

Chapter 10

Schedule M-1 Audit Techniques

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**INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES**

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Overview

Introduction

Taxpayers have different objectives when they prepare the financial statements and when they complete their tax return. The financial statements are prepared with an objective of maximizing income and thus increasing the net worth of the shareholders, while maintaining conformity with GAAP. The tax return is prepared with the objective of minimizing taxable income and thus reducing taxes paid, while maintaining compliance with tax law.

The books and records of a corporation are kept in accordance with GAAP and not in accordance with tax law. The result of these differing objectives is a large disparity between book income and taxable income. Schedule M-1 is the bridge (reconciliation) between the books and records of a corporation and its income tax return. Items included on this schedule will not be found in the corporate books and must be analyzed from workpapers prepared by the taxpayer.

Objectives

At the end of this chapter, you will be able to:

- Compute taxable income using book income and Schedule M-1;
 - Identify potential issues by analyzing Schedule M-1, and;
 - List some audit procedures for Schedule M-1.
-

Basic Information

Link or Bridge Schedule M-1 of the Corporate Income Tax Return, Form 1120 is the link or bridge between financial accounting and tax reporting. The tax return is prepared after completing Schedule M-1 adjustments. Understanding Schedule M-1 is a crucial part of the examination of a corporate income tax return.

Schedule M-1 Differences As mentioned previously, there are different rules for determining the taxpayer's financial income under GAAP and for determining taxable income. These rules result in differences that can be:

- Timing differences that are reported for tax purposes in a different accounting period, and;
 - Permanent differences that are never reported for tax purposes.
-

4 General Categories Both types of differences result in M-1 adjustments which fall into four general categories:

- Income subject to tax but not recorded on the books this year;
- Expenses recorded on the books this year but not deducted on this return;
- Income recorded on the books this year but not included on this return, and;
- Deductions on the tax return but not charged against book income this year.

Most of the GAAP and tax differences fall into one of the four general categories. Schedule M-1 adjustments are found in the taxpayer's supporting workpapers for nearly every line item.

For consolidated returns, you will also need to analyze separately the M-1 entries for each member of the controlled group. The principles covered in this lesson thus apply to all entities regardless of form.

Timing Differences

Timing Differences

Timing differences occur because tax laws require the recognition of some income and expenses in a different period than that required for book purposes. Timing differences originate in one period and reverse or terminate in one or more subsequent periods.

There are four basic categories of timing differences:

- Income recognized in financial statements before it is taxable;
 - Income taxable before it is recognized in financial statements;
 - Expenses recognized in financial statements before they are deducted on the tax return, and;
 - Expenses deductible on the tax return before they are recognized on financial statements.
-

Permanent Differences

Permanent Differences

Permanent differences between book and tax income result from transactions that (under applicable tax laws and regulations) will not be offset by any corresponding differences in other periods.

If a permanent Schedule M-1 difference is missed on an examination, it will be lost forever. If a timing difference is missed, there will likely be no permanent loss of tax revenue.

Schedule M-1 Mechanics

Schedule M-1 Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return

1. Net income (loss) per books
 2. Federal income tax
 3. Excess of cap losses over cap gains
 4. Income subject to tax not recorded on books this year (itemize):

 5. Expenses recorded on books this year not deducted on this return (itemize):
 - a. Depreciation \$ _____
 - b. Contributions carryover \$ _____
 - c. Travel and entertainment \$ _____
-

6. Add lines 1 through 5

7. Income recorded on books this year not included on this return (itemize):
Tax-exempt
Interest \$ _____

8. Deductions on this return not charged against book income this year (itemize)

- a. Depreciation \$ _____
 - b. Contributions carryover. \$ _____
-

9. Add lines 7 and 8

10. Income (line 28, page 1) line 6 less 9

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Schedule M-1 Mechanics, Continued

Discussion of Schedule M-1

When looking at the Schedule M-1, line items in the left hand column (lines 2-5) are adjustments added to book income. This results in an increase to taxable income. Line items in the right hand column (lines 7-8) are adjustments reducing book income. Lines 7-8 decrease taxable income.

Taxpayers may show negative amounts on Schedule M-1. These have the opposite effect on taxable income than that described above. Although correct, negative amounts can be confusing when determining whether income is increased or decreased.

Line items 4 and 8 of the Schedule M-1 contain items that appear on the tax return but not on the books.

Line items 5 and 7 of the Schedule M-1 start with items on the books that are then adjusted for tax purposes. These items appear on the financial statements but will not be on the tax return.

Be alert for taxpayers combining multiple Schedule M-1 adjustments and be aware that large amounts may be offset. On the surface, the net figure might not warrant examination.

Schedule M-1 principles

The principles described above can be summarized as follows:

| ITEMS--PLUS | ITEMS-MINUS |
|---------------------------------|-----------------------------------|
| Book Income (Starting Point) | |
| Federal Income Tax | Book Income not on Tax Return |
| Net Capital Loss | Expenses for Tax not in the Books |
| Taxable Income not on the Books | Book Expenses not on Tax Return |
| Taxable Income (Ending Point) | |

Schedule M-1 Line Items

Line 1 Schedule M-1 starts with the net income per books (after the deduction for income tax expense) as shown in the corporation's profit or loss account. The amount should be taken from the actual books, not from a set of workpapers.

Frequently, taxpayers will use an income amount that does not appear in the company books, the annual report, or the financial statements. These taxpayers have "off-book" adjustments, which do not appear on the Schedule M-1. Any "off-book" adjustments should be closely scrutinized for potential tax issues.

Line 2 The provisions for federal income tax (line 2 of Schedule M-1) should be compared with the federal tax liability on Schedule J on Form 1120. Line 2 of Schedule M-1 represents the current federal tax provision for the book income amount of the current year plus the deferred tax provision, which recognizes future obligations and contingencies. Line 10 of Schedule J is the net federal tax amount on taxable income of the current year.

An analysis of line 2 is important because the deferred tax liability should include cumulative deferred adjustments. Deferred taxes are created by timing differences that will eventually be reported on Schedule M-1. We will discuss the deferred tax liability in more detail in another lesson when we look at FASB 109, which deals with accounting for income taxes.

Line 3 This represents a timing difference since capital losses can be deducted on the books. Under IRC section 1211, capital losses can only be deducted to the extent of capital gains. The excess capital loss can be carried back three years and forward five years for tax purposes. There is no limitation on losses expensed for book purposes.

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Schedule M-1 Line Items, Continued**Line 4**

This line restores to taxable income those items, which because of timing or other generally acceptable accounting provisions, have either:

- Been previously reported,
- Been used to reduce a balance sheet item, or
- Will be reported in some subsequent period.

Prepaid rental income is a good example. Advanced rents are timing differences, which, for tax purposes, are included in taxable income in the year of receipt, but are reported in the period earned for book purposes.

Prior year income represents an item included as book income in a prior year but taxed in the current year. For example, insurance proceeds in excess of basis on an involuntary conversion may not have been reinvested within the prescribed time period. Treasury Regulation 1.1033(a)-2(c)(2) requires that the tax liability for the year for which the election was made to be recomputed if the converted property is not replaced within the required period of time.

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Schedule M-1 Line Items, Continued**Line 5**

This line contains both permanent and timing differences. Some of the more common entries on this line are listed below.

- Book depreciation that exceeds the amount allowed for tax will be shown in this section.
- Reserves for future expenses, which are not currently deductible for tax, are a common entry on line 5.
- Expenses incurred to earn tax-exempt income are not allowed as a deduction in the computation of taxable income. An analysis of professional services account may indicate expenses incurred for the production of tax-exempt income.
- Contributions in excess of the 10% of taxable income limitation would result in a timing adjustment in this section.
- Officer's life insurance premiums are not allowed as a deduction for tax purposes in certain situations, but would be reflected as a book deduction. For example, a company may maintain a life insurance policy on the life of its CEO and other top management in which the company is named as beneficiary. For book purpose, the premiums are expensed as incurred (usually as insurance expense). If the policy provides for a cash surrender value, the portion of the premium that relates to cash surrender value is recorded as an asset. For tax purposes, under IRC 264(a)(1), no deduction is allowed for premiums paid on any life insurance policy covering the life of any officer/employee when the company is directly or indirectly the beneficiary of the policy.
- The conservatism principle in accounting requires companies to recognize liabilities when they become probable. Provisions for estimated expenses are established for book purposes as contingencies, but they are not allowed for tax purposes until they become fixed and determinable.

Line 6

This is the sum of lines 1 through 5.

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Schedule M-1 Line Items, Continued

Line 7 The books may reflect current income for financial reporting while deferring the item for tax purposes. This line also includes financial income not subject to tax.

Examples include:

- Tax-exempt interest on municipal bonds,
- Officer's life insurance proceeds (since the premiums are not deductible, income from the policy is exempt from tax), and
- Installment receipts, which show up as deferred gross profit on line 7.

Line 8 This includes all deductions claimed for tax purposes that are not recorded in the corporation's books. This is the opposite of line 5.

Examples include:

- Depreciation is the most common example. Generally, taxpayers are allowed to use accelerated depreciation for tax purposes while using the straight-line method for book purposes.
- The excess contribution carryover (not allowed as a deduction for tax purposes in prior years) appears here as a timing difference.

Line 9 This is the sum of lines 7 and 8.

Line 10 This is line 6 minus line 9 and is the actual taxable income reported on Line 28 of page 1 of the income tax return. You should investigate any difference between the amount reported on line 10 of the M-1 and line 28 of page 1.

Auditing Techniques

| Step | Action |
|------|---|
| 1 | Request the workpapers and supporting documents used to prepare the tax return, and reconcile the book income shown on line 1 of the Schedule M-1 to the actual net profit or loss. |
| 2 | Reconcile the federal income tax on line 2 of the Schedule M-1 to the amount reported on the books. (This amount includes current and deferred taxes). |
| 3 | Secure a comparative analysis of each Schedule M-1 adjustment, comparing the current year(s) Schedule M-1 to the prior and subsequent years' Schedule M-1. (See Exhibit 2-3). |
| 4 | Prepare workpapers to verify the propriety and accuracy of all Schedule M-1 adjustments. |
| 5 | Secure all pertinent documentation to substantiate the computation of the entries including: <ul style="list-style-type: none"> • Books of original entry, • Audited financial statements, • Audit workpapers or schedules, and Source documents such as invoices, contracts, agreements, etc. |
| 6 | Review book balance sheet and book profit and loss accounts for possible omissions from Schedule M-1 increases to income. |
| 7 | Develop a list of expected items to be included on Schedule M-1. Ask the taxpayer to explain the accounting treatment for such items, for book and tax purposes, if the expected items are not listed on Schedule M-1. |

Mechanical Errors

The entries on Schedule M-1 are not part of the taxpayer's double-entry accounting system. The normal accounting controls do not exist and consequently, errors are frequent. An item may be deducted on the books and then deducted again erroneously on Schedule M-1. Many times, numbers will be transposed resulting in an erroneous adjustment. Seemingly innocent adjustments have yielded large audit issues.

Continued on next page

Auditing Techniques, Continued

| | |
|---------------------------------------|--|
| Book Expense not on Tax Return | It is important to investigate expenses not deducted on the return. An expense per books but not on the return could result in an incorrect amount on the Schedule M-1. For Example, a \$5,000 amount on line 4 or 5 does not mean that the amount should not be \$500,000. Review the accounts and account numbers to determine if the taxpayer handled them correctly. |
| Netting Items | The taxpayer may inadvertently disguise the significance of the Schedule M-1 adjustment by combining or netting items, which would normally be reported as a separate line item. Although there may not be an adjustment to income, it does distort a realistic analysis of the Schedule M-1. Separately, an item may stand out as an improper item. |
| Simple Mistakes | Finding simple mistakes, like a Schedule M-1 entry on the wrong side of Schedule M-1, often results in quick agreed adjustments. If a \$300,000 Schedule M-1 entry for unallowable travel and entertainment was erroneously made to decrease taxable income, there is a \$600,000 adjustment. |
| Omitted Items | Omitted Schedule M-1 items can be found by investigating balance sheet accounts (especially liabilities), which are not affected by Schedule M-1 adjustments on the tax return. Based on the titles to these accounts and other information developed in the audit, determine if a book and tax difference exists. The taxpayer often misses new general ledger accounts that should be included in M-1 adjustments. |
| FASB's | There are numerous Financial Accounting Standards Board (FASB) statements, which result in Schedule M-1 adjustments. |
| Consistency | For examinations involving a consolidated return or examination of separate returns in the same industry, you should compare similar Schedule M-1 entries and similar trial balance accounts between the various companies. |

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Auditing Techniques, Continued

Adjusting Journal Entries

Understanding adjusting journal entries (AJEs) and reclassification entries is a vital part of examining a taxpayer's books and may lead to Schedule M-1 adjustments. The following example shows how.

A taxpayer made the following year-end Adjusting journal entries (AJE):

| | | |
|---------------------------|-------------|-------------|
| Debit. Cost of Goods Sold | \$1,000,000 | |
| Credit. Inventory | | \$1,000,000 |

The net effect of this AJE decreases net income. The taxpayer claims the AJE was made to revalue discontinued or obsolete items due to financial accounting requirements. For tax purposes, the revaluation is determined not to be deductible. Therefore, a Schedule M-1 adjustment on line 5 should appear on the tax return in the amount of \$1,000,000.

Incorrect Account Balances

Examiners should look for Schedule M-1 entries that were computed by reference to incorrect account balances. This can occur when the Schedule M-1 entry was computed using book account balances believed to be accurate but later altered by year-end adjusting journal entries. Additionally, look for Schedule M-1 entries computed by reference to book account balances that included adjusting entries not applicable to the year under examination. Incorrect account balances can be illustrated as follows:

Current Year's Adjusting Journal Entry Ignored

| | 1998 | 1999 |
|------------------------|--------------|-------------|
| Tax depreciation | \$2,225,000 | \$2,219,000 |
| Less Book Depreciation | \$1,118,000* | \$1,115,000 |
| Taxpayer's Sch. M-1 | \$1,107,000 | \$1,104,000 |
| Correct Schedule M-1 | \$1,207,000 | \$1,104,000 |
| Adjustment | | \$100,000 |

*The 1998 book depreciation was actually \$1,018,000 after a \$100,000 credit in a 1998 year-end adjusting journal entry

Reversing Differences

It is important to remember that timing differences will reverse in subsequent periods.

Sample IDR's

Exhibit 1

Exhibit 1 is an example or template of an IDR requesting specific Schedule M-1 information. A description of the documents requested follows.

- Please provide the consolidating tax assembly or tax grouping workpapers that were prepared to arrive at the amount reflected for book income on Schedule M-1, line 1.
 - Please provide the reconciliation of the book income amount reflected on Schedule M-1, line 1 to the net earnings amount reflected in the consolidated statement of earnings prepared by the independent auditors.
 - Indicate those entities, which were added to, or deleted from, the book income amount in going to the statement of earnings amount. Alternatively, indicate those entities, which were deleted from, or added to the statement of earnings amount in going to the book income amount.
 - Provide all journal entries, which were prepared in determining the statement of earnings amount.
-

Exhibit 2

Exhibit 2 is an example or template of an IDR requesting Schedule M-1 information by line item. A description of the documents requested follows.

Please provide the workpapers, schedules, and other such information which was used to prepare the following Schedule M-1 entries:

- Line 4 Entries: (List items here)
 - Line 5 Entries: (List items here)
 - Line 7 Entries: (List items here)
 - Line 8 Entries: (List items here)
-

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Sample IDR's, Continued

Exhibit 3

Exhibit 3 is an example or template of an IDR requesting information regarding Schedule M-1 entries that may have been combined. A description of the documents requested follows.

It would appear that line item entries on Schedule M-1 (lines 4, 5, 7, 8) represent account information by the same name and description. To the extent a Schedule M-1 entry actually represents a combination of accounts and amounts of different names and descriptions, it will be necessary to provide information and other data in support of such a Schedule M-1 entry.

Employee Plans Schedule M-1's

**Deferred
Comp.
Arrangements**

Deferred compensation arrangements can take many forms: qualified pension and profit-sharing plans, incentive stock options, stock purchase plans, nonstatutory stock options and nonqualified deferred compensation agreements. For tax purposes, the timing of an employer deduction depends on whether the plan is qualified under IRC 401.

**Qualified Plan
IRC 404(a)(5)**

A pension plan is an arrangement whereby an employer provides benefits payments to employees after they retire. Because a pension is viewed as a form of deferred compensation, it follows that the cost of the pension occurs over the period that the employees provide services to the employer.

For book purposes, under FASB No. 87 and FASB No. 88, as the employees work, pension expense is incurred and the company's liability increases. The computation of pension cost is very complicated because it is a function of a number of factors including service cost, interest, prior service costs, net gain or loss on the value of plan assets and the actual return on plan assets.

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Employee Plans Schedule M-1's, Continued

**Qualified Plan
IRC 404(a)(5)
(continued)**

For tax purposes, under IRC 404, a deduction is allowed for employer contributions to a pension, profit-sharing or stock bonus plan that meet the tax qualification rules of IRC 401, generally in the year in which paid to the plan, subject to limitations determined under IRC 412. Under IRC 412, minimum and maximum funding limits are determined. Any contribution in excess of the maximum funding would be deferred and deducted in a subsequent year. Under IRC 404(a)(6), a contribution for a qualified plan made after the close of the taxable year is deemed made on the last day of the year if:

- it is made on account of such year and
 - not later than the due date (including extensions) for the employer's income tax return due for such year.
-

**NonQualified
Deferred
Comp. Plans
IRC 404(a)(6)**

In addition to, or in lieu of a qualified plan, a company may maintain nonqualified deferred compensation agreements, also referred to as unfunded deferred compensation. An unqualified plan does not require that an amount be set aside to irrevocably fund the benefits for the employee. For example, a company may pay cash bonuses to certain sales and management personnel. The awards may be based on sales volume, sales quotas, etc. Subsequent to the year in which the awards are earned, the company determines the exact amount of the bonuses and pays the recipients.

For book purposes, under APB Opinion No. 12, deferred compensation is expensed in the year earned by the recipients based on management's estimate of the future liability. If long-term, the compensation must be accrued in a systematic and rational manner over the period of active employment starting with the contract date.

For tax purposes, under IRC 404(a)(5), cash bonus awards are considered to be nonqualified deferred compensation, deductible in the taxable year in which the compensation is included in the recipient's gross income. However, Temp. Reg. 1.404(b)-1(T) provides that compensation paid to an employee within two and one half (2 ½) months after the end of the employer's taxable year in which it is earned is not considered to be deferred compensation and is allowed as a deduction in the year in which it is earned.

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Employee Plans Schedule M-1's, Continued

**Comp.
Absences IRC
404(a)(5)**

A compensated absence is an absence from employment due to vacation, holiday, or illness for which it is expected that the employee will be paid. A vested right exists when an employer has an obligation to make payment to an employee even if that employee terminates. Accumulated rights are those rights that can be carried forward to future periods if not used in the period in which earned.

For book purposes, FASB No. 43 requires that a liability be accrued for the cost of compensation for future absences where (1) the obligation relates to services already rendered; (2) the rights vest or accumulate; (3) payment is probable; and (4) the amount can be reasonably estimated. For tax purposes, under IRC 404(a)(5), vested vacation pay that is paid more than two and one half (2 ½) months after taxable year-end is treated as deferred compensation and deducted when paid. Vested vacation pay paid during the year or within two and one half (2 ½) months after taxable year-end is deducted currently. Accordingly, the amount of the vacation pay accrual account at year-end over the amount of the preceding year's accrued vacation pay account at year-end results in an increase or decrease in the portion of the vacation pay accrual that is not deductible for tax purposes.

One of the issues currently being pursued involves an arrangement whereby the taxpayer purchases a letter of credit (or other similar financial instrument) within two and one half (2 ½) months after the end of the taxable year in the amount of the unpaid accrual at the time the letter of credit is purchased. The taxpayer argues that this constitutes payment of the accrual for purposes of accelerating the entire amount of the accrual as a deduction in the preceding taxable year. It is the Government's position that the purchase of the letter of credit does not constitute payment of the benefits for purposes of avoiding the application of the 2 ½-month rule.

Although the Tax Court rendered an adverse decision to the Government in *Schmidt Baking Company*, 107 T.C. 271 (1996), the Service has NOT acquiesced in this case. Therefore, examiners should NOT be conceding this issue. It should also be noted that Congress introduced in 1998 specific legislation to overturn the effects of the *Schmidt* decision, and has been adopted in the Revenue Reconciliation Act of 1998 for years beginning after 7-20-98.

Summary

Summary

You have learned in this chapter the comprehensive analysis of Schedule M-1. It is imperative that you understand the differences between income and expenses based on accounting principles that generate book income, and tax laws, which generate taxable income.

The following key points were covered in this lesson:

- Schedule M-1 links the books to the tax return,
 - Timing differences originate in one period and reverse in one or more subsequent periods,
 - Permanent differences do not reverse in other periods,
 - Auditing techniques include verifying net profit or loss reported on financial statements, performing comparative analyses, and substantiating significant M-1 entries,
 - Tracing reserve accounts to M-1 entries is an excellent source for potential audit adjustments, and
 - Timing differences result in M-1 entries that must be reversed in subsequent periods.
-

Schedule M-1 Example

Tax Return Look to pages 22 through 25 for a copy of the tax return. Page 2 of the Form 1120 is not included because there was no cost of sales.

Line 1 In our example, Net Income (Loss) Per Books is \$27,358,158. The EP Agent verified the figure by reviewing the certified Financial Statement for the period ended December 31, 2001.

Although this information was not provided as part of the tax return, the EP Agent verified the pension expense per the certified Financial Statement for the period ended December 31, 2001 as \$6,246,075. A summary of the various book accounts that make up the total of \$6,246,075 requested and provided as well.

Line 2 In our example, Federal Income Tax is \$2,779,405. The provisions for Federal Income Tax should be compared with the federal tax liability on Schedule J on Form 1120.

Line 2 of Schedule M-1 represents the current federal tax provision for the book income amount of the current year plus the deferred tax provision, which recognizes future obligations and contingencies. Schedule J is where the net federal tax amount on taxable income of the current year is computed.

Line 3 In our example, there were no Excess Capital Losses Over Capital Gains.

Excess Capital Losses Over Capital Gains represents a timing difference since capital losses can be deducted on the books. Under IRC section 1211, capital losses can only be deducted to the extent of capital gains. The excess capital loss can be carried back three years and forward five years for tax purposes. There is no limitation on losses expensed for book purposes.

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Schedule M-1 Example, Continued

Line 4 In our example, Income Subject to Tax Not Recorded On Books This Year is \$94,846,491. This line restores to taxable income Deferred Intercompany Gain, Gain on Sale of Asset, and Section 420 Transfer - Cash Balance Plan per Statement 1 attached to Form 1120.

The Deferred Intercompany Gain is from the sale of an asset to a party outside the consolidated group upon which an intercompany gain had been reported for financial purposes in previous years. The Gain on Sale of Asset is necessary due to accelerated depreciation for tax deduction purposes.

The item that would concern the EP Agent would be the Section 420 Transfer - Cash Balance Plan entry of \$4,646,938 that could impact Line 24 (pension expense) on Form 1120.

Line 5 In our example, Expenses Recorded On Books This Year Not Deducted On This Return is \$51,701,102. This line restores to taxable income Depreciation, Charitable Contributions, Travel and Entertainment, and other miscellaneous items detailed on Statement 1 attached to Form 1120.

It is common to reverse the entire amount of depreciation. It is also possible to net book and tax depreciation, which would result in only one Schedule M-1 adjustment for depreciation. In this case, the entire amount of book depreciation was reversed. The adjustment to Travel and Entertainment and Charitable Contributions is necessary due to tax limitations on the deduction.

None of these expenses would appear to impact Line 24 (pension expense) on Form 1120.

Line 6 In our example, the subtotal of Lines 1 through 5 is \$176,685,156.

Line 7 In our example, Income Recorded On Books This Year Not Included On This Return is \$390,476. Per Statement 1 attached to Form 1120, this represents unearned income that reduces taxable income and would not appear to impact Line 24 (pension expense) on Form 1120.

Continued on next page

Schedule M-1 Example, Continued

Line 8 In our example, Deductions On This Return Not Charged Against Book Income This Year is \$168,644,298. Tax Depreciation is adjusted here and since tax and book depreciation were not netted, this adjustment reconciles to Line 20 (depreciation expense) on Form 1120.

Per Statement 1 attached to Form 1120, many miscellaneous items reduce taxable income. The only item that would appear to impact Line 24 (pension expense) on Form 1120 would be the Additional Pension Expense of \$250,000 for funding of a 401(h) account.

Line 9 In our example, the subtotals of Lines 7 and 8 is \$169,034,774.

Line 10 In our example, Income Per the Tax Return on Line 28 on Form 1120 is the difference between Lines 6 and 9 and is \$7,650,382.

You should investigate any difference between the amount reported on Line 10 of Schedule M-1 and Line 28 on Form 1120.

Reconcile Line 24 of Form 1120 to the Employer's set of books

In our example, Line 24 on Form 1120 is \$1,849,137. We also determined when reviewing Line 1 on Schedule M-1 that book income was \$6,246,075 for that same line item when various accounts were rolled up together.

Using Schedule M-1 adjustments that only impact Line 24 (pension expense) on Form 1120, the pension plan expense per books can be reconciled to the pension plan expense per the tax return.

| Schedule M-1 Reconciliation | Total |
|--|---------------|
| Pension Plan Expense Per Books | \$6,246,075 |
| Line 4 - Income Subject to Tax Not Recorded on Books This Year | \$(4,646,938) |
| Line 8 - Deductions on This Return Not Charged Against Book Income This Year | \$250,000 |
| Pension Plan Expense Per Tax Return | \$1,849,137 |

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Schedule M-1 Example, Continued

Explanation Note that when applying Schedule M-1 principles to the pension plan expense by itself, additions to taxable income on Schedule M-1 on Form 1120 would decrease the pension expense while decreases to taxable income on Schedule M-1 on Form 1120 would increase the pension plan expense.

Line 4 Line 4 - Section 420 Transfer - Cash Balance Plan is a combination of entries:

| Description | Amount |
|---|--------------|
| 12-27-01 Cash | \$51,361,105 |
| 12-28-01 EPTA Inc. Common Stock | \$11,974,950 |
| 12-29-01 Misc. Assets | \$73,556 |
| 12-31-01 Cash | \$19,112,327 |
| Subtotal | \$82,521,938 |
| Gain Recorded On Books (AJE #24) | \$78,000,000 |
| Subtotal | \$4,521,938 |
| Dividend Received on Door Corporation Terminated in 1994 | \$125,000 |
| Section 420 Transfer - Cash Balance Plan | \$4,646,938 |

Schedule M-1 Reconciliation

EPTA Inc.
Schedule M-1 Reconciliation
For the Year Ended December 31, 2001

Form 1120 US Corporation Income Tax Return

Statement 1

Schedule M-1, Line 4 - Other Taxable Income

| | |
|--|----------------------------|
| Deferred Intercompany Gain | \$5,498,124 |
| Gain on Sale of Asset | 84,701,429 |
| Section 420 Transfer - Cash Balance Plan | 4,646,938 |
| Total | <u>\$94,846,491</u> |

Schedule M-1, Line 5 - Other Book Expense

| | |
|------------------------------|-------------------------|
| Non Deductible Contributions | \$22,500 |
| Non Deductible Penalties | 10,634 |
| Miscellaneous Expense | 14,398 |
| Related Party Bonus | 450,765 |
| Specific Item Accrual | 10,489 |
| Total | <u>\$508,786</u> |

Schedule M-1, Line 7 - Other Book Income

| | |
|------------------|-------------------------|
| Unearned Revenue | <u>\$390,476</u> |
|------------------|-------------------------|

Schedule M-1, Line 8 - Other Tax Expense

| | |
|------------------------------|----------------------------|
| Tax Amortization | \$89,629 |
| Deferred Compensation | 59,490 |
| Deferred Directors Fees | 90,876 |
| Deferred Executive Plan | 976,493 |
| Tax Loss from Asset Disposal | 115,934 |
| Bad Debt Reserve | 4,907,289 |
| State Taxes | 50,923 |
| Accrued Vacation | 59,934 |
| Accrued Bonus for Officers | 250,693 |
| Stock Options | 1,409,395 |
| Loss Reserve | 1,972,234 |
| Accrued Expense | 465,585 |
| Additional Pension Expense | <u>250,000</u> |
| Total | <u>\$10,698,475</u> |