Five Things Economists and Lawyers Can Learn from Accountants: An Illustration Using the Domestic Production Activities Deduction

Abstract *- This paper is part of the perspectives of three researchers—an economist, an accountant and a lawyer—on tax policy. The domestic production activities deduction in AJCA 2004 provides a specific platform to introduce five concepts from financial accounting that affect tax policy: book income matters; tax rate changes immediately affect earnings; current tax expense does not generally equal taxes paid; accounting mixes different methods and permits management judgment; and consolidation rules differ for book and tax, complicating jurisdictional inferences.*

INTRODUCTION

Accounting is often referred to as the "language of business." In addition to providing a language, it is also akin to a translation program. The corporation uses accounting principles and rules to aggregate all of the year's transactions to a few tables of numbers; the stock analyst studies these few tables of numbers to understand the events and estimate the value of the corporation. When I speak to high school students about accounting as a profession, I relate my experience of enjoying word problems in fourth grade. If one were to place attorneys at the verbal end of the spectrum and economists at the quantitative end of the spectrum, accountants are in the middle, because they need facility in translating words to numbers and numbers to words.

The domestic production activities deduction in the American Job Creation Act (AJCA) of 2004 provides a specific platform to introduce five concepts from financial accounting that lawyers and economists should consider when setting tax policy: book income matters; tax rate changes immediately affect earnings; current tax expense does not generally equal taxes paid; accounting mixes different methods and permits management judgment; and consolidation rules differ for book and tax income, complicating jurisdictional inferences.

This paper provides a brief introduction to these issues and their implications for the production activities deduction and for tax policy debates broadly.

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BOOK INCOME MATTERS

In setting tax policy, economists might think that managers of corporations will view alternatives as equivalent if they provide equal present values of after–tax cash flows. Legislators can construct an investment incentive through a statutory rate cut, a credit, a permanent deduction, or an accelerated deduction, and write the law to make any of those structures economically equivalent. However, because different structures have different effects on reported book income, corporations may lobby in favor of one alternative over another.

Only rate decreases, credits and permanent deductions increase book income. Accelerating deductions reduces taxable income but does not change reported total tax expense book income.

Table 1 in the Appendix illustrates why expensing an asset for tax purposes improves cash flow but does not change book income. In brief, total tax expense for book purposes equals the sum of tax owed now (current tax expense) plus tax owed later (deferred tax expense) on book income this period. A tax policy that permits accelerated depreciation (in the extreme, expensing an asset) decreases current tax expense but increases deferred tax expense, leaving total tax expense unchanged. If deferred tax expense were discounted for the time value of money, the accelerated tax benefit would affect book income, but accounting for income taxes does not generally reflect any discounting.[1]

The example of expensing versus depreciating begs the following questions. If the effect on tax expense is so simple, why can't financial statement users observe the cash flow benefit of the tax policy? Are markets so inefficient? The question of whether and in what settings financial reporting "matters" are at the heart of academic research in accounting. Policymakers need to worry about short–run and transition effects. Although markets are reasonably efficient, at least in the long run, evidence is mixed about short–run market efficiency (see Fama (1998), Kothari (2001), and Thaler (1999) for reviews of this literature).

The most obvious short–run effects involve contracts. For example, manager bonuses and debt covenant restrictions are frequently based on reported book income and balance sheet amounts. Such contracts induce preferences for rate decreases, credits or permanent deductions over rapid expensing. Reported details concerning deferred tax expense components do not permit financial statement users to understand easily the benefit of a tax change on a corporation's cash flows. The more complex is the tax change, the less able are analysts (Plumlee, 2003) and other financial statement users to evaluate the effect of the tax change on the corporation. Hence, the mapping of a tax benefit into the corporation's stock price is likely to be less efficient in the short run, especially as the complexity of the tax provision increases. For example, casual inspection of company footnotes shows many firms reporting that the company has not determined the effect of the repeal of extra–territorial income (ETI) exclusion and the enactment of the domestic production activities deduction on the company's financials.

[1] To the extent the book–tax difference already reflects discounting, the deferred tax expense will as well. For example, Statement of Financial Accounting Standards No. 106 requires that firms record a book expense for the estimated present value of post–retirement benefits other than pensions. This expense for promised benefits (typically medical benefits) is not deductible until paid. Because the book expense is the present value amount, the associated deferred tax expense is already discounted as well. Note that because this is a delayed deduction, the entry to deferred tax expense is a credit, meaning that it represents a future deduction, or deferred tax asset.

The domestic manufacturing deduction is a new deduction that reduces only taxable income but does not change book expenses. As such, this deduction is a "permanent" item, because pre–tax book income is unchanged, but taxable income is lower. Net book income will increase, however, because current and total tax expense will both be smaller. When the domestic manufacturing deduction was first passed, the Financial Accounting Standards Board (FASB) opined that it was not equivalent to a rate cut (FSP FAS 109–1—Application of FASB Statement No. 109, *Accounting for Income Taxes*, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 (December 21, 2004)) and, thus, should only affect tax expense prospectively. As the next section shows, rate cuts have immediate effects on income because they affect existing deferred tax assets and liabilities.

TAX RATE CHANGES AFFECT ACCUMULATED DEFERRED TAXES

As explained above, a deferred tax asset is a tax benefit that will materialize in the future. The utilization of a deferred tax asset simply reduces taxable income in the future and results in a tax benefit in that future period. A common example of a future tax benefit arising from the utilization of a deferred tax asset relates to using a net operating loss carryforward to offset future taxable income. Another example noted above is a deferred tax asset arising from other post–retirement employment benefits.[2] Because retirement medical expenses for current workers cannot be deducted until the medical costs are paid to retirees, the tax benefit of the current book expense is deferred.

In contrast, a deferred tax liability is additional tax that must be paid later. The most common example relates to accelerated depreciation or expensing. In future years when the tax basis is exhausted, the taxable revenues are no longer sheltered by depreciation, and the tax benefit of such acceleration must be repaid. In such years, the book depreciation expense exceeds any tax depreciation expense, and the deferred tax liability begins to reverse.

Statutory tax rate changes affect the rate at which benefits are received or liabilities are repaid. If the statutory tax rate *decreases*, corporations' deferred tax assets are worth less because benefits will occur at lower rates. At the same time, corporations' deferred tax liabilities cost less because the liabilities are repaid at lower rates. Thus, corporations with a net asset position must record a loss, but firms with a net liability position report a book gain.

When Congress was considering various tax policy alternatives to motivate domestic manufacturing, corporations with net deferred tax assets preferred a permanent *deduction* rather than a *rate cut* because they did not want to write down their deferred tax assets. Coming on the heels of the 2001 recession, many corporations had large net operating loss carryforwards (NOLs), which generated deferred tax assets. Thus, companies with NOLs would have opposed a rate cut.

CURRENT TAX EXPENSE DOES NOT EQUAL TAXES PAID

Although accountants understand the limitations of using current tax expense to estimate taxes paid, researchers, analysts, reporters and commentators who are not trained in accounting still use tax expense as a naïve proxy for taxes paid. In the worst case, readers use the total tax expense to infer something about U.S. taxes paid. But total tax expense includes taxes to be paid later (deferred tax, as explained

[2] Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (Issue Date 12/90).

above) as well as foreign, state and other taxes. A better, but still imperfect proxy for U.S. taxes paid is the U.S. current tax expense.

Current tax expense differs from taxes paid in several important respects (see Hanlon (2003) for a thorough but clear paper devoted to this topic). First, exercising nonqualified stock options affects current tax expense differently than taxes paid on the return. Nonqualified stock option expense reduces taxable income, which reduces taxes paid on the tax return. Prior to 2006, however, companies were not required to record any book expense related to stock options. The reasoning was that a company should not record a gain or loss from trading in its own stock.[3] Thus, exercising nonqualified stock options reduced taxes paid on the return but did not affect book income or current tax expense. Any tax benefit from the exercise of stock options was recorded only as an increase in stockholders' equity.

However, the FASB reconsidered the argument that when employees can purchase stock for less than fair market value, they receive compensation. Starting in 2006, firms must record an expense for the value of the granted options. The valuation method uses a modified Black–Scholes pricing formula. However, the estimated expense at the date of grant will still be lower than the difference between fair value and strike price for exercised in–the–money options. As a result, taxes paid on the U.S. tax return will be lower than recorded U.S. current tax expense for companies that have a stock option deduction, both pre–2006 and post–2005.

A second difference between current tax expense and tax paid on the return is the provision for tax contingencies, or tax cushion. Under Statement of Financial Accounting Standards No. 5 (SFAS5), *Accounting for Contingencies*, a firm must record probable and estimable loss contingencies. Thus, if the firm reports tax positions that it believes will probably be detected and overturned by the IRS or other tax authorities, it must accrue a provision for the loss. Recently, the FASB (2006) provided new guidance about how to record tax benefits related to those positions. The FASB now requires that corporations record "the best estimate of the impact of a tax position only if that position is more likely than not of being sustained on [IRS] audit based solely on the technical merits of the position," thus reducing the flexibility that management judgment previously permitted. Firms must determine this probability based solely on the merits of the position and ignore any detection risk. Consistent with the difference between U.S. current tax expense and taxes paid on the U.S. corporation income tax return including tax cushion, Gleason and Mills (2002) find the difference is related to IRS audit adjustments.

Finally, tax attributes such as unused credits and loss carryovers generate differences between current tax expense

[3] The requirement to record a book expense for stock options developed slowly from initial disclosure requirements (SFAS123).

Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123* (Issue Date 12/02).

Statement No. 123 (revised 2004), *Share-Based Payment* (Issue Date 12/04) Effective Date:
For public entities that do not file as small business issuers—as of the beginning of the first interim or annual reporting period that begins after June 15, 2005; for public entities that file as small business issuers—as of the beginning of the first interim or annual reporting period that begins after December 15, 2005; for nonpublic entities—as of the beginning of the first annual reporting period that begins after December 15, 2005.

Statement No. 123, *Accounting for Stock-Based Compensation* (Issue Date 10/95).

and taxes paid. For financial reporting purposes, the tax benefit of loss and credit carryovers are recognized in full, reduced by a valuation allowance for probable expiration. However, taxes paid will not decrease until the credit or loss carryover reduces future taxes paid.

To conclude point three—that current tax expense does not equal taxes paid—this section reviews the disclosures in the financial statement income tax footnote. For illustration purposes, Table 2 in the Appendix displays excerpts from the 2005 income tax footnote for Corning Inc. The tax footnote discloses the components of income tax expense, divided into (if material): current versus deferred, and U.S., foreign, state and other. Thus, for Corning Inc., observe that total pretax income (in millions) is $550.10 U.S. and $262.20 foreign. Note that the U.S. likely taxes more income than $550.10, because intercompany repatriations from foreign subsidiaries such as dividends or royalties would not be recorded as book income.

Further, the firm discloses the material components of deferred tax assets and liabilities. However, the components of deferred tax assets and liabilities are not broken down by U.S. versus foreign. Therefore, a reader of the financial statement cannot tell to which jurisdictions the temporary differences relate. For example, Corning Inc. has a deferred tax liability of $196.40 related to property, plant and equipment, but we cannot tell how much of this is due to property, plant and equipment bonus depreciation on post 9/11/2001 investment in U.S. property.

Finally, the tax footnote reconciles (either in dollars or percentage of pretax income) total income tax expense to the tax expense computed at the top U.S. statutory rate (currently 35 percent). The items that reconcile the effective tax rate to 35 percent include credits, permanent differences, valuation allowances, and tax cushion, although the latter is rarely disclosed. Corning Inc. has an effective tax rate of 31.20 percent, which is lower than 35 percent due to extraterritorial income tax incentives, the domestic manufacturing deduction, the U.S. tax effect of foreign earnings and dividends, the deduction allowed for tax exempt interest income, and other net deductions.

As a permanent difference, the domestic manufacturing deduction is disclosed in the effective tax rate reconciliation if it is material. FASB's FSP FAS 109-1—Application of FASB Statement No. 109, *Accounting for Income Taxes*, to the Tax Deduction on Qualified Production Activities Provided by AJCA 2004 made clear that such treatment was prospective only and should not be treated as equivalent to a rate cut. Because the domestic manufacturing deduction phases in from three percent to six percent to nine percent, the disclosure may not materialize until the deduction is fully phased in. Corning Inc., however, is one of the companies that disclosed the effect of the domestic manufacturing deduction. As the tax footnote illustrates, the domestic manufacturing deduction reduced Corning Inc.'s income tax provision by $4.80.

ACCOUNTING MIXES DIFFERENT METHODS AND PERMITS MANAGERIAL JUDGMENT

Researchers in accounting, finance, economics and other disciplines use financial statement balance sheet information as measures of investment. Measures such as "market-to-book" ratios or "q" are used to estimate value relative to cost. However, researchers must understand that assets and liabilities are recognized under different methods, depending on the item. Because firms have some latitude in methods, recognition is not perfectly consistent across firms. Further, accounting standards generally provide principles, not rules, so managers exercise judgment and discretion in the valuation of assets.

A brief set of examples follows. These examples do not attempt to be comprehensive concerning financial reporting. Rather, I intend to show the variation in methods for reporting assets and liabilities within a single balance sheet.

Researchers that are not trained in accounting often assume that under Generally Accepted Accounting Principles, assets are reported at historical cost. In actuality, balance sheet amounts are reported at historical cost, current cost or fair value, net realizable value and discounted present value (see, for example, Revsine, Collins and Johnson (1999, chapter 4)). Even with historical cost, however, differences exist. Regarding inventory on hand at the end of the period, the items may be valued based on the oldest inventory (last–in, first–out) or based on the most recently purchased inventory (first–in, first–out). Relatedly, inventory must be stated at the lower of cost or market value, so it may be stated at replacement cost, rather than historical cost, when market values are declining.

Some assets are restated to fair market value at each reporting period. One example is marketable securities held as short–term investments. Both trading and available–for–sale securities are marked–to–market on the balance sheet, although the gain or loss is only recorded in income for trading securities and is recorded in stockholders' equity for securities classified as "available for sale." In addition to different measurement rules for recorded assets, some expenditures cannot be recorded as assets even though the firm incurs the costs hoping for future benefits. Specifically, R&D and advertising expenditures are treated as expenses and do not create assets. Thus, self–created intangibles (patents, know–how, brands) generate much of the spread between the market value and the book value of the firm. However, purchased intangibles are recorded at their fair market value at purchase.[4] Hence, corporations have differing "market–to–book" or "q" depending not only on the value of their underlying intangible assets, but also on whether such intangibles were purchased or self–created.

Liabilities also reflect differences in recognition method. Again, liabilities traditionally reflect historical cost. Thus, if a corporation borrows debt at a then–prevailing market rate of interest, the debt is recorded at face value. Such debt is not generally written up or down as the interest rates change. However, as financial markets grew more complex in the last decades, more debt carries variable rates of interest or derivative financial instruments that have the effect of market interest rates.[5] Hence, many liabilities are stated at market values.

[4] SFAS 141 and 142 both affected the accounting for intangibles. SFAS 141 now requires that all acquisitions be accounted for as purchases, eliminating the so–called "pooling method." SFAS 142, however, eliminated the 40–year book amortization of purchased goodwill, only requiring writedowns if such goodwill is impaired. Statement No. 142, *Goodwill and Other Intangible Assets* (Issue Date 6/01) Effective Date: For fiscal years beginning after December 31, 2001; goodwill acquired in business combinations after June 30, 2001 shall not be amortized. Statement No. 141, *Business Combinations* (Issue Date 6/01) Effective Date: For all business combinations initiated after June 30, 2001.

[5] The FASB has worked to provide guidance that keeps pace with growing complexity of financial instruments. A brief list of standards related to liabilities and equity follows.

Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (Issue Date 4/03).

Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities—an amendment of FASB Statement No. 133* (Issue Date 6/00).

Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133—an amendment of FASB Statement No. 133* (Issue Date 6/99).

Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (Issue Date 6/98).

Note that an interesting exception to market valuation of liabilities relates to deferred tax liabilities. Because a taxpayer does not owe interest on deferred tax liabilities, the market value of owing more tax when a temporary difference reverses is less than the face amount of the deferred tax liabilities. Thus, the face value of future tax owed when, for example, depreciation deductions reverse, exceeds the discounted present value. Not all deferred tax items are at face value, however. Because the non–deductible book expense for other post–retirement employee benefits is itself based on the discounted cost of such benefits, the deferred tax asset is effectively discounted, too.

More broadly, worldwide financial statements are not designed to consistently disclose U.S. versus foreign investments. SFAS 131 requires disclosures of reportable operating segments.[b] These operating segment disclosures sometimes, but not always, reveal the country in which revenues are earned and assets held. However, SFAS131 does not require an enterprise to report information that is not prepared for internal use if reporting it would be impracticable. Thus, financial accounting standards do not require consistent geographic disclosures that would permit policymakers or tax enforcers to estimate domestic manufacturing.

CONSOLIDATION RULES DIFFER FOR BOOK AND TAX INCOME

Consolidated financial statements include all the controlled entities of the parent corporation. Generally, control is presumed to exist if the corporation owns greater than 50 percent of the voting stock. Note that in the 1990s, corporations could exclude special purpose entities from their consolidated financial statements even with stock ownership as great at 97 percent. Corporations could use such special entities to remove debt from the consolidated balance sheet (Mills and Newberry, 2005). The FASB tightened its reporting requirements for such entities in Interpretation 46(R), {Interpretation 46(R) *Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51*}, to make it more difficult to exclude such entities from the consolidated financial statement.

Tax consolidation is governed by IRC §1501, which provides that affiliated groups may elect to file a single consolidated return. An affiliated group generally consists of a domestic parent corporation and all of its domestic subsidiaries in which it has at least an 80 percent ownership interest.

Due to the differing rules, 50–79 percent owned domestic corporations and 50–100 percent owned foreign corporations are excluded from the U.S. tax return but are included in the worldwide financial statement. Thus, the worldwide consolidated financial statement includes assets, liabilities, income and expenses for a larger enterprise than does a U.S. consolidated tax return. These differences contribute to difficulty in using the tax return reconciliation form Schedule M—1 (Mills and Plesko, 2003).

Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (Issue Date 10/94).

[b] Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (Issue Date 6/97). "This Statement requires that a public business enterprise report a measure of segment profit or loss, certain specific revenue and expense items, and segment assets. It requires reconciliations of total segment revenues, total segment profit or loss, total segment assets, and other amounts disclosed for segments to corresponding amounts in the enterprise's general–purpose financial statements. It requires that all public business enterprises report information about the revenues derived from the enterprise's products or services (or groups of similar products and services), about the countries in which the enterprise earns revenues and holds assets, and about major customers regardless of whether that information is used in making operating decisions. However, this Statement does not require an enterprise to report information that is not prepared for internal use if reporting it would be impracticable" (SFAS131 Summary).

Nevertheless, until Schedule M—3 and related instructions clarified tax return reporting requirements, many taxpayers appeared to include aggregated balance sheets on Schedule L that might have included all the financial statement entities or failed to post elimination entries between related corporations. Mills, Newberry, and Trautman (2002) document that the Schedule L balance sheet assets and liabilities sometimes exceeded even the consolidated worldwide financial statement amounts. Further, Boynton, DeFilippes and Mills (2004) reveal that Statistics of Income adjustments for intercompany dividends, while correcting gross dividends and special deductions, do not clearly indicate whether book income on the Schedule M—1 reflects appropriate eliminations.

Cross–border accounting is critical for tax enforcement, but less so for financial reporting. Although firms separately report domestic versus foreign pretax income in their income tax footnotes, this distinction does not follow U.S. sourcing rules. Hence, policymakers and tax administrators cannot rely on financial statement disclosures to determine income over which the U.S. has jurisdiction. This caveat is important for estimating the revenue consequences of replacing the current corporate income tax system with one that taxes U.S. book income. Tax administrators need complex regulations to define sources of income and deductions. In fact, the regulations for the domestic production activities deduction mirror the transfer–pricing regulations of IRC Section 861.

CONCLUSIONS

The domestic production activities deduction provides a setting to consider how financial accounting considerations can affect tax policy debates. Increasingly, policymakers consider accounting and capital market effects in evaluating alternatives. For instance, the President's Advisory Panel on Federal Tax Reform considered the implications of various reforms on financial accounting.

To recap, publicly traded corporations care about book income and are likely to lobby to avoid losses and increase income. Because rate changes affect deferred tax assets and liabilities, rate changes affect corporate income immediately. I offer several caveats about using financial statement data to provide evidence on tax policy. First, balance sheets do not perfectly measure investment. Second, current tax expense does not equal taxes paid. Finally, because consolidation rules differ for book and tax, it is difficult to estimate U.S. entity effects from financial statements. In sum, public data such as financial statements provide imperfect pictures of tax reporting. Corporate tax return data, if made public, could permit non–government researchers to assist policymakers and tax administrators with additional analysis. Continued cross–education among accountants, lawyers and economists can only help us improve our separate contributions.

I offer two closing notes to my colleagues. To the lawyers: Lawyers need to keep in mind that accounting as a language will typically communicate via numbers and legal nuances may get lost. To the economists: Despite the fact that accounting provides numerical measures of firm performance, accounting principles may not allow certain economic measures to be represented to the markets as clearly as an economist would like. Therefore, since accounting is the primary means by which management communicates to the market, it is important for lawyers and economists to understand what accounting can and cannot communicate.

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APPENDIX

TABLE 1
ILLUSTRATION OF THE DIFFERENTIAL EFFECTS OF ACCELERATED DEPRECIATION ON CASH FLOWS AND BOOK NET INCOME

Assumptions:

1. The company has a $7,000 annual gross margin.
2. The company has a $3,000 asset with a three–year depreciable life.
3. Straight line depreciation is used for book purposes.
4. The company is in the 30% tax bracket.

Tax Return	Year 1	Year 2	Year 3
Gross margin pretax	$7,000	$7,000	$7,000
Immediately expense asset for tax	–3,000	0	0
Taxable income	4,000	7,000	7,000
Taxes payable (30%)	–$1,200	–$2,100	–$2,100

Note: immediate expense decreases Year 1 cash outflow for taxes.

Financial Statement			
Gross margin pretax	$7,000	$7,000	$7,000
Book straight–line depreciation	–1,000	–1,000	–1,000
Pretax book income	6,000	6,000	6,000
Temporary difference between book income and taxable income	2,000	–1,000	–1,000
Deferred tax expense (30%)	–600	300	300
Current tax expense from above	–1,200	–2,100	–2,100
Total tax expense	–$1,800	–$1,800	–$1,800
Net income per books	$4,200	$4,200	$4,200

Note: net income per books is the same each year.

Source: Martin (2001).

TABLE 2
DOW CORNING CORPORATION'S* 2005 TAX FOOTNOTE

The components of income before income taxes and minority interests as of December 31, 2005, 2004 and 2003 are as follows:

	Dollars in millions		
	2005	2004	2003
Income Before Income Taxes and Minority Interests:			
Domestic	$550.10	$215.60	$148.10
Foreign	262.20	166.30	129.20
Total Income Before Income Taxes and Minority Interests	$812.30	$381.90	$277.30

The components of the income tax provision as of December 31, 2005, 2004 and 2003 are as follows:

	2005		
	Current	Deferred	Total
Provision (Credit) for Income Taxes:			
Domestic	$98.80	$62.80	$161.60
Foreign	64.10	28.10	92.20
Total Provision (Credit) for Income Taxes	$162.90	$90.90	$253.80

	2004		
	Current	Deferred	Total
Provision (Credit) for Income Taxes:			
Domestic	$71.90	$15.80	$87.70
Foreign	50.50	-13.00	37.50
Total Provision (Credit) for Income Taxes	$122.40	$2.80	$125.20

	2003		
	Current	Deferred	Total
Provision (Credit) for Income Taxes:			
Domestic	$25.70	$24.90	$50.60
Foreign	45.30	-1.60	43.70
Total Provision (Credit) for Income Taxes	$71.00	$23.30	$94.30

The tax effects of the principal temporary differences as of December 31, 2005 and 2004 giving rise to deferred tax assets and liabilities were as follows:

	2005	2004
Deferred Tax Assets:		
Implant costs	$586.30	$619.50
Accruals and other	67.00	138.10
Postretirement benefit obligations	192.70	183.10
Inventories	28.80	28.50
Long-term debt	31.70	22.20
Tax loss carryforwards	160.60	192.80
Total Deferred Tax Assets	1,067.10	1,184.20
Deferred Tax Liabilities:		
Property, plant and equipment	-196.40	-197.80
Net Deferred Tax Asset Prior to Valuation Allowance	870.70	986.40
Less: Valuation Allowance	-1.60	-3.10
Net Deferred Tax Asset	$869.10	$983.30

Management believes that it is more likely than not that the net deferred tax asset will be realized. This belief is based on criteria established in SFAS No. 109. The criteria that management considered in making this determination were historical and projected operating results, the ability to utilize tax planning strategies and the period of time over which the tax benefits can be utilized.

Tax effected operating loss carryforwards at December 31, 2005 amounted to $160.60 compared to $192.80 at the end of 2004. All of the tax effected operating loss carryforwards are subject to expiration in 2007 or have an indefinite carryforward period. Substantially all tax effected operating loss carryforwards were generated by the Company's subsidiary in the United Kingdom. There is an unlimited carryforward of net operating losses in the United Kingdom and management has determined that no valuation allowance is needed for these net operating losses.

The valuation allowance of $1.60 is attributable to the inability to utilize net operating loss carryforwards from the Company's subsidiaries of $0.50 in Australia, and $1.10 in Ireland. The operating loss carryforward in Australia is subject to expiration in 2007. The operating loss carryforward in Ireland has an indefinite carryforward period.

Cash paid during the year for income taxes, net of refunds received, was $156.80 in 2005, $103.70 in 2004 and $66.50 in 2003.

The income tax provision at the effective rate differs from the income tax provision at the United States federal statutory tax rate in effect during December 31, 2005, 2004 and 2003 for the reasons illustrated below:

	2005	2004	2003
Income Tax Provision at Statutory Rate	$284.30	$133.60	$97.00
Foreign provisions and related items	0.40	−11.50	−0.40
Extra territorial income	−14.70	−7.20	−5.90
Domestic manufacturing deduction	−4.80	–	–
U.S. tax effect of foreign earnings and dividends	−21.20	12.30	−2.50
State income taxes	27.40	1.10	3.20
Tax exempt interest income	−4.70	−1.90	−2.20
Other, net	−12.90	−1.20	5.10
Total Income Tax Provision at Effective Rate	$253.80	$125.20	$94.30
Effective Rate	31.20%	32.80%	34.00%

The Company has completed its evaluation of FSP No. FAS 109–2 with respect to all foreign subsidiaries. As of December 31, 2005, the Company had repatriated approximately $246.70 of earnings from 11 foreign subsidiaries under this provision. The total net tax expense associated with these remittances was approximately $12.70. Income of $4.50 was recognized during the year ended December 31, 2005, and expense of $17.20 was recognized during the year ended December 31, 2004, as the result of these remittances.

During the year ended December 31, 2005, the Company recorded a deferred income tax asset of $9.80 on $46.40 of undistributed earnings that will be repatriated in the foreseeable future. In addition, the Company recorded a deferred income tax liability of $1.10 on $10.90 of undistributed earnings that are not considered to be permanently reinvested. As of December 31, 2005, income and remittance taxes have not been recorded on $166.20 of undistributed earnings of foreign subsidiaries, either because any taxes on dividends would be offset substantially by foreign tax credits or because the Company intends to reinvest those earnings indefinitely.

*A corporation owned by Corning Incorporated and the Dow Chemical Company.
Source: Corning Incorporated 2005 10–K.