No. 147
Monday August 2, 2004
ISSN 1522-8800

Lead Tax Report

Corporate Taxes

Corporations Urged to Use 2004 M-3 Transition as Trial Run for Compliance

Large and mid-size corporations will benefit from relaxed Schedule **M-3** requirements for the 2004 tax year and should use that time as a trial run to develop systems to address the additional requirements associated with the form in 2005, which may be more significant than corporations and their tax departments now realize, practitioners and academics have told BNA.

The Internal Revenue Service July 7 released a draft final version of the Schedule **M-3**, Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More, meant for all large and mid-size businesses to use in reconciling their accounting and tax income and losses (130 DTR G-5, L-3, 7/8/04).

Officials have said that the form is intended to increase transparency between financial accounting net income and taxable income, providing information that will identify taxpayers that may have engaged in aggressive transactions and allowing the service to target high-risk taxpayers for audit.

It also is intended to reduce the IRS examination cycle time, which can take years and has been flagged by IRS Commissioner Mark Everson as an area of necessary improvement.

Accounting Differences

As IRS has said, the books and records of a corporation are kept in accordance with generally accepted accounting principles, not tax law, resulting in differences between book income and taxable income that the service previously tried to bridge with Schedule M-1 of Form 1120.

There is an inherent tension between financial and tax accounting: financial statements are prepared with the objective of maximizing income and shareholder value while conforming to GAAP, while tax forms are approached with a view toward minimizing taxable income and paying the lowest taxes possible under tax law.

The new form is effective for corporations with total assets at the end of the taxable year of $10 million, as determined on an accrual basis consistent with corporate financial statements, for taxable years ending on or after Dec. 31, 2004.

IRS acceded to comments suggesting that the form not be effective in full for the 2004 tax year, and will require that a corporation complete only Part I and Columns B and C of Parts II and III for the first taxable year the corporation is required to file, allowing corporations to plan for gathering the information from the book accounts for Columns A and D.

Part I reconciles the book income of entities included in the financial statement to the book income of entities included in the tax return. Parts II and III separately identify categories of income and expense differences between book income and taxable income.

Breathing Room

Linda Gurene, a tax principal in Ernst & Young's Tax Operations National group, told BNA July 28 it is helpful that corporations are not required to complete Columns A and D of Parts II and III in 2004. "What it does is give people extra breathing room, thinking about it this year and making system changes to start fresh so they have the information they need for the 2005 return," she said.

The message she is delivering to her clients is to use 2004 return preparation to test what they have done in the past, see what they need to do differently, and make changes to processes and systems in the one-year transition "that is really a testing period."

For some companies, completing Part I of their 2004 returns may be challenging, Gurene said. Most larger companies go through some kind of analysis reconciling between their financial statements and book net income per Schedule M-1, but dealing with hundreds of subsidiaries and different reporting of includible entities for financial and tax purposes may take a while to reconcile and report in the Part I required format, she said.

Likewise, Don Saltz, a tax partner in Ernst & Young's Chicago office, told BNA July 26 that corporations still are going to have to investigate and analyze their books of original entry to identify all of the categories required under the form because they still will have to present book tax difference even in the first transition year.

Timothy McCormally, executive director of the Tax Executives Institute, said that the decision to postpone the effective date of Column A is a great help in wrestling with the mechanics of complying with Schedule **M-3**, though some corporations still wonder whether they will be able to get information required in time to comply with rules in time for the 2005 tax year.

2003 Compliance Season

Robert Kilinskis, a partner at Deloitte & Touche and member of the American Institute of Certified Public Accountants' Tax Accounting Technical Resource Panel, told BNA July 27 that corporations may not realize the gravity of the new form just yet because they are working on their tax returns for the 2003 tax year. Calendar year corporations generally file in September, and right now is the compliance season.

Once those returns are filed, more attention can be devoted to the Schedule **M-3**, he said. There also is a lack of clarity right now because the final instructions for the form have not been issued, Kilinskis said. IRS has said it anticipates detailed instructions on the form will be released in September.

Both Kilinskis and Gurene agreed that, right now, many corporate tax departments do not understand the magnitude of the Schedule **M-3**--and may be surprised at the level of burden involved. Most sources agreed that, while there is some compliance burden for the 2004 tax year, 2005 is when the burden will really become significant.

As AICPA's comments to IRS on the proposed Schedule **M-3** stated, the form requires a transaction-by-transaction approach to accumulating and identifying book-tax differences, with book income and expense reported in categories defined by tax law (87 DTR G-3, TaxCore, 5/6/04). Most of these tax law categories do not exist for book purposes and most corporate tax departments will be ill-prepared to make the transition to this type of methodology without significant investment in their compliance process, the comments said.

Saltz said that there is going to be greater effort required to complete the **M-3** versus the existing Schedule M-1, given the fact that corporations will have to adjust from completing eight categories of book-tax difference to more than 70 specific categories to reconcile financial statements with the Form 1120. "Particularly for larger taxpayers that are diverse and complex organizations, this could be quite a bit of effort," he said.

Several sources said the amount of effort involved in complying with the new form will vary from taxpayer to taxpayer. Kilinskis cited several factors, including the corporation's size and complexity, how many subsidiaries it has, and how automated its process is.

System Changes

He said that filling out Column A beginning in 2005 will require corporations to take book income and expense and allocate them to all Schedule **M-3** categories. Accounting systems are not set up for that, and changes to the underlying accounting system--or a whole new system--will be necessary if the corporation wants to automate that new function.

McCormally said that some of the effort involved in complying with the new form is getting software vendors to make the appropriate changes in a timely manner. One challenging aspect is that, depending on how a corporation's books are kept, new software that would map transactions in a manner that allows them to be reported properly has to be in place before transactions are entered into, he said.

"Even though it seems a fairly long period of time before the mandatory use of the form, new systems need to be put in place by the beginning of the tax year, so the window for making programming changes is fairly narrow," McCormally said.

Already Available

Lillian Mills, an accounting professor at the University of Arizona who served as a consultant to IRS on the **M-3** project, explained to BNA July 28 that companies already attach detailed lists of book-tax differences to their tax returns as support for the aggregate categories in the existing Schedule M-1. For large corporations, such attachments already run many line items more than requested by IRS on Schedule **M-3**, often running multiple pages.

She said the main burden that providing more than 70 categories of book-tax difference creates is that taxpayers have to map their existing labels for book-tax differences into the standardized categories the **M-3** provides.

"The fact that more detail is being requested should not by itself present a new burden," Mills said. "The burden is putting them into exact classifications that IRS is asking for."

IRS officials have said that the Schedule **M-3** should not present problems in terms of having to gather more information, because that information should already exist in order to complete the Schedule M-1 (99 DTR G-1, 5/24/04).

George Plesko, an accounting faculty member at MIT's Sloan School of Management, agreed, telling BNA July 30 that, in general, the information required to complete Schedule **M-3** in the course of current tax or financial reporting should be available to firms already. The new form will allow better information about consolidation and income measurement issues to be presented earlier on in the process, he said.

Software Issues

Presently, Mills said, IRS and the Treasury Department understand from software vendors that many large companies prepare Schedule M-1 work papers offline, or not automated through the general ledger, but using book-tax spreadsheets based on separate computations.

Corporations may choose to implement additional general ledger mapping to automate compliance with Schedule **M-3**, which would help them in determining proper amounts for Column A, Mills said. Some might be in the process of making changes related to Sarbanes-Oxley and other accounting controls that would make this a convenient time to enhance the ease of compliance with the **M-3**, she said.

Brian Tully, vice president of sales at TaxStream, a software vendor, told BNA July 29 that his company provides software based on Financial Accounting Standards Board Statement No. 109, which already tracks for Schedule M-1 and should allow users to easily adjust to meet requirements for the Schedule **M-3**. Some vendors offer software that follows FASB's Accounting Principles Board Opinion No. 11, which had been the guideline up until a few years ago and is not set up as well to comply with Schedule **M-3**.

Some corporations are just coming around to the FASB Statement No. 109 system in the wake of Sarbanes-Oxley, Tully said.

Consistency

Mills said the new form will provide a way to consistently code information into computer files so IRS researchers can do cross-firm analysis. IRS examiners have been able to review all of the supplemental line items before. However, without standardization, the IRS research division could not use all that detail to identify firms with higher compliance risk.

Gurene said some corporate tax people who have not had time to review the draft instructions may be under the impression that they can just do things as they always have. For larger companies with hundreds of thousands of transactions, the issue becomes how to categorize all of the book income and expense accounts and pull out the information and push it into the right format, she said.

For example, some corporate tax departments have grown accustomed to taking the difference in balance sheet accounts, which generally produces an appropriate amount of book-tax difference, though now trying to fit that process into the **M-3** structure is simply going to take additional time, she said.

Intended Result

IRS has said the intent of the new form is to provide a method of presentation to obtain more useful, descriptive information at the time the federal income tax return is filed to assist the service in the identification of tax returns that should or should not be selected for audit, identification of issues that should or should not be audited, and identification of trends and areas of greater audit risk.

Plesko said that a key issue IRS has to examine is the extent to which income is properly reported and allocated relative to financial reports that are made to shareholders. Those two sets of numbers are expected to be different because different rules govern financial reporting and tax reporting, but at some point the two need to be linked, he said.

Mills said IRS's intent in developing and implementing the form is not to audit more corporations--and could not be because of the service's limited resources--but to allow the service to better sort out who should not or should be audited in ways that do not waste taxpayers' time and government resources.

By Kurt Ritterpusch