Study: Very low effective tax rates often do not reflect high levels of corporate tax avoidance

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Company	Year	ETR	Adj. ETR	Primary non-tax source(s) of deviation between ETR and Adj. ETR
Goodyear Tire & Rubber Co.	2014	-267.0%	50.4%	Valuation allowance release net of accruals
Toll Brothers	2012	-331.3%	39.2%	Valuation allowance release; Net reversal of uncertain tax positions
Advanced Micro Devices Inc.	2011	-0.8%	34.0%	Valuation allowance release
AT&T Inc.	2010	-6.4%	37.4%	IRS Settlement

Additional examples of ETRs that are artificially low for non-tax reasons. Credit: Casey M. Schwab, Bridget Stomberg, Junwei Xia

Companies' low effective tax rates have drawn the ire of politicians, policymakers, the media and the public. As Congress begins debating changes to corporate taxes to partially fund a $3.5 trillion budget plan, the Biden administration is raising questions about how much corporations pay in taxes. But new research from the Indiana University Kelley School of Business and research colleagues elsewhere suggests very low effective tax rates often do not reflect high levels of tax avoidance.

Effective tax rates, or ETRs, are a measure of tax expense computed under U.S. Generally Accepted Accounting Principles as a percentage of pretax income. To better understand the scope of potential limitations of ETRs, the researchers created an "adjusted ETR" for nearly 15,800 company-year observations from 3,375 companies between 2008 and 2016 to remove items largely unrelated to tax avoidance.

The researchers defined tax avoidance as tax planning strategies managers use to reduce their company's explicit tax burdens, such as claiming tax credits and shifting income to low-tax jurisdictions.

The study found that companies often report low ETRs not because of aggressive tax avoidance in the current year but rather because of changes in performance or favorable tax settlements with the IRS.

"Financial statement users often compare tax expense as a percentage of income to the statutory tax rate. When the ratio is lower, some may think the company is engaging in tax shenanigans, but our research finds that is often not the case," said Bridget Stomberg, associate professor of accounting and a Weimer Faculty Fellow at the Kelley School of Business. "We find that many times, very low ETRs—those below 5% – can be attributed to changes in performance that affect the ETR because of rules under U.S. GAAP."

For example, Stomberg said American Airlines reported an ETR of only 10% in 2014 and a negative ETR in 2015. People might compare these rates to the federal statutory tax rate—which was 35% in those years—and conclude that the company was doing something aggressive to reduce its tax liability.

"However, in these cases, these low ETRs reflect a turnaround in American's operating performance that allows the company to deduct losses generated in prior periods—a perfectly legal and sound tax policy," Stomberg said. Other airlines such as Delta and United reported similar patterns following the financial crisis, which hit the airline industry particularly hard.

Companies in other industries can have their ETRs affected in this way as well. Goodyear Tire & Rubber Co. reported a negative ETR in 2016, which would have been almost 20% ignoring the accounting effects of prior year losses and its subsequent turnaround.

"Even ETRs that are low for reasons related to the company's tax behavior do not always signal aggressive tax avoidance that tax authorities are wont to overturn," said Casey Schwab, one of the study's co-authors and a professor and Ryan Endowed Chair in Accounting at the University of North Texas G. Brint Ryan College of Business. "U.S. GAAP rules limit companies' ability to recognize all the tax benefits from an uncertain or aggressive tax position in the year the position is initially reported to the IRS. If a company subsequently settles the position favorably with the IRS—or if the IRS does not audit the position before the statute of limitations expires—it recognizes those previously unrecognized tax benefits, which lowers the ETR."

For example, AT&T favorably settled an IRS audit of its restructuring in 2010. As a result, the company reported a negative ETR for the year. "Given the IRS effectively agreed with the tax positions underlying the settlement, it is difficult to argue that AT&T's low ETR indicates aggressive tax avoidance," Schwab added. "Moreover, AT&T's decision not to recognize the tax benefits of this position while its outcome was uncertain can benefit shareholders."

Company	Year	ETR	Adj. ETR	Primary non-tax source(s) of deviation between ETR and Adj. ETR
LSI Industries Inc.	2013	120.1%	-11.4%	Valuation allowance accrual; Goodwill impairment
MGM Resorts International	2014	69.0%	-122.0%	Valuation allowance accrual
salesforce.com inc.	2016	173.8%	-47.7%	Valuation allowance accrual
News Corporation	2015	239.0%	31.0%	Goodwill impairment

Additional examples of ETRs that are high for non-tax reasons. Credit: Casey M. Schwab, Bridget Stomberg, Junwei Xia,

The researchers aggregated items that lower a company's ETR in a specific year (excluding state taxes) and compared the relative magnitude of the aggregated items. This analysis indicates that the impact of claiming tax credits or shifting income to low-tax jurisdictions—what people usually consider corporate tax planning strategies—is relatively smaller for companies reporting low ETRs.

Instead, non-tax items such as valuation allowance releases and accounting for uncertain tax positions are the major drivers of these low ETRs.

"This finding is surprising, and it has changed how I interpret very low ETRs", said Junwei Xia, assistant professor of accounting at the Texas A&M University Mays Business School and another of the study's co-authors. "Users need to exercise caution before concluding very low ETRs signal aggressive corporate tax behavior."

Although the study's data ended in 2016, discrepancies between GAAP and adjusted ETRs persist. For example, salesforce.com reported an ETR of -12.9% in 2019 fiscal year. However, after adjusting for non-tax items including a valuation allowance release that reduced the company's ETR by approximately 62.3%, salesforce.com had an adjusted ETR of 60.5%.

The researchers also identified problems with high ETRs, which companies sometimes highlight to deflect scrutiny about their tax planning. However, items including valuation allowance accruals, goodwill impairments and unfavorable tax settlements with the IRS can increase GAAP ETRs, making companies appear less aggressive than they are. For example, Moody's settled tax issues unfavorably with the IRS in 2016, forcing the company to accrue additional amounts of unexpected tax. To an unsuspecting reader, Moody's 50.6% GAAP ETR could appear benign when it reflected an unfavorable outcome with the IRS. Without the impact of the settlement, Moody's GAAP ETR would have been 23.2%.

The researchers also aggregated items that increase a company's ETR in a specific year (excluding state taxes) and compare the relative magnitude of the aggregated items. This analysis indicates that non-tax items such as valuation allowance accruals and the tax effects of goodwill impairments are relatively larger for companies reporting GAAP ETRs above 40%. In contrast, tax items are relatively constant across all values of GAAP ETRs.

"Researchers have recognized limitations of GAAP ETRs as a measure of tax avoidance and proposed alternatives such as averaging amounts over multiple years, adjusting for industry averages, or looking at tax payments instead of accruals," Stomberg said. "However, we find similar problems plague these measures to varying degrees. Outside of using adjusted ETRs, single year measures of tax payments as a percentage of pretax income offer the best alternative."

The paper, "What Determines ETRs? The Relative Influence of Tax and Other Factors," has been accepted by the journal Contemporary Accounting Research. Co-authors are two academics formerly at Kelley—Casey Schwab and Junwei Xia.

The researchers are making all of their data publicly available.

More information: Casey M. Schwab et al, What Determines ETRs ? The Relative Influence of Tax and Other Factors†, *Contemporary Accounting Research* (2021). DOI: 10.1111/1911-3846.12720

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