The Evolving Schedule M–3: A New Era of Corporate Show and Tell?

Abstract - This paper supplements the arguments for replacing Schedule M–1 and outlines the main features of the proposed Schedule M–3. We examine the magnitude of reported book–tax differences and provide evidence of consolidation issues affecting Schedules M–1, L, and Form 1120. Features of the new Schedule M–3 are designed to standardize reporting across firms and distinguish permanent from temporary book–tax differences. Overall, comments received by IRS and Treasury from private industry generally support the proposed changes, with some concerns regarding scope, the size threshold, the need to determine book income on a transaction basis, and effective date.

INTRODUCTION


We supplement arguments for revising Schedule M–1 using data from the year 2000 to provide evidence of reporting inconsistencies. We discuss the magnitude of aggregate book–tax difference (BTD) and evidence of ambiguity as to what taxpayers report on Schedule M–1 and the related Schedule L book balance sheet. Further, we present evidence that some large corporations (assets of $1 billion or more) use improper consolidation shortcuts in preparing Form 1120, Schedule M–1, and Schedule L balance sheet.

We provide a progress report on the joint Treasury/IRS working group that developed proposed Schedule M–3. In
doing so, we describe new features of Schedule M–3 and the proposed effective date and scope.

We conclude by summarizing the discussion by George Manousos of this paper on May 21, 2004, at the National Tax Association (NTA) Midyear meeting. That discussion focuses on responses received by the IRS and Treasury during the comment period that ended April 30, 2004.

2000 BOOK–TAX DIFFERENCE (BTD)

Plesko (2004) reviews the trend and components of book–tax differences from 1995 through 2001. We focus on the year 2000 for simplicity and describe how aggregate book–tax differences include both large positive and large negative differences.

See Table 1. We measure book tax differences (BTD) as book income (Schedule M–1, line 1) plus book federal income tax expense (Schedule M–1, line 2), less net income for tax (Form 1120, page 1, line 28). For tax return years ending July 2000 through June 2001 (hereafter 2000), the aggregate book–tax difference (BTD) for all 2,172,705 C corporations (excludes S, RIC, REIT) is $266.1 billion with $611.9 billion greater than zero and ($345.8) billion less than zero. For 2000, for the 2,555 C corporations with Schedule L total assets of $1 billion or more, BTD is $302.8 billion with $491.3 billion greater than zero and ($188.5) billion less than zero. For 2000, for the 44,501 C corporations with Schedule L total assets of $10 million to $1 billion, aggregate BTD is ($48.4) with $72.1 billion greater than zero and ($120.5) billion less than zero. For 2000, for the 2,125,649 C corporations with Schedule L assets of less than $10 million, aggregate BTD is $11.7 billion with $48.5 billion greater than zero and ($36.8) billion less than zero.

For 2000, total tax less credits for all C Corporations was $201.7 billion. Of this, $148.1 billion tax is paid by C corporations with Schedule L assets of $1 billion or more, $ 39.5 billion by C corporations with Schedule L total assets of $10 million to $1 billion, and $14.1 billion by C corporations with Schedule L assets of less than $10 million. Thus, more than 90 percent of corporate tax revenues are paid by corporations with assets greater than $10 million.

ENTITY DIFFERENCES

Parts of the following discussion also appear in Boynton, DeFilippes, Lisowsky, and Mills (2004). In general, financial statement consolidation requires all entities controlled by a corporation to be consolidated in the financial statements.\(^1\) Tax return consolidation cannot include foreign corporations, less than 80 percent owned domestic corporations, and non–corporations. Thus, we generally expect the assets of the includible corporations on the consolidated tax return to be less than the assets of the entities in a consolidated worldwide financial statement.

"BOOK" INCOME AND ASSETS ON TAX RETURN OFTEN DO NOT EQUAL FINANCIAL STATEMENTS

Schedule M–1 begins with net income according to the corporation’s “books and records.” However, these instructions do not specify the source for book income or which entities it should encompass. In Table 2, we demonstrate the inconsistencies in the Schedule M–1 starting point

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### TABLE 1
AGGREGATE BOOK–TAX DIFFERENCES FOR ALL C CORPORATION TAX RETURN YEARS ENDING JULY 2000 THROUGH JUNE 2001

<table>
<thead>
<tr>
<th>2000 CSOI: Excluding S-Corps, RICs, and REITs (Dollars in thousands, Weighted)</th>
<th>RETURNS</th>
<th>BTD = M1 Lines 1+2 less NET-INCM</th>
<th>BTD &gt; 0</th>
<th>BTD &lt;= 0</th>
<th>TOT–TX–LS–CR</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sum</td>
<td>%</td>
<td>Sum</td>
<td>%</td>
<td>Sum</td>
</tr>
<tr>
<td>All</td>
<td>2,172,704.8</td>
<td>100.0</td>
<td>266,138,212.6</td>
<td>100.0</td>
<td>611,919,752.2</td>
</tr>
<tr>
<td>Assets &gt;= $1 Billion</td>
<td>2,555.0</td>
<td>0.1</td>
<td>302,844,444.1</td>
<td>113.8</td>
<td>491,344,890.0</td>
</tr>
<tr>
<td>Assets: $250 Mil–$1 Bil</td>
<td>4,094.0</td>
<td>0.2</td>
<td>~20,444,923.4</td>
<td>~7.7</td>
<td>38,914,069.5</td>
</tr>
<tr>
<td>Assets: $100–$250 Mil</td>
<td>5,678.3</td>
<td>0.3</td>
<td>~10,874,948.5</td>
<td>~4.1</td>
<td>15,155,951.4</td>
</tr>
<tr>
<td>Assets: $50–$100 Mil</td>
<td>6,187.4</td>
<td>0.3</td>
<td>~6,341,500.1</td>
<td>~2.4</td>
<td>6,514,862.6</td>
</tr>
<tr>
<td>Assets: $10–$50 Mil</td>
<td>28,541.6</td>
<td>1.3</td>
<td>~10,716,928.0</td>
<td>~4.0</td>
<td>11,531,903.5</td>
</tr>
<tr>
<td>LMSB: Assets &gt;= $10 Mil</td>
<td>47,056.3</td>
<td>2.2</td>
<td>254,467,144.1</td>
<td>95.6</td>
<td>563,461,677.0</td>
</tr>
<tr>
<td>SBSE: Assets &lt;$10 Mil</td>
<td>2,125,648.5</td>
<td>97.8</td>
<td>11,671,068.4</td>
<td>4.4</td>
<td>48,458,075.1</td>
</tr>
</tbody>
</table>
## TABLE 2
COMPARISONS OF BOOK INCOME AND ASSETS BETWEEN TAX RETURN AND FINANCIAL STATEMENT

<table>
<thead>
<tr>
<th></th>
<th>Assets &gt;= $1 Billion</th>
<th>Assets: $250 Mil to 1 Bil</th>
<th>Assets: $100 to $250 Mil</th>
<th>Assets: $50 to $100 Mil</th>
<th>Assets: $10 to $50 Mil</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sum</td>
<td>%</td>
<td>Sum</td>
<td>%</td>
<td>Sum</td>
</tr>
<tr>
<td>RETURNS</td>
<td>702</td>
<td>100.0</td>
<td>676</td>
<td>100.0</td>
<td>482</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a NI Ratio &lt;0.995</td>
<td>323</td>
<td>46.0</td>
<td>283</td>
<td>41.9</td>
<td>140</td>
</tr>
<tr>
<td>b NI Ratio 0.995–1.005</td>
<td>155</td>
<td>22.1</td>
<td>254</td>
<td>37.6</td>
<td>250</td>
</tr>
<tr>
<td>c NI Ratio&gt;1.005–1.250</td>
<td>98</td>
<td>14.0</td>
<td>80</td>
<td>11.8</td>
<td>62</td>
</tr>
<tr>
<td>d NI Ratio&gt;1.250</td>
<td>126</td>
<td>17.9</td>
<td>59</td>
<td>8.7</td>
<td>30</td>
</tr>
<tr>
<td>a AssetRatio&lt;0.995</td>
<td>250</td>
<td>35.6</td>
<td>294</td>
<td>43.5</td>
<td>186</td>
</tr>
<tr>
<td>b AssetRatio 0.995–1.005</td>
<td>124</td>
<td>17.7</td>
<td>210</td>
<td>31.1</td>
<td>207</td>
</tr>
<tr>
<td>c AssetRatio&gt;1.005–1.250</td>
<td>169</td>
<td>24.1</td>
<td>132</td>
<td>19.5</td>
<td>70</td>
</tr>
<tr>
<td>d AssetRatio&gt;1.250</td>
<td>159</td>
<td>22.6</td>
<td>40</td>
<td>5.9</td>
<td>19</td>
</tr>
<tr>
<td></td>
<td>100.0</td>
<td></td>
<td>100.0</td>
<td></td>
<td>100.0</td>
</tr>
<tr>
<td></td>
<td>100.0</td>
<td></td>
<td>100.0</td>
<td></td>
<td>100.0</td>
</tr>
</tbody>
</table>

Note: Sample consists of matched tax returns and financial statements for SOI year 2000 (July 2000–June 2001) for nonfinancial C corporations (exclude S, RIC, REIT and SIC codes 6000–6999) where net income per books (M–1 line 1) and net income per financial statements were both positive. We examine the frequency with which the net income per books matched (within+/–0.5%)(0.995–1.005), was less (<0.995), greater (>1.005), or much greater (>1.250) than the net income per financial statements. We further examine the frequency with which total assets per books (Schedule L) matched (0.995–1.005), was less (<0.995), greater (>1.005), or much greater (>1.250) than total assets per financial statements. We analyze the data within asset classes based on the total assets per book (Schedule L).
by comparing line 1 to net income on published financial statements.

For 2000, for a matched sample of 2,548 C corporations with publicly available financial statements and with positive financial statement net income and positive book income (Schedule M–1, line 1), the percent reporting the same (within +/–0.5 percent) book income and financial statement net income is 62.6 percent for Schedule L assets of $10 million to $50 million (406 corporations), 55.7 percent for $50 million to $100 million (282 corporations), 51.9 percent for $100 million to $250 million (482 corporations), 37.6 percent for $250 million to $1 billion (676 corporations), and 22.1 percent for $1 billion or more (702 corporations).

We focus our attention on the 702 sample corporations with assets $1 billion or more. If only 22 percent start Schedule M–1 with their published financial statement net income, then interpreting book–tax differences is obscured by an inconsistent starting point. Further, the remaining 78 percent are not consistently reporting in either direction. About 46 percent report book income less than financial statement net income. This is not surprising because one reasonable approach would be to exclude income of nonincludible corporations like foreign subsidiaries. However, about 32 percent report book income greater than financial statement net income, which is harder to explain. Boynton, DeFilippes, Lisowsky, and Mills (2004) explore consolidation anomalies in more depth and find that many of the corporations with this anomalous line 1 reporting also misreport intercompany dividends. We suggest that regardless of the reason, additional detail and standardized reporting, as required by proposed Schedule M–3, will remedy the inconsistencies among firms.

We also consider whether corporations are using their financial statement balance sheet information to complete Form 1120, Schedule L. Looking at our sample of 2,548, the percent reporting the same (within +/–0.5 percent) Schedule L total assets and financial statement total assets is 55.7 percent for Schedule L assets of $10 million to $50 million (406 corporations), 50.4 percent for $50 million to $100 million (282 corporations), 42.9 percent for $100 million to $250 million (482 corporations), 31.1 percent for $250 million to $1 billion (676 corporations), and 17.7 percent for $1 billion or more (702 corporations). A total of 35.6 percent of the C corporations in the sample with Schedule L assets of $1 billion or more reported Schedule L total assets of less than financial statement total assets and 46.7 percent reported more. Since the tax return excludes foreign corporations and 51 to 79 percent owned U.S. corporations, it is anomalous to report more book assets on the tax return than on the financial statement balance sheet.

INTERCOMPANY DIVIDENDS

Boynton, DeFilippes, Lisowsky, and Mills (2004) discuss the issues below in further detail. In 2000, 1,485 C corporations, out of the total of 2,172,705 C corporations, failed to consolidate Schedule C dividends received data by failing to eliminate intercompany distributions from consolidated dividends received.²

² Under Internal Revenue Code Section 1501, an affiliated group of corporations may elect to file a consolidated return. IRC Section 1504 defines an affiliated group as consisting of a parent corporation and includible corporations in which the parent owns at least 80 percent of voting power and value. Per Section 1504(b), an includible corporation excludes foreign corporations. For purposes of this paper, we refer to dividends paid among members of the affiliated group, such as a dividend from an includible corporation to its parent, as “intercompany distributions” per Regulation 1.1502–13(f)(2)(i). According to Reg. 1.1502–13(f)(2)(ii), “an intercompany distribution is not included in the gross income of the distributee member (B) . . . B’s dividend received deduction under section 243(a)(3) is determined without regard to any intercompany distributions
The overstated total dividend received amount flows from Schedule C to Form 1120, page 1, line 4 total dividends, from there to line 11 tax total income, and from there to line 28 tax net income. The overstated special deductions (DRD) flows from Schedule C to Form 1120, page 1, line 29b special deductions and offsets the overstated total dividends received amount on line 28 when both are combined for line 30 taxable income.

The Statistics of Income (SOI) division of IRS prepares the tax return data that we use for this analysis. If SOI determines that intercompany distributions have not been eliminated from Schedule C, SOI subtracts them from all affected fields. SOI started making the corrections with the 1990 SOI corporate data files. Starting with the 1999 file, SOI began reporting the amount of the correction as the variable DIV–AFFIL–ADJ and also began removing the amount from Schedule M–1, line 10. SOI is unable to make the correction elsewhere in Schedule M–1 because it is not possible for anyone other than the taxpayer to determine where the correction should be made.3

Schedule M–1 reconciles Form 1120, page 1, line 28 tax net income with the sum of income per books (Schedule M–1, line 1) and federal tax expense per books (Schedule M–1, line 2). If the dividends received amount is overstated on Schedule C, then, as discussed above, the amounts on Form 1120, page 1, line 4 total dividends, line 11 tax total income, and line 28 tax net income are overstated. Schedule M–1, line 10 (calculated tax net income for Schedule M–1) must agree with page 1, line 28 tax net income. If page 1, line 28 tax net income is overstated, some item within Schedule M–1 must include the overstatement.

Table 3 shows the amount of intercompany dividend improperly included in both gross dividends and the dividends received deduction. The amount of this error for 2000 is $134 billion. In 2000 there are 2,555 C corporations with Schedule L total assets of $1 billion or more. Of these, 437, or 17.1 percent, made the error.

If we assume that line 1 (book income) is not overstated by intercompany dividends, corrected BTD from Schedule M–1 is computed as line 1 plus line 2 less line 10, where line 10 is reduced by DIV–AFFIL–ADJ. The dividend error of $134 billion is 50.3 percent of corrected BTD of $266 for all C corporations and is 80.2 percent of corrected BTD for those firms making the error. Simply put, net book–tax differences are masked by the taxpayer’s failure to consolidate Schedule C dividends received.4

**IMPETUS FOR CHANGE**

The collapse of Enron in 2001 has been important in setting the stage for calls for better tax disclosure at least to the government and possibly to the public. On July 2, 2002, Alan Murray in the *Wall Street Journal* suggested that information on the tax return of public corporations should be public. A few days later, Senator Grassley of the Senate Finance Committee asked the Treasury and SEC to comment on the value of public disclosure of some of the information on corporate tax returns. Canellos and Kleinbard (2002) immediately suggested

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3 Starting in 1999, SOI corporate file data for Schedule M–1 does not reconcile if the variable DIV–AFFIL–ADJ is non–zero and is not subtracted in calculating line 10. Starting in 1999, the calculation of line 10 becomes “line 6 minus line 9 minus line 9a.”

4 Several members of the Schedule M–3 working group are also working with the IRS to review Form 1120 instructions with respect to consolidation issues affecting balance sheet and dividends received reporting.
## TABLE 3
MAGNITUDE OF INTERCOMPANY DIVIDEND REPORTING ERROR BY SIZE CLASS OF RETURN

<table>
<thead>
<tr>
<th>RETURNS</th>
<th>BTD = M1 Lines 1+2 less NET-INCM</th>
<th>BKTXDIFF &gt; 0</th>
<th>BKTXDIFF &lt;= 0</th>
<th>DIV–AFFIL–ADJ</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sum</td>
<td>%</td>
<td>Sum</td>
<td>%</td>
</tr>
<tr>
<td>All</td>
<td>2,172,704.8</td>
<td>100.0</td>
<td>266,138,212.6</td>
<td>100.0</td>
</tr>
<tr>
<td>a DivAffAdj = 0</td>
<td>2,171,220.3</td>
<td>99.9</td>
<td>99,312,272.8</td>
<td>37.3</td>
</tr>
<tr>
<td>b DivAffAdj &gt; 0</td>
<td>1,484.5</td>
<td>0.1</td>
<td>166,825,939.9</td>
<td>62.7</td>
</tr>
</tbody>
</table>

| Assets >= $1 Billion | 2000 CSOI: Excluding S–Corps, RICs, and REITs (Dollars are in thousands, Weighted) | b Div–Aff–Adj > 0 | Assets: $250 Mil– $1 Bil | 364.0 | 0.0 | 160,925,805.9 | 60.5 | 216,337,833.4 | 35.4 | -55,412,027.5 | 16.0 | 125,435,254.4 | 93.7 |
| Assets: $100– $250 Mil | Assets: $50– $100 Mil | a Div–Aff–Adj > 0 | Assets: <$10 Mil | 364.0 | 0.0 | 191,404.5 | 0.1 | 821,629.1 | 0.1 | -630,224.6 | 0.2 | 919,899.1 | 0.7 |

Note: DIV–AFFIL–ADJ indicates within–tax–consolidation–group dividends that should have been eliminated in consolidation but were not. SOI removes this amount from dividend income and dividend received deduction. It is unclear what correction should be made to Schedule M–1.
that a disclosure of Schedule M–1 would be beneficial.

This led to a conference jointly sponsored by the University of North Carolina Tax Center and the Brookings Institution in April 2003 on “Public Disclosure of Corporate Tax Returns: An Academic Look at Whether (and How) It Would Work.” At the invitation of the conference hosts, Mills and Plesko wrote “Bridging the Reporting Gap: A Proposal for More Informative Reconciling of Book and Tax Income” (2003). To the surprise of both authors and the Internal Revenue Service, there was no public disagreement to the proposal concept from audience members, including representatives from the Tax Executives Institute.

FORMATION OF THE TREASURY–IRS SCHEDULE M–1 REVISION TEAM IN JUNE 2003

In June 2003, the IRS and the Treasury department formed a joint working group to revise Schedule M–1. Both Boynton and Mills were members of this group: Boynton in his capacity as a Surrey Fellow in the Treasury Department and Mills in her capacity as a consultant to IRS Research.

NEW SCHEDULE M–3

Appendix A presents the proposed Schedule M–3 as of July 7, 2004.

New M–3 Standard Line Items

Because the Schedule M–1 only has 10 lines, most of the information is reported by taxpayers on supplemental schedules. Although an IRS examiner can review these book–tax differences in detail if the return is selected for audit, lack of standard categories means that IRS Research cannot analyze book–tax differences for compliance risk by comparing one taxpayer to others.

One example that points out the need for standard line items is stock options. Because few companies expensed any portion of stock option compensation for financial reporting purposes during the 1990s, the tax deduction for stock option exercise sometimes eliminated all taxable income. Thus, the book–tax difference for stock option deduction by itself could explain large differences between financial statement income and taxable income. Hanlon (2003) analyzes Cisco’s and Microsoft’s 2000 financial statements and infers from the tax benefit for stock options in the stockholders’ equity footnote.
that neither company appeared to pay U.S. tax, in spite of reporting a positive current tax expense.

Unfortunately, the IRS cannot easily observe either the stock option deduction or the specific book–tax difference for stock options on the M–1. The large aggregate book–tax difference could cause the return to be selected for audit, because the company might have strong financial profits but no taxable income. If, however, the book–tax difference for stock options were separately reported, that return might be considered lower risk because stock option deductions are provided through legislative grace.

Schedule M–3, Part II provides separate lines for items of income (loss) that generate book–tax differences, and Part III provides separate lines for items of expenses. These lines include items that should represent areas of less compliance risk (e.g., stock option deductions) versus items that should represent areas of higher compliance risk (e.g., charitable contributions of intellectual property).

**New M–3 Temporary Versus Permanent**

During the 1990s, tax departments were increasingly viewed as profit centers rather than cost centers. Phillips (2003), in his study of compensation and effective tax rates in 1997, finds that when business unit managers are compensated on an after–tax basis, firms have lower effective tax rates. Enron tax department personnel specifically told the Joint Committee on Taxation (JCT) staff that the tax department took on the role of a profit center, generating both financial statement earnings and cash flow (McGill and Outslay, 2004).

Book–tax differences that are permanent affect the financial statement effective tax rate. Book–tax differences that are temporary affect only deferred tax expense. A transaction with low visibility that results in a permanent book–tax difference with book income but no tax income is regarded by tax advisors and corporate tax directors as the perfect tax shelter (U.S. Department of the Treasury, 1999, pp. 31–3; McGill and Outslay, 2003 and 2004). In light of the anecdotal and research evidence that firm managers seek tax savings that affects book income, Mills and Plesko (2003) recommended that the M–1 revision require corporations to distinguish permanent from temporary differences. When a corporate tax planning strategy generates a permanent difference, the IRS has only one chance to pick it up on audit.

Finally, the IRS does not presently evaluate whether the tax deficiencies it identifies on audit have permanent effects, long–term effects, or short–term effects. If substantial audit effort is devoted to single–year temporary differences (requiring deductions to be delayed until next year), this effort does not have as substantial present value revenue implications as effort devoted to permanent or long–lived differences. McGill and Outslay (2004) discuss the permanent or long–lived nature of many tax shelters.

In requiring taxpayers to classify differences as permanent or temporary, the draft instructions to Schedule M–3 specifically direct the taxpayer to make the classification according to its financial reporting treatment. The IRS is not dictating financial accounting to corporations, but only wants to know how the corporate taxpayer classifies the difference. Statement of Financial Accounting Standards No. 109 (SFAS 109) specifically defines temporary differences, but no longer refers directly to permanent differences, as did the prior standard Accounting Principles Board Opinion No. 11 (APB 11). Thus, the Schedule M–3 instructions describe permanent differences as those differences that are not considered temporary under the company’s interpretation.
of financial accounting standards. The IRS recognizes that not all corporations will interpret the standards in the same way, but they want the corporation to follow its financial reporting in completing Schedule M–3.

Specifically the draft 3/11/04 instructions state:

If financial statements are prepared by the corporation in accordance with GAAP [Generally Accepted Accounting Principles], differences that are treated as temporary for GAAP must be reported in column (B) and differences that are permanent (that is, not temporary for GAAP) must be reported in column (C). Generally, pursuant to GAAP, a temporary difference affects (creates, increases, or decreases) a deferred tax asset or liability.

If the corporation does not prepare financial statements, or the financial statements are not prepared in accordance with GAAP, report in column (B) any difference that will reverse in a future tax year (that is, have an opposite effect on taxable income in a future tax year (or years) due to the difference in timing of recognition for financial accounting and Federal income tax purposes) or is the reversal of such a difference that arose in a prior tax year. Report in Column (C) any difference that will not reverse in a future tax year (and is not the reversal of such a difference that arose in a prior tax year).

If the corporation is unable to determine whether a difference between column (A) and column (D) for an item will reverse in a future tax year or is a reversal of a difference that arose in a prior tax year, report the difference for that item in column (C).

New M–3 Living Document

The IRS intends to review the Schedule M–3 periodically to consider revising it to track new issues. Further, the IRS expects to consider extending similar reporting requirements to other filing groups, such as partnerships and other flow-through entities.

In general, software vendors told the Treasury–IRS M–3 team that programming the M–3 was not a problem. Tax is a second system that sits on top of or after the general ledger system. If the general ledger system does not provide a specific code for tax, the tax department generally identifies the item manually and inputs it into the tax system. Vendors said that most large companies rely on GL codes for about 30 percent of tax return entries and manual analysis for about 70 percent of tax return entries.

The M–3 changes will likely cause companies to revisit how extensively they use the general ledger codes to support tax filings. Many companies could benefit from a greater use of tax sensitive general ledger codes. The vendors thought, however, that companies will be somewhat more receptive to this change than before, because Sarbanes–Oxley and new SEC audit rules were causing concurrent changes. They noted that the marginal cost of getting the tax system right is less as part of other changes than if it were undertaken alone.

Software vendors inform the IRS that line additions can be made with sufficient notice, asking for six months minimum. Vendors noted that even if lines are dropped from future versions of the M–3, they must keep them active in the software each year to accommodate amended returns and carrybacks.

The work group is coordinating M–3 reporting requirements with Tax Shelter disclosures required by Form 8886 and associated regulations. George Manou-
sos (Treasury) noted in his discussion that avoiding overlapping burden is an important consideration in improving the coordination of such reporting for book–tax differences.

WHEN WILL SCHEDULE M–3 TAKE EFFECT?

As proposed, Schedule M–3 takes effect for tax years ending on or after 12/31/2004. Final rules on Schedule M–3 are to be announced by September 30, 2004.

In our experience, large corporations file on the extended due date. This due date is September 15, 2005 for calendar year 2004 returns, which is still more than one year away. Corporations will not be able to remap their general ledgers until the year starting after the effective date under consideration (i.e., January 1, 2005 at the earliest). As noted above, software vendors observe that most firms prepare Schedule M–1 supplemental detail as separate calculations in their corporate tax departments. Such detailed computations already exist to report in the Schedule M–3 form, even though full general ledger mapping has not yet occurred. Below, George Manousos (Treasury) discusses taxpayers’ concerns related to identifying the book income amount of each book–tax difference.

WHO MUST FILE THE NEW SCHEDULE M–3?

As proposed on January 28, 2004, corporations reporting ending assets on Schedule L exceeding $10 million must file Schedule M–3. This requirement corresponds to the IRS classification of corporations in the Large and Mid–Sized Business (LMSB) program. Table 4 shows the number of taxpayers to which this filing requirement would apply. About two percent of corporate taxpayers are subject to the new filing requirement: 47 thousand out of 2.2 million corporations.

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Number of returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets &gt; $1 billion</td>
<td>2,355</td>
</tr>
<tr>
<td>Assets between $10,000,000 and $1 billion</td>
<td>44,501</td>
</tr>
<tr>
<td>Subtotal: Assets &gt; $10,000,000 (will file M–3)</td>
<td>47,056</td>
</tr>
<tr>
<td>Assets &lt;= $10,000,000 (will not file M–3)</td>
<td>2,125,649</td>
</tr>
<tr>
<td>Total C Corporations</td>
<td>2,172,705</td>
</tr>
</tbody>
</table>

PRAISE FOR M–3 COLLABORATION

The IRS/Treasury working group designed the Schedule M–3 draft between June 2003 and January 2004, incorporating input from internal stakeholders. During the comment period that ended April 30, 2004, the IRS/Treasury group met specifically with the Tax Executives Institute, the American Institute of Certified Public Accountants, and tax software vendors. Team members also enjoyed informal discussions with American Bar Association and American Taxation Association members at conferences this winter. Finally, many of the above stakeholders and many others provided written comments to the IRS or Treasury via the formal comment process.

SUMMARY OF DISCUSSION

BY GEORGE MANOUSOS,
U.S. TREASURY DEPARTMENT

Manousos emphasized the intent of the IRS to lower taxpayer burden and reduce examination cycle times. If the new M–3 can help IRS Research identify areas of compliance risk (and areas of lesser risk) more effectively, not only should compliant taxpayers be subject to less audit burden, but better issue identification should shorten examination times.

In discussing the comments to date, most of the comments concern the size threshold, effective date, and taxpayers’ ability to determine book income amounts
on a transaction basis. Manousos noted that the size threshold, which conforms to the Large and Mid–Sized Business (LMSB) division threshold, includes corporations with assets above $10,000,000 in LMSB and excludes smaller corporations in the Small Business Self Employment (SBSE) division. Because corporations would not know until the last day of the year whether they were subject to filing, transition rules provide that Columns A and D need not be completed for the first year that Schedule M–3 applies to a corporation.

The comments about the effective date and reporting book income for specific book–tax differences generally cite the need to modify general ledger accounting and its mapping into tax returns at the beginning of a tax year. However, Manousos generally believes that all information to complete the Schedule M–3 is already available in current Schedule M–1 workpapers. While modifying the tax software and general ledger software will undoubtedly speed compliance in future years, compliance in 2004 appears to be possible based on existing Schedule M–1 detail and first year transition rules.


REFERENCES

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Boynton, Charles, Portia DeFilippes, Petro Lisowsky, and Lillian Mills.
Canellos, Peter, and Edward Kleinbard.

Hanlon, Michelle.
“What Can We Infer About a Firm’s Taxable Income from its Financial Statements?” National Tax Journal 56 No. 4 (December, 2003): 831–63.

Joint Committee on Taxation.

McGill, Gary, and Edmund Outslay.
McGill, Gary, and Edmund Outslay.


Mills, Lillian, and Kaye Newberry.

Mills, Lillian, and George Plesko.

Murray, Alan.

Phillips, John D.

Plesko, George.
### Part I: Financial Information and Net Income (Loss) Reconciliation

1a Did the corporation (see Form 1120) file a final income statement period ending with or within this tax year?
   - Yes, skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
   - No, go to line 1b.

b Did the corporation prepare a certified audited income statement for that period?
   - Yes, skip lines 1c and complete lines 2a through 11 with respect to that income statement.
   - No, go to line 1c.

c Did the corporation prepare an income statement for that period?
   - Yes, complete lines 2a through 11 with respect to that income statement.
   - No, skip lines 2a through 10 and enter the corporation’s net income (loss) per its books and records on line 11.

2a Enter the income statement period: Beginning / / Ending / /

b Has the corporation’s income statement been restated for the income statement period on line 2a?
   - Yes, (If “Yes,” attach an explanation and the amount of each item restated.)
   - No.

c Has the corporation’s income statement been restated for any of the five income statement periods preceding the period on line 2a?
   - Yes, (If “Yes,” attach an explanation and the amount of each item restated.)
   - No.

3a Is any of the corporation’s voting common stock publicly traded?
   - Yes.
   - No. If “No,” go to line 4.

b Enter the symbol of the corporation’s primary U.S. publicly traded voting common stock: __________________________

c Enter the nine-digit CUSIP number of the corporation’s primary publicly traded voting common stock: __________________________

4 Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1

5a Net income from nonincludible foreign entities (attach schedule) __________________________

5b Net loss from nonincludible foreign entities (attach schedule and enter as a positive amount) __________________________

6a Net income from nonincludible U.S. entities (attach schedule) __________________________

6b Net loss from nonincludible U.S. entities (attach schedule and enter as a positive amount) __________________________

7a Net income of other includible entities (attach schedule) __________________________

7b Net loss of other includible entities (attach schedule and enter as a negative amount) __________________________

8 Adjustment to eliminate transactions between includible and nonincludible entities (attach schedule) __________________________

9 Adjustment to reconcile income statement year to tax year of tax return (attach schedule) __________________________

10 Other adjustments to reconcile to amount on line 11 (attach schedule) __________________________

11 Net income (loss) per income statement of includible corporations. Combine lines 4 through 10 __________________________
### APPENDIX A (continued)

#### Part II

**Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return**

<table>
<thead>
<tr>
<th>Income (Loss) Items</th>
<th>Income (Loss) per Income Statement (Column b)</th>
<th>(b) Temporary Difference</th>
<th>(c) Permanent Difference</th>
<th>(d) Income (Loss) per Tax Return (optional)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Income (loss) from equity method foreign corporations</td>
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<tr>
<td>2 Gross foreign dividends not previously taxed</td>
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<tr>
<td>3 Subpart F, OSIR for similar income inclusion</td>
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<tr>
<td>4 Section 78 gross-up</td>
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<tr>
<td>5 Gross foreign distributions previously taxed</td>
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<tr>
<td>6 Income (loss) from equity method U.S. corporations</td>
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<tr>
<td>7 U.S. dividends not eliminated in tax consolidation</td>
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<tr>
<td>8 Minority interest for includible corporations</td>
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<tr>
<td>9 Income lost from U.S. partnerships (attach schedule)</td>
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<tr>
<td>10 Income lost from foreign partnerships (attach schedule)</td>
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<tr>
<td>11 Income (loss) from other pass-through entities (attach schedule)</td>
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<tr>
<td>12 Items relating to reportable transactions (attach details)</td>
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<tr>
<td>13 Tax-exempt interest</td>
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<tr>
<td>14 Total accrual to cash adjustment</td>
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<tr>
<td>15 Hedging transactions</td>
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<tr>
<td>16 Mark-to-market income (loss) other than from inventory</td>
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<tr>
<td>17 Inventory valuation adjustments</td>
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<tr>
<td>18 Sale versus lease</td>
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<tr>
<td>19 Section 481(a) adjustments</td>
<td></td>
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<tr>
<td>20 Unearned/deferred revenue</td>
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<tr>
<td>21 Income recognition from long-term contracts</td>
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<tr>
<td>22 Original issue discount and other imputed interest</td>
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<tr>
<td>23 Income statement gain/loss on disposition of assets other than inventory</td>
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<tr>
<td>24 Gain/loss reported on Form 4797, line 18</td>
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<tr>
<td>25 Gross capital gain from includible corporations</td>
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<tr>
<td>26 Gross capital loss from includible corporations</td>
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<tr>
<td>27 Other gain/loss on disposition of assets other than inventory</td>
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<tr>
<td>28 Disallowed capital loss in excess of capital gains</td>
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<tr>
<td>29 Utilization of capital loss carryforward</td>
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<tr>
<td>30 Other income (loss) items with differences (attach schedule)</td>
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<tr>
<td>31 Other income (loss) items with no differences</td>
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<tr>
<td>32 Total income (loss) items. Combine lines 1 through 31</td>
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</tr>
<tr>
<td>33 Total expense/deduction items (from Part III, line 41)</td>
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<tr>
<td>34 Reconciliation totals. Subtract line 33 from line 32</td>
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</tr>
</tbody>
</table>

**Note.** Line 34, column (a), must equal the amount on Part I, line 11, and column (d) must equal the amount on Form 1120, page 1, line 28.
### APPENDIX A (continued)

#### Part III  Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Expense/Deduction Items

<table>
<thead>
<tr>
<th>Expense/Deduction Items</th>
<th>(a) Expense per Income Statement Expense</th>
<th>(b) Temporary Difference</th>
<th>(c) Permanent Difference</th>
<th>(d) Deduction per Tax Return (optional)</th>
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</thead>
<tbody>
<tr>
<td>1. U.S. current income tax expense</td>
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<tr>
<td>2. U.S. deferred income tax expense</td>
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<tr>
<td>3. State and local current income tax expense</td>
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<tr>
<td>4. State and local deferred income tax expense</td>
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<tr>
<td>5. Foreign current income tax expense (other than foreign withholding taxes)</td>
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<tr>
<td>6. Foreign deferred income tax expense</td>
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<tr>
<td>7. Foreign withholding taxes</td>
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<tr>
<td>8. Incentive stock options</td>
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<tr>
<td>9. Nonqualified stock options</td>
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<tr>
<td>10. Other equity-based compensation</td>
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<tr>
<td>11. Meals and entertainment</td>
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<td>12. Fines and penalties</td>
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<td>13. Punitive damages</td>
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<td>14. Excess parachute payments</td>
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<td>15. Excess section 162(m) compensation</td>
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<tr>
<td>16. Pension and profit-sharing</td>
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<tr>
<td>17. Other post-retirement benefits</td>
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<tr>
<td>18. Deferred compensation</td>
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<tr>
<td>19. Charitable contribution of cash and tangible property</td>
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<tr>
<td>20. Charitable contribution of intangible property</td>
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<tr>
<td>21. Charitable contribution limitation</td>
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<tr>
<td>22. Charitable contribution carryforward used</td>
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<tr>
<td>23. Current year acquisition or reorganization investment banking fees</td>
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<tr>
<td>24. Current year acquisition or reorganization legal and accounting fees</td>
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<tr>
<td>25. Current year acquisition/reorganization other costs</td>
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<tr>
<td>26. Amortization/Impairment of goodwill</td>
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<tr>
<td>27. Amortization of acquisition, reorganization, and start-up costs</td>
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<tr>
<td>28. Other amortization or impairment write-offs</td>
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<tr>
<td>29. Abandonment losses</td>
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<tr>
<td>30. Worthless stock deduction (attach details)</td>
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<tr>
<td>31. Section 198 environmental remediation costs</td>
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<tr>
<td>32. Depletion</td>
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<tr>
<td>33. Depreciation</td>
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<tr>
<td>34. Bad debt expense</td>
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<tr>
<td>35. Expense for contingent liabilities (attach details)</td>
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<tr>
<td>36. Expense for other reserves (attach details)</td>
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<tr>
<td>37. Corporate owned life insurance premiums</td>
<td></td>
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<tr>
<td>38. Section 481(a) adjustments</td>
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<tr>
<td>39. Other expense/deduction items with differences (attach schedule)</td>
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<tr>
<td>40. Other expense/deduction items with no differences</td>
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<tr>
<td>41. Total expense/deduction items. Combine lines 1 through 40. Enter here and on Part II, line 33</td>
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</tbody>
</table>