Bridging the Reporting Gap: A Proposal for More Informative Reconciling of Book and Tax Income

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Bridging the reporting gap:  
a proposal for more informative reconciling of book and tax income

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In this paper we review the history and purpose of the corporation income tax return’s  
Schedule M-1 in light of recent attention to corporate reporting issues.  Although the  
traditional role for the schedule has been to assist the audit process, the reconciliation of  
book to tax accounting numbers also provides information that is useful to tax analysts. We  
find the existing tax return Schedule M-1, largely unchanged since its introduction in 1963,  
provides insufficient detail for complex reconciliation issues.  We propose a modified M-  
1 to achieve better reconciliation, and discuss the advantages, and disadvantages, of public  
disclosure of such data.

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Introduction

A spate of high-profile cases involving profitable corporations reporting little or no taxable income, or engaging in transactions that increased their financial income without affecting their current tax liabilities, have drawn attention to the sources and magnitudes of differences between tax and book income.\(^1\) The Wall Street Journal (January 29, 2003, “The Corporate Reform Tax Cut”) critiques current financial reporting disclosures as follows:

Ending the double taxation of dividends would also bring more transparency to corporate accounting. Currently it is almost impossible to know a firm's tax bill by looking at its financial statements, and thus it is impossible to figure out what actual profits are. Profits reported to the IRS, where firms have less discretion in making calculations, are considered to be closer to the truth, but they are confidential and unavailable to investors. Book profits and tax profits can be wildly different -- a divergence, by the way, that increased markedly in the 1990s.

Such press reports are reminiscent of the mid-1980s, when, during the development of the Tax Reform Act of 1986 (TRA86), part of the motivation for the Alternative Minimum Tax was reports of large firms paying little or no income taxes regardless of their level of reported income. In contrast to the popular press view above that taxable income is now the new standard for “actual profits,” book-tax differences were previously viewed as indicators of tax aggressiveness. In an often-quoted passage, the Joint Committee on Taxation’s staff report on TRA86 states:

In particular, Congress concluded that both the perception and the reality of fairness have been harmed by instances in which corporations paid little or no tax in years when they reported substantial earnings, and may even have paid substantial dividends, to shareholders. Even to the extent that these instances may reflect deferral, rather than permanent avoidance, of corporate tax liability, Congress concluded that they demonstrated a need for change. (Joint Committee on Taxation (1987), pp. 432 – 433)

Although an aggressive use of the tax code’s preferences was identified as the source of problems in the 1980s, current concerns are focused on potentially abusive structured financial arrangements like tax shelters. The Joint Committee on Taxation’s (2003) report and testimony from expert witnesses (Outslay 2003, Plesko 2003a and Seida 2003) discuss how financial incentives appear to have motivated Enron to structure transactions that reduced the amount of taxes paid without reporting any corresponding decrease in pretax book income. Similarly, the Permanent Subcommittee on Investigations (2003) reported on transactions that increased pretax book income without a corresponding increase in tax liability.

On July 8, 2002, Senator Charles Grassley wrote to Paul O’Neil, Secretary of Treasury, and Harvey Pitt, Chairman of the Securities and Exchange Commission to “raise the question of whether the information contained in the corporate tax returns of publicly traded companies could be of benefit to government regulators as well as shareholders and workers.” On July 24, 2002, the Tax Executives Institute submitted comments to the Department of Treasury and the SEC protesting the proposed public disclosure of tax return information, stating “public disclosure of corporate tax returns is not only contrary to the longstanding policy of protecting the confidentiality of taxpayer returns, but is potentially counterproductive to the goal of providing shareholders with meaningful information.” (emphasis in original) Canellos and Kleinbard (Tax Notes 8/12/02) take a
middle ground of recommending “that a publicly held corporation’s Schedules M and L and its financial statement income tax disclosure be conformed into a single public financial statement-tax reconciliation schedule, filed with the corporation’s tax return in lieu of current Schedule M, and also included in the corporation’s financial statements.” In October, Senator Grassley, in a letter to the President, asked for a review of corporate disclosure requirements, including a review of the Schedule M-1 and financial statement disclosures (Lupi-Shen, 2002). We extend these general recommendations to detail a specific expansion of the Schedule M-1 that provides a more informative reconciliation, and then introduce the arguments for and against public disclosure.

In this paper we address the reporting issues related to the reconciliation of financial and tax reporting income, and the role increased reporting could play in tax administration and economic analysis. We begin with a review of accounting concepts under both tax and financial reporting, highlighting situations in which differences arise. We then examine current reporting requirements and evaluate the adequacy of the current Schedule M-1.

We conclude that the current M-1 does not provide sufficient detail to inform existing users (IRS and other government analysts) about book-tax reconciliations to effectively evaluate compliance risks and perform other analyses. We recommend the M-1 be revised to directly reconcile public financial statement worldwide net income (from SEC Form 10-K) with taxable income. Providing such a consistent starting point will, in and of itself, provide a significant improvement because it is difficult to quantify how much of the aggregate book-tax differences are due to differing rules for grouping entities for book and tax purposes. We additionally recommend more uniform detailed categories of
reconciliation to include consolidation differences, stock options, depreciation, and other
specific items. Finally, we recommend the reconciliation separately identify the effects of
permanent and temporary accounting differences, because many tax shelters are designed to
produce permanent differences. Hanlon (2003) concludes that tax disclosures required
under Generally Accepted Accounting Principles (GAAP) do not easily permit financial
statement users to estimate reported taxable income either in the U.S. or internationally.
Thus, we also recommend that, to the extent there is serious discussion about making
corporate tax returns public, the starting point should be the public disclosure of the
revised M-1. Such disclosure, by itself, will address many of the shortcomings of the
financial accounting requirements, such as the lack of informativeness and specificity,
while imposing minimal additional reporting costs on firms.

Origins and trends in book-tax differences

Book-tax differences have existed for as long as the corporate income tax, and are
cased by differences in the reporting rules under each system. In the early 1900s, tax
returns were public, and viewed by many as a more useful source of information than
company’s financial statements. The public release of tax returns has its own extensive
history that is reviewed in a companion paper (Lenter, Shackelford and Slemrod 2003) and
we will not repeat it here.

Although the Securities Acts of 1933 and 1934 provided for regulation and
registration of certain corporations, some federal standards had existed as early as 1907
for public utilities. (May (1949)) The corporate excise tax of 1909, although not
implemented, required cash method of accounting for tax reporting purposes, regardless of
the taxpayer’s usual accounting method. The Revenue Act of 1918 first codified a link
between tax and financial reporting. Although the Act generally allowed the taxpayer to follow for tax purposes the method of accounting it used for regular business purposes, it gave the Commissioner of Internal Revenue the authority to provide a separate definition if income was not clearly reflected (§ 212(b), as reported by May p. xviii). In recounting the period from 1918 to 1948, May (1949) observed that many differences between tax and financial reporting income arose, primarily “from the introduction into law of a constantly increasing number of provisions which modify the general concept of income underlying the statute, in order to give relief or for other reasons of a policy character.” (p. xxi) As described later in this paper, book-tax differences have increased in complexity because business organizations and transactions have become more complex. At the same time, tax law and financial accounting standards have become more complex in response to complicated transactions.

In what appears to be the first comprehensive approach to identifying and quantifying the various differences in accounting methods, Smith and Butters (1949) compared the financial and tax reports of a number of companies for 1929-1936. Overall, they found that book income and its tax equivalent, statutory net income, “did not differ greatly” (p. 167). However,

Book profit typically exceeded statutory net income, but usually by less than 10 percent. Data on adjustments made to taxable income in the process of audit by the Bureau of Internal Revenue indicate that the slight tendency for book profit to exceed statutory net income in most industries is approximately offset by the auditing. In other words, when book profit is compared with audited statutory net income the two figures tend to be about equal in most industries. …

The margin between the book and tax data tended to be considerably wider, over the period as a whole, for companies reporting statutory deficits than for companies reporting statutory net incomes. That is, statutory deficits tended to be larger relative to book losses than book profits were relative to statutory net incomes. (p. 167)
As the tax system developed during the first half of the 20\textsuperscript{th} century, so did the system of financial reporting. Under the Securities and Exchange Act of 1934, the Securities and Exchange Commission (SEC) has the authority to proscribe accounting and other reporting standards of publicly traded firms. Although given this authority, the SEC has generally ceded rulemaking to the private sector. The American Institute of Certified Public Accountants (AICPA), has relied on a series of standard-setting organizations beginning with the Committee on Accounting Practice (1939 to 1959), the Accounting Principles Board (1959 to 1973), and, since 1973, the Financial Accounting Standards Board, or FASB (Kieso et al. 2001, Ch.1).

Various authors have provided estimates of the magnitude and growth in aggregate book-tax income differences for the past decade (U.S. Treasury 1999, Plesko 2000b, Talisman 2000, Desai 2002, Manzon and Plesko 2002) Mills Newberry and Trautman (2002). In Figure 1, we reproduce a chart presented in Talisman (2000), plotting the magnitude of book-tax differences of the largest firms. This figure shows two things: first, an increase in the book-tax difference during the 1990s, and second, that net depreciation differences are not a significant component. However, as previously pointed out, these differences have existed since the inception of the corporate tax. Although recent evidence suggests these differences have dramatically increased during the 1990s, a lack of data for other time periods makes it difficult to determine whether this is only a recent phenomenon or the continuation of a long-term trend.

Data on the amount of income reported under each system have been published only sporadically and not necessarily in comparable ways. Nonetheless, some comparisons from these various time periods can be made. Table 1 provides aggregate data on after-tax
measures of tax and financial reporting income as reported on the Schedule M-1 for selected years from the 1970s and 1990s. During the four years from the 1970s, book income exceeded after-tax tax net income in each of the years. However, the gap between the two narrowed, owing to faster growth in after tax net income. During these four years, the combined amount of book income was 20 percent greater than the combined amount of after-tax tax net income, ranging from 7 percent in 1975 to nearly 40 percent in 1972. By contrast, during the late 1990s, book income exceeded after-tax tax net income by more than 36 percent in each year, including a more than 70 percent difference in 1998. Plesko (2003a) argues that although the growth in the book-tax difference during the late 1990s is driven both by both tax-minimization and aggressive financial reporting, the financial reporting component appears to be particularly large. During the 1996 to 1998 period, tax net income fell slightly while pretax book income grew 8.5 percent.

**Types of differences**

Reconciling reported book income to taxable income involves two broad classes of differences: reporting entity and income measurement. Following our discussion of these broad classes, we discuss current requirements for book-tax reconciliation for either financial statement or tax return purposes.

*Reporting entity*

The challenge of reconciling book income with taxable income starts with the problem of identifying “whose book income.” Unfortunately, the current M-1 does not specifically require a consistent starting point definition for book income. Many large corporations own part or all of other U.S. and foreign corporations. Financial reporting standards and tax laws provide different rules for whether and how related corporations
should be combined. To prepare a single consolidated financial report, the individual lines of income and expense of related entities are combined, eliminating transactions between related parties.²

The fact that the consolidation rules differ for book and tax purposes presents a problem when we want to compare a financial statement to a (U.S.) tax return. For example, let’s assume that a U.S. parent corporation (A) owns some of companies B and C. Suppose also that A has $100 of book income, B has $50 of book income, and C has $30 of book income, and that none of the entities have transactions with each other. If only A and B are consolidated for financial statements under Generally Accepted Accounting Principles ($150 of book income), and if only A and C are consolidated under tax law ($130 of book income), then it is difficult to compare the financial statement to the tax return without knowing which entities are included in each report.

As an example of the potential reconciliation challenge, Enron’s 2000 year consolidated U.S. tax return included 713 returns that are part of its tax affiliated group (JCT 2003, Vol I, p. 52). Additional returns outside the consolidated tax return consisted of 190 returns for domestic entities not consolidated with Enron, 1,485 foreign branch and subsidiary returns, and 98 entities and branches included in partnership returns. We discuss the detailed rules for book versus tax consolidation below.

Statement of Financial Accounting Standards (SFAS) No. 94 generally governs financial consolidation. The consolidated reporting group includes the parent corporation and all subsidiaries (both domestic and foreign) in which the parent has more than 50% ownership. If the parent corporation does not own 100% of the subsidiary, it subtracts

² This section is paraphrased substantially from Mills, Newberry and Trautman (2002).
from net income the portion of the subsidiary’s earnings that is allocable to the minority shareholder interest.

If a corporation owns between 20 and 50 percent of another corporation, the parent corporation includes its percentage interest in the net income of that entity as “net equity of unconsolidated subsidiaries.”\(^3\) If the parent owns less than 20 percent of a corporation, then it only includes the dividends of such corporation in book income.\(^4\) Special Purpose Entities (SPEs) provide a mechanism to avoid financial consolidation, even when the parent company owns more than 50%.\(^5\) The corporation excludes the assets and the associated debt and equity of the SPE from the consolidated balance sheet. However, if the SPE is treated as a partnership for tax purposes, SPE losses could be deductible on the U.S. consolidated tax return.

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

The different financial and tax rules for combined reporting can result in either book or tax income being more inclusive, depending on the type of difference, as discussed by Dworin (1985), Manzon and Plesko (1998), Canellos and Kleinbard (2002) and Mills,

\(^3\) Accounting Principles Board Opinion No. 18, “The Equity Method of Accounting for Investments in Common Stock.”

\(^4\) If the investor corporation has significant influence on the investee corporation, it can use the equity method under Financial Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock: An Interpretation of APB Opinion No. 18.

\(^5\) See Financial Executives International (2002) for a discussion of SPE guidelines. Companies such as Enron used Special Purpose Entities to structure transactions that generate losses or deductions outside the financial statement consolidated group. If such entities are structured as partnerships for tax purposes, the losses and deductions flow through to the tax return.
Newberry and Trautman (2002). The following chart summarizes the main consolidation differences between GAAP and tax law, where the shaded blocks show common definitions of included entities:

<table>
<thead>
<tr>
<th>Consolidated for GAAP (books)</th>
<th>Consolidated for tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parent company</td>
<td>Parent company</td>
</tr>
<tr>
<td>Plus 100% income earned by domestic subsidiaries owned $\geq 80%$</td>
<td>Plus 100% of income earned by domestic subsidiaries owned $\geq 80%$</td>
</tr>
<tr>
<td>Plus 100% income of all other (domestic or foreign) subsidiaries owned $&gt; 50%$</td>
<td></td>
</tr>
<tr>
<td>Less % income attributable to minority interest in subsidiaries above</td>
<td></td>
</tr>
<tr>
<td>Plus % income attributable to equity interest in corporations owned $\geq20%$ but $\leq50%$</td>
<td></td>
</tr>
<tr>
<td>Exclude income/loss from Special Purpose Entities that meet strict ownership tests above but can be excluded under special rules.</td>
<td>Include income/loss from Special Purpose Entities structured as partnerships for tax purposes under the “check the box” regulations.</td>
</tr>
<tr>
<td>Less income/expense from intercompany transactions with entities included above.</td>
<td>Less income/expense from intercompany transactions with entities included above.</td>
</tr>
<tr>
<td></td>
<td>Plus [pre-tax] dividends from entities not included above (e.g. dividends from foreign or $&lt;80%$ domestic subsidiaries).</td>
</tr>
<tr>
<td>= Book income for entities included in consolidated financial statements</td>
<td>= Book income for entities included in the consolidated tax return.</td>
</tr>
</tbody>
</table>

Note that for a purely domestic company that owns 100% of its U.S. subsidiaries and files a consolidated tax return, book and tax consolidation are the same. However, when a company has foreign subsidiaries or domestic subsidiaries owned less than 100%, the book and tax consolidation rules diverge.

Researchers cannot easily determine the sources of consolidation differences, even when tax return and financial statement are available (see Mills and Newberry 2000, Boynton et al. 2002, Plesko 2000a, 2003b). Thus, many of the substantial changes we propose to the Schedule M-1 are intended to help in reconciling these consolidation differences.

To illustrate the difficulty for an extremely complex multinational company, we reproduce as our Table 1 “Enron Corp. and Subsidiaries: Reconciliation of Financial
Statement Income to Taxable Income 1996-2000”, which is Table 2 from the Joint Committee on Taxation written testimony of 2/14/2003. The upper half of the table shows the necessary adjustments to reconcile book income as reported on the consolidated financial statement (SEC Form 10-K) to the book income Enron chose to show as its starting point for Schedule M-1. Later in the paper we recommend that such reconciling items be required in our revised Schedule M-1.

**Income measurement**

As discussed above, the fundamental purposes of financial and tax reporting generate substantial differences in income measurement. Although financial rules tend to constrain companies from overstating income to financial statement users, tax rules constrain companies from understating income to the tax authorities. Other differences between the two systems arise because the tax system is also used in an attempt to provide incentives or disincentive for particular activities, (e.g. accelerated depreciation to encourage investment, limits on deductible compensation to discourage excessive payments). Although IRC §446(a) states, “taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books,” the IRS can disallow accounting methods that do not ‘clearly reflect income.’

Tax law only requires conformity with financial reporting in the case of last-in first-out (LIFO) inventory. For an extensive discussion of accounting rules, tax law and judicial precedent that apply to a variety of book-tax differences, see Knott (2003).

**Temporary differences**

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6 IRC §446(b). See also *Thor Power Tool Co. v. Commissioner*, 79-1 USTC 9139 for a detailed discussion by the Supreme Court of financial accounting not governing tax treatment.
Temporary differences between book and tax income generally arise from differences in when an item constitutes revenue or expense, not whether it should be recognized.

Accruals

For financial reporting purposes, revenues on the provision of a good or service are not recognized until they are both realized and earned. This means the firm must have provided the good or service and have reasonable assurance payment will be received. As a result, the receipt of cash from a customer may occur before, during, or after the period in which the goods or services are provided. In the case of cash payments received in advance, firms will record unearned revenue (a liability) until the contracted goods or services are delivered. By contrast, the Claim of Right Doctrine allows the tax authority to claim advance payments as revenue when received and under the clear control of the taxpayer, even if the taxpayer uses the accrual method and will recognize them as financial reporting income at a later time.\(^7\)

Accrued expenses are recorded for book purposes when incurred and matched with revenue. Specific rules provide that contingent liabilities should be recorded as an expense when they are probable and estimable under SFAS No. 5. However, accrued expenses cannot be deducted for tax purposes unless they are “fixed and determinable" -- a stricter standard that typically delays the deduction relative to financial reporting. For certain classes of expenses, notably tort liabilities and non-recurring services, the deduction must

\(^7\) North American Oil Consol. V. Burnet, 286 U.S. 417 (1932). For example, rental payments received in advance by a company will be recognized for book purposes pro-rata over the period of the lease, although the entire amount is taxable income in the current period. To the extent that a rental period extended over more than one fiscal year, a temporary difference between book and tax income would arise and reverse in a later year.
also meet an economic performance standard (IRC §461), which often delays the deduction until payment.

A substantial temporary difference arose due to Statement No. 106, “Employers’ Accounting for Postretirement Benefits Other Than Pensions,” generally effective for fiscal years beginning after December 15, 1992, but implemented early in 1992 by many large companies. The required catch-up accrual to change from pay-as-you-go to accruing the expense for books resulted in a large expense for companies that provided retiree medical benefits, especially those heavily unionized companies with generous benefits. Because the expense is not deductible until paid, the SFAS 106 accrual resulted in a large one-time and continuing temporary difference.

Other examples of accruals and reserves that occur frequently in the deferred tax disclosures of financial statements are inventory write downs and reserves, warranty claims, discontinued operations, restructuring reserves, and the valuation allowance account.

Asset recovery rules

Asset cost recovery for financial reporting purposes is guided by the principle of matching production expenses with sales revenues. Thus, book depreciation for tangible assets (as well as depletion of natural resources and the amortization of intangible assets) reflects estimates of useful lives and residual values that reflect their economic values. Cost recovery for tax purposes follows explicit asset classifications that specify the life and method to be used.

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For financial reporting, capital investments are generally depreciated using the straight-line method over an estimate of each asset’s expected useful life, to some residual value. For tax purposes, corporations can use accelerated methods of depreciation following procedures given by the tax code, typically over a shorter life, with no residual value. These differences in depreciation accounting will generally lead to greater reductions in taxable income than book income as the tax deduction for depreciation will be greater than the depreciation expense charged against earnings. At some future time, the amount of depreciation allowed for tax purposes on these assets will be less than the amount reported for book purposes, reversing the relation between the two measures of income. Such reversals will be reported as an “expense recorded on books this year not deducted on this return,” on the current M-1 and included in the itemization for depreciation. Asset recovery provisions change frequently in response to Congress’ use of asset write-offs for economic incentives. For example, recent economic events motivated the creation of a 30% first-year bonus depreciation for certain short-lived tangible property acquired between September 11, 2001 and September 10, 2004 (IRC §168).

**Intangible assets**

Intangible assets have a varied history that has affected whether their associated book-tax differences are temporary or permanent. For book purposes, intangible assets other than goodwill are amortized over their useful lives, consistent with the matching principle. For many years, goodwill was amortized over a maximum 40 years for book purposes (APB Opinion No 17), a time period often used by firms to minimize the effect of these charges on reported income. However, under SFAS No. 142, generally effective for fiscal years beginning after 12/15/2001, financial accounting changed to an impairment
method, whereby goodwill is only written down if it is judged by management and auditors to be impaired.

By contrast, through 1993, intangible assets other than goodwill were amortized straight-line over their useful lives for financial reporting purposes, but goodwill was not tax deductible. The adoption of IRC §197, effective for intangible assets acquired after August 9, 1993, requires most intangibles, including goodwill, to be amortized over 15 years for tax purposes.

Thus, for assets acquired prior to 1993 and subsequent to 2002, goodwill amortization generated a permanent book-tax difference. For assets acquired between 1994 and 2001, goodwill amortization generates a temporary difference.

Other examples of temporary differences are mark-to-market accounting method differences and capital losses in excess of capital gains, which reverse if capital losses are used before they expire. The only temporary differences explicitly detailed on the current Schedule M-1 are depreciation and the excess of capital losses over capital gains.

**Permanent differences**

Permanent differences arise from fundamental differences in the scope of activities considered to be income or expenses under each reporting system. In this section we provide examples of permanent differences that have recently generated attention.

**Stock options**

The financial accounting debate about whether employee stock options should create an expense are complex and beyond the scope of this manuscript. In brief, the issue contrasts the principle that transactions of a firm in its own stock do not (generally) affect
income with the argument that compensation for employee services should be recorded as expense. Although SFAS No. 123 appears to require that corporations record the imputed value (using a modified Black-Scholes option pricing formula) of options granted to employees, it is not mandatory because it leaves open an election to continue to use the old accounting standard that does not require an expense be recorded. If companies choose not to adopt, they must still make a *pro forma* footnote disclosure of earnings as if SFAS 123 were adopted. The FASB is re-considering requiring companies to record rather than merely disclose an expense for stock option compensation.\(^{11}\) Several companies have said they will begin to voluntarily record an expense for stock option compensation, including General Electric and Coca-Cola.\(^{12}\)

The tax treatment of stock options depends on the type of option. Qualified options, currently designated Incentive Stock Options, generally result in no compensation deduction (or employee salary income) when granted. However, non-qualified stock options generate a compensation deduction to the firm (and ordinary income to the employee) at the date of exercise equal to the difference between the fair market value of the stock and the amount paid by the employee at the time of exercise.

Until recently, stock options have generated an unusual form of permanent difference. We say unusual, because the difference is not transparent in the tax footnote. Hanlon and Shevlin (2002) describe the difficulty in book-tax reconciliation because the financial disclosure of the tax benefit from the stock option deduction is usually recorded

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10 SFAS 109 does not define the term permanent difference, but it is commonly understood as those differences that are not temporary differences. That is, permanent differences arise from book income or expense that is never reported as taxable income or deduction, or vice versa.

in the stockholders equity accounts, and described in the related footnote (see also Graham et al. 2003, Manzon and Plesko 2002 and Shevlin 2002). As a result, neither the current nor deferred income tax expense reflected the stock option tax benefit, resulting in companies like Microsoft and Cisco appearing to pay substantial amounts of federal income tax (based upon a reported large positive current tax expense) when their actual tax liability is substantially smaller, or negative (Hanlon and Shevlin 2002). The current M-1 does not specifically detail the stock option difference, but we recommend specific disclosure because this is both a material difference for many firms and the financial accounting treatment across firms may vary.

**Intangible assets**

As described above, cost recovery for intangible assets can generate either permanent or temporary differences depending on the financial or tax reporting regime.

**Merger and acquisition valuation issues – the inside/outside basis problem**

Mergers and acquisitions can generate book-tax differences beyond the goodwill differences discussed above. In general, differences arise because the rules differ concerning when acquired assets should be restated to fair market values. If, for example, book asset values are restated to fair market value but tax assets are not, then book-tax differences will arise through the remaining lives of such assets, as inventory is sold, property is depreciated, etc.\(^{13}\) One such setting arose during the late 1990’s when high-tech

\(^{12}\) [Http://www.usatoday.com/money/companies/regulation/2002-08-08-options-pit_x.htm.]

\(^{13}\) Under SFAS Nos. 141 and 142 (effective for acquisitions after June 30, 2001), acquisition of more than 50% of another corporation is treated as a purchase and the target’s assets are restated to their fair market values. This rule applies whether the acquirer purchases the assets directly or purchases the stock of the target. The excess of the purchase price over the fair market values of the tangible assets less liabilities is recorded as goodwill.

Until June 30, 2001, Accounting Principles Board Opinion No. 16 provided an alternative called Pooling of Interests, allowing a merger of equals through an exchange of common stock. Transactions were
companies wrote-off the value of purchased in-process research and development costs. This write-off typically generated a permanent difference, because the assets were not restated to fair market value for tax purposes.\textsuperscript{14} For a striking example, see IBM’s 1995 annual report, showing a nine percentage point increase in its effective tax rate due to the write-off of purchased in-process research and development related to its acquisition of Lotus. Because GAAP no longer requires goodwill amortization, the incentive for immediate write-off has disappeared, and we no longer observe large differences for this item.

As previously noted, the current Schedule M-1 provides little specific detail. We recommend that the revised Schedule M-1 include a specific line item for book-tax basis differences in addition to the depreciation differences already reported.

\textsuperscript{14} In a taxable transaction, if the acquirer purchases assets they are restated to fair market values; if the acquirer purchases stock the target stock has a new basis equal to the acquisition price (the “outside basis”), but the assets of the target corporation (the “inside basis”) are not restated barring an election under IRC §338. This election causes the target corporation to immediately recognize any built-in gains and losses so only firms with sufficient favorable tax attributes to offset the potential tax liability typically make this election. The typical taxable structure used to acquire a freestanding C corporation is a taxable stock purchase in which the inside basis of the target’s assets are not stepped-up (i.e., no §338 election).

In tax-free acquisitions, the inside basis of the target’s assets cannot be stepped up to fair market value. Erickson (1998) indicates that almost all acquisitions of freestanding C corporations result in a carryover basis for tax. As a result, we should see large differences for companies that engage in substantial M&A activity, and such differences are frequently treated as permanent differences.

The exception to this rule occurs if the target is a subsidiary of a C corporation or a conduit entity (e.g., S corporation). In these transactions it is not uncommon for the deal to be structured to include a §338(h)(10) election, resulting in a step-up in the tax basis of the acquired entity’s assets (see Erickson and Wang (2000), Ayers, Lefanowitz and Robinson (2000), and Erickson and Wang (2003)). Thus, in acquisitions of subsidiaries and conduit entities, the tax bases of the target’s assets are often recorded at fair market value. When an R&D write-off occurs for such an acquisition, the tax basis of the assets is not written down for tax purposes at the same time that the book write-down occurs. Therefore, the write-down will create a book/tax temporary difference.
Both the Internal Revenue Service and financial statement users consider book-tax reconciliation important because each set of accounting rules have discretion. Thus, if company managers use the discretion to increase book income or to decrease taxable income, the difference between book and tax income might have implications for either tax compliance or for earnings quality. We discuss the contrasting incentives for book and tax reporting below.

Although book-tax differences include several mechanistic differences due to specific methods required by financial accounting principles and tax laws, they also include opportunistic differences due to managers exercising discretion in financial reporting to manage (increase or smooth) book income, and differences due to managers exercising flexibility in tax rules to manage (generally decrease or defer) taxable income.

Financial reporting principles are designed to provide relevant and reliable information to financial statement users, emphasizing consistency over time within a firm. However, they also permit considerable flexibility in the choice of methods and discretion in estimation, particularly when the information is not deemed to be of sufficient magnitude to affect a user’s decision (i.e. material). Independent auditors are necessary to constrain managers’ opportunistic use of the discretion granted by financial accounting principles to overstate income and assets, smooth income or to take a “big bath” in loss years.

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By contrast, because the Internal Revenue Service is the nation's tax collection agency and administers the Internal Revenue Code enacted by Congress, it uses audits of tax returns to detect and deter underreporting.¹⁷

Shackelford and Shevlin (2001) review an extensive empirical literature on how conflicting incentives affect tax, financial, and regulatory reporting. Although researchers acknowledge that book-tax differences reflect both book and tax incentives at the same time, some studies emphasize one system as the economic benchmark to evaluate manipulation in the other system. For example, some accounting studies imply that estimates of taxable income inferred from financial statements provides a benchmark for high-quality earnings (Mills and Newberry 2001, Joos et al. 2002, Phillips et al. 2002 or Hanlon 2003). Other authors (Cloyd 1995, Cloyd et al. 1996, Mills 1998, Mills and Sansing 2000) emphasize how firms’ decisions regarding book and tax methods are related to the perceived effect of book-tax differences on IRS audit scrutiny. If book-tax differences are positively related to IRS audit adjustments or perceptions of increased IRS scrutiny (Cloyd 1995), differences could be interpreted as signals of aggressive tax avoidance. Finally, other research questions the extent to which financial statements can be used to infer the underlying tax information of a firm and therefore the extent to which each reporting system constrains each other (Plesko 2000a, 2003b).

In summary, financial statement users (especially recently) and tax return users (traditionally) view book-tax difference reconciliation as important because such

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¹⁷ The IRS stated mission is service oriented: “to provide America's taxpayers with top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.” [http://www.irs.gov/irs/index.html](http://www.irs.gov/irs/index.html)
differences, to the extent not mechanistically determined by standards and laws, could indicate aggressive reporting in one direction or the other.

**Current requirements for and limitations in reconciliation between book and taxable income**

*Financial Statement Reconciliation – SFAS 109 requirements for tax footnote disclosures*

As discussed in a companion paper, Hanlon (2003) concludes that the tax footnotes in financial statements are inadequate for precisely determining U.S. taxable income or understanding in what jurisdictions book-tax differences arise, consistent with Plesko’s (2000a, 2003b) empirical results. To better understand why the current reconciliation is inadequate we begin with a description of the current tax return reconciliation schedule.

*Tax Return Reconciliation – Current Schedule M-1*

Prior to 1964 the form 1120 Corporation Income Tax Return included a Schedule M, “Reconciliation of Taxable Income and Analysis of Earned Surplus and Undivided Profits.” In this schedule, firms were required to reconcile the change in earned surplus from the end of the prior tax year to the end of the current year. Beginning in 1964 the M-1 appeared on the 1120, in essentially the same form as it appears today. Figure 2 shows the current fourth page of the form 1120, which contains the Schedule L, Balance Sheet per Books, the Schedule M-1, Reconciliation of Income (Loss) per Books with Income per Return, and the Schedule M-2, Analysis of Unappropriated Retained Earnings per Books.

The Schedule M-1 begins with a company’s “net income (loss) per books,” which is intended to be the after-tax income reported to shareholders. We say intended, rather than actual, because current instructions to Form 1120 Schedules L and M-1 are
sufficiently imprecise as to permit substantial reporting flexibility regarding the book accounting numbers disclosed on the tax return, especially when the company has different reporting entities for book and tax purposes.\textsuperscript{18}

Consistent with consolidation differences existing for foreign subsidiaries, Mills and Newberry (2000) show that average book income reported on the tax return ($427 million), falls between worldwide consolidated pretax income ($483 million) and U.S. pretax income ($306 million), based on a joint data set of IRS tax return and Compustat financial statement data (Table 2, p.169). Their finding for large industrial firms is consistent with some, but not all, foreign income being included in taxable income when it is repatriated as a dividend. Our recommendations for revising the M-1 address this issue by explicitly identifying the starting point of the reconciliation as the worldwide-consolidated book income reported to shareholders on SEC form 10-K.

A brief example will illustrate the problem the imprecise instructions can create. Suppose that U.S. Parent (USParent) earns $1000 and has two 100%-owned subsidiaries: a U.S. subsidiary (USSub1) that earns $100 and a foreign subsidiary (ForSub2) that earns $100. Assume that none of the companies have transactions with each other. If the foreign subsidiary pays all of its profits to the U.S. parent as a dividend, there are no differences in the pretax income reported for financial statements versus the tax return.

Absent any dividend payments, the consolidated financial statement would show

\textsuperscript{18} Mills, Newberry and Trautman (2002) found that for many large multinationals, the balance sheet on the tax return substantially differed from the tax return on the published financial statements. Reports from audit teams to IRS Research suggest some companies do not carefully post elimination entries when compiling the tax return balance sheet. Although balance sheet reporting is not the focus of this paper, we recommend that the IRS consider making its Schedule L instructions more specific, or providing a reconciliation of entities in the published financial statements to the entities included in the tax return balance sheet.
$1200 of pretax earnings, but the U.S. tax return would include only $1,100 of pretax earnings before any book-tax differences due to income measurement, as follows. Finally, if the foreign subsidiary pays 50% of its profits as a dividend, the U.S. tax return would include $1,150 of pretax earnings. Example 1 illustrates these results.

<table>
<thead>
<tr>
<th>Pretax income of:</th>
<th>Financial Statements</th>
<th>U.S. Tax Return (100% dividend from foreign subsidiary)</th>
<th>U.S. Tax Return (no dividend from foreign subsidiary)</th>
<th>U.S. Tax Return (50% dividend from foreign subsidiary)</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Parent company</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>U.S. subsidiary</td>
<td>$100</td>
<td>$100</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Foreign subsidiary</td>
<td>$100</td>
<td>$100</td>
<td>$0</td>
<td>$50</td>
</tr>
<tr>
<td>Pretax income included in consolidated report</td>
<td>$1,200</td>
<td>$1,200</td>
<td>$1,100</td>
<td>$1,150</td>
</tr>
</tbody>
</table>

Large book-tax differences arise in either direction depending on which “book” number is used as a starting reference point. The Schedule M-1 requires taxpayers to begin with their net income according to their books and records. This could reasonably be interpreted as worldwide net book income or U.S. net book income reported on the public financial statements, or a newly constructed book income for only those entities included in the U.S. tax return.

Example 2 illustrates how the book-tax difference could be negative, positive, or zero depending on whether the corporation starts its Schedule M-1 (lines 1 + 2) with book
income on a worldwide, U.S., or intermediate basis.

<table>
<thead>
<tr>
<th>Book-Tax Entity Difference will be:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public financial statement worldwide pretax income</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Pretax book income used for M-1</th>
<th>NEGATIVE</th>
<th>POSITIVE</th>
<th>ZERO</th>
</tr>
</thead>
<tbody>
<tr>
<td>($1,200 = 1000 + 100 + 100)</td>
<td>$1,100</td>
<td>$1,150</td>
<td>$1,150</td>
</tr>
<tr>
<td>Plus (minus) foreign income</td>
<td>($50)</td>
<td>$50</td>
<td>$0</td>
</tr>
<tr>
<td>Pretax book income taxed in the U.S.</td>
<td>$1,150</td>
<td>$1,150</td>
<td>$1,150</td>
</tr>
</tbody>
</table>

Thus, the above example illustrates that the same set of facts can result in either a positive book-tax difference, a negative book-tax difference, or no difference, all depending on the reporting choice the firm makes in completing the Schedule M-1. The vague Schedule M-1 instructions complicate the Internal Revenue Service’s job in having to reconcile the beginning point of the Schedule M-1 for entity differences before they can begin to consider the differences in income measurement between book and tax.

These simple examples are easily complicated by recognizing that dividends from unconsolidated entities can be paid out of more than the current year’s income.

The second line of the M-1 is the amount of Federal income tax, which is added back to book net income to determine pre-tax book income. Because taxpayers could have reported U.S. or worldwide net income (or some other amount) on Line 1, it is not clear that the federal tax expense on Line 2 will always represent U.S. tax expense.
The remainder of the M-1 either adds or subtracts specific types of items depending on the differential treatment for financial and tax purposes. Line 3 specifically itemizes “excess of capital losses over capital gains,” which represent losses on the sale of capital assets (such as securities) not deducted in the current tax year.

Line 4 shows additions for “income subject to tax not recorded on books this year.” Here, corporations report income amounts recognized for tax purposes but not included for financial accounting purposes, such as advance cash payments discussed previously.

Line 5, “expenses recorded on books not deducted on the return,” are differences in the accounting treatment of expenses that increase taxable income relative to financial reporting income by being recognized for book, but not tax, purposes. Line 5 separately identifies two items: the expense for travel and entertainment in excess of deductible limits (typically 50%), and any excesses of book depreciation over tax depreciation, which typically occurs due to reversal of previous excess tax depreciation. Lines 1 through 5 are subtotaled on Line 6.

Line 7 shows “income recorded on books this year not included on this return” records book income not recognized as taxable net income, including tax-exempt interest (separately delineated), life insurance proceeds, and reversals of income previously recognized as taxable that was not considered income under GAAP.

Line 8 shows tax deductions in excess of their charges against book income, with depreciation separately itemized. As discussed previously tax depreciation will typically exceed book depreciation in the early part of an asset’s life, and in the aggregate for growing firms. Also included here would be the effects of the differential treatment of stock-based compensation, discussed above. Line 9 subtotals lines 7 and 8.
Line 10, calculated as line 6 less line 9, equals tax net income (tax return Form 1120, page 1, line 28), not taxable income (line 30). Taxable income (line 30) equals tax net income (line 28) less the net operating loss deduction and other special deductions (e.g., the deduction for dividends received). Unlike book income or tax net income, income subject to tax cannot be negative.

**How does the Internal Revenue Service use the Schedule M-1?**

The IRS’ Internal Revenue Manual (IRM) describes the role of the Schedule M-1 in the audit process. The IRS recognizes its first task in using the Schedule M-1 is to understand the starting book income on Line 1 and reconcile it to the taxpayer’s books (IRM § 4.10.3.5.6). IRM § 4.10.3.6.1 outlines procedures for analyzing the book-tax differences in the Schedule M-1, noting “Schedule M-1 is a critical schedule for identifying potential tax issues resulting from both temporary and permanent differences between financial and tax accounting.” Audit techniques include verifying “large Schedule M-1 adjustments going in opposite directions … were not netted to arrive at what appears to be an immaterial amount that would not be reviewed.” The audit procedures are consistent with the discussion above about reserves resulting in book expenses being accrued before they are tax-deductible. As an example of an audit procedure using the Schedule M-1, the IRS recommends agents prepare a schedule showing beginning and ending balances in accrued expenses. “If the reserve increases during the year, a Schedule M-1 adjustment should have been made [by the taxpayer] to increase taxable income.” If it wasn’t, the agent will ask further questions.
Finer detail needed for accurate reconciliation

Our premise for a revised M-1 is that information provided in such a reconciliation could greatly improve the ability of those who use the form to better understand the financial position of a company, and provide a mechanism to link firms’ tax reports to their financial filings. Better linkage could lead to improvements in both tax and financial reporting, as similar information will be required on both sets of reports. As part of both the audit process, and to understand the effects of differential consolidation, we believe it is imperative that all tax reports of a public corporation can be matched to their financial reporting numbers. Figure 3 presents our proposal for an expanded Schedule M-1.

Part 1 newly requires that publicly traded firms report the parent company names and identification numbers for both tax (employer identification number, or EIN) and book (CUSIP) associated with the entity that files the 10-K. Part 1 additionally requires an asset reconciliation of consolidated book assets on the 10-K with consolidated book assets for entities included in the consolidated tax return.

Because of the previously outlined differences in consolidation between tax and financial entities, Part 2 begins with the information needed to link the return to its related consolidated financial reporting entities. Line 1 is a specifically defined and independently identifiable measure of pretax book income equal to worldwide net income from the SEC Form 10-K for publicly traded companies.

Line 2 displays the components of tax expense presently recorded in financial statement tax footnotes. GAAP requires separate disclosure of current and deferred components of U.S., foreign, and state (with other) income tax expenses. We believe

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19 The provision of such data is not new; form 5500, “Annual Return/Report of Employee Benefit Plan” already requires a firm to provide the CUSIP of a plan sponsor.
separately detailing these components (in place of the current Line 2) will be informative.
The U.S. current tax expense is an estimate of the taxpayer’s U.S. tax obligation for the
current year, with notable exceptions for stock option accounting and “tax cushion”, which
is the accrued expense for probable and estimable contingent tax liability (Gleason and
Mills 2002). The foreign current tax expense indicates the potential availability of foreign
tax credits to reduce domestic taxes owed. The taxpayer adds these expenses back to net
income to derive worldwide pretax book income (Line 3).

Lines 4 through 9 reconcile the book income of entities included in the consolidated
financial statement with book income included in the consolidated tax return. Line 4
subtracts from financial statement income the book income of those U.S.-owned entities
that are not consolidated for tax purposes. Typically, these would be entities for which the
parent owned between 50 and 80%. Line 5 subtracts book income of all foreign
subsidiaries included in the consolidated financial statement because foreign subsidiaries
are not eligible for inclusion in a consolidated tax return.

Line 6 adds back book income from domestic and foreign entities excluded from
financial reporting but included for tax, such as dividends from non-tax-consolidated
entities, e.g. dividends from 60% owned domestic corporations. Line 6 also includes
income or losses from Special Purpose Entities that are treated as partnerships or branches
for tax purposes.

Line 7 provides a subtotal that should equal the book income of U.S. entities
included in the U.S. consolidated tax return, but before deemed or actual dividend
repatriations of foreign source income. Because U.S. entities receive flow-through income
from foreign branches and partnerships, Line 7 already includes foreign income from such
sources, as well as any income such as interest, rents, royalties and management fees from foreign subsidiaries.

Lines 8 and 9 report taxable income due to actual or deemed dividends from foreign subsidiaries. Line 8 reports dividend repatriations of foreign source income from foreign corporations. In Line 8a, the taxpayer reports the net (cash) dividend, and in Line 8b, the taxpayer reports the (IRC §78) gross-up, if applicable. Line 9 reports taxable income, including gross-up, from controlled foreign corporations under Subpart F (IRC §956, etc.).

Line 10 equals pretax book income of U.S. consolidated tax group plus taxable deemed or actual foreign repatriations. Finally, Line 11 subtracts deductible state (and other) income taxes. Line 11 may not equal Line 2e, which was an estimate for the financial statements.

The subtotal on Line 12 is pretax book income of the U.S. consolidated tax group plus repatriations of foreign income, but after the deduction for state income tax expense. This subtotal represents what was probably reported on the combination of Lines 1 and 2 of the existing Schedule M-1 when companies started with a book income other than consolidated worldwide income or strictly U.S. entities’ book income.

Lines 13 through 17 are taken from the current M-1, and serve to identify differences in the reporting of income and expense between the two systems. Our goal in this section is twofold. First, the revised M-1 provides more detailed itemization of particular items than the current M-1 provides.\(^\text{20}\) Second, the revised M-1 separates the differences in income and expense that are temporary (due to timing differences) from

\(^{20}\text{We believe that the instructions should specific a materiality level for line item reporting that prevents firms’ netting otherwise material transactions into immaterial net amounts.}\)
differences that are permanent. As a result, we add lines for pension income, stock options, and the amortization of goodwill. In some cases, the accounting for these items will have both temporary and permanent effects that should be separately listed. In addition, though we do not address the issues specifically here, we suggest strict rules be implemented to ensure that “other” reconciliation items that fall into these categories but which are not specifically itemized on the form are reported consistently across all firms. Such consistency will require that the netting of temporary differences not be allowed and that a materiality rule be established so that any transaction above a specified threshold will be separately identified.

**Potential benefits of revised M-1**

*Potential benefits to tax administrators and policymakers.*

If the M-1 is an audit tool, then the primary beneficiaries of a revised M-1 should be auditors. However, we recognize that IRS examiners already have the authority to require taxpayers to provide additional detail as needed. We also recognize that the tax return as filed typically includes supplemental schedules that provide additional detail supporting the Schedule M-1 line items. For example, the longest of the more detailed Enron Schedule M-1s took five pages for 1998, (JCT 2003, Volume II, pages A-29 through A-50)

Nevertheless, we believe that standardizing additional detail on the face of the Schedule M-1 will assist audit efficiency. For example, auditors could more quickly identify the magnitude of (multinational) consolidation issues and determine whether an International Specialist is needed. Standardization of additional detail will also facilitate comparisons across firms. Finally, the introduction of detail concerning temporary and
permanent differences will permit the IRS to consider whether permanent versus temporary issues should receive equal attention for tax enforcement. For example, the Treasury (1999) described the perfect tax shelter as one that reduces taxable income without affecting book income. To gain a financial statement benefit through a reduced effective tax rate, such differences must be considered permanent. Although improvements in audit efficiency clearly benefit the IRS, they also reduce the audit-related costs of otherwise compliant firms.

An additional beneficiary of improved M-1 disclosure will be IRS Research. The Research division uses large-sample tax return data for audit selection, classification and issue identification. Standardizing the detail for material book-tax differences will permit IRS Research to better evaluate whether book-tax differences of various types relate to compliance risk, potentially increasing audit efficiency. For example, because stock option deductions are permitted by legislative grace, the book-tax difference for stock options should not by itself represent a compliance risk, even if it generates a large aggregate spread between book income and taxable income. Finally, any improvements in IRS audits and tax compliance research apply to state tax administration as well, because the state governments have access to federal tax return data and perform similar enforcement functions.

Beyond the administration of the tax code, additional M-1 detail will provide other users of tax return information a more complete picture of tax returns’ relation to publicly available financial statements. Such a link between the tax return and publicly available data should allow for better understanding of the economic and financial behavior of firms in response to tax changes. The 1999 Treasury report on tax shelters and Treasury
testimony (Talisman 1999), for example, pointed to the disparity in book-tax income as potential evidence of increasingly aggressive tax positions being taken by firms. A more detailed M-1 would provide additional information to those studying these issues.

Finally, book-tax differences affect federal budget forecasting and economists’ estimates of the national accounts. Because tax return data become available approximately two years later than public financial statement data, economic forecasters use public financial statement data to predict corporate profits and tax collections adjusting financial statement income for expected book-tax differences. Better data on the relation between taxable and financial reporting income could make extant financial data more useful to policy analysts.

_Potential benefits to financial statement users_

Although the provision of additional detail in the M-1 would be beneficial to currently authorized users -- tax administrators, policymakers, and other internal government users, the same information could also be useful to other external parties were it to be made public. GAAP requires various disclosures and reconciliation of a firm’s financial statements with its ultimate tax liability, however, this information appears to be incomplete, as the evidence seems to indicate it is unreliable in determining the amount of income reported for tax purposes. Hanlon (2003) summarizes research that indicates current disclosures under FAS 109 are not sufficiently complete to allow inferences of taxable income or taxpaying status.21

Because the revised Schedule M-1 serves as a tax-reporting analog to a firm’s tax footnote, were it to be publicly available it could address many of the shortcomings of
current financial reporting and allow investors to utilize both sets of reports in evaluating a company’s performance. Alan Murray’s column (WSJ, July 2, 2002) reasoned that tax return information “may not be of much use to the average investor. But conscientious stock analysts – surely there are some out there? – could spend their time analyzing the gaps between book and tax income, attempting to find truth in between.” In addition to those who are making investing decisions, other potential beneficiaries include the business and general press and other financial and policy analysts.

**Potential costs of additional disclosure**

Regardless of the audience, the supply of additional information raises questions as to the costs of supplying the information. Information should be required only if the benefits of reporting the information outweigh the costs. In the case of tax return information, a difficult trade-off is that the costs are borne by distinctly separate groups than those that receive the potential benefits.

**Compliance costs**

We do not believe that requiring additional line-item detail on the Schedule M-1 will substantially increase the tax return compliance costs. Although the revised M-1 totals 25 lines, the line count is misleading. The first eleven lines, all new to the M-1, are used to reconcile net income from the 10-K to the current first line of the M-1, and are necessary to control for consolidation differences. Of these eleven, the first three would be taken directly from the 10-K filing. The reconciling items of the current M-1 are left essentially unchanged in new lines 13 to 19, but with supplemental detail that would already be part of current record keeping and reported in supplemental attachments or used to prepare the

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21 Outslay (JCT testimony 2003) and Seida (JCT testimony 2003) discuss that the substantial tax net operating losses disclosed in Enron’s financial statement tax footnotes made it easier to estimate taxable
deferred tax assets and liability reconciliation for the financial statement tax footnotes. The six remaining new lines (20 to 25) summarize information reported elsewhere on the return.

As a point of comparison, Australia requires 28 lines in its book-tax reconciliation (Company Tax Return 2002, Schedule 7). Canada recently expanded its book-tax reconciliation schedule to include more than 100 specific reconciling items (Schedule 1, for taxation years 2000 and later). Requiring companies to classify their detailed book-tax differences into approximately 20 categories instead of four main categories is not unreasonable.

*Data consistency*

Our recommendations for changes to the Schedule M-1 preserve the existing category subtotals, so the time series of Statistics of Income data will be uninterrupted.

*Privacy issues related to public disclosure of tax return information*

We do not think that public disclosure of a modified Schedule M-1 would pose significant problems to firms from either a regulatory burden or competitiveness standpoint. From a burden view, the details provided in a modified M-1 are information a corporation should already have available as part of its normal filing. From a competitiveness perspective, any concern that these additional disclosures would harm a company must be viewed in the context of the extent to which this information goes beyond the information a firm should be providing under GAAP.

costs from mandated segment disclosures. However, our anecdotal conversations with corporate controllers suggest that although companies publicly protest additional disclosure on competitive grounds, managers are privately more concerned about customers knowing their profit margin. Such information does not appear to be derivable from the Schedule M-1.

**Disclosure of other tax return data**

We have limited our scope to recommendations for expanded book to tax income reconciliation. A partial approach to full disclosure could involve the disclosure of the revised M-1 along with other selected items of taxable income and expense. As a starting point, we suggest the entire M-1 of each tax return could be made publicly available, because it contains information that others, such as FASB, have already deemed as important to the general public.

**Summary recommendations**

Shortcomings in the current state of financial and tax information suggest a failure of both sets of regulatory guidelines. Increased reporting of book-tax differences within the tax return system would assist current users of tax return information, including tax administrators, tax policy analysts, and other government users such as the Bureau of Economic Advisors. Although the detailed reconciliation data we recommend are already available to tax examiners on request during audit, such data are not reported in useable form to facilitate aggregation and comparisons among taxpayers.

We assert that making (more detailed) M-1 data public should not impose unreasonable costs on taxpayers. First, taxpayers are already computing detailed

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22 Outslay (2003) suggests the first four pages of the Form 1120 (which includes the M-1) could be made public.
reconciliations to complete the current M-1 and tax disclosures required by SFAS No. 109. Although corporations do not report all the detail they collect on either the tax return or in the tax footnotes, the fact that they prepare it for tax examiners and independent auditors suggests any incremental compliance burden would be minimal. Second, we assert that potential privacy concerns are disingenuous considering that SFAS 109 would already appear to require disclosure of material book-tax reconciling items, although Hanlon (2003) points out the limitations of current financial disclosure in adequately providing transparency on book-tax differences. We leave further debate on the privacy concerns to Lenter, Shackelford, and Slemrod (2003).

To the extent that much of the information in the M-1 is not available, or cannot be inferred, from current data suggests that important characteristics of firms are not available to external users of financial information. Beyond the advantages of increased reporting within the tax system, additional information, if made public, would better assist investors and the general public in assessing the effects of the corporate tax system, and provide an important source of supplemental information to assess both the performance of publicly-traded corporations, and the tax system under which they operate.
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Seida, J., 2003, Testimony before the Senate Finance Committee on “Enron: The Joint Committee on Taxation's Investigative Report,” (February 13).


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### Table 1

**Enron Corp. and Subsidiaries: Reconciliation of Financial Statement Income to Taxable Income 1996-2000**

Table 2 from Joint Committee on Taxation written testimony of 2/14/2003

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All amounts in millions of dollars</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Income Reported in Consolidated Financial Income Statement</td>
<td>584</td>
<td>105</td>
<td>703</td>
<td>893</td>
<td>979</td>
</tr>
<tr>
<td>Less Net Income from Entities not Included in Consolidated Tax Return</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic Corporations</td>
<td>-96</td>
<td>-189</td>
<td>-149</td>
<td>-152</td>
<td>-345</td>
</tr>
<tr>
<td>Foreign Corporations</td>
<td>-232</td>
<td>-44</td>
<td>-521</td>
<td>-1110</td>
<td>-1722</td>
</tr>
<tr>
<td>Partnerships</td>
<td>-145</td>
<td>-211</td>
<td>-319</td>
<td>-638</td>
<td>-6899</td>
</tr>
<tr>
<td>Total</td>
<td>-473</td>
<td>-444</td>
<td>-989</td>
<td>-1900</td>
<td>-8966</td>
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<tr>
<td>Plus Net Income from:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intercompany Elimination Made for Books but not for Tax</td>
<td>1322</td>
<td>1300</td>
<td>1884</td>
<td>3997</td>
<td>13625</td>
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<tr>
<td>Entities not Controlled for Financial Accounting Included for Tax</td>
<td>0</td>
<td>0</td>
<td>14</td>
<td>122</td>
<td>258</td>
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<tr>
<td>Total</td>
<td>1322</td>
<td>1300</td>
<td>1898</td>
<td>4119</td>
<td>13883</td>
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<tr>
<td>Book Income Reported on Consolidated Tax Return</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1433</td>
<td>961</td>
<td>1612</td>
<td>3112</td>
<td>5896</td>
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<td>Significant Book to Tax Adjustments</td>
<td></td>
<td></td>
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<tr>
<td>Federal Income Taxes</td>
<td>159</td>
<td>-35</td>
<td>45</td>
<td>-128</td>
<td>193</td>
</tr>
<tr>
<td>Net Partnership Adjustments</td>
<td>-107</td>
<td>-122</td>
<td>-109</td>
<td>-338</td>
<td>-481</td>
</tr>
<tr>
<td>Net Mark to Market Adjustments</td>
<td>-118</td>
<td>118</td>
<td>-333</td>
<td>-906</td>
<td>-537</td>
</tr>
<tr>
<td>Constructive Sale (section 1259)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>5566</td>
</tr>
<tr>
<td>Structures Treated as Debt for Tax not for Book (e.g., equity or minority interest)</td>
<td>-2</td>
<td>-24</td>
<td>-3</td>
<td>-12</td>
<td>-149</td>
</tr>
<tr>
<td>Company Owned Life Insurance Adjustment</td>
<td>-19</td>
<td>-24</td>
<td>-27</td>
<td>-35</td>
<td>-20</td>
</tr>
<tr>
<td>Stock Options Deduction</td>
<td>-113</td>
<td>-9</td>
<td>-92</td>
<td>-382</td>
<td>-1560</td>
</tr>
<tr>
<td>Depreciation Differences</td>
<td>-67</td>
<td>-65</td>
<td>-57</td>
<td>-124</td>
<td>-154</td>
</tr>
<tr>
<td>Equity Earnings Reversal Per Tax Return</td>
<td>-1183</td>
<td>-1023</td>
<td>-1688</td>
<td>-2868</td>
<td>-5516</td>
</tr>
<tr>
<td>All Other Book to Tax Differences</td>
<td>-293</td>
<td>-281</td>
<td>-101</td>
<td>223</td>
<td>-137</td>
</tr>
<tr>
<td>Taxable Income Reported on Consolidated Tax Return</td>
<td>-310</td>
<td>-504</td>
<td>-753</td>
<td>-1458</td>
<td>3101</td>
</tr>
</tbody>
</table>

**Notes:**
- (1) As originally reported.
- (2) Corporations not meeting 80 percent vote and value test (sec. 1504(a)(2)).
- (3) Foreign corporations are not eligible for inclusion in consolidated tax return (sec. 1504(b)(3)).
- (4) Partnerships are required to file separate Federal income tax returns. The financial accounting to tax return reconciliation in Appendix A contains additional details of these amounts.
- (5) Disregarded entities for Federal tax purposes (Treas. Reg. sec. 301.7701-3) not included in consolidated financial statements. The financial accounting to tax return reconciliation in Appendix A contains additional details of these amounts.
- (6) Amounts as reported in Enron presentation to the Joint Committee staff, June 7, 2002. Appendix B contains this presentation. In addition, Appendix A contains further details of Enron’s book to tax adjustments as reported in the tax return.
### Table 2
**Book Net Income and After-Tax Tax Net Income, Selected Years**
*(in thousands of dollars)*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>After-Tax Tax NI</strong></td>
<td>56,896,897</td>
<td>71,770,342</td>
<td>84,113,998</td>
<td>82,957,585</td>
<td>404,477,881</td>
<td>424,081,619</td>
<td>351,968,885</td>
</tr>
<tr>
<td><strong>Book Net Income</strong></td>
<td>79,380,619</td>
<td>92,865,160</td>
<td>93,855,794</td>
<td>88,828,436</td>
<td>553,496,834</td>
<td>599,869,698</td>
<td>600,318,898</td>
</tr>
<tr>
<td><strong>Ratio of Book Net Income to After-Tax Tax Net Income</strong></td>
<td>0.395</td>
<td>0.294</td>
<td>0.116</td>
<td>0.071</td>
<td>0.368</td>
<td>0.415</td>
<td>0.706</td>
</tr>
</tbody>
</table>

Book Net Income is defined on after-tax basis while Tax Net Income is a pre-tax concept. See Plesko (2002) for a discussion.

Source: IRS Corporation Income Tax Returns (Publication 16), selected years, and Plesko (2002)
FIGURE 1

The Difference Between Book and Tax Corporate Income
Firms with Assets Over $1 Billion

Source: Talisman (2000)

Book Income = After-tax book income from Schedule M-1 + Federal taxes - tax exempt interest
Tax Income = Total Receipts - Total Deductions
Corporations excluding S corporations, RICs, REITs, and Foreign Corporations
Source: Internal Revenue Service, Statistics of Income

source: Talisman (2000)
### FIGURE 2
CURRENT SCHEDULE L, M-1 and M-2

**Schedule L**
Balance Sheets per Books

<table>
<thead>
<tr>
<th>Assets</th>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
<th>(d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Cash</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2a Trade notes and accounts receivable</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b Less allowance for bad debts</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Inventories</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 U.S. government obligations</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Tax-exempt securities (see instructions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Other current assets attach schedule</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 Loans to shareholders</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8 Mortgage and real estate loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9 Other investments (attach schedule)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10a Buildings and other depreciable assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b Less accumulated depreciation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11a Depletable assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b Less accumulated depletion</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12 Land (net of any amortization)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13a Intangible assets (amortizable only)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b Less accumulated amortization</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14 Other assets attach schedule</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15 Total assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Liabilities and Shareholders’ Equity**

<table>
<thead>
<tr>
<th>Liabilities and Shareholders’ Equity</th>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
<th>(d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>16 Accounts payable</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17 Mortgages, notes, bonds, payable in less than 1 year</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18 Other current liabilities (attach schedule)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19 Loans from shareholders</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20 Mortgages, notes, bonds, payable in 1 year or more</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21 Other liabilities (attach schedule)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>22 Capital stock a Preferred stock</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b Common stock</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>23 Additional paid-in capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>24 Retained earnings Appropriated (attach schedule)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>25 Retained earnings Unappropriated</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26 Adjustments to shareholders’ equity (attach schedule)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>27 Less cost of treasury stock</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>28 Total liabilities and shareholders’ equity</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Schedule M-1**
Reconciliation of Income (Loss) per Books With Income per Return (see page 20 of instructions)

<table>
<thead>
<tr>
<th>Income per books</th>
<th>Income per return</th>
<th>Tax-exempt interest</th>
<th>Deductions on this return not charged against book income this year (filing)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income (less)</td>
<td>7 Income recorded on books this year not included on return (filing)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal income tax per books</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Excess of capital losses over capital gains</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income subject to tax not recorded on books this year (filing)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenses recorded on books this year not deducted on this return (filing)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a Depreciation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b Charitable contributions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Travel and entertainment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Add lines 1 through 5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8 Add lines 7 and 8</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Schedule M-2**
Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

<table>
<thead>
<tr>
<th>a Cash</th>
<th>b Stock</th>
<th>c Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 Distribution:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Other decreases (filing)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 Add lines 5 and 6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8 Balance at end of year (line 4 less line 7)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
FIGURE 3
PROPOSED M-1
Strict overlap with current M-1 is indicated in *italics*

Firm identification (of parent company if consolidated filing)

<table>
<thead>
<tr>
<th>Tax (per 1120)</th>
<th>Book (per 10-K)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name</td>
<td>Name</td>
</tr>
<tr>
<td>EIN</td>
<td>CUSIP</td>
</tr>
</tbody>
</table>

Part 1:
Asset reconciliation (book values)

<table>
<thead>
<tr>
<th></th>
<th>Beginning of year</th>
<th>End of year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Total worldwide consolidated book assets (from 10-K)</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Less book assets of entities in financial statements not included in consolidated tax return</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Plus book assets of entities included in tax return not consolidated for financial statements</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Adjustments to elimination entries</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Schedule L consolidated book assets for entities in consolidated U.S. tax return. These assets should be book values of assets for entities that generate pre-tax domestic earnings on Schedule M-1, line 7, adjusted by elimination entries for transactions within these entities.</td>
<td></td>
</tr>
</tbody>
</table>
## Part 2
### Schedule M-1. Reconciling book income to taxable income.

<table>
<thead>
<tr>
<th></th>
<th>Worldwide net income (from SEC Form 10-K)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Worldwide tax expense (from 10-K)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a. U.S., current</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b. U.S., deferred</td>
<td></td>
</tr>
<tr>
<td></td>
<td>c. foreign, current</td>
<td></td>
</tr>
<tr>
<td></td>
<td>d. foreign, deferred</td>
<td></td>
</tr>
<tr>
<td></td>
<td>e. state (and other), current</td>
<td></td>
</tr>
<tr>
<td></td>
<td>f. state (and other), deferred</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Worldwide pretax income (1+2) (from 10-K)</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>less book income from U.S. subsidiaries not consolidated for tax (50-80%)</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>less book income from foreign subsidiaries not consolidated for tax (50-100%)</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>plus dividends from nonconsolidated U.S. entities and other book income from U.S. and foreign entities excluded from books (SPEs) but included for tax (partnerships, branches, dividends from U.S. subsidiaries on the equity method for books, etc.). Do not include repatriations from foreign entities, which should be shown on Line 3.</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>equals book income of consolidated entities for tax before repatriations of foreign source income.</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>plus repatriations of foreign source income (taxable amount):</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a. net dividend</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b. gross-up (if applicable)</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>plus Subpart F income from CFCs (taxable amount including gross-up)</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>equals Pretax book income of U.S. consolidated tax group plus repatriations of foreign income.</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>less state (and other) tax expense deduction for tax</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Pretax book income of U.S. consolidated tax group plus repatriations of foreign income after state tax deduction.</td>
<td></td>
</tr>
</tbody>
</table>

### Income subject to tax not recorded on books this year (itemize)
- a. Permanent differences (itemize)
- b. Temporary (itemize)

### Expenses recorded on books this year not deducted on this return (itemize)
- a. Permanent differences (itemize)
  - Travel and entertainment
  - goodwill and/or intangible amortization
  - stock option expense
- b. Temporary differences (itemize)
  - capital losses in excess of capital gains
  - depreciation
  - goodwill and/or intangible amortization
  - other temporary basis differences
  - stock option expense
  - other accrued expenses

---

23 Extraordinary income and discontinued operations will cause Line 3 to differ from pretax income reported on the 10-K.
15 Add lines 12 through 14: total book income subject to tax

16 *Income recorded on books this year not included on this return (itemize)*
   a. Permanent differences
      *tax exempt interest*
   b. Temporary differences
      *pension income*

17 *Deductions on this return not charged against book income this year (itemize)*
   a. Permanent differences
      Stock option expense
   b. Temporary differences
      *depreciation*
      *goodwill or intangible amortization*
      *stock option expense*
      *Other accrued expenses*

18 Add lines 14 & 15: taxable adjustments

19 *Income (line 28, page 1) before NOLD and special deductions*

20 less NOLD and special deductions:
   a NOLD (memo item: unused NOL carryforward _______________
   b Special deductions

21 Taxable income (line 30, page 1)

22 Tax on taxable income

23 Other taxes

24 Less credits:
   a business credits
   b foreign tax credits. (memo item: unused FTC carryforward _______________
   c other credits

25 Tax after credits