Abstract - This paper examines the implications for multinational firms of recent proposals to conform tax and financial reporting (i.e., book–tax conformity). Proponents of book–tax conformity argue that the current dual system in the U.S. allows firms to simultaneously manage their taxable income downward while managing their book income upward. By requiring book–tax conformity, they contend that firms will be forced to trade off reporting high earnings numbers to shareholders and reporting low earnings to the taxing authority, resulting in improved financial reporting and less tax avoidance. Reduced compliance costs and easier auditing have also been cited as potential benefits of book–tax conformity.

However, before one can evaluate the costs and benefits of book–tax conformity it is necessary to understand international implications of conformity, particularly regarding the foreign operations of U.S. multinationals. We describe several possible approaches to implementing book–tax conformity for firms that have both domestic and foreign operations. We discuss issues likely to arise with each approach and conjecture at the behavioral responses to each. Using firm–level financial data from Compustat, we simulate the effects of book–tax conformity on publicly traded U.S. firms. Specifically, we simulate the effects of book–tax conformity on the level and variability of tax payments/collections.

INTRODUCTION

This paper examines the implications for multinational firms of recent proposals to conform tax and financial reporting (i.e., book–tax conformity). Proponents of book–tax conformity argue that the current dual system in the U.S. allows firms to simultaneously manage their taxable income downward while managing their book income upward. By requiring book–tax conformity, they argue that firms will be forced to trade off their desire to report high earnings numbers to shareholders and the desire to report low earnings to the taxing authority, resulting in improved financial reporting and less tax avoidance. Reduced compliance costs and easier auditing from having a single set of books have also been cited as potential benefits of book–tax conformity.

We describe several possible approaches to implementing book–tax conformity for firms that have both domestic and
foreign operations. These approaches include: 1) book–tax conformity while retaining worldwide taxation but with no deferral of foreign income, 2) book–tax conformity while retaining both worldwide taxation and deferral of foreign income, 3) book–tax conformity along with territorial taxation, and 4) book–tax conformity with formulary apportionment. We discuss issues with implementing each system and conjecture at the behavioral responses to each. Using financial statement data for the publicly traded U.S. firms, we simulate the tax consequences of book–tax conformity for the first and third approaches. Specifically, we simulate the effects of book–tax conformity on the mean and variance of tax payments/collections. We are not able to simulate the other approaches in the same manner due to data limitations. However, we attempt to provide a rough estimate of the aggregate effect on tax revenues for option 2 (retaining deferral) using aggregate data on reinvested earnings from the Bureau of Economic Analysis (BEA). We also describe in broad strokes what formulary apportionment would look like if implemented.

As with the current system of taxation, many complications emerge when one begins considering how actually to apply a new tax system to multinationals. The goal of the paper is not to spell out all of the details necessary to implement such a system, but rather to give a sense of how book–tax conformity would play out in terms of the numbers both in aggregate and at the firm level, to describe the stress points in implementation that would require additional rules, and to conjecture where behavioral responses could be expected.

We believe that such a study fills a hole in the literature, as book–tax conformity has emerged in policy circles as a potential means to improve efficiency and curb the perceived ability of firms to “have their cake and eat it too.” For example in Professor Mihir Desai’s testimony before the House Ways and Means Committee he states, “More ambitiously, if corporations simply paid taxes on reported GAAP income, significant compliance costs would be nearly eliminated, the top marginal corporate tax rate could be reduced significantly to 15 percent without a loss of revenue, and actions designed to exploit differences between these two reporting systems would be eliminated.”

In addition, the recent Tax Reform Panel established by President Bush considered a proposal to tax large entities based on their net income reported on financial statements. The Tax Reform Panel ultimately did not include book–tax conformity in its set of proposals and instead called for additional research to understand better the consequences of adopting book–tax conformity. The objective of this paper is to provide such research, at least in terms of the international effects of book–tax conformity.

There is limited prior research on the implications of book–tax conformity. Most of the prior research is focused on opportunistic reporting, compliance savings, and U.S. capital market costs. For example, Guenther, Maydew and Nutter (1997) examine the impact of book–tax conformity on firms’ financial reporting and tax planning activities using a small set of publicly traded firms required to increase conformity after the Tax Reform Act of 1986 (TRA 86). Overall, Guenther et al. (1997) conclude that increasing the extent of book–tax conformity causes firms to defer financial statement income. Hanlon and Maydew (2008) examine the accounting implications of book–tax conformity. Other studies, including Hanlon, Laplante and Shevlin (2005), Hanlon and

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1 Statement of Mihir Desai, Testimony before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, May 9, 2006.
Shevlin (2005), and Hanlon, Maydew and Shevlin (2008), examine the potential loss of information when firms are required to increase their level of conformity. The evidence suggests that if conformity were increased there would be a loss of information from earnings to the capital markets, thus illustrating one cost to book–tax conformity.

On the other hand, Desai (2005) argues that because the U.S. system of dual reporting allows (indeed, requires) different computations of income for book and tax purposes, the quality of earnings reported to both the capital markets and tax authorities is reduced by opportunistic behavior by managers. In other words, because managers attempt to maximize financial accounting income and minimize taxable income and are “unconstrained” by the rules in the other system (i.e., the tax and book rules are not conformed), they can act opportunistically, thereby reporting lower income to the tax authorities and also misleading shareholders. ²

Although the U.S. has not implemented an overall regime that closely links the two income measures and, thus, large sample evidence of a regime change is unavailable using U.S. data, several international studies have examined these issues. Ali and Hwang (2000) examine the relation between measures of information content of financial accounting data and several country–specific factors. Ali and Hwang (2000) find that the information content of earnings is lower when tax rules significantly influence financial accounting measurements.³

Ball, Kothari and Robin (2000) also find that valuation in code–oriented countries (i.e., where tax and book incomes are very closely linked) is much less related to reported earnings. Similarly, Guenther and Young (2000) report evidence consistent with accounting earnings in the U.K. and the U.S. being more closely related to underlying economic activity than accounting earnings in France and Germany, where greater conformity is required.⁴,⁵

To date, however, no one has studied the international tax implications of the U.S. moving to a conformed system of taxation. Because multinational firms account for a substantial fraction of total economic activity, the implications of book–tax conformity for these firms in terms of tax planning and reporting, the accounting for income taxes, and the reporting of income under Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) is of great importance.

We note that our analysis assumes that only the U.S. changes to a book–tax con-

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² Note, however, that even under the U.S.’s current system of unconformed incomes, firms may voluntarily conform when committing financial accounting fraud. For example, Erickson, Hanlon, and Maydew (2004) report evidence consistent with firms accused of reporting fraudulent financial accounting earnings simultaneously overstating taxable income and, thus, paying taxes on the overstated income. These results provide one scenario that calls into question the validity of the argument that conforming book and taxable incomes will increase the quality of financial reporting or taxable earnings.

³ This result is consistent with tax laws being influenced by political, social, and economic objectives rather than the information needs of investors. This evidence would lead to the prediction that if book and tax incomes are conformed in the U.S., there would be a loss of value–relevant information in the capital markets. See also, Harris, Lang, and Moller (1994), which examines the value relevance of German accounting measures over a period in which the German accounting rules included a closer link between book and taxable incomes and a greater emphasis on both detailed prescriptive regulations and the needs of debtholders.

⁴ In another study, Young and Guenther (2003) use the degree of book–tax conformity as one of two proxies for the informativeness of financial accounting in a country (low book–tax conformity, higher informativeness) and test whether capital flows into a country are decreasing with increased book–tax conformity. Their results are consistent with this prediction. Thus, another cost of book–tax conformity documented by Young and Guenther (2003) is decreased capital mobility.

⁵ See also, Desai, Dyck and Zingales, 2005; Desai and Dharmapala, 2006a,b; and McClelland and Mills, 2007.
formed system (not any other countries), so that much of the effect of conformity is on domestic income. However, what we discuss and show are some of the complications and issues that arise for U.S. multinational firms with respect to their foreign earnings. Thus, conformity may not be as much of a simplification as some proponents may suggest.

This paper proceeds as follows. The second section provides an overview of how current U.S. Federal taxation differs from U.S. GAAP and describes how taxes, particularly book–tax differences, are reflected in firms’ financial statements. The third section describes several possible approaches to applying book–tax conformity to firms that have both domestic and foreign operations. The fourth section simulates the effects of book–tax conformity on U.S. multinationals using firm–level financial data from Compustat. In this section, we examine the effects of book–tax conformity on the mean and variance of tax collections. The fifth section concludes.

DIFFERENCES BETWEEN HOW THE TAX CODE AND GAAP MEASURE INCOME AND HOW THOSE DIFFERENCES ARE REFLECTED IN FINANCIAL STATEMENTS

Although the tax code requires large corporations to use the accrual method, accrual accounting for tax purposes is not necessarily the same as accrual accounting for GAAP purposes. For example, similar to the financial accounting rules, when a firm makes a sale and receives an account receivable in exchange, income is recognized for tax purposes even though no cash has been exchanged. Likewise, if the firm incurs an expense and does not pay in cash but instead generates an account payable, the amount can still be expensed for tax purposes. However, many differences between accrual accounting for tax purposes and GAAP exist. For example, depreciation is recorded differently for tax purposes, generally following the Modified Accelerated Cost Recovery System, which for many assets results in depreciation at an accelerated pace relative to the straight–line depreciation taken for financial accounting purposes. In addition, there are fewer depreciation methods allowable for tax purposes compared to book purposes.

Some other financial accounting accruals are simply not allowed for tax purposes. For example, the estimates used to record the expense for the warranty expense and bad debt reserve generally are not allowed for income tax purposes. Thus, before deducting an amount for warranty costs the firm must actually pay these costs (the customer must return the product for warranty service and the seller must perform the service). Similarly, bad debts cannot be estimated but rather are only deductible once the debt has actually gone bad (thus, the company is on the specific write–off method for tax purposes).

In terms of international aspects, the tax code operates significantly differently than the rules under GAAP. Under the current U.S. tax system, U.S. resident companies are subject to current U.S. tax on their worldwide income.6 However, no U.S. tax is owed on the earnings of a foreign subsidiary until those earnings are distributed to the U.S. parent in the

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6 Under a worldwide system such as that employed in the U.S., the U.S. taxes the worldwide income of its permanent residents and domestic corporations and uses foreign tax credits to mitigate double taxation of the earnings (we discuss the foreign tax credit further below). This is in contrast to a territorial tax system in which a country taxes only income that was earned within its borders. It is important to note that under the U.S. worldwide system, U.S. corporations are taxed on their worldwide income. However, foreign corporations are taxed only on the income they earn in the U.S. (thus, the U.S. effectively operates a territorial system for foreign corporations).
form of a dividend. The postponement of U.S. taxes until the time of repatriation is commonly referred to as “deferral.” The deferral concept in tax is an important distinction from financial accounting.

For tax purposes, consolidation can be elected, but is not required, when ownership, direct or indirect, of a domestic subsidiary is at least 80 percent in terms of voting power and value. Foreign subsidiaries generally cannot be included in the domestic tax consolidation. Thus, the financial statements will include the income or loss of foreign subsidiaries that are more than 50 percent owned and the representative share of income or loss of foreign entities owned between 20 and 50 percent, while the tax return will not include any of these amounts. Instead the tax return will include any dividends received from these entities while the financial statements will not include these dividend amounts.

Thus, differences between tax and GAAP consolidation can lead to book–tax differences with regards to income from foreign (and domestic) affiliates. If the entity is greater than 50 percent owned by the U.S. parent, the earnings will be part of U.S. worldwide income for financial accounting purposes. However, if the income from the foreign subsidiary is deferred for tax purposes (i.e., not repatriated back to the U.S. and made subject to tax currently), then a book–tax difference will result because book income will include the foreign subsidiary’s income and taxable income will not. Because of the significant tax advantages potentially afforded under the deferral rules, a series of anti–abuse rules have been enacted to prevent U.S. taxpayers from deferring U.S. tax on certain classes of income, such as passive income that could easily be shifted to a tax haven. These anti–abuse rules are contained in subpart F of the Internal Revenue Code (IRC). Essentially, these rules act to restrict the benefits of deferral to the active business income of a foreign subsidiary and, as a result, lessen the book–tax difference attributable to the deferral rules in the current U.S. tax system.

Another provision of the tax code that becomes important in the discussion of international book–tax differences is the allowance of tax credits against a firm’s U.S. tax liability for foreign taxes paid or accrued. While the tax credits themselves are not book–tax differences, a firm’s tax planning in the international arena is often directed toward maximizing the amount of foreign tax credit it can use to offset its U.S. tax liability, all else constant. Because firms have engaged in strategies to shift income to and between foreign sources to maximize the available credit, additional rules have been written in the tax code to 1) prevent the credit from offsetting U.S. tax on domestic–source income, and 2) provide guidance on how to allocate income and expenses between domestic and foreign sources. The tax strategies employed by firms can generate additional book–tax differences and, thus, a discussion of the foreign tax credit rules is necessary here.

Foreign tax credits are allowed to mitigate the double taxation that would occur when foreign–sourced income is earned by a U.S. company because the income would be taxed in both the foreign country in which it was earned and in the U.S., where the company is incorporated. The U.S. also has foreign tax credit limitation

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7 There are exceptions (e.g., Subpart F income rules) that will be discussed below.
8 If the foreign subsidiary had income effectively connected with a U.S. trade or business, then that income would be subject to U.S. tax; however, the foreign subsidiary still would not be part of the tax consolidation with the U.S. parent.
9 Another difference between tax and book consolidations is that intercompany transactions are eliminated for book purposes while they are deferred for tax purposes and the accompanying investment basis adjustment rules mimic the equity method of financial reporting.
rules which, in general terms, limit the foreign tax credit to the U.S. tax rate times the foreign source income calculated according to U.S. tax rules. Thus, the foreign tax credit after limitation is the minimum of foreign income taxes paid and the foreign tax credit limitation (i.e., U.S. tax rate times the foreign source income).

An important consideration for the foreign tax credit limitation is, of course, the delineation of what is foreign source and domestic source income—how are these measures derived for tax purposes and how do they compare to the domestic pre-tax book income and foreign pre-tax book income reported for financial accounting purposes? There are very detailed rules for the sourcing of income, including expense allocation, for the computation of the U.S. foreign tax credit purposes. Adding such rules to U.S. GAAP (or IFRS) would be a major addition to the accounting standards and deleting them from the tax code would create a large divergence from the current foreign tax credit computation.

In sum, taxable income will differ from book income because of different accrual rules and different consolidation rules. Where the income of a firm is earned or where the assets are located is of lesser importance for financial accounting purposes, as the consolidation rules in financial accounting do not distinguish between domestic and foreign subsidiary-}

ies. This is very different from the tax code, in which the source of income matters because of differing taxing jurisdictions and the need to mitigate double taxation across these jurisdictions through the use of a foreign tax credit.

**IMPLEMENTATION APPROACHES TO BOOK–TAX CONFORMITY IN AN INTERNATIONAL SETTING**

It is important to consider the manner in which conformity would be accomplished. The often-heard refrain “the devil is in the details” is particularly appropriate here. In this section we consider how book–tax conformity could be implemented in the context of taxing multinational firms. We describe four different approaches to implementing book–tax conformity. These approaches include: 1) book–tax conformity while retaining worldwide taxation but with no deferral of foreign income, e.g., Altshuler and Grubert (2008), 2) book–tax conformity while retaining both worldwide taxation and deferral of foreign income, 3) book–tax conformity along with territorial taxation, and 4) book–tax conformity with formula apportionment. Finally we discuss 1) the implications of book–tax conformity using any of these approaches coupled with adoption of International Financial Reporting Standards (IFRS), 2) potential areas for partial conformity, and 3) some

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10 For tax purposes, IRC §§ 861–865 deal with the allocation of worldwide income to U.S. source versus foreign source. These rules provide definitions for income from sources within the U.S. (§861—e.g., what types of interest income, dividend income, personal services income, rentals and royalties, gains and losses from real property or inventory, and others) and without the U.S. (§862—e.g., generally interest income, personal services income and dividends not classified as from the U.S. in §861, rentals and gains and losses from real property located outside of the U.S., and others). There are also special rules (under §§863–865, and the regulations thereunder) for determining the source of income for items not listed in §§861 and 862. For example, IRC §864 provides, among other things, rules for allocating interest expense. In general, interest expense incurred in the U.S. is allocated between U.S. and foreign income on the basis of the value of the taxpayer’s assets (book or market) that generate U.S.–source and foreign–source income. Interest expense allocated to foreign–source income reduces the foreign tax credit limitation by reducing the amount of foreign source income for foreign tax credit purposes. It is important to recognize that these rules affecting the source of income for foreign tax credit computation purposes affect the tax liability through their effect on the foreign tax credit limitation, but they do not alter the amount of taxable income reported on the U.S. tax return under the current system of worldwide taxation.
areas where transition rules would be particularly important.

**Considerations Applicable to All of the Possible Approaches**

**Who Will Determine the Rules and How Will Firms Respond?**

With each of the approaches to book–tax conformity, an over–arching question is whether taxable income would be conformed to financial accounting income or whether financial accounting income would be conformed to taxable income. Even this question is likely not as simple as it seems. Most proposals and conjectures would call for the use of financial accounting income to compute taxable income (i.e., taxable income would conform to GAAP). If the FASB were retained as the primary standard setter of GAAP, this would effectively put the FASB in charge of writing the tax laws for entities that would be subject to book–tax conformity. Under this scenario, presumably the Congress would still determine the tax rates, but the tax base in terms of business income would be determined by the FASB (or the International Accounting Standards Board if the U.S. moves to International Financial Reporting Standards).11

Would Congress be able to resist the temptation to interfere with the FASB in its new role? Hanlon and Shevlin (2005) argue that in practice the eventual result would be for Congress to begin tinker–ing with GAAP for the same fiscal and social policy reasons that it cites now when it amends the current tax code. The end result could be a GAAP that looks much like the current tax code. Indeed, as economist Milton Friedman observed, the end result of base broadening is just a renewed opportunity for lawmakers to sell old tax preferences (Thorndike, 2006).

At a minimum, Congress would likely require some say into who is appointed to the FASB; currently the government plays no role in their selection.

Even in the absence of Congressional interference in GAAP, it is likely that firms’ motivations to reduce their tax payments would cause them to alter their accounting choices, even while staying within GAAP, to achieve better tax treatment (Guenther et al., 1997). We label management’s altering (lowering) of their financial reporting income to reduce tax payments as the behavioral response to book–tax conformity.

In our simulations, we assume that taxable income will be conformed to book income as it is currently reported. Thus, our simulations assume the current accounting standards will be used to determine the one income measure that is reported to both shareholders and the tax authorities and that there will be no behavioral response by firm management.

**What Entities Will Be Subject to Book–Tax Conformity?**

Another over–arching question is what entities would be subject to book–tax conformity. Would all corporations be subject to book–tax conformity, only corporations over a certain size threshold, or only publicly traded corporations? Would large partnerships and S corporations be subject to book–tax conformity? What about sole proprietorships? If book–tax conformity was not applicable to all businesses, then the tax code would need to be retained for the companies to which it would not apply. On the other hand, if book–tax conformity did apply to all companies, the GAAP rules would need to be applied by all the companies for which it is currently not required (e.g., non–public entities).

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11 In addition, the current set of tax treaties that the U.S. is party to would need to be re–examined and perhaps renegotiated.
What About Losses?

In addition, all methods of book–tax conformity would have to confront the issue of losses. Under GAAP, if a firm has negative income for a period, it simply reports negative income. Losses are not carried backward or forward under GAAP. The tax code, in contrast, allows for net operating loss (NOL) carrybacks and carryforwards so that firms can offset income and losses. Under current law, NOLs can be carried back two years and forward up to 20 years. Without the opportunity for NOL carrybacks and carryforwards, asymmetric taxation can result as firms pay taxes in years they have positive income but get no tax relief from years in which they have negative income. Firms in cyclical industries would face heavier tax burdens over their life than would firms in stable industries. To avoid this result, it seems likely that NOL rules would need to be appended to GAAP for tax purposes. To preserve the informational role of financial statements, the effects of NOL carrybacks and carryforwards on the income statement would need to be confined to their effects on tax expense, so that pre–tax income would reflect that of the current period. Accordingly, our simulations allow for NOLs based on GAAP pre–tax income. To keep the simulations manageable we allow for losses to be carried forward indefinitely and we do not allow losses to be carried back.

How to Deal with Transactions that Currently Qualify for Non–Recognition?

Finally, an issue with all of the approaches is whether to preserve any of the current non–recognition provisions in the tax code, which are not currently in GAAP, and if not, how to make sure reliance on GAAP does not open up massive opportunities for tax avoidance. For example, the current tax code allows for certain transactions to be non–taxable, or more properly viewed as tax–deferred. Common examples include acquisitions and divestitures under Section 368, like–kind exchanges under Section 1031, and corporate formations under Section 351. Under these provisions the gain in the transaction is deferred for tax purposes, but the basis is not stepped up except to the extent that gain is recognized.

For example, suppose that firm A acquires all of the stock of firm B in exchange for A stock in a transaction that qualifies for non–recognition under Section 368. Neither firm B nor the shareholders in firm B will recognize any taxable income in the transaction itself. However, firm B’s assets will keep the same tax basis that they had immediately before the transaction; the tax bases will not be stepped up to fair market value. This preserves the potential for future corporate level taxation of the gains built into B’s assets. Moreover, former shareholders of B who now hold A stock instead will take the same tax basis in A stock that they used to have in their B stock (i.e., a substituted basis). This preserves the potential for future investor level taxation of the gains that B shareholders had in their B stock.

The closest analogy in GAAP to the non–recognition rules in the tax code was pooling of interests accounting, which is no longer allowable. In a pooling transaction, an acquirer would purchase a target firm in a stock–for–stock exchange. The assets of the target firm would then be reflected on the balance sheet of the acquirer not at their fair market value, but at the same book values they had previously had on the target’s balance sheet. In contrast, purchase accounting, the only method currently permissible under GAAP for business combinations, results in the target’s assets and liabilities being recorded at fair market value on the balance sheet of the acquirer. Often this results in the recording of goodwill and other intangible assets to the extent the purchase price exceeds the fair

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market value of the tangible assets less liabilities.\textsuperscript{12}

With purchase accounting as the only option for business combinations under GAAP, strict adherence to book–tax conformity would seem to eliminate the ability to acquire businesses via tax deferred methods. Selling shareholders and corporations would have to recognize gains and losses for tax purposes for the difference between their tax basis and the fair market value of the consideration received, even in pure stock–for–stock acquisitions. To the extent capital allocation is improved by allowing acquisitions that defer taxation, there could be an efficiency loss associated with strict adoption of purchase accounting for tax purposes. On the other hand, if purchase accounting was retained for GAAP but exceptions were made to allow for different methods for tax purposes, that would lead to the return of book–tax differences following acquisitions and would undercut many of the perceived benefits of book–tax conformity. Since our simulations are based on the financial statements of publicly traded companies, the numbers will include the effects of purchase accounting acquisitions and, thus, implicitly allow tax depreciation for basis step–ups on which no tax was paid.

Worldwide Taxation with Book–Tax Conformity: No Deferral of Foreign Income

Implementation

The first and most straightforward option (at least on its face) is to simply adopt GAAP as the basis of taxation in its entirety. Because GAAP counts income when it is earned regardless of whether it is earned in the U.S. or abroad, this would maintain the current worldwide system of taxation but without the deferral of foreign income of foreign subsidiaries. It is important to note in this analysis that because there would be no deferral of foreign earnings, the U.S. taxation of the earnings of foreign subsidiaries would be accelerated. Thus, this first approach will have a different (broader) tax base both because of the elimination of book–tax differences and the elimination of deferral (because deferral is a book–tax difference in some sense). However, this type of a system would allow foreign losses, if they exist, to offset domestic income, which is currently not allowable. For publicly traded firms, this approach would be equivalent to taking the total worldwide pre–tax income from the firm’s 10–K and using that as taxable income.

If we desire to retain a system in which we allow tax credits to mitigate the effect of double taxation, we would continue to allow for a foreign tax credit against the U.S. tax. If we retain a foreign tax credit, we would need to either retain income and expense sourcing rules similar to those currently in the tax code (see footnote 10 above) either as a separate system outside of GAAP or require FASB to include these rules within GAAP. A foreign tax credit under this approach to implementing book–tax conformity would be somewhat indirect because unless the financial accounting rules are the same worldwide and book–tax conformity is implemented worldwide (i.e., all countries use the same rules for both accounting and tax purposes) it is likely that the income included on the U.S. financial statement for the foreign subsidiaries would be different than the income reported for foreign tax purposes in the foreign jurisdiction. Thus, the credit system would be imperfect at offsetting double taxation year to year in the sense that it would not give a credit for foreign taxes paid or deemed paid on the exact dollar of earnings reported in the U.S. in the same period it is reported

in the foreign jurisdiction. The reason is that that the income could be recognized in the U.S. before or after it is included in taxable income in the foreign tax jurisdiction. However, over the life of the firm, theoretically a foreign tax credit system should accomplish the goal of mitigating double taxation.

Predictions and Behavioral Response

In this section we make predictions regarding the outcome of implementing book–tax conformity in the manner outlined above. Later in the paper, where possible, we evaluate these predictions through simulations using firm–level financial data. It is important to keep in mind, however, that the data in the simulations are from the current system of taxation and financial reporting and, thus, do not take into account any behavioral response on the part of firms to a system of book–tax conformity. Thus, the simulations are not so much tests of hypotheses as they are calculations designed to shed light into some of the likely effects of book–tax conformity. We do, however, discuss how we think firms will change their behavior when faced with book–tax conformity.

We predict that book–tax conformity based on worldwide income with no deferral would broaden the tax base relative to the current system of taxation. There are three reasons for this prediction. First, as stated above, ending deferral would likely increase the tax base. Second, the incentives of managers are to report a higher book income to shareholders and lower taxable income to the taxing authorities and these incentives will be reflected in the data (i.e., financial accounting earnings will be higher because of managerial incentives). Third, GAAP has over time moved gradually from being based on historical cost accounting to being increasingly based on estimated fair market value. If the market value of a firm’s net assets (assets less liabilities) is increasing, then an accounting system based on market values will, on average, produce higher earnings than historical cost accounting. However, we note that there is also an alternative property of financial accounting that works in the opposite direction. Financial accounting rules are conservative (expenses are generally recognized before gains) and income tax rules are not (future expenses cannot be estimated and deducted currently). This conservatism will work against the base being broadened.

Our other prediction concerns the variability of tax collection under book–tax conformity. The concept at work here is that earnings represent the sum of cash flows and accruals. Prior research shows that changes in cash flows and changes in accruals are negatively correlated; that is on average, accrual earnings are much smoother than cash flows. Therefore, if the tax system was replaced with one based on GAAP earnings that include more accruals, we would expect that the tax base would exhibit less variation over time.

As mentioned above, the behavioral response common to all methods of book–tax conformity is that if financial accounting were used as the base for the measurement of taxable income, firms would have incentives to reduce the amount of income reported for financial reporting. Thus, while we predict that book–tax conformity would broaden the base using the data available to us, our estimates of how much broader the base would be (if at all) are overstated because

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13 This shift has occurred piecemeal as some assets and liabilities on the balance sheet are reflected at historical cost while others are recorded at market value. Because earnings arise from changes in assets and liabilities, the methods used to record assets and liabilities can affect earnings.
firms would likely begin reporting lower income for financial accounting purposes, thus reducing the base relative to what our estimates will show (for empirical evidence on this issue, see Guenther et al. (1997)).

In addition, as with the current tax system, a behavioral response could arise under the conformed system because, even though worldwide income would be currently taxable by the U.S., there would be incentives to shift income across jurisdictions in order to maximize the foreign tax credit (assuming all countries did not adopt the same system). This is much like the incentive that firms currently have under the tax law. In other words, more foreign-source income for U.S. tax purposes that does not actually trigger foreign taxes (because of differing source of income rules between the U.S. and the foreign jurisdiction) will increase the foreign tax credit limitation and thereby allow more foreign taxes to be creditable if the firm faces a binding foreign tax credit limitation (binding foreign tax credit limitations are common among U.S. multinationals). If the U.S. corporate tax rate was reduced as a result of base broadening under book–tax conformity, more firms would face binding foreign tax credit limitations, which would accentuate this type of behavioral response. Thus, although worldwide income would be taxed in the U.S. under this system, income shifting would still be attractive to maximize the foreign tax credit. There would, of course, be cross-sectional variation in how attractive the income shifting would be under such a system based on the amount of base broadening for the firm and whether the firm had a binding foreign tax credit limitation.

Worldwide Taxation with Book–Tax Conformity: Allowing for Deferral of Foreign Subsidiary Income

Implementation

A second manner in which book–tax conformity could be implemented would be to conform U.S. taxable income to U.S. GAAP but to continue allow for deferral of taxation on foreign earnings until they are repatriated as dividends to the U.S. parent company. This would mean there could be timing differences between when foreign subsidiary income would be recognized for GAAP and tax purposes. Thus, foreign income would not be included in U.S. taxable income and the current foreign tax credit system would operate as it does under the current system. Here we will assume that this system would be implemented by not allowing foreign subsidiaries into the U.S. tax consolidation. This would produce a different consolidated group for GAAP and tax purposes even though there would otherwise be book–tax conformity. That is, foreign entities would only be subject to U.S. tax on their U.S. source earnings and would use GAAP to determine those earnings. The foreign income of foreign subsidiaries would not be subject to U.S. taxation until repatriated to a U.S. shareholder (e.g., U.S. parent). If the income were repatriated, its amount would be determined under GAAP. In addition, there would likely be a demand for rules to prevent deferral of passive income, similar to the Subpart F rules in the current tax law.

Predictions and Behavioral Response

Relative to the current system of taxation, our predictions under this approach

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14 For papers that examine the capital market effects of this type of behavioral response, see Hanlon and Shevlin (2005) and Hanlon, Maydew and Shevlin (2008).

15 Thus, as stated above, the importance of the identity of the source of income would either require additional rules in GAAP to specify where income is earned or a separate system of rules outside of GAAP (e.g., a mini–tax code). Currently GAAP does not have detailed rules to determine the source of income.
are in the same direction as the first approach. That is, relative to the current system we expect that moving to book–tax conformity on a worldwide basis with no deferral would: 1) broaden the tax base (but less so than option 1 above), and 2) result in less variation over time in aggregate tax collections. Unfortunately we lack micro data on reinvested foreign earnings and, thus, are unable to test these predictions. We do, however, provide some evidence in the simulations section of the paper of the effects of deferral on the tax base using aggregate data on reinvested foreign earnings. This is useful because as discussed above shifting from the current system to worldwide conformity with no deferral of foreign income turns two “dials” at once: conformity and eliminating deferral of foreign income. The second approach turns only one dial relative to the current system: conformity.

In terms of the behavioral response, similar to the first approach to conformity discussed above, the second approach would place greater pressure than currently exists for GAAP to have rules to determine where income is earned. As in the current system and in the first approach, firms would have an incentive to shift income for U.S. foreign tax credit purposes to create more foreign source income to increase the foreign tax credit limitation. In addition, firms could also have incentives to make sure their foreign source income is reported in foreign subsidiaries and not in domestic subsidiaries to keep the income out of the domestic consolidation and defer U.S. tax on the foreign income (similar to incentives in the current system). Transfer pricing between domestic and foreign subsidiaries could be a strategy employed. GAAP would need to be enhanced to specify rules for transfer pricing. Transfer pricing incentives issues are mitigated under current GAAP to some extent by consolidating entities under common control, regardless of whether they are domestic or foreign, and then eliminating intercompany transactions (e.g., no income is reported in the consolidated financial statements under GAAP if subsidiary A sells something to subsidiary B). If foreign subsidiaries were not consolidated for tax purposes, then even though their taxable income was otherwise determined using GAAP rules, that would give rise to incentives to manage transfer pricing to reduce the overall tax burden of the larger group of controlled entities.16

**Territorial Taxation with Book–Tax Conformity**

**Implementation**

The third option for book–tax conformity would be to adopt it in conjunction with a territorial tax system. Note that territorial taxation would generally be consistent with the proposals in President’s Advisory Panel on Federal Tax Reform (2005). Under this type of system, the conformity would then be that U.S. taxes would be based on U.S. domestic source financial accounting income, but foreign source earnings would not be taxed by the U.S. Accordingly, foreign source losses could not be used to offset domestic income.

A move to territorial taxation based on GAAP would require additional rules in GAAP to determine the source of income, similar to the approaches above. Indeed, the territorial option would likely place...
the most strain on these rules because foreign–sourced earnings would never be taxed in the U.S. Shifting income to low–tax jurisdictions would permanently reduce the aggregate tax burden of the group. Under this approach, GAAP would have a consolidated group consisting of the same entities as the tax consolidated group. However, only domestic–source income from the entities would be included for tax purposes, whereas worldwide income would be included for GAAP, creating a permanent book–tax difference for foreign–sourced income.

Predictions and Behavioral Response

Relative to the current system of taxation, we cannot predict ex ante what the effects of book–tax conformity with territorial taxation would be in terms of the tax base. While moving to conformity should broaden the tax base, moving to territorial taxation should reduce the tax base. Although we do not predict the net effects of this approach, we can and do provide empirical evidence of what such a system would look like. Specifically, in the fourth section, we use micro data from publicly traded firms to simulate book–tax conformity with territorial taxation.

In terms of the behavioral response, several studies have examined the effects of moving to a territorial tax system (see Merrill, Eckstein, Grosman, and van Kessel (2006) and Altshuler and Grubert (2001) as examples). We do not re–examine this issue here except as it might interact with book–tax conformity. While many studies on the effects of territorial taxation conclude that there would likely not be an increase in foreign investment at the expense of domestic investment, income shifting using transfer pricing or other non–real investment methods (especially for passive–type income) would likely be an issue. For the purposes of our examination of using GAAP as the basis for tax, the concern is that GAAP currently has very minimal rules regarding the source of income, whereas territorial taxation places a lot of emphasis on the source of income. This discrepancy would need to be resolved either through much more rigorous rules added to GAAP or the maintenance of a tax code to supplement GAAP with these rules.

Worldwide Book–Tax Conformity Combined with the Use of a Formulary Apportionment System

Implementation

This approach would combine book–tax conformity using worldwide income with the method that U.S. states use to apportion income among them. Instead of attempting to determine the source of income, a firm’s income would be apportioned among jurisdictions based on a formula. The traditional formula used by the states apportions income based on property, payroll and sales. For example, suppose firm A was being taxed by State Z and had ten percent of its sales in State Z, 30 percent of its property in State Z and 50 percent of its payroll in State Z. Assuming State Z’s apportionment formula weighted each of the factors equally, then 30 percent of firm A’s income would be taxable by State Z \[ \frac{(10\% + 30\% + 50\%)}{3} \]. An advantage of formulary apportionment is that one does not need to try to figure out where income is sourced. In that sense formulary apportionment would go well with taxation based on GAAP

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17 U.S. states can use different weightings. Over time, tax competition among the states has caused many states to weight the sales factor more heavily than the property and payroll factors, to reduce the tax burden on in–state producers and increase the tax burden on out of state producers (see Goolsbee and Maydew (2000) and Anand and Sansing (2000)). In particular, many states double weight the sales factor and some states base apportionment solely on the sales factor.
income because determining the location where income is earned is not a major emphasis of the rules in GAAP. Moreover, the ability to shift income into low-tax jurisdictions is mitigated under formulary apportionment because to shift income to the low-tax jurisdiction, the firm would have to shift factors, property, payroll and/or sales to the low-tax jurisdiction.

Complications still arise with formulary apportionment, to be sure. For example, with formulary apportionment one needs to determine where to count sales for purposes of the sales factor. There can also be complications with where payroll and property are located, as employees have been known to travel and some property is mobile, but arguably these complications are less cumbersome than those that arise with attempting to source income.

Predictions and Behavioral Response

Relative to the current system of taxation, we do not venture predictions on what effects of formulary apportionment coupled with book-tax conformity would have on the tax base or on firms’ after-tax earnings. In terms of empirical evidence, we are also limited by the fact that firms’ financial statements typically do not include the distribution of property, payroll and sales across domestic and foreign sources. Therefore, we are unable to use micro data from the financial statements to simulate the effects of this approach.

In prior literature, Shackelford and Slemrod (1998) estimate the revenue consequences of using formulary apportionment for 46 U.S. multinational firms from 1989–1993. They use data from financial statements to obtain an estimate of taxable income and the asset and sales factors from geographic segment data. In addition, they obtain an estimate of the payroll factor by industry from the 1989 Bureau of Economic Analysis Benchmark Survey. They estimate that, ignoring behavioral responses, shifting to an equal-weight, three-factor formula would have increased these 46 firms’ U.S. tax liabilities by 38 percent, with an 81 percent increase for oil and gas firms. They find that the firms report a lower percentage of their worldwide profits as U.S. profits than their share of assets, sales, or payroll. The segment data used by Shackelford and Slemrod (1998) is generally not widely available post 1997 (after the implementation of SFAS 131) and, thus, we cannot conduct a firm-level analysis using more recent data.

To shed light on the behavioral response to book-tax conformity coupled with formulary apportionment, one can look at how firms respond at the state level. Some types of state-level tax planning involve transactions with subsidiaries that are not taxable in a particular state due to issues of nexus. For a firm to be taxable by a particular state, it must have sufficient contact with the state, i.e., nexus. Thus, sometimes firms can reduce their state tax burden by simply avoiding nexus with certain states or causing only certain of its subsidiaries to have nexus with a given state. We expect nexus to be less of an issue at the federal level, especially when coupled with book-tax conformity, which would consolidate entities that are under common control. It would be hard for a large multinational to avoid nexus with the entire U.S., and because its controlled entities would be consolidated for both book and tax purposes, this would mitigate the ability to avoid taxes by shifting income across entities.

Other Items


Another possibility for implementing book-tax conformity would be if all or many countries that have adopted or are adopting IFRS also adopted book-tax conformity. This creates a variation of each of the prior four options where instead
of book income being defined by U.S. GAAP, book income (and, thus, the tax base) would be defined by IFRS. The main advantage of coupling book–tax conformity to international accounting standards would be having one set of accounting rules for both book and tax purposes and for all countries that so adopted.

An advantage to having multiple countries using the same rules is that the foreign tax credit would more accurately mitigate double taxation on a year–to–year basis. For example, assume Company X reports $200 of earnings under IFRS. Further assume that $140 is designated as domestic–source income and $60 is designated as foreign–source income. Forty dollars of this foreign–source income was earned in France and $20 in Ireland. Now if the U.S. taxes total worldwide income then $200 will be taxable in the U.S. whether repatriated or not. Because all countries would be on IFRS and have a conformed book–tax system (again assuming no country–specific adjustments in the conformity process) and assuming the sourcing of income rules were the same, the company’s taxable income in France would be $40 and their taxable income in Ireland would be $20. As a result, the U.S. could allow for foreign tax credits on taxes paid on foreign sourced earnings that would align annually between the foreign sourced income taxed in the U.S. and abroad.

Of course, the main hurdle with such a program would be obtaining buy–in from the various countries, similar to issues the EU faces with a number of decisions. Small low–tax countries (i.e., tax havens) in particular may be reluctant to endorse such a system if they perceive that they are the beneficiaries of the current system of taxation.

Partial Conformity

While many of the proposals are about conformity in general, we recognize that partial conformity would be a more likely policy option. The challenge with this option, however, is deciding which book–tax differences to eliminate. One item that seems to pose little harm in terms of both information loss to investors or revenue to the government would be the elimination of the uniform capitalization rules in IRC Section 263(A). If Section 263(A) were eliminated for tax purposes and inventory costing done for both book and tax purposes as firms currently cost their inventory for book purposes, there likely would be 1) no change in the information set available to investors, 2) a decrease in compliance cost, and 3) little lost in terms of revenue. 18

There are many other potential book–tax differences, but most would involve a trade–off of information for investors and revenue and control for the government. For example, items such as the allowance for doubtful accounts could be conformed. If conformed to the tax method of allowing only specific write–offs, investors will not receive information from managers regarding the proportion of current receivables that are expected to be uncollectible. However, if tax were to conform to the financial accounting method of estimating the amount to expense, the government would suffer a revenue loss and be subject to deductions based on management expectations, which would be more difficult to verify and audit (Hanlon and Shevlin, 2005).

Transition Rules

Such a large–scale policy and reporting change would require an extensive set of transition rules. For example, if a firm had recorded depreciation differently for book and tax on a previously purchased asset and the rules were changed so that strict book–tax conformity was required, firms would be allowed double deductions for depreciation if accelerated depreciation

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18 We thank Peter Merrill for suggesting this item in particular.
were allowed for tax purposes prior to the change and then the remaining book basis were depreciated following the rule change. Some transition rule would be necessary to prevent tax deductions for the same basis twice. Another example pertains to accruals made for financial reporting prior to the tax deduction (e.g., reserves for bad debts, warranties). In this case some transition rule would need to be considered for firms to obtain the deduction for tax purposes. Consideration of how these transition rules would work specifically is beyond the scope of this paper but would be important should conformity be enacted.

ESTIMATED ECONOMIC EFFECTS OF BOOK–TAX CONFORMITY

In this section, we estimate the effects of book–tax conformity for those approaches where we have sufficient data to permit reasonable estimation. We use firm–level financial statement data for publicly traded firms. These data are sufficiently detailed to allow us to simulate book–tax conformity under the first approach above, which would adopt book–tax conformity on worldwide income with no deferral of foreign income, and the third approach, which would adopt book–tax conformity in conjunction with territorial taxation. We do not have micro data on reinvested foreign earnings and, thus, cannot perform the same kinds of simulations for the second approach, book–tax conformity on worldwide income with deferral of foreign reinvested earnings. However, we do present some macro data relevant for that approach.

As part of the estimations, we simulate the new U.S. tax rate that would be required to make the book and tax conformed system revenue neutral (note that these are static estimates). We also compute the volatility of the tax revenue stream under the current and conformed systems. We do not attempt to simulate the behavioral effects of the adoption of book–tax conformity in general or the efficiency effects of resulting lower marginal tax rates.

Data Limitations

There are, of course, data limitations in computing these estimates. The first issues arise in the computation of book income. Under the current U.S. financial accounting rules, the income statement of the firm will show revenues and expenses and then the net of these before tax expense is called pre–tax book income. The next expense shown on the income statement is the income tax expense (both current and deferred) related to the pre–tax book income from continuing operations. Below this pre–tax book income number are several items reported net of tax (both current and deferred)—the cumulative effect of an accounting change, extraordinary items, and discontinued operations. In our analysis, we make no adjustments for these net of tax items. We are not advocating that these items be tax exempt in a book–tax conformed system. However, due to data limitations, attempting to adjust for net of tax items could distort our analysis more than it would improve it. For example, we do not know the gross amount of income or expense for these items. Only the amount net of tax is reported in Compustat and the amount of tax is not disclosed separately. We could gross all of these items up by the statutory tax rate to estimate the gross amount of the income and expense, but this would introduce measurement error into our computation of book income.

Perhaps even more problematic with trying to adjust for the net of tax items is that to compute revenue neutrality we assume that the firm’s U.S. current

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19 Both the reserve for bad debts and the reserve for warranty expense are discussed above.
tax expense is the amount of U.S. taxes actually owed or paid on the current year’s income (we discuss the problems and benefits of this assumption below). Because the tax expense line on the firm’s financial statement includes only taxes on pre-tax book income, this number will not include the taxes on the extraordinary items, the discontinued operations, or the cumulative effect of accounting changes. Thus, if we adjusted income for the net of tax items, our benchmark measure—current tax expense—would be understated to the extent our firms had current taxes on these items and overstated to the extent our sample firms reduced their current tax liability with losses generated by these items. As a result, we would not be making a valid comparison (or computation of a revenue-neutral rate). In addition, we do not know the extent to which the taxes on these items are current or deferred or even which portion is U.S. or foreign, so trying to adjust the current tax expense to be comparable with any income adjustment we could make would be nearly impossible. Thus, we opt to leave the income (loss) from the cumulative effect of accounting changes, extraordinary items, and discontinued operations out of our pre-tax book income number. Based on descriptive data in our sample, only 8.7 percent of the sample has non-zero or non-missing amounts for any of these three items and the average of the three amounts is only -1.3 percent of pre-tax book income.

Another set of issues that arise in the computation of book income stem from how ownership of other firms is reported under GAAP and, thus, on Compustat. Many of the ownership/consolidation rules are discussed above and we discuss here how these specifically affect our computation of book income for our aggregate calculations. Most important is the potential for double counting of income. There are many cases where the same income is reported and filed on two separate 10-Ks (and is included in Compustat twice as a result). To the extent possible we try to eliminate this double counting. We discuss each case in turn below.

First is the case where one company owns more than 80 percent of another company and the remaining shares (or company debt) of the owned company are publicly traded. To eliminate double counting, we exclude all firms from our sample with a stock ownership code in Compustat (STK) that indicates it is a subsidiary of another publicly traded company (STK=1). As a result, in our analyses we only tax the income of the subsidiary one time and that is in the income of the parent (GM in this case).

Second is the case where one company owns between 20 percent and 50 percent (inclusive) of another company—for discussion purposes let’s say Company X owns 40 percent of Company Z. As described above, under such conditions Company X records 40 percent of the net income of Company Z on Company X’s financial statements under the heading “Equity earnings (loss) of affiliates.” As long as Company Z is publicly traded (its equity or debt), it will also file financial

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20 This is a disclosure code in Compustat and, thus, probably not 100 percent accurate. For example, we looked up Kraft Foods, which was approximately 85 percent owned by Altria, and it did not have an STK code of 1. However, we looked up several other companies (e.g., GMAC, General Electric’s subsidiaries, and others) and found all of these to have a code of 1. In addition, we believe this code to apply to only subsidiaries more than 50 percent owned. To investigate we looked up DirecTV which is 33.8 percent owned by News Corporation and it did not have a code indicating it was a subsidiary.

21 We note that because we exclude subsidiaries of publicly traded companies from the sample, there is no adjustment necessary for minority interest because Compustat’s data item #170 will (generally) not have minority interest subtracted from it (Compustat reports this number as a below data #170 item). Thus, 100 percent of the subsidiary’s income remains fully taxed under our computation.
statements with the SEC showing 100 percent of its income. There are at least two possible ways such investments could be treated under a book–tax conform system. The first is to subject the equity earnings recorded in Company X’s financial statements to tax under the assumption of strict book–tax conformity (no book–tax differences for Company X). This treatment results in the equity earnings being taxed to X and to Z because Z will be taxed on its full pre–tax book income as well. We take this approach in the simulations by making no adjustments to the investor’s pre–tax book income (Company X in our example). The second option is to exempt the equity earnings in affiliates from taxation and continue to tax 100 percent of the Company Z’s pre–tax book income as reported on their 10–K. This treatment would be consistent with the concept of not double taxing investment earnings. However, doing this creates a (permanent) book–tax difference for Company X. As a result, we do not take this approach in our simulations.22

For entities that are owned 20 percent or less and are classified as trading securities, any changes in market value to the securities are included in the book income of the entity that owns the security under current GAAP rules. We include this mark–to–market income in the book–income number we use, assuming strict conformity. Note that the actual income (not market–value based) of the partially owned company will also be taxed when that firm’s own 10–K is subjected to taxation. Conceptually we would back out this mark–to–market income from pre–tax book income in our secondary analysis below to prevent taxation of investment income. However, there is no data item in Compustat that allows us to parse this income item out and as a result we do not adjust for this item. More broadly, how mark–to–market issues will be dealt with in a book–tax conformity system is beyond the scope of this paper.

**Sample**

Because the simulations assume no book–tax differences and no behavioral response on the part of the firms, we use the pre–tax book income number reported on firms’ 10–Ks in our main analysis. To conduct the analysis we first pull a sample of firms from Compustat with the requisite data. We start with all U.S. incorporated, non–financial firms on Compustat that are not subsidiaries of another publicly traded firm (STK not equal to 1) and have assets greater than zero during the years 1995–2004 (10,912 firms and 68,143 firm years). We then eliminate all observations that are ADRs, LPs, and Trusts, because of the different tax rules for these firms (and, thus, additional problems with the use of current tax expense disclosures), and we also eliminate observations with CUSIPs ending in “Z” or “Y” to help eliminate double counting of firms that have redundant data in Compustat.

We then delete observations for which we cannot obtain measures of worldwide, U.S., and foreign components of the firm’s current tax expense, total tax expense, and pre–tax book income. Finally, we exclude observations that have an interrupted time series of data in Compustat because we cannot compute net operating loss carryforwards over the missing years. For these observations we include the longest continuous string of data available. The final sample consists of 53,477 firm–year observations from 10,185 firms.

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22 We note that under the current unconformed system, equity earnings are not taxed to the parent when recorded for financial accounting purposes, but any dividends paid from the investee to the investor are taxable, subject to the dividends–received deduction. Under book–tax conformity the dividends would be fully exempt from taxation at the parent level because they are never included in book income.
Simulations of Worldwide Taxation with Book–Tax Conformity: No Deferral of Foreign Income

Table 1 presents simulations under a book–tax conformed system with worldwide taxation and no deferral of foreign income. We perform the simulation under both revenue neutrality and with the current statutory tax rate. For the revenue–neutral scenario we compute a new statutory tax rate that results in the same aggregate tax revenue to the government over the sample period as under the current system. For the current statutory tax rate scenario we hold the statutory rate at 35 percent and apply it to the new, conformed tax base.

Several assumptions go into these estimates. When we compute a rate to keep the system revenue neutral, we assume the U.S. current tax expense is the actual tax collected by the U.S. government. We recognize that there are many problems with this assumption (e.g., the tax contingency reserve, the accounting for stock option deductions, etc. (see Hanlon and Shevlin (2002) and Hanlon (2003)), but as a first pass we use it as an empirical estimation basically because of the lack of availability of anything better. For example, we also attempt to use Statistics of Income (SOI) data (untabulated), but because we do not know the exact intersection of Compustat firms and firms included in the SOI data, we do not believe these data to be any more reliable than using the current tax expense as an estimation of taxes collected for our sample of firms. Further, we cannot use cash taxes paid from the cash–flow statement for our sample firms because this amount will include taxes paid to all jurisdictions, for past years’ audit settlements, and current–year estimated payments, but not the amount, if any, due with the current year’s return (although it will include the amount due with the prior year’s return).

Thus, we recognize that to the extent current tax expense differs from actual taxes paid, this will introduce measurement error in our estimates. However, some of the measurement error will wash out across time and across firms. In addi-

<table>
<thead>
<tr>
<th>YEAR</th>
<th>PTBI</th>
<th>NON–CONFORM</th>
<th>CONFORM—RETAIN 35% RATE</th>
<th>CONFORM—REVENUE NEUTRAL</th>
<th>t CONFORM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>282,141</td>
<td>66,530</td>
<td>87,818</td>
<td>63,481</td>
<td>0.262</td>
</tr>
<tr>
<td>1996</td>
<td>328,894</td>
<td>76,913</td>
<td>99,177</td>
<td>72,189</td>
<td>0.262</td>
</tr>
<tr>
<td>1997</td>
<td>345,608</td>
<td>88,182</td>
<td>106,465</td>
<td>77,702</td>
<td>0.262</td>
</tr>
<tr>
<td>1998</td>
<td>306,360</td>
<td>85,346</td>
<td>108,149</td>
<td>79,432</td>
<td>0.262</td>
</tr>
<tr>
<td>1999</td>
<td>397,401</td>
<td>98,555</td>
<td>130,572</td>
<td>95,498</td>
<td>0.262</td>
</tr>
<tr>
<td>2000</td>
<td>329,983</td>
<td>101,237</td>
<td>131,358</td>
<td>94,852</td>
<td>0.262</td>
</tr>
<tr>
<td>2001</td>
<td>34,227</td>
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<td>92,348</td>
<td>66,202</td>
<td>0.262</td>
</tr>
<tr>
<td>2002</td>
<td>115,996</td>
<td>53,807</td>
<td>100,508</td>
<td>71,903</td>
<td>0.262</td>
</tr>
<tr>
<td>2003</td>
<td>399,588</td>
<td>66,300</td>
<td>118,541</td>
<td>84,467</td>
<td>0.262</td>
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<tr>
<td>2004</td>
<td>479,854</td>
<td>92,221</td>
<td>134,879</td>
<td>94,542</td>
<td>0.262</td>
</tr>
<tr>
<td>ALL</td>
<td>3,020,052</td>
<td>800,200</td>
<td>1,109,815</td>
<td>800,269</td>
<td>0.262</td>
</tr>
</tbody>
</table>

Notes: YEAR is the Compustat fiscal year variable YEARA. PTBI is Compustat data #170, aggregated across all firms in the year. ESTIMATED U.S. TAX COLLECTIONS NON–CONFORM is the sum of current federal tax expense for all firms in the year. ESTIMATED U.S. TAX COLLECTIONS CONFORM—RETAIN 35% RATE is the simulated current tax expense under book–tax conformity and territorial taxation, assuming the rate is equal to 35%. t CONFORM is the tax rate necessary to achieve revenue neutrality over the aggregate 10–year period, assuming the U.S. tax collections from the sample are equivalent to aggregated Compustat current federal tax expense.
tion to this first assumption that current tax expense is a reasonable estimate of taxes paid, we also assume that under book–tax conformity there would be 1) no net operating loss (NOL) carrybacks, 2) indefinite NOL carryforwards, and 3) foreign tax credits subject to foreign tax credit limitations similar to those under the current system and that be carried forward indefinitely.\textsuperscript{23}

We begin with worldwide financial accounting pre–tax book income (PTBI shown in the second column of Table 1). We then show the amount of U.S. current tax expense (Compustat data item #63) for the sample as is reported under the current non–conformed system. Next we show current tax expense under the simulated conformed system, first assuming that the 35 percent statutory tax rate applies and then assuming revenue neutrality over the aggregate ten–year period. We do not enforce revenue neutrality on a year–by–year basis because if we did, it would result in a statutory tax rate that changes year to year. Having a statutory tax rate that floated from year to year would likely be unacceptable and introduce many problems.

To arrive at the simulated revenue–neutral tax rate, we calculate each firm’s U.S. current tax expense under a book–tax conformed system for each year. In making this calculation we first adjust each firm’s worldwide pre–tax book income for past losses, assuming no carryback and an indefinite carryforward period. This adjusted worldwide pre–tax book income number is then multiplied by a first pass simulated tax rate which results in the same amount of current tax expense as under the current non–conformed system. Foreign tax credits are then computed as the lesser of foreign pre–tax income times the simulated tax rate or reported foreign current tax expense. The foreign tax credit is then subtracted from the calculated U.S. current tax expense. Foreign tax credits are carried forward indefinitely, but are not carried back, to make the simulation more tractable. Because the foreign tax credit (and, therefore, the simulated current tax expense) depends on the simulated revenue–neutral tax rate, we iteratively choose the tax rate until the sum of the simulated current tax expenses (after foreign tax credits) over the years is close to actual current tax expense over those same years.

Note that the new tax rate required is lower than the U.S. statutory rate under the current system: 26.2 percent versus the current statutory rate of 35 percent. The lower rate is consistent with the prediction that conformity would result in a broader base of taxation (ignoring any behavioral responses).\textsuperscript{24} This can be seen by comparing the domestic current tax expense under the current system to what it would be under conformity with the same 35 percent statutory tax rate. For the mean year, aggregate current taxes from our sample would increase from approximately $80 billion to approximately $110.9 billion if conformity were adopted but the same tax rate were retained. Tested at the firm level, this difference is statistically significant (p–value <0.0001). Further,

\textsuperscript{23} Note we do not have any other credits in the conformed system. For example, we do not include a research and development credit.

\textsuperscript{24} Note that in our simulations we make no adjustments for stock option deductions. During the time period of our tests, firms were not required to expense stock options for financial accounting purposes under most cases. Following the strict book–tax conformity for which we can do computations, we use book income with no adjustments and, thus, do not adjust for stock option compensation. We note that the current tax expense amount we use to estimate actual taxes paid is overstated for firms that obtained deductions for stock options and as a result our tax rate estimates are likely overestimated for this time period. We note that the financial accounting rules have since changed to requiring expensing of the estimate of the value of the stock option over the vesting period. If we would do an as–if calculation over our sample period based on these new rules, it would lower book income and increase the rate required to maintain revenue neutrality.
in comparing the current system to one with revenue–neutral book–tax conformity, Table 1 indicates that the standard deviation of annual tax collections would decrease from approximately $15.6 billion to approximately $12 billion, consistent with our prediction that the variability of tax receipts would decline. However, with only ten annual observations, this decrease is not statistically significant.

In Table 2 we present average tax rates (estimated aggregated U.S. and foreign current tax expense divided by pre–tax earnings) by industry (both the numerator and denominator are summed over the ten years in our sample).25 The by–industry estimates include only firms with positive pre–tax earnings (aggregate over the ten years). The table reveals that there would be substantial variation in the effect of book–tax conformity by industry. For example, industries where firms have relatively large book–tax differences, where book income is higher than taxable income, will experience an increase in their rate in the case of revenue–neutral implementation—the elimination of their book–tax differences outweighs the reduction in the rate. In our data the industries most affected are the Manufacturing of

<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>NFIRMS</th>
<th>NON–CONFORM</th>
<th>CONFORM—RETAINT 35% RATE</th>
<th>DIFF</th>
<th>CONFORM—REVENUE NEUTRAL</th>
<th>DIFF</th>
</tr>
</thead>
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<tr>
<td>Not assigned</td>
<td>42</td>
<td>0.191</td>
<td>0.354</td>
<td>0.163</td>
<td>0.275</td>
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<tr>
<td>Mining/Construction</td>
<td>113</td>
<td>0.347</td>
<td>0.358</td>
<td>0.011</td>
<td>0.276</td>
<td>-0.070</td>
</tr>
<tr>
<td>Food</td>
<td>146</td>
<td>0.293</td>
<td>0.360</td>
<td>0.067</td>
<td>0.286</td>
<td>-0.007</td>
</tr>
<tr>
<td>Textiles/Print/Public</td>
<td>289</td>
<td>0.320</td>
<td>0.371</td>
<td>0.051</td>
<td>0.289</td>
<td>-0.031</td>
</tr>
<tr>
<td>Chemicals</td>
<td>126</td>
<td>0.302</td>
<td>0.377</td>
<td>0.075</td>
<td>0.308</td>
<td>0.005</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>105</td>
<td>0.307</td>
<td>0.356</td>
<td>0.049</td>
<td>0.275</td>
<td>-0.032</td>
</tr>
<tr>
<td>Extractive</td>
<td>213</td>
<td>0.293</td>
<td>0.399</td>
<td>0.106</td>
<td>0.347</td>
<td>0.054</td>
</tr>
<tr>
<td>Manf:Rubber/glass/etc</td>
<td>131</td>
<td>0.338</td>
<td>0.400</td>
<td>0.062</td>
<td>0.327</td>
<td>-0.012</td>
</tr>
<tr>
<td>Manf:Metal</td>
<td>181</td>
<td>0.281</td>
<td>0.369</td>
<td>0.087</td>
<td>0.289</td>
<td>0.008</td>
</tr>
<tr>
<td>Manf:Machinery</td>
<td>186</td>
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<td>0.072</td>
<td>0.301</td>
<td>0.000</td>
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<td>Manf:ElectricalEqpt</td>
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<td>0.444</td>
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<td>0.358</td>
<td>-0.031</td>
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<tr>
<td>Manf:TransportEqpt</td>
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<td>0.237</td>
<td>0.398</td>
<td>0.161</td>
<td>0.326</td>
<td>0.090</td>
</tr>
<tr>
<td>Manf:Instruments</td>
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<td>0.369</td>
<td>0.079</td>
<td>0.290</td>
<td>0.001</td>
</tr>
<tr>
<td>Manf:Misc.</td>
<td>58</td>
<td>0.316</td>
<td>0.365</td>
<td>0.049</td>
<td>0.282</td>
<td>-0.034</td>
</tr>
<tr>
<td>Computers</td>
<td>577</td>
<td>0.325</td>
<td>0.376</td>
<td>0.052</td>
<td>0.300</td>
<td>-0.024</td>
</tr>
<tr>
<td>Transportation</td>
<td>280</td>
<td>0.258</td>
<td>0.382</td>
<td>0.124</td>
<td>0.290</td>
<td>0.032</td>
</tr>
<tr>
<td>Utilities</td>
<td>122</td>
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<td>0.374</td>
<td>0.057</td>
<td>0.286</td>
<td>-0.031</td>
</tr>
<tr>
<td>Retail:Wholesale</td>
<td>260</td>
<td>0.308</td>
<td>0.368</td>
<td>0.089</td>
<td>0.285</td>
<td>-0.024</td>
</tr>
<tr>
<td>Retail:Misc.</td>
<td>329</td>
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<td>0.351</td>
<td>0.017</td>
<td>0.265</td>
<td>-0.069</td>
</tr>
<tr>
<td>Retail:Restaurant</td>
<td>96</td>
<td>0.316</td>
<td>0.360</td>
<td>0.044</td>
<td>0.280</td>
<td>-0.036</td>
</tr>
<tr>
<td>Services</td>
<td>601</td>
<td>0.322</td>
<td>0.371</td>
<td>0.049</td>
<td>0.288</td>
<td>-0.033</td>
</tr>
</tbody>
</table>

All Firms: 4,481 | 0.298 | 0.373 | 0.075 | 0.295 | -0.003 | 25 We use the term average tax rate in reference to our computation of estimated current U.S. and foreign tax expense (as a proxy for taxes paid) divided by pre–tax earnings. We avoid the use of the term effective tax rate because GAAP effective rates are total income tax expense—including deferred taxes, which do not exist under book–tax conformity—divided by pre–tax earnings.
Transportation Equipment, Extractive, and Transportation industries. On the other hand, industries where firms have small book–tax differences will now have a lower rate without a significant broadening of their tax base. From our data, the industries in this situation appear to be Mining/Computers, Computers, and Retail firms.

The Effects of Deferral of Foreign Income

As discussed earlier, we do not have micro data on firms’ decisions to reinvest or repatriate foreign earnings and, therefore, we cannot undertake detailed simulations to estimate how a book–tax conformed system would be affected if an exception was made for reinvested foreign income. Moreover, even if we knew the amounts of reinvested earnings, we would also need to know how much foreign tax had been paid on those earnings to estimate foreign tax credits in the firm–level simulations. We can, however, use aggregate data on reinvested foreign earnings to provide at least some sense of the magnitude of reinvestment. Data from the Bureau of Economic Analysis (BEA) Survey of Current Business show that amount of reinvested foreign income across all industries averaged approximately $65 billion per year during 1995–2004. Unfortunately, to know the effect on U.S. tax revenues we would need to know, at a minimum, how much foreign tax was paid on that income. If the foreign taxes paid on these earnings were, say, ten percent lower than the U.S. rate, that would suggest an effect in the ballpark of $6.5 billion in terms of annual aggregate U.S. tax collections that would be foregone if deferral were retained in our book–tax conformed system. We caution though that this is a very crude estimate. We note that the question of the tax revenues/burden of deferral is not settled in prior literature. The main point that we want to convey is that book–tax conformity in the strict sense (as detailed above in the first approach we take) eliminates deferral and, thus, broadens the tax base beyond just eliminating domestic book–tax differences. If deferral were retained along with book–tax conformity (i.e., allow a book–tax difference for foreign–source earnings of foreign subsidiaries), then the base would likely be smaller and the tax rate necessary to remain revenue neutral would be higher than the rate we estimate above.

Simulations of Book–Tax Conformity Coupled with Territorial Taxation

In Table 3 we combine book–tax conformity with territorial taxation and simulate its effects using firm–level data. This simulation takes advantage of the fact that firms, as part of the tax footnote to their financial statements, report their GAAP pretax domestic income and GAAP pretax foreign income. To simulate territorial taxation with book–tax conformity, GAAP pretax domestic income becomes the new tax base. We assume the losses would still be able to be used to offset income in other years and implement this by allowing NOL carryforwards. To keep the simulations tractable, we do not allow for NOL carrybacks. There is no need for foreign tax credits in this system because in a strict territorial system foreign income would never be subject to U.S. tax.

As with the simulations in Table 1, in Table 3 we report the effects of conformity first assuming the current 35 percent tax rate was applied to the new tax base and then assuming a new revenue–neutral tax rate. Recall that we did not make predictions of how book–tax conformity

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26 See Desai and Hines (2004), Grubert (2005) and Desai and Hines (2005) and the references therein for some statistics, estimates, and debate on the topic.
with territorial taxation would compare with the current system, nor did we have expectations of how it would compare with book–tax conformity with worldwide taxation.

Interestingly, the aggregate results of book–tax conformity with territorial taxation appear fairly similar to those obtained with worldwide taxation and no deferral. This may seem surprising at first since territorial taxation by definition exempts foreign income from the U.S. system, whereas worldwide taxation at least potentially subjects foreign income to U.S. tax to the extent that U.S. tax rates exceed foreign tax rates. According to the firm–level simulations, little U.S. tax must come from foreign income (i.e., the foreign tax credit must eliminate most of the U.S. tax receipts on foreign sourced earnings). If a 35 percent tax rate was applied to domestic income only, Table 3 reveals an estimated $102 billion in annual aggregate tax collections for our sample firms. The corresponding number in Table 1 for worldwide taxation is approximately $111 billion per year in aggregate. When we impose revenue neutrality for the sample firms in the study, the simulation produces a tax rate of 27.4 percent under territorial taxation versus 26.2 percent under worldwide taxation. Thus, there does seem appear to be a modest reduction in the tax base under territorial taxation compared to worldwide taxation.

Table 4 is the analog to Table 2, except that Table 4 employs territorial taxation.

---

**Table 3**

<table>
<thead>
<tr>
<th>YEARS</th>
<th>PTBI</th>
<th>US–PTBI</th>
<th>NON–CONFORM</th>
<th>CONFORM—RETAIN 35% RATE</th>
<th>CONFORM—REVENUE NEUTRAL</th>
<th>tCONFORM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>282,141</td>
<td>197,148</td>
<td>66,530</td>
<td>82,999</td>
<td>65,036</td>
<td>0.274</td>
</tr>
<tr>
<td>1996</td>
<td>328,894</td>
<td>234,645</td>
<td>76,913</td>
<td>95,100</td>
<td>74,518</td>
<td>0.274</td>
</tr>
<tr>
<td>1997</td>
<td>345,608</td>
<td>244,746</td>
<td>88,182</td>
<td>101,677</td>
<td>79,671</td>
<td>0.274</td>
</tr>
<tr>
<td>1998</td>
<td>306,360</td>
<td>205,684</td>
<td>85,346</td>
<td>99,345</td>
<td>77,844</td>
<td>0.274</td>
</tr>
<tr>
<td>1999</td>
<td>397,401</td>
<td>284,494</td>
<td>98,555</td>
<td>122,946</td>
<td>96,337</td>
<td>0.274</td>
</tr>
<tr>
<td>2000</td>
<td>329,983</td>
<td>204,886</td>
<td>101,237</td>
<td>121,154</td>
<td>94,933</td>
<td>0.274</td>
</tr>
<tr>
<td>2001</td>
<td>34,227</td>
<td>57,527</td>
<td>71,109</td>
<td>84,694</td>
<td>66,364</td>
<td>0.274</td>
</tr>
<tr>
<td>2002</td>
<td>115,996</td>
<td>5,820</td>
<td>53,807</td>
<td>91,457</td>
<td>71,663</td>
<td>0.274</td>
</tr>
<tr>
<td>2003</td>
<td>399,588</td>
<td>262,117</td>
<td>66,300</td>
<td>105,845</td>
<td>82,937</td>
<td>0.274</td>
</tr>
<tr>
<td>2004</td>
<td>479,854</td>
<td>287,353</td>
<td>92,221</td>
<td>116,004</td>
<td>90,898</td>
<td>0.274</td>
</tr>
<tr>
<td>ALL</td>
<td>3,020,052</td>
<td>1,984,420</td>
<td>800,200</td>
<td>1,021,221</td>
<td>800,200</td>
<td>0.274</td>
</tr>
<tr>
<td>MEAN</td>
<td>302,005</td>
<td>198,442</td>
<td>80,020</td>
<td>102,122</td>
<td>80,020</td>
<td></td>
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<tr>
<td>STDEV</td>
<td>133,491</td>
<td>94,207</td>
<td>15,578</td>
<td>14,309</td>
<td>11,212</td>
<td></td>
</tr>
</tbody>
</table>

Notes: YEAR is the Compustat fiscal year variable YEARA. PTBI is Compustat data #170, aggregated across all firms in the year. ESTIMATED U.S. TAX COLLECTIONS NON–CONFORM is the sum of current federal tax expense for all firms in the year. ESTIMATED U.S. TAX COLLECTIONS CONFORM—RETAIN 35% RATE is the simulated current tax expense under book–tax conformity and territorial taxation, assuming the rate is equal to 35%. tCONFORM is the tax rate necessary to achieve revenue neutrality over the aggregate 10-year period, assuming the U.S. tax collections from the sample are equivalent to aggregated Compustat current federal tax expense.

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27 This observation is consistent with statistics available from the IRS’s Statistics of Income division. See specifically Figure B in “Statistics of Income Studies of International Income and Taxes” available at http://www.irs.gov/taxstats/articl/0,,id=117514,00.html.
Table 4 reveals that when average tax rates are computed at the industry level, the average tax rate of the sample under the current system is 29.8 percent. Moving to book–tax conformity on a territorial basis but retaining the 35 percent statutory rate would increase the average industry tax rate to an estimated 35 percent. In addition, as in Table 2, the data reveal substantial variation across the industries, with some experiencing an increase in tax per dollar of reported accounting earnings and some experiencing a decrease in tax per dollar of earnings.

CONCLUSIONS

While book–tax conformity has many pros and cons, the international implications of book–tax conformity are largely unexplored. We describe several possible approaches to implementing book–tax conformity for firms that have both domestic and foreign operations. These approaches include: 1) book–tax conformity while retaining worldwide taxation but with no deferral of foreign income, 2) book–tax conformity while retaining both worldwide taxation and deferral of foreign income, 3) book–tax conformity along with territorial taxation, and 4) book–tax conformity with formulaary apportionment. We discuss issues with implementing each system and conjecture at the behavioral responses to each.


<table>
<thead>
<tr>
<th>INDUSTRY</th>
<th>NFIRMS</th>
<th>NON–CONFORM</th>
<th>CONFORM—RETAIL 35% RATE</th>
<th>DIFF</th>
<th>CONFORM—REVENUE NEUTRAL</th>
<th>DIFF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not assigned</td>
<td>42</td>
<td>0.191</td>
<td>0.312</td>
<td>0.121</td>
<td>0.263</td>
<td>0.072</td>
</tr>
<tr>
<td>Mining/Construction</td>
<td>113</td>
<td>0.347</td>
<td>0.356</td>
<td>0.010</td>
<td>0.287</td>
<td>-0.060</td>
</tr>
<tr>
<td>Food</td>
<td>146</td>
<td>0.293</td>
<td>0.336</td>
<td>0.042</td>
<td>0.287</td>
<td>-0.006</td>
</tr>
<tr>
<td>Textiles/Print/Publish</td>
<td>289</td>
<td>0.320</td>
<td>0.364</td>
<td>0.044</td>
<td>0.297</td>
<td>-0.023</td>
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<tr>
<td>Chemicals</td>
<td>126</td>
<td>0.302</td>
<td>0.352</td>
<td>0.050</td>
<td>0.308</td>
<td>0.005</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>105</td>
<td>0.307</td>
<td>0.299</td>
<td>-0.008</td>
<td>0.258</td>
<td>-0.048</td>
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<tr>
<td>Extractive</td>
<td>213</td>
<td>0.293</td>
<td>0.386</td>
<td>0.093</td>
<td>0.347</td>
<td>0.054</td>
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<tr>
<td>Manf:Rubber/glass/etc</td>
<td>131</td>
<td>0.338</td>
<td>0.384</td>
<td>0.046</td>
<td>0.333</td>
<td>-0.006</td>
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<tr>
<td>Manf:Metal</td>
<td>181</td>
<td>0.281</td>
<td>0.342</td>
<td>0.060</td>
<td>0.292</td>
<td>0.011</td>
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<tr>
<td>Manf:Machinery</td>
<td>186</td>
<td>0.301</td>
<td>0.351</td>
<td>0.049</td>
<td>0.301</td>
<td>-0.000</td>
</tr>
<tr>
<td>Manf:ElectricalEqpt</td>
<td>200</td>
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<td>0.420</td>
<td>0.030</td>
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<td>0.366</td>
<td>0.129</td>
<td>0.317</td>
<td>0.080</td>
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<tr>
<td>Manf:Instruments</td>
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<td>0.289</td>
<td>0.333</td>
<td>0.044</td>
<td>0.285</td>
<td>-0.005</td>
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<td>Manf:Misc.</td>
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<td>0.316</td>
<td>0.319</td>
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<td>-0.042</td>
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<td>0.337</td>
<td>0.013</td>
<td>0.289</td>
<td>-0.036</td>
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<td>Transportation</td>
<td>280</td>
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<td>0.380</td>
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<td>0.302</td>
<td>0.044</td>
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<td>0.376</td>
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<td>0.299</td>
<td>-0.017</td>
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<td>Retail:Wholesale</td>
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<td>0.351</td>
<td>0.042</td>
<td>0.285</td>
<td>-0.023</td>
</tr>
<tr>
<td>Retail:Misc.</td>
<td>329</td>
<td>0.334</td>
<td>0.349</td>
<td>0.015</td>
<td>0.276</td>
<td>-0.057</td>
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<tr>
<td>Retail:Restaurant</td>
<td>96</td>
<td>0.316</td>
<td>0.343</td>
<td>0.027</td>
<td>0.289</td>
<td>-0.027</td>
</tr>
<tr>
<td>Services</td>
<td>601</td>
<td>0.322</td>
<td>0.369</td>
<td>0.047</td>
<td>0.299</td>
<td>-0.022</td>
</tr>
</tbody>
</table>

All Firms                  | 4,481  | 0.298       | 0.350                    | 0.052| 0.295                    | -0.003|

Notes: All variables are defined in Table 3.
mity on the mean and variance of tax payments/collections. Our simulations indicate that under book–tax conformity the tax base would be broadened, resulting in a revenue–neutral corporate tax rate that is lower than the current statutory rate. These simulations are necessarily imperfect as the data upon which they are built have many limitations. For example, we do not incorporate any behavioral response in our estimates and, thus, the revenue–neutral rate we estimate is likely understated relative to what would be necessary to actually retain revenue neutrality.

The process of thinking through the implementation of book–tax conformity and simulating its effects reveals many of the complications that would arise if it were to be implemented, such as how to avoid double–taxing the income of entities that are accounted for under the equity method and whether to allow non–taxable acquisitions or strictly apply purchase accounting to the taxation of mergers and acquisitions. Of course, the current non–conformed system of taxation is also not without complications.

Acknowledgments

Scott Dyreng and Jake Thornock provided valuable research assistance on this project. We appreciate comments from Mihir Desai (discussant), Peter Merrill (discussant), Joel Slemrod (discussant) and from Ed Outslay, Jim Poterba, Richard Sansing, Doug Shackelford, Terry Shevlin, Martin Tittle, and participants at the American Tax Policy Institute, the International Tax Policy Forum, the NBER Conference on Financial Reporting and Taxes, and the University of Iowa Sydney Winter Lectures. We appreciate funding from the International Tax Policy Forum, the American Tax Policy Institute, and the NBER Conference on Financial Reporting and Taxes.

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