio of 20% to prevent any spurious overstatement of aggregate exercise levels. Implicit in this calculation is the assumption that all employees behave similarly in their exercise behavior. Core and Guay (2001) and Huddart and Lang (1996) compare the behavior of top executives and employees more generally and find both are sensitive to recent price performance. Given the additional reporting requirements of the top five, it is conceivable that other employees are more opportunistic than the top five executives.

absolute magnitudes of the amounts involved, and the proliferation of repricing strategies suggests that the proliferation of options will likely survive a market downturn.¹⁷

Given the extrapolation involved in Table 2, it is useful to undertake a more detailed analysis of the largest 150 firms (by market value of equity) in order to ascertain the reliability of these estimates and the degree to which they correspond to actual tax benefits.¹⁸ Table 3 summarizes the evidence provided in Appendix Table 1 of Desai (2002) on the behavior of these firms and yields more precise, and comparable, estimates of the impact of the proliferation of options on the corporate tax base.¹⁹ Using hand-collected data on the exercise of options, \$78 billion was realized as proceeds from option exercises for just the top 150 firms in 2000. This figure corresponds to a mean ratio of proceeds from option exercises to operating cash flow of 29%. Table 3 highlights the growing absolute magnitude of the exercises and the growing ratio of those exercises to measures of corporate profitability during the late 1990s. The detail in Appendix Table 1 of Desai (2002) demonstrates that the use of options is proliferating through firms of all types and are not limited to high-technology or “new economy” companies. For a variety of traditional consumer goods and financial services firms - including Colgate Palmolive, Safeway and Home Depot - option net proceeds appear to comprise greater than 10% of operating cash flow or net income.

The proceeds from option exercises might not translate into tax deductions at the firm level for a variety of reasons. In particular, loss-making firms, firms employing incentive stock options, or firms employing variable-priced options may not realize comparable tax benefits as indicated by their net proceeds from options exercises. Table 4

¹⁷ Such a conclusion is necessarily speculative but the evidence on repricings in Brenner, Sundaram and Yermack (2000) and recent high-publicity events surrounding CEO compensation suggest that levels of compensation are being adjusted on other margins to accommodate the levels of compensation recently enjoyed by CEOs.

¹⁸ Selecting on market value may create some biases. First, by selecting on market value, these firms are likely to have some of the largest five-year returns. As such, the potential for realized gains might be the largest in this group. At the same time, this group excludes a variety of smaller capitalization stocks that would have recently gone public and are most likely to have used ESOs heavily during their earlier years. Finally, the market value ranking was taken as of early November and, consequently, does not include a variety of firms that experienced rapid gains and subsequent losses during the period from 1996 to 2000 which may have experienced large proceeds from stock option realizations.

¹⁹ A more detailed discussion of the methodology employed in constructing the sample underlying Table 3 is provided in the Data Appendix of Desai (2002).

takes the 30 firms with the largest ratio of option exercises to operating cash flow from Appendix Table 1 of Desai (2002) and details their reporting of the tax benefits associated with option exercises.²⁰ As described in Hanlon and Shevlin (2001), the incipient reporting of these tax benefits need not reflect the actual tax benefits realized by firms. Nonetheless, 18 of the 30 firms (this propensity to report tax benefit figures corresponds to the figures reported in Hanlon and Shevlin for Nasdaq firms) with the largest ratios of option exercises to operating cash flow report tax benefits associated with the exercises.

Unsurprisingly, there is considerable heterogeneity with some firms - for example eBay - reporting limited, if any, tax benefits from the deductions associated with the exercise of stock options. Nonetheless, for all these firms reporting tax benefits, the average ratio of tax benefits to estimated net proceeds from option exercises is 32% across the three years suggesting that the option exercise figures correspond to tax deductions that are being close to fully employed.²¹ Taken together, Tables 2, 3, and 4 suggest that the proliferation of option instruments to compensate employees has had a significant role in creating a large and growing gap between tax and book income and in changing the corporate profit base. Additionally, the more detailed study of the largest firms suggests that the estimates from Execucomp for the overall corporate universe are reliable estimates for the aggregate levels of the impact of option exercises on the corporate tax base.

5. *Testing a Model of Costly Sheltering with Accounting Data*

In order to isolate the degree to which the growing gap between tax and book income is associated with increased sheltering activity, this section begins with a discussion of the use of firm-level accounting data to isolate book and tax income. In this subsection, special attention is paid to an alternative explanation for the emerging book-tax income gap – increasingly aggressive earnings management. In order to motivate specific empirical tests of sheltering, a model of costly sheltering is then developed and implemented with these accounting-based measures of book and tax income.

²⁰ The tax benefits from employee exercises of stock options were collected for 1998 through 2000 by examining both the statement of cash flows and the statement of shareholders' equity in the consolidated financial statements reported in the 10-K (or other documents if incorporated by reference).

5.1 *The Use of Accounting Data to Compare Book and Tax Income*

While Figures 1 and 2 consider the gap between tax income and book income as generated by data from tax forms, an alternative methodology that employs accounting data can be used to generate a related notion of what the gap between tax and book income is. As noted previously, the gap generated by this methodology has an important difference from the gap generated using data from tax forms: the accounting of stock option activity removes this deduction from both tax income and book income. As such the gap between estimates of tax and book income generated from accounting data is unlikely to be associated with stock option activity but could be associated with depreciation discrepancies or the reporting of foreign source income as well as sheltering activity. The use of accounting data also holds out the possibility of using micro data more readily than what is available from aggregates based on tax forms.

Inferring tax income from accounting reported book income involves a variety of alternative measures of tax expense. Current and deferred tax expenses are jointly considered in order to capture permanent and temporary differences between tax and accounting reporting of income. Plesko (1999) reviews the varied alternative methods for calculating tax expenses and their correlations with actual tax income.²² The analysis that follows employs the measure of tax liability associated with Stickney and McGee (1982).²³ Use of the measures argued for by Porcano (1986), Zimmerman (1983), and Shevlin (1987) do not yield dissimilar results in the regression results that follow.

Figure 3 reports calculated tax and book income, generated from accounting statements, in 1992 dollars for a large universe of public companies that comprise an unbalanced panel from 1982 to 2000. For this large sample, there appear to be three distinct phases of the relationship between book and tax income. First, until the Tax Reform Act of 1986, book income far exceeded tax income. Second, from TRA through

²¹ Given that reporting of the tax benefits does not appear to be standardized nor, as demonstrated by Hanlon and Shevlin (2001), to be necessarily correlated with the tax deductions actually taken by firms, it is not clear that there is any sample bias by selecting on those firms with the largest ratios.

²² See also Callihan (1994), Kinney and Swanson (1993), Omer, Molloy and Ziebart (1991), and Dworin (1985) for further discussion of the varied methodologies in using Compustat data and the relative merits of alternative measures.

²³ This involves total tax expense with an adjustment for deferred tax expenses.

the early 1990s, differences between book and tax income became considerably smaller. Finally, from the early 1990s book income has begun to diverge in a consistent manner from tax income. This gap reassuringly mirrors the gap between book and tax income presented in Figure 1.

While deductions associated with the net proceeds from stock option exercises are not likely to be part of that gap, it is possible that changed patterns of depreciation differences and reinvested earnings abroad might contribute to this gap. Applying the same figures from Table 1 to the gap in Figure 3 demonstrates that there still appears to be a considerable gap between actual aggregate book income and simulated book income for much of the 1990s. Given that the adjustments associated with depreciation differences and reinvested earnings abroad are for *all* firms with assets greater than \$250 million, the gap between book income and calculated tax income would be even larger during the 1990s as the evidence in Figure 3 is only for 6,000 firms. This gap appears to persist in a balanced panel from 1982 to 2000 of 500+ firms and for an unbalanced panel from 1992 to 2000 for which there exists detailed compensation data as presented in Appendix Figures 1a and 1b of Desai (2002).

The gap between tax and book income could be associated with a secular increase in managerial efforts to boost book income through earnings management rather than a secular increase in efforts to depress tax income. As discussed above, researchers have struggled to find aggregate evidence of a meaningful, sustained role for earnings management. Nonetheless, it is useful to consider the motives and evidence related to earnings management so that empirical tests can attempt to discriminate between these two explanations. Theories of earnings management typically try to explain management of earnings through smoothing whereby managers intertemporally shift income to accomplish a variety of objectives. Managers may smooth earnings in order to signal firm quality (Barnea, Ronen and Sadan (1975)), to influence future shareholders and long-run share prices (Dye (1988) and Goel and Thakor (2001)), to derive incumbency rents (Fudenberg and Tirole (1995)), or to lower borrowing costs due to reduced perceived probabilities of financial distress (Trueman and Titman (1988)). For smoothing to explain the gaps depicted in Figure 2 would require a massive, sustained borrowing from future earnings

during the 1990s. Moreover, earnings smoothing explanations of Figure 2 would require that the period during which earnings have been mortgaged has yet to occur. Given that most of these models correspond to quarterly, and possibly annual, smoothing of income, it is hard to imagine the managerial motives that could correspond to long-run acceleration of income as would be required for earnings smoothing to explain the gaps in Figure 2.²⁴

Empirical efforts to isolate earnings management typically employ one of three methods that provide some instruction for the empirical tests that follow. First, earnings management and smoothing can be detected by looking for evidence of discretionary accrual accounting. In particular, Jones (1991) develops a model of discretionary accruals that attempts to isolate firms or industries with large amounts of discretion in accrual methods. Studies tend to emphasize those industries with particularly large opportunities for discretionary accruals such as provided in banking with provisions for loan loss reserves in searching for evidence of earnings management. Second, Burgstahler and Dichev (1997) and Degeorge, Patel and Zeckhauser (1998) try to detect earnings management by examining the distribution of earnings around threshold levels such as the expected earnings of financial analysts. Finally, the underlying economics of specific accounts can be modeled, such as valuation allowances for deferred tax assets as in Miller and Skinner (1998), and then actual accrual behavior can be compared with predicted levels to isolate discretionary accruals. The most convincing evidence of earnings management comes from studies of distributions of earnings around threshold levels while other efforts reach contradictory conclusions regarding increased levels of earnings management and the overall relevance of earnings management. The industry-specificity of discretionary accruals and the objective of smoothing earnings relative to thresholds suggest that industry fixed-effects as well as sorting firms by relative levels of the variability of book income relative to tax income might usefully distinguish earnings management explanations from tax sheltering activities.

5.2 *A model of corporate tax shelter activity*

²⁴ In contrast to earnings smoothing, earnings management could take on the form of fraudulent reporting of book income. This practice is more difficult to distinguish from tax sheltering and efforts to disentangle the two are considered below.

In order to motivate the empirical tests of increased sheltering, the appendix specifies a model of costly sheltering which suggests that increased levels of sheltering will be evidenced by a distinctive relationship between book and tax income at low levels of tax income. More specifically, the model suggests that sheltering will be reflected by a relatively flatter relationship between book and tax income at low levels of tax income. The model generates an estimating equation (equation A7) which is tested through piecewise linear regressions between book and tax income. Increased levels of sheltering will be reflected in a flattening of the relationship between tax and book income at low levels of tax income.

The intuition behind this result comes from the nature of the costs of sheltering in the model developed in the appendix. It is useful to imagine a world without sheltering initially. In such a world, estimation of (A7) would result in a forty-five degree line that mapped tax income to book income and that passed through the origin. The impact of sheltering in altering the shape of that line will be a function of the nature of the costs of sheltering. In particular, costs of sheltering in this model are associated with the amounts sheltered and not the levels of true income conferring no advantage on those firms with large amounts of true economic income. As a consequence, all firms shelter in a manner to avoid the same amount of tax. If there were no progressivity in the tax schedule, then estimation of (A7) would still result in a forty-five degree line but would intersect the y-axis at some non-zero level of book income reflecting the fact that all firms shelter some income to avoid a given amount of taxes. Progressivity in the tax schedule, however, will result in a flattening of the relationship between book income and tax income at low levels of tax income because more income can be sheltered given the lower tax rates and the constant amount of tax liabilities being avoided. In turn, increased levels of sheltering will be associated with a flattening of the relationship between book and tax income at low levels of tax income.²⁵

²⁵ While it is possible to recast the problem of costly sheltering as a problem of costly earnings management, a model of earnings management where inflating book income was costly would not generate the curvature at low levels of tax income as it arises from the progressivity of the tax schedule. Only if zero earnings was a particularly important threshold level and the costs of earnings management were a function of such a threshold, it is possible to arrive at a theoretical model of earnings management that delivers corresponding

Alternative specifications of the costs of sheltering would result in distinctive patterns in the relationship between tax and book income. For example if costs of sheltering were a function the fraction of true income sheltered, thereby suggesting that firms with large amounts of income find it easier to shelter more income, then increased sheltering would be associated with the initial forty-five degree line taking on a parabolic shape. The specification employed above and tested below has the advantage of being consistent with taxing authorities that maximize revenue collection and the notion that firms of different sizes face the same probability of detection when sheltering a given amount of income.

5.3 *Testing the model of sheltering*

As indicated above, increasing levels of sheltering should be evident through a changed relationship between book and tax income at low levels of tax income. The analysis in Table 5 and Figures 4a and 4b employs a piece-wise linear regression framework for relating the logarithm of book income to the logarithm of tax income and traces that relationship through the decade. This approach has the advantage of tracing the changing relationship of tax income to book income over the decade and testing for whether the disconnect between book and tax income has become most pronounced for reporters with small amounts of tax income.

In Table 5, observations are aggregated into three distinct sub sample periods in order to isolate the trends in the relationship between book income and tax income. The specification employing data from 1992 to 1994 demonstrates that coefficients become larger and more statistically significant as tax income becomes larger. The more interesting pattern is the comparison across time periods. First, coefficients on the splines at low levels of tax income become considerably smaller dropping from 0.61 and 0.69 in 1992-1994 to 0.22 and 0.60 in 1998-2000, respectively. Additionally, the significance of these estimates drops and the overall degree to which tax income predicts book income is reduced. Finally, the decreased levels of coefficients are not nearly as pronounced at higher levels of tax income.

empirical predictions. The empirical analysis below employs measures of the variability of earnings to

Given the industry-specificity of discretionary accrual opportunities, it is useful to employ industry fixed effects in these piecewise linear regressions in an effort to isolate a sheltering explanation for this phenomena from an earnings management explanation. The results presented in Table 5 with the inclusion of industry fixed effects demonstrate that within-industry variation provides even stronger results for a weakening of the relationship between book and tax income at low levels of tax income. The coefficients from the three specifications employing industry fixed effects are used to construct the lines in Figure 4a. This figure provides the flattening of the relationship between book and tax income as predicted in the model of costly sheltering over the course of the 1990s. This same exercise is repeated by year with industry fixed effects and the results are presented in graphical form in Figure 4b. Figure 4b provides similar results as the coefficients on the first spline are positive and significant in early years of the sample and approach zero by 2000. As reported in Desai (2002), the explanatory power of the regressions that underly Figure 4b decline over the sample period suggesting further the reduced link between book and tax income.

This regression evidence is difficult to reconcile with alternative rationales for the disparity between tax and book income. For example, if the differential measurement of depreciation or of reinvested earning abroad were to wholly account for this changed pattern, this differential measurement would have to have become more concentrated amongst low tax income firms during the 1990s. While these possibilities appear unlikely, it is possible that the accounting of option exercises, if firms follow clean surplus accounting, would have reduced tax income, as measured by accounting statements, for young growth firms with low tax income. Controlling separately for the levels of option activity in these regressions demonstrates that option activity cannot explain this decoupling of book and tax income at low levels of tax income. In order to ensure that results are not being disproportionately the different behavior of small or large firms, Appendix Table 2 and Appendix Figures 1a and 1b of Desai (2002) attempt the same piecewise linear regressions provided in Table 5 by dividing the sample at the median level of sales. The same patterns appear to hold.

distinguish between these models.

In addition to using industry fixed effects to separate out earnings management explanations from tax sheltering explanations, it is possible to consider the relative variability of book and tax income in an effort to segregate active earnings managers from non earnings managers.²⁶ In order to do so, ratios of the standard deviations of book income to tax income are calculated for all the firms in the sample and firms. This ratio has a median of 0.91 and firms with a ratio below the median are considered earnings-smoothing firms and firms with a ratio above the median are considered non-smoothers. If earning management were a primary driver of the breakdown of the relationship between book and tax income at low levels of tax income, then firms with different propensities to smooth book income should exhibit a different relationship between tax and book income at low levels of tax income over the course of the decade. The evidence provided in Table 6 and Figures 5a and 5b suggest otherwise as both earnings-smoothers and non-earnings smoothers exhibit similar underlying trends over the course of the decade with respect to a flattening of the book-tax income relationship at low levels of tax income.

The regression framework explored in Tables 5 and 6 and Figures 4 and 5 provides evidence that is consistent the model of sheltering provided in section 5.2. The implication of these results is that sheltering became considerably less costly, either through lowered probabilities of detection or perceived lower penalties, and that firms became more aggressive during the 1990s. The alternative explanation of a secular increase in earnings management is difficult to reconcile with the data provided in the paper. First, earnings management theories typically do not allow for such long-run intertemporal shifting of income as would be required to explain the aggregate trends in Figure 2. Second, if earnings management opportunities are particularly associated with discretionary accrual opportunities in some industries, then within industry variation should have reduced, rather than increased, evidence of this underlying behavior in the micro evidence. Finally, if increased earnings management were the cause of the flattening of the relationship between book and tax income at low levels of tax income, simple distinctions in the relative variability of book and tax income should have demonstrated more pronounced

²⁶ Such a distinction resembles other studies that attempt to isolate earnings smoothers by the relative absence of variability in reported earnings as in Myers and Skinner (2001) who study firms with consistent increases in reported earnings.

differences in this breakdown. While it is not possible to definitively rule out earnings management – particularly fraudulent book reporting of income - as a source of some of the aggregate phenomena observed in Figure 2, this micro analysis suggests that the distinctive way in which the relationship between book and tax income has deteriorated over the decade is consistent with increased levels of costly sheltering.

6. *Conclusion*

This paper attempts to illuminate the debate on tax sheltering by disentangling varied explanations for the breakdown in the relationship between tax and book income over the last decade. First, the paper demonstrates that identifiable factors which used to account well for the difference between tax income and book income fail to account for the large gap between book and tax income in more recent years. In particular, by 1998, more than half of the difference between tax and book income – approximately \$154.4 billion or 33.7% of tax income – cannot be accounted for by these historically relevant measures of the discrepancy between tax and book income. Second, the paper demonstrates that within those identifiable factors, changed patterns in employee compensation are creating the largest disconnect between book and tax income. By 1998, differing treatment of employee options accounted for nearly three times as much to the difference between book and tax income as did distinct definitions of depreciation.

By examining this same disconnect between book and tax income using accounting data, the paper demonstrates that this breakdown has been particularly pronounced at low levels of tax income and has degenerated progressively over the decade. These results are consistent with the model of costly sheltering presented in the paper and decreased costs of sheltering over the decade leading to greater gaps between tax and book income. Tests to check if these results are driven by increased levels of earnings smoothing do not appear to diminish the results that suggest that increased sheltering is responsible for the distinctive breakdown in the relationship between book and tax income.

The large discrepancy reported between simulated and actual book income from Figure 2 along with the regression evidence suggests that efforts by firms to circumvent tax payments are becoming more significant, cheaper to implement, and harder to detect.

These developments provide yet another reason to reevaluate the manner in which corporate earnings are taxed as the underlying developments driving these phenomena – including increased access to global opportunities and the rapid development of financial innovations – are unlikely to decline in importance in the near future. Similarly, these trends illustrate the need to revisit the rationales for distinctive book and tax reporting and the degree and manner in which firms are forced to reconcile book and tax income.

Appendix

In order to motivate the empirical tests of increased sheltering, it is useful to specify a model of costly sheltering. Let I equal true economic income, B equal reported book income and T equal reported tax income. Book income is presumed to correspond to true economic income with noise so that:

$$(A1) \quad B = Ie^u \quad \text{where } u \sim N(0, \sigma^2)$$

In order to specify what tax income would be, let s equal sheltered income which is associated with costs $\gamma(s)$ which are characterized by $\gamma'(s) > 0$ and $\gamma''(s) > 0$. In this setting, costs of sheltering only correspond to the amount of income sheltered and not the amount of true economic income. In other words, larger firms have no advantage in sheltering income relative to smaller firms. As a consequence, tax income is given by:

$$(A2) \quad T = I - s - \gamma(s)$$

and the tax rate is a function of this taxable income as represented by $\tau(I - s - \gamma(s))$.

Firms choose the amount of income to shelter by solving:

$$(A3) \quad \max_s [I - s - \gamma(s)](1 - \tau(I - s - \gamma(s))) + s$$

which yields the first-order condition:

$$(A4) \quad -(1 + \gamma'(s))(1 - \tau(\cdot)) + [I - s - \gamma(s)](1 + \gamma'(s))\tau'(\cdot) + 1 = 0.$$

To analyze this problem further, it is useful to consider two regions of the tax schedule where there is progressivity and where there is no progressivity. At sufficiently high levels of income, then the tax rate will exhibit no progressivity, $\tau'(\cdot) = 0$, and then (A4) will collapse to:

$$(A5) \quad (1 + \gamma'(s))(1 - \tau(\cdot)) = 1$$

At such levels of income, levels of sheltering will no longer vary with levels of income, as

$\frac{ds}{dI} = 0$. As a consequence, it is possible to rewrite the level of tax income in (A2) as:

$$(A6) \quad T = I - s - \gamma(s) = I - \bar{k}$$

Taking logarithms of both sides of (A6) and (A1) and employing a first-order Taylor approximation, it is possible to rewrite (A1) as:

$$(A7) \quad \ln(B) = \ln(I) + \frac{k}{I} + u$$

which in turn becomes the estimating equation in the empirical analysis that follows.

When levels of income are such that $\tau'(\cdot) \neq 0$, the first order condition in (A4) can be rewritten as an expression for tax income,

$$(A8) \quad T = [I - s - \gamma(s)] = \frac{(1 - \tau) - \frac{1}{(1 + \gamma'(s))}}{\tau'(\cdot)}.$$

In order to make this tractable, it is useful to transform this into:

$$(A9) \quad F(T) = \frac{-1}{1 + \gamma'(s)} \text{ where } F(x) = [\tau'(\cdot)x + \tau(\cdot) - 1]$$

and to define the inverse function as $G(z) \equiv F^{-1}(z)$. This specification allows tax income to be rewritten as:

$$(A10) \quad T = G\left(\frac{-1}{1 + \gamma'(s)}\right)$$

Given that the curvature of $G(\cdot)$ will be small when the curvature of $F(\cdot)$ is high, it becomes clear that at low levels of income, $\frac{dT}{dI} \geq 0$.²⁷ With respect to the estimating equation provided in (A7), this model suggests that the relationship between book income and tax income will be distinctive at low levels of tax income necessitating a piecewise linear model to estimate (A7). More specifically, the model suggests that sheltering will be reflected by a relatively flatter relationship between book and tax income at low levels of tax income. Correspondingly, increased levels of sheltering will be reflected in a flattening of the relationship between tax and book income.

²⁷ More precisely, this requires the additional assumption that $\tau''(\cdot) = 0$ and that $\gamma''(\cdot) \ll \tau'(\cdot)$ as

$$\frac{dT}{dI} = 1 - \frac{2\tau'(\cdot)(1 + \gamma'(s))^3}{\gamma''(s) + 2\tau'(\cdot)(1 + \gamma'(s))^3}$$

References

Adams, J. 2001. "A Pension Accounting Primer," CSFB Equity Research Report (June 13).

Auerbach, A. and J. Poterba. 1987. "Why Have Corporate Tax Revenues Declined?" In *Tax Policy and the Economy* 1, L. Summers, ed. (Cambridge, MA: MIT Press), 3-29.

Bankman, J. 1999. "The New Market in Corporate Tax Shelters." *Tax Notes Today* 83 (June 22), 1775-1795.

Barnea, A., J. Ronen and S. Sadan. 1975. "The Implementation of Accounting Objectives-An Application to Extraordinary Items." *The Accounting Review* 50, 58-68.

Bear Stearns. 2000. "Employee Stock Options." *Accounting Issues* (July 6).

Brenner, M., R. Sundaram, and D. Yermack. 2000. "Altering the Terms of Executive Stock Options." *Journal of Financial Economics* 57, 103-128.

Burgstahler, D. and I. Dichev. 1997. "Earnings Management to Avoid Earnings Decreases and Losses." *Journal of Accounting and Economics* 24 (1), 99-126.

Callihan, D. 1994. "Corporate Effective Tax Rates: A Synthesis of the Literature." *Journal of Accounting Literature* 13, 1-43.

Core, J. and W. Guay. 2001. "Stock Option Plans for Non-Executive Employees." *Journal of Financial Economics* 61 (2), 253-287.

Dechow, P. and D. Skinner. 2000. "Earnings Management: Reconciling the Views of Accounting Academics, Practitioners, and Regulators." *Accounting Horizons* 14 (2), 235-250.

Degeorge, F., J. Patel and R. Zeckhauser. 1998. "Earnings Management to Exceed Thresholds." *Journal of Business* 72 (1), 1-33.

Desai, M. 2002 "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," NBER Working Paper No. 8866.

Desai, M., C. Foley, J. Hines Jr. 2001 "Repatriation Taxes and Dividend Distortions." *National Tax Journal* 54 (2001): 829-851.

Desai, M., C. Foley, J. Hines Jr. 2002 "Chains of Ownership, Regional Tax Competition, and Foreign Direct Investment." Forthcoming in *Foreign Direct Investment in the Real and Financial Sector of Industrial Countries*, edited by Robert Lipsey.

Desai, M. and J. Hines Jr. "Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions." Forthcoming in *National Tax Journal*.

Dworin, L. 1985. "On Estimating Corporate Tax Liabilities from Financial Statements." *Tax Notes Today* 85 (December 2), 965-971.

Dye, R. 1988. "Earnings Management in an Overlapping Generations Model." *Journal of Accounting Research* 26 (2), 195-235.

Engel, E., M. Erickson and E. Maydew. 1999. "Debt-equity Hybrid Securities." *Journal of Accounting Research* 37 (2), 249-274.

Fudenberg, D. and J. Tirole. 1995. "A Theory of Income and Dividend Smoothing Based on Incumbency Rents." *Journal of Political Economy* 103 (1), 75-93.

Goel, A. and A. Thakor. 2001. "Why Do Firms Smooth Earnings?" Working paper (forthcoming in *Journal of Business*).

Goolsbee, A. 2000a. "What Happens When You Tax the Rich? Evidence from Executive Compensation." *Journal of Political Economy* 108 (2), 352-378.

-----. 2000b. "Taxes, High-Income Executives, and the Perils of Revenue Estimation in the New Economy." *The American Economic Review* 90 (2), 271-275.

Hall, B. and J. Liebman. 2000. "The Taxation of Executive Compensation." In *Tax Policy and the Economy* 14, J. Poterba, ed. (Cambridge, MA: MIT Press), 1-44.

Hanlon, M. and T. Shevlin. 2001. "Accounting for Tax Benefits of Employee Stock Options and Implications for Research." University of Washington Working Paper.

Healy, P. and J. Wahlen. 1999. "A Review of the Earnings Management Literature and Its Implications for Standard Setting." *Accounting Horizons* 13 (4), 365-383.

Huddart, S. and M. Lang. 1996. "Employee Stock Option Exercises: An Empirical Analysis." *Journal of Accounting and Economics* 21, 5-43.

Joint Committee on Taxation. 2000. "Testimony of the Staff of the Joint Committee on Taxation Concerning Interest and Penalties and Corporate Tax Shelters before the Senate Committee on Finance." (Washington, D.C.: U.S. Government Press), March 8.

Jones, J. 1991. "Earnings Management During Import Relief Investigations." *Journal of Accounting Research* 29, 193-228.

Kies, K. 1999a. "Statement of Kenneth Kies: Testimony before the House Committee on Ways and Means Hearing on Penalty Provision in President's Fiscal Year 2000 Budget." (Washington, D.C.: U.S. Government Press), March 10.

-----. 1999b. "A Critical Look at the Administration's 'Corporate Tax Shelter' Proposals." *Tax Notes Today* 83 (June 7), 1463-1486.

----. 1999c. "Statement of Kenneth Kies: Testimony before the House Committee on Ways and Means Hearing on Corporate Tax Shelters." (Washington, D.C.: U.S. Government Press), November 10.

----. 2000. "Statement of Kenneth Kies: Testimony before the Senate Finance Committee Hearing on Penalty and Interest Provisions in the Internal Revenue Code." (Washington, D.C.: U.S. Government Press), March 8.

Kinney, M. and E. Swanson. 1993. "The Accuracy and Adequacy of Tax Data in COMPUSTAT." *Journal of American Taxation Association* 15, 121-135.

Mackie, J., III. 2000. "The Comeback of the Corporate Income Tax." In *Proceedings of the Ninety-Second Annual Conference on Taxation* (Washington, D.C.: National Tax Association), 93-102.

Manzon, G., Jr. and G. Plesko. 2001. "The Relation Between Financial and Tax Reporting Measures of Income." Working Paper.

McIntyre, R. 2000. "Corporate Income Taxes in the 1990s." (Washington, D.C.: Institute on Taxation and Economic Policy), October.

Miller, G. and D. Skinner. 1998. "Determinants of the valuation allowances for Deferred Tax Assets under SFAS No. 109." *The Accounting Review* 73 (2), 213-233.

Mills L. and K. Newberry. 2000. "The Influence of Tax and Non-Tax Costs on Book-Tax Reporting Differences: Public and Private Firms." University of Arizona at Tucson Working Paper.

Murphy, K. 1999. "Executive Compensation" In *Handbook of Labor Economics Volume III* (eds. Orley Ashenfelter and David Card) (New York: North-Holland).

Myers, L. and D. Skinner. 2001. "Earnings Momentum and Earnings Management." University of Michigan Working Paper.

Office of Management and Budget. 2002. Historical Tables: Fiscal Year 2003 Budget of the U.S. Government. (Washington, D.C.: U.S. Government Press).

Omer, T., K. Molloy and D. Ziebart. 1991. "Measurement of Effective Corporate Tax Rates Using Financial Statement Information." *Journal of the American Taxation Association* 13, 57-72.

Petrick, K. 2001. "Comparing NIPA Profits with S&P 500 Profits." *Survey of Current Business* (April), 16-20.

Plesko, G. 1999. "An Evaluation of Alternative Measures of Corporate Tax Rates." MIT Working Paper.

----. 2000. "Book-Tax Differences and the Measurement of Corporate Income." In

Proceedings of the Ninety-Second Annual Conference on Taxation (Washington, D.C.: National Tax Association), 171-176.

Plesko, G. 2002. "Reconciling Corporation Book and Tax Net Income, Tax Years 1996-1998," *SOI Bulletin*, Spring 2002.

Porcano, T. 1986. "Corporate Tax Rates: Progressive, Proportional, or Regressive?" *Journal of the American Taxation Association* 7, 17-31.

Schipper, K. 1989. "Commentary: Earnings Management." *Accounting Horizons* 3 (4), 91-102.

Shevlin, T. 1987. "Taxes and Off-Balance Sheet Financing: Research and Development Limited Partnerships," *The Accounting Review*, 62 (3), 480-509.

Stickney, C. and V. McGee. 1982. "Effective Corporate Tax Rates – The Effect of Size, Capital Intensity, Leverage, and Other Factors." *Journal of Accounting and Public Policy* 1, 125-152.

Sullivan, M. 1999a. "Shelter Fallout? Corporate Taxes Down, Profits Up." *Tax Notes Today* 84 (August 2), 653-657.

----- 1999b. "A Revenue Estimate for Corporate Tax Shelters." *Tax Notes Today* 85 (November 22), 981-983.

----- 2000a. "Lobbyist's Figures Flawed, Data Indicate Corporate Shortfalls." *Tax Notes Today* 86 (January 17), 309-313.

----- 2000b. "Let the Good Times Roll: Options and Tax-Free Profits." *Tax Notes Today* 87 (May 29), 1185-1191.

Talisman, J. 1999. "Statement of Jonathan Talisman: Testimony before the House Committee on Ways and Means Hearing on Corporate Tax Shelters." (Washington, D.C.: U.S. Government Press), November 10.

Trueman, D. and S. Titman. 1988. "An Explanation for Accounting Income Smoothing." *Journal of Accounting Research* 26, 127-139.

U.S. Department of the Treasury. 1999. "The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals." (Washington, D.C.: U.S. Government Press).

Zimmerman, J. 1983. "Taxes and Firm Size." *Journal of Accounting and Economics* 5, 119-149.

Figure 1a: Corporate Tax Receipts as Percent of Total On-Budget Receipts, 1971-2001

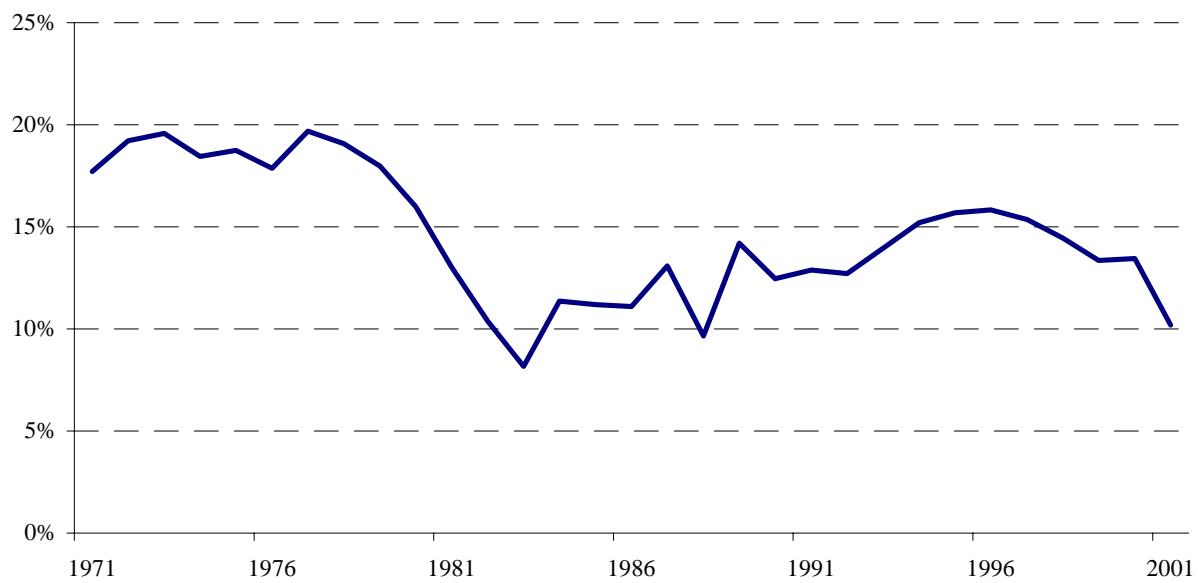
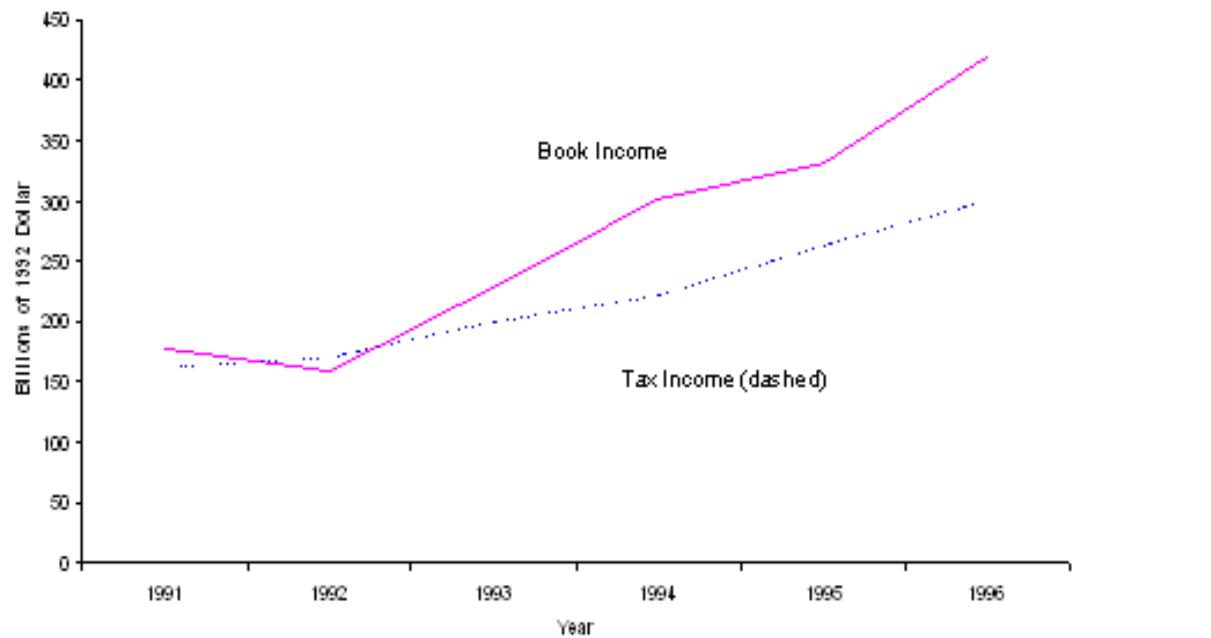


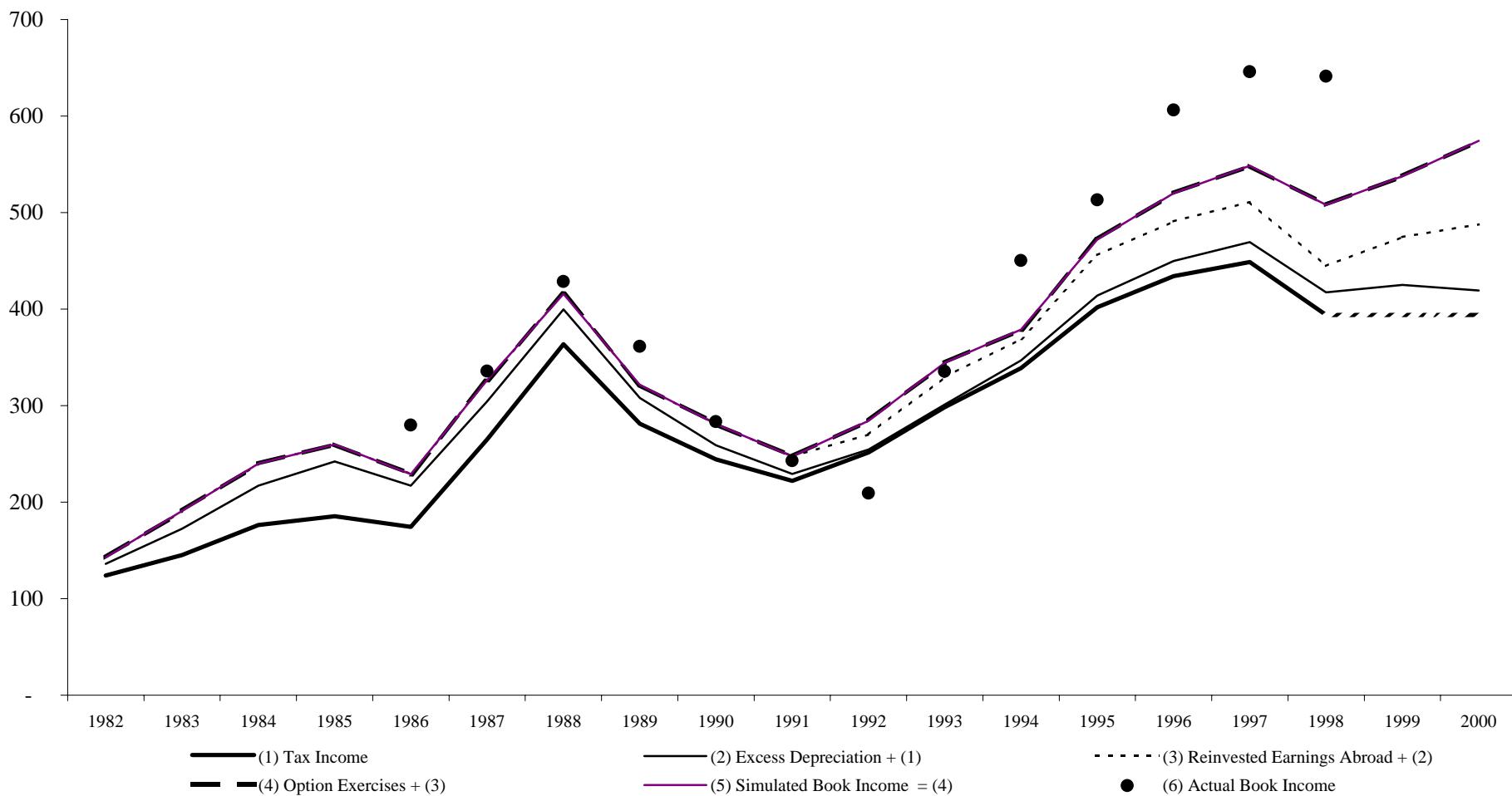
Figure 1b: Actual Book and Tax Income, Firms with greater than \$1 Billion in Assets, 1991-1996



	1991	1992	1993	1994	1995	1996
Inferred Multiple of Book over Tax Income	1.13x	0.94x	1.15x	1.39x	1.26x	1.40x
Inferred Excess of Book over Tax Income	20.0	(10.0)	30.0	85.0	70.0	120.0

Note: Figure 1a is the ratio of corporate tax receipts to all on-budget federal receipts as reported in OMB (2002). Figure 1b is extracted from Talisman (1999). Book Income corresponds to after-tax book income from Schedule M-1 plus federal taxes less tax-exempt interest. Tax Income is the difference between total receipts and total deductions. This is based on all corporations with assets greater than \$1 billion and excludes S Corporations, RICs, REITs and foreign corporations.

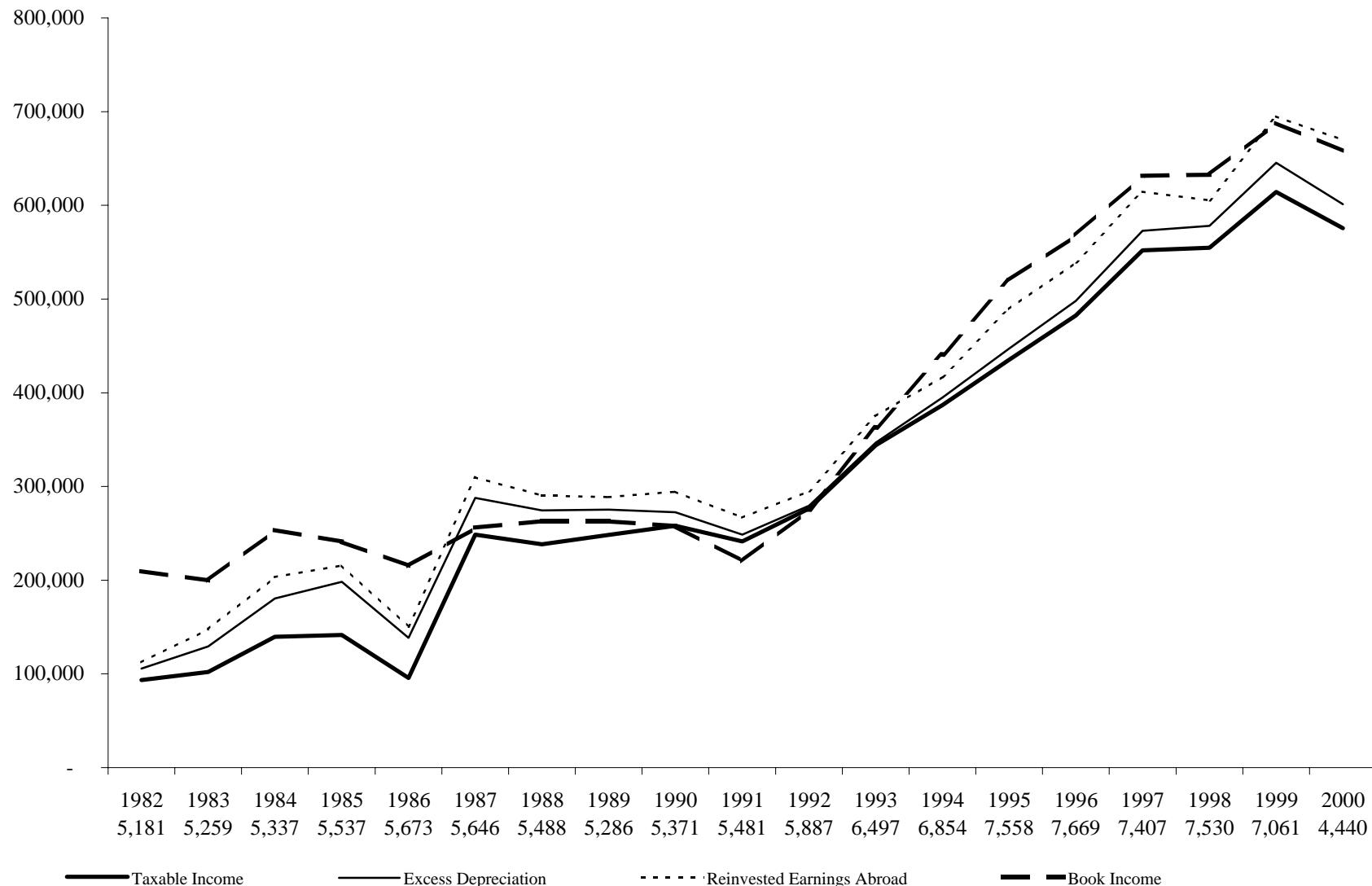
Figure 2
Tax, Simulated Book and Actual Book Income for Firms with greater than \$250 Million in Assets, 1982-2000



	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Actual BI / Actual TI	1.60x	1.27x	1.18x	1.28x	1.16x	1.09x	0.83x	1.12x	1.33x	1.28x	1.40x	1.44x	1.63x
Actual BI - Actual TI	105	70	65	80	39	21	(42)	37	111	111	172	197	247
Actual BI / Simulated BI	1.22x	1.03x	1.03x	1.12x	1.01x	0.98x	0.74x	0.97x	1.19x	1.09x	1.17x	1.18x	1.26x
Actual BI - Simulated BI	51	9	13	40	2	(5)	(75)	(9)	71	41	86	97	133

Note: Tax income corresponds to total receipts less total deductions for filers with more than \$250 million in assets excluding RICs, REITs, and S-Corporations. Excess depreciation corresponds to the difference in tax and economic depreciation as outlined in CCA adjustments. Reinvested earnings abroad is the difference between earnings abroad and repatriated earnings as reported by the BEA. Option exercises are estimated from Execucomp data and are only available from 1992 onward. Simulated book income is the sum of those items. Black dots correspond to actual book income for those same companies and represent after-tax book income from Schedule M-1 plus federal taxes less tax-exempt interest. Figures are in 1992 dollars. For 1989, IRS data is available only for all filers. The greater than \$250 million category is interpolated by assuming the ratio for this category relative to all filers is the average of those ratios in 1988 and 1990. The bottom four rows compare actual book income to actual tax income and actual book income to simulated book income.

Figure 3
Calculated Book and Taxable Income for All Public Companies, 1982-2000



Note: Taxable Income and Book Income are drawn from Compustat as described in the text and are presented for an unbalanced panel from 1982 to 2000. The number of firms for each year is presented below the year. Excess depreciation and reinvested earning abroad are the same as in Table 1 and Figure 2.

Figure 4a: Book Income versus Taxable Income, Spline Estimates by Three-Year Intervals with Industry Fixed Effects, 1992-2000

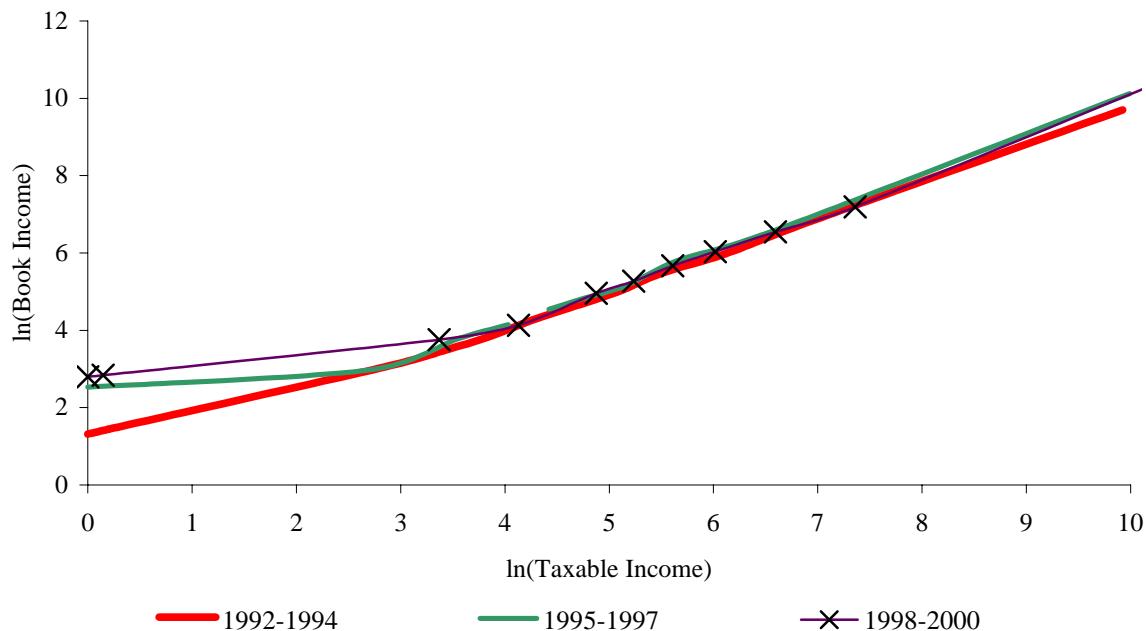
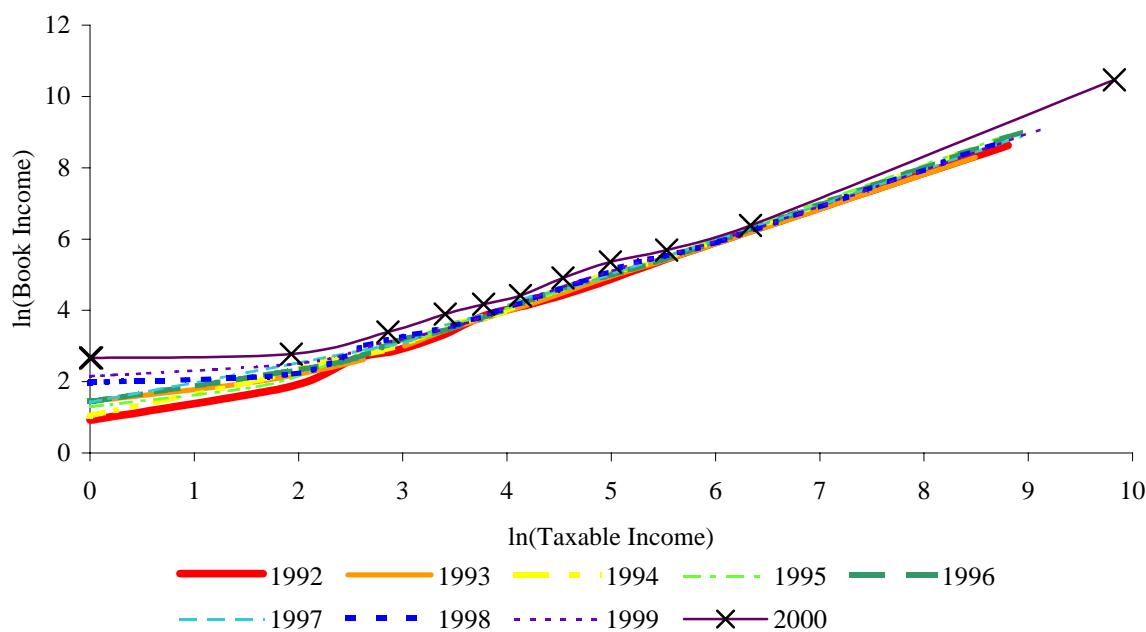


Figure 4b: Book Income versus Taxable Income, Spline Estimates by Year with Industry Fixed Effects, 1992-2000



Note: In Figure 4a, the three lines are constructed using the coefficients of spline regressions reported in Table 5 where industry fixed effects are employed for the groups of years 1992-1994, 1995-1997, and 1998-2000. In Figure 4b, the lines are constructed using the coefficients of spline regressions reported in Table 6 where industry fixed effects are employed for each year from 1992 to 2000.

Figure 5a: Book Income versus Taxable Income, Earnings-Smoothing Firms, Spline Estimates by Three-Year Intervals with Industry Fixed Effects, 1992-2000

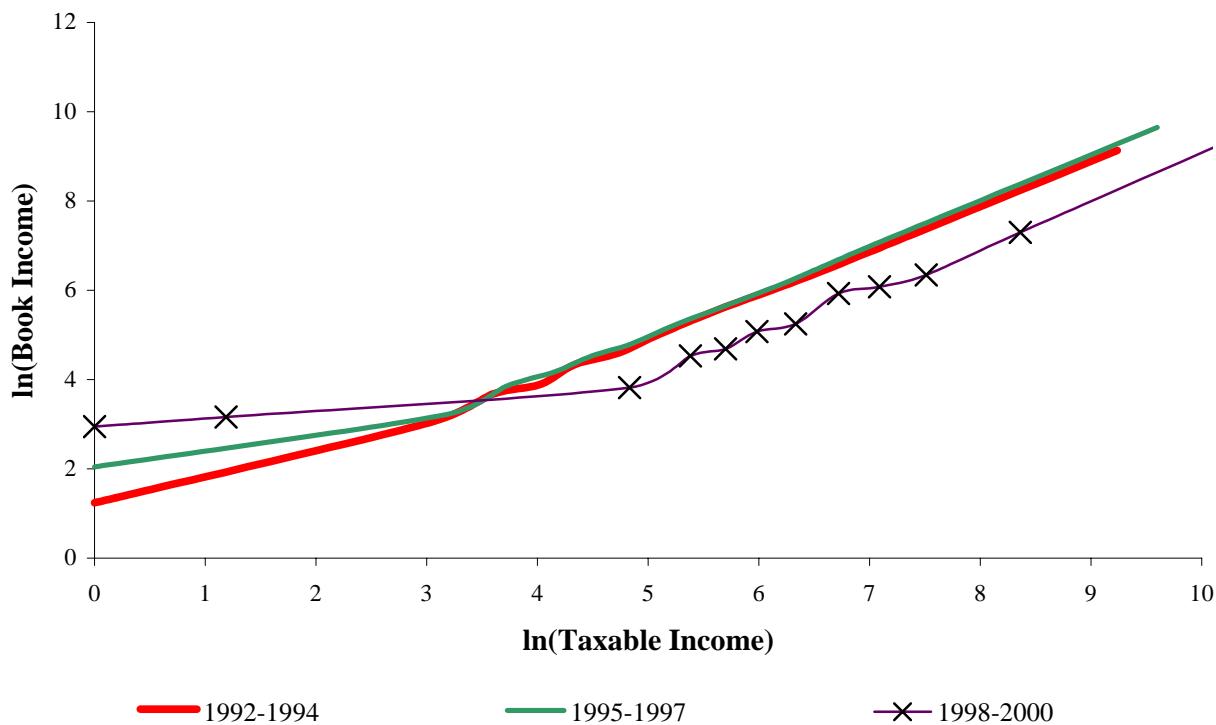
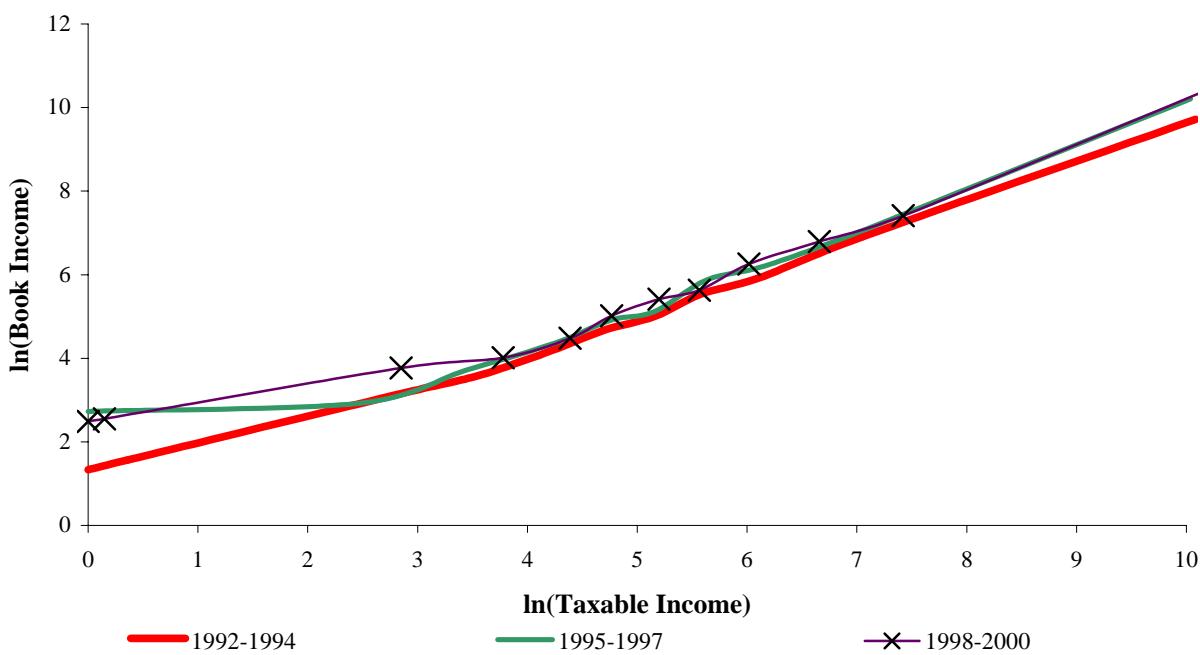


Figure 5b: Book Income versus Taxable Income, Non-Earnings-Smoothing Firms, Spline Estimates by Three-Year Intervals with Industry Fixed Effects, 1992-2000



Note: In Figures 5a and 5b, the three lines are constructed using the coefficients of spline regressions reported in Table 7 for the groups of years 1992-1994, 1995-1997, and 1998-2000. The figures employ regressions for two samples of firms that are divided at the median ratio of the standard deviation of book income to the standard deviation of taxable income. Firms with ratios above the median ratio are termed "non-earnings smoothing firms" and those below the median are termed "earnings smoothing firms."

Table 1
Tax Income and Components of Simulated Book Income, 1982-2000

Year	Tax Income	Excess Depreciation	Reinvested Earnings Abroad	Proceeds from Option Exercises	Simulated Book Income
1982	85,223	8,437	4,574	na	98,234
1983	103,103	19,340	13,107	na	135,550
1984	130,569	30,276	16,803	na	177,649
1985	142,224	43,557	13,397	na	199,179
1986	136,194	33,457	9,247	na	178,899
1987	214,618	31,915	17,687	na	264,220
1988	306,665	30,341	13,447	na	350,453
1989	248,551	23,759	11,775	na	284,085
1990	227,723	13,542	20,488	na	261,753
1991	215,572	7,031	17,568	na	240,171
1992	251,587	3,014	15,733	14,086	284,419
1993	307,302	2,866	29,212	15,365	354,744
1994	357,936	8,545	23,342	10,416	400,240
1995	436,533	13,095	45,708	17,649	512,985
1996	485,645	17,427	46,035	32,412	581,519
1997	513,332	23,660	47,728	42,626	627,346
1998	457,575	27,356	31,620	73,598	590,150
1999	457,575	37,218	58,806	74,832	628,431
2000	457,575	31,243	84,111	106,265	679,195

Note: All dollar figures are in current dollars. Tax income is total receipts less total deductions for firms with greater than \$250 million in assets excluding RICs, REITs, and S-Corporations. The tax income figures for 1999 and 2000 are not available so the simulated book income figure assumes that tax income stays at 1998 levels. Excess depreciation corresponds to the CCA adjustment scaled for the relative use of depreciation by firms with greater than \$250 million in assets. Reinvested earnings abroad are the difference between foreign earnings and repatriations scaled for the relative levels of foreign income for firms with greater than \$250 million in assets. Option exercises are the proceeds from exercises as more fully reported in Table 2. Simulated Book Income is the sum of those figures.

Table 2
Estimates of Option Grants and Exercises, 1992-2000 (Execucomp)

Year	No. of Firms	To Top Five Executives			To All Employees	
		Grant Value (\$)	Exercises (\$)	Median Share of All Exercises	Grant Value (\$)	Exercises (\$)
1992	1,442	1,510	2,416	24.1%	8,713	14,086
1993	1,591	2,407	2,341	26.7%	12,915	15,365
1994	1,646	3,494	1,892	28.5%	17,892	10,416
1995	1,727	3,646	2,655	27.5%	20,280	17,649
1996	1,865	6,010	4,257	27.6%	32,286	32,412
1997	1,920	8,382	6,718	27.1%	47,015	42,626
1998	1,910	9,620	9,421	24.9%	79,555	73,598
1999	1,765	13,768	10,413	25.7%	123,113	74,832
2000	1,435	16,430	14,628	23.5%	199,085	106,265

Note: The data presented in this table is taken for the full universe of firms reported in the Execucomp database. Grant values represent the dollar value using the Black-Scholes valuation model of option grants; exercises represent the excess of the market value of shares under exercises options over the proceeds from exercised options; the median share of all of a company's options (based on shares granted) accounted for by the top five executives is the ratio of grants to the top five employees to all grants. Grant values for all employees are determined by grossing up the value of grants to the top five executives by a company's share of options granted to the top five executives; exercises for all employees are estimated by grossing up exercises of the top five executives by the average across all years of the median share of all exercises, excepting that if the average is less than 1%, then exercises are grossed up using 20%.

Table 3
Estimates of Option Exercises, 1996-2000 (SEC Filings)

Item	2000	1999	1998	1997	1996	Cumulative 1996-2000
Number of Companies	145	142	139	113	109	145
Median Option Exercises (\$MM)	147	149	135	96	52	592
Mean Option Exercises (\$MM)	543	525	362	238	132	1,684
Aggregate Option Exercises (\$MM)	78,779	74,539	50,376	26,909	14,398	244,151
Median Ratio of Option Exercises to Operating Cash Flow	7.9%	7.7%	10.0%	6.8%	4.8%	9.0%
Mean Ratio of Option Exercises to Operating Cash Flow	29.1%	22.6%	19.6%	12.7%	9.8%	27.2%

Note: This table presents data compiled from SEC filings for the universe of companies with the largest market capitalization as detailed in Appendix Table 1. Median, mean and aggregate values of option exercises are calculated as the excess of market value over the average strike price where the volume-weighted average price in a given year is used to establish market values. The median and mean ratio of option exercises to operating cash flow scales estimated annual option exercises by operating cash flows or net income, in the case of financial institutions. The underlying data for this table is provided in Appendix Table 1 and the methodology is more fully described in the data appendix.

Table 4
Reported Tax Benefits and Estimated Option Exercises, 1998-2000 (SEC Filings)

Rank	MV Rank	Company name	2000 Option Exercises / OCF	2000		1999		1998	
				Tax Benefits From Opt. Exercises	Option Exercises	Tax Benefits From Opt. Exercises	Option Exercises	Tax Benefits From Opt. Exercises	Option Exercises
1	97	Lucent Technologies	668%	1,064	2,030	394	1,542	287	1,143
2	131	eBay	272%	37	273	11	229	0	849
3	145	Immunex	254%	na	437	na	135	na	16
4	77	Genentech	245%	226	475	83	310	17	na
5	147	Forest Laboratories	160%	80	289	24	44	17	53
6	29	Oracle	158%	na	3,437	na	710	na	144
7	128	Maxim Integrated	138%	239	667	155	488	137	254
8	12	AOL-Time Warner	115%	na	2,247	na	7,271	na	1,898
9	15	Cisco Systems	113%	1,397	6,940	2,495	4,478	837	2,340
10	35	Amgen	92%	377	1,505	152	725	108	372
11	78	EMC	81%	208	1,716	58	565	44	228
12	109	Charles Schwab	80%	na	578	na	713	na	198
13	33	Dell Computer	79%	929	3,314	1,040	3,093	444	2,407
14	73	Applied Materials	77%	387	1,272	161	610	28	106
15	28	American Home Prod.	72%	na	398	na	307	na	557
16	63	Sun Microsystems	72%	816	2,684	708	1,134	222	418
17	129	Compaq Computer	69%	234	392	142	310	104	702
18	4	Pfizer	69%	na	4,288	na	2,286	na	2,292
19	106	Kohl's	69%	99	256	47	115	10	23
20	133	Analog Devices	66%	44	466	15	116	13	38
21	42	Pharmacia	57%	na	955	na	237	na	439
22	2	Microsoft	56%	3,107	7,795	5,535	15,325	2,066	7,438
23	41	Texas Instruments	45%	na	985	na	763	na	207
24	103	UnitedHealth Group	41%	na	304	na	45	na	84
25	10	Intel	41%	887	5,234	506	2,928	415	2,375
26	53	Merrill Lynch	38%	na	1,446	na	443	na	428
27	67	Cardinal Health	35%	159	303	47	161	65	192
28	83	Marsh & McLennan	33%	na	392	na	169	na	102
29	62	Hewlett-Packard	33%	495	1,446	289	768	157	371
30	68	Automatic Data Proc.	28%	na	297	na	181	na	142
Tax Benefit From Option Exercises Scaled by Option Exercises:		Mean		31.9%		31.8%		31.7%	
		Median		30.4%		30.4%		30.3%	

Note: This table reports reported tax benefits from option exercises and estimated option exercises in 1998, 1999 and 2000 for those thirty firms with the highest ratios of option exercises to operating cash flow in 2000. The means and medians presented at the bottom of the table are for the ratio of reported tax benefits by estimated by option exercises for each year.

Table 5: Piecewise Linear Regression of Book Income on Taxable Income with and without Industry Fixed Effects, 1992-1994, 1995-1997, 1998-2000

	1992-1994		1995-1997		1998-2000	
	No Fixed Effects	Fixed Effects	No Fixed Effects	Fixed Effects	No Fixed Effects	Fixed Effects
Constant	1.3091 (0.3728)	1.3175 (0.3888)	2.5274 (0.2885)	2.5313 (0.2619)	2.9443 (0.4228)	2.7976 (0.3982)
Spline 1	0.6101 (0.1588)	0.6090 (0.1646)	0.1719 (0.1243)	0.1626 (0.1137)	0.2209 (0.1526)	0.2846 (0.1466)
Spline 2	0.6852 (0.2032)	0.7562 (0.2038)	0.8781 (0.1436)	0.9478 (0.1367)	0.6046 (0.2360)	0.4861 (0.2306)
Spline 3	0.9361 (0.2440)	0.8258 (0.2321)	0.8224 (0.1854)	0.7543 (0.1799)	0.9907 (0.2856)	1.1018 (0.2909)
Spline 4	0.9662 (0.1726)	1.0494 (0.1678)	1.0021 (0.2379)	1.0285 (0.2268)	1.1847 (0.2906)	1.1239 (0.2992)
Spline 5	0.8916 (0.1947)	0.8860 (0.1919)	0.8546 (0.2146)	0.8370 (0.2020)	0.7383 (0.2765)	0.8768 (0.2755)
Spline 6	0.9957 (0.1520)	0.8900 (0.1483)	0.8358 (0.2018)	0.8139 (0.1930)	1.1002 (0.2643)	1.0636 (0.2512)
Spline 7	1.1361 (0.1618)	1.1440 (0.1544)	1.3056 (0.1906)	1.3244 (0.1939)	1.0382 (0.2213)	0.8919 (0.1958)
Spline 8	0.8743 (0.1133)	0.8135 (0.1122)	0.8199 (0.1302)	0.7767 (0.1401)	0.8000 (0.1474)	0.8953 (0.1380)
Spline 9	1.0190 (0.0773)	1.0284 (0.0792)	1.0207 (0.0645)	0.9718 (0.0775)	0.9592 (0.1056)	0.8450 (0.1131)
Spline 10	0.9946 (0.0317)	0.9624 (0.0367)	1.0076 (0.0263)	1.0436 (0.0342)	1.0701 (0.0364)	1.1052 (0.0447)
R² / Adjusted R²	0.9096	0.9162	0.8923	0.9056	0.8626	0.8766
# of Obs	1229	1229	1384	1384	942	942
Categories Absorbed	-	62	-	62	-	61

Note: The dependent variable in all specifications is the logarithm of book income summed across relevant years. The percentile splines create separate coefficients depending on the logarithm of taxable income summed across relevant years. Columns 2, 4 and 6 employ industry fixed effects.

**Table 6: Piecewise Linear Regression of Book Income on Taxable Income
with Industry Fixed Effects, 1992-1994, 1995-1997, 1998-2000**

	Earnings-Smoothing Firms			Non-Earnings-Smoothing Firms		
	1992-1994	1995-1997	1998-2000	1992-1994	1995-1997	1998-2000
Constant	1.2383 (0.6463)	2.0452 (0.2573)	2.9492 (0.5058)	1.3308 (0.5457)	2.7289 (0.4368)	2.4859 (0.5010)
Spline 1	0.5950 (0.2472)	0.3673 (0.0898)	0.1806 (0.1430)	0.6395 (0.2515)	0.0802 (0.2096)	0.4503 (0.2332)
Spline 2	1.1182 (0.2608)	1.1662 (0.1845)	1.2951 (0.2963)	0.6115 (0.2432)	0.8189 (0.1964)	0.2631 (0.3181)
Spline 3	0.5037 (0.3286)	0.7375 (0.2063)	0.5001 (0.3719)	0.8447 (0.2442)	0.7807 (0.2901)	0.7671 (0.3013)
Spline 4	1.4327 (0.2740)	1.0750 (0.2999)	1.3600 (0.4390)	0.9654 (0.3519)	0.8755 (0.3312)	1.4259 (0.3657)
Spline 5	0.6570 (0.2250)	0.7543 (0.2737)	0.4971 (0.3181)	1.0318 (0.3084)	1.0981 (0.2787)	0.9210 (0.3382)
Spline 6	1.1333 (0.2493)	1.0672 (0.1892)	1.7572 (0.3039)	0.7238 (0.2155)	0.4744 (0.3604)	0.5751 (0.3955)
Spline 7	1.0332 (0.1946)	0.9333 (0.1858)	0.4019 (0.3154)	1.2591 (0.2243)	1.5830 (0.3078)	1.4016 (0.2877)
Spline 8	0.9188 (0.1113)	0.9695 (0.1464)	0.6261 (0.2888)	0.7336 (0.1787)	0.6411 (0.2304)	0.8319 (0.1804)
Spline 9	0.9860 (0.1422)	1.0733 (0.1049)	1.1190 (0.1636)	1.0461 (0.1095)	0.9444 (0.1095)	0.8093 (0.1503)
Spline 10	1.0162 (0.0570)	1.0260 (0.0440)	1.0885 (0.0672)	0.9285 (0.0508)	1.0567 (0.0528)	1.0879 (0.0680)
Adjusted R²	0.9382	0.9432	0.8896	0.8990	0.8839	0.8817
# of Obs.	535	604	434	694	780	508
Categories Absorbed	55	57	57	60	62	59

Note: The dependent variable in all specification is the logarithm of book income in given years. The percentile splines create separate coefficients depending on the logarithm of taxable income in given years. Columns 1, 2, and 3 report specifications for those firms with a below median ratio of standard deviation of book income to standard deviation of taxable income. Columns 4, 5, and 6 report specifications for those firms with an above median ratio of standard deviation of book income to standard deviation of taxable income.