

Distribution of Corporate Book and Taxable Income

Green, Henry, McGovern, Plesko

Discussion by Elena Patel, University of Utah

Tax Economists Ask

- Observation: an excess of firms reporting \$0 in taxable income.
- What is the elasticity of corporate taxable income?



Tax Accountants Ask

- Observation: excess mass of firms reporting small profits.
- Is there evidence of earnings management?



This paper brings these questions together

- Examines distribution of *both* book and taxable income for
 - Publicly Traded C Corporations
 - Private C Corporations
- Focus on 2018 implementation of the TCJA
- Conceptual tension in discontinuities
 - Markets create pressure to **increase** earnings
 - Changing marginal tax rates create pressure to **decrease** taxable income
 - These two behaviors have opposite predictions.
- Analysis finds that incentive to minimize taxes outweighs incentive to avoid reporting losses to shareholders

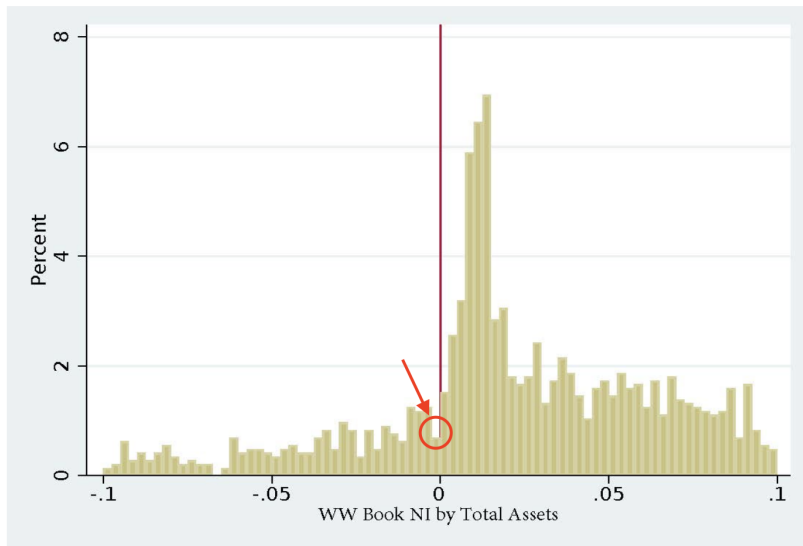
Standardized Differences

- Heart of this analysis is one of missing or excess mass
 - Financial Statement Prediction: excess small profits firms and missing small loss firms
 - Taxable Income Prediction: excess \$0 taxable income mass

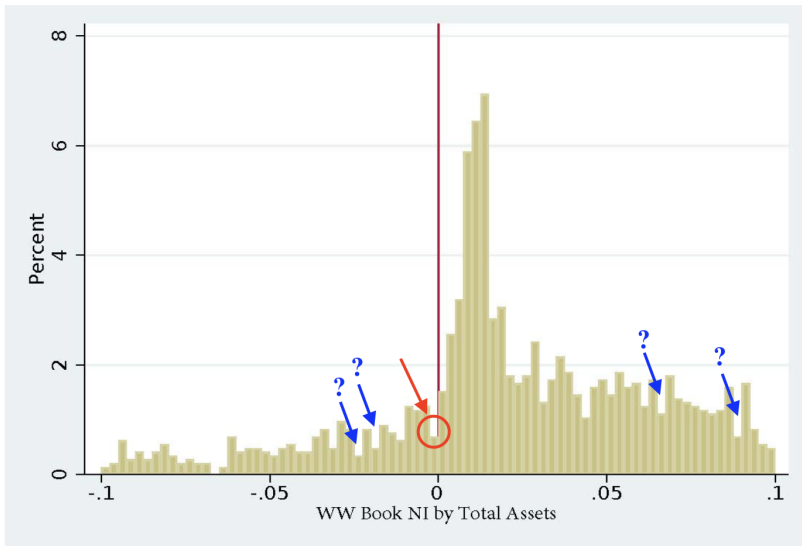
- Empirical tool employed: standardized differences
 - Test of statistical significance of a discontinuity in a density

- Expansion of context and intuition for measurement will help clarify results
 - How sensitive is measure to choice of bin size?
 - Can you use cross-validation techniques for bin size choice?
 - In which contexts is this measure reflective of something causal?

Worldwide Book Income: Missing Small Losses for Public Firms



Placebo Test: How Many Other Standardized Differences Are Significant?



Excess/Missing Mass Analysis: Bunching Analysis?

- Bunching methodology will provide a more rigorous way of identifying missing masses from densities.
 - Bunching mass point varies based on the stock of NOLs available.
- Pros
 - Relatively easy to implement via `bunching` Stata package.
- Cons
 - Requires making an assumption about the shape of the counterfactual distribution.
 - But, can relax these assumptions somewhat using truncation methods.
 - Relatively data intensive – perhaps insurmountable in the context of public firms.

Expand Direct Comparison of Treated and Counterfactual Firms

- Public and private firms are analyzed separately
- Can you use private firms as a counterfactual distribution for a more direct public/private comparison?
- Comparison might be facilitated by re-weighting private firms to match the density of public firms, rather than scaling by assets

N. Feldman, L. Kawano, E. Patel et al.

Journal of Public Economics 196 (2021) 104370

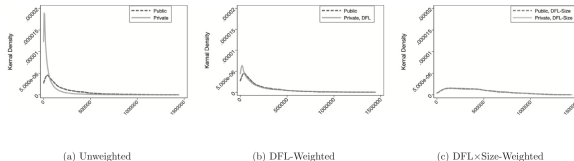


Fig. 3. Distribution of public and private firms by size: gross receipts. Notes: Financial measures are converted to thousands of 2004 dollars based on CPI. DFL weights were generated within 2-digit industry by year to match public and private firms based on firm size as measured by average gross receipts. Source: SOI Corporate Sample, 2005–2015.

2018 SOI Year

2017 Tax Law					2018 Tax Law						
July 2018	Aug 2018	Sept 2018	Oct 2018	Nov 2018	Dec 2018	Jan 2019	Feb 2019	Mar 2019	Apr 2019	May 2019	Jun 2019

- “2018 Tax Year”: tax years ending July 1, 2018 – June 30, 2019
- TCJA effective for tax years beginning after December 31, 2017
 - Translation: tax years ending after December 31, 2018
- Consequence: only those businesses with tax years ending December 31, 2018 and later were subject to the TCJA
- Some of the firms in your density graphs are subject to the old tax law

2018 SOI Year

2017 Tax Law					2018 Tax Law						
July 2018	Aug 2018	Sept 2018	Oct 2018	Nov 2018	Dec 2018	Jan 2019	Feb 2019	Mar 2019	Apr 2019	May 2019	Jun 2019

- Examination of 2018 data provides an opportunity to exploit this variation to identify a counterfactual density function:
 - Treated Firms: Firms with tax years ending December 31, 2018 - June 30, 2019
 - Control Firms: Firms with tax years ending July 1, 2018 - December 30, 2018
- Tax years for both Treated and Control firms contained in the same calendar year.
- You could compare the distribution of book/tax income for treated and control firms in this way within *public* or *private*

Connection to Policy Context

- Motivating policy: 15% minimum tax on adjusted financial statement income.
 - Concern: will induce behavioral responses in financial statement income similar to known distortions to taxable income.
- BBB “adjusted financial statement of income” allows many big adjustments
 - NOLS
 - General Business Credits
 - Foreign AMT
- How different are “adjusted financial statement income” and “taxable income”?
 - Only timing of income/cost recognition? Something more?
- In 2018: how many firms would have been affected by such a tax?

Thank You!