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1455 Pennsylvania Avenue, NW  
Washington, DC 20004-1081

April 25, 2011

Ms. Heather Maloy  
Commissioner  
Internal Revenue Service  
Large Business and International Division  
Mint Building  
801 Ninth Street, NW  
M4-313  
Washington, D.C. 20001

RE: Comments on Schedule M-3 with the Objective of Reducing Burden and Duplication

Dear Ms. Maloy:

The American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to provide our preliminary comments relative to Schedule M-3, *Net Income (Loss) Reconciliation*. As the national professional association of certified public accountants comprised of approximately 370,000 members, the AICPA is well positioned to comment on Schedule M-3. Our members prepare income tax returns that include Schedule M-3 for thousands of corporate and partnership taxpayers, advise taxpayers regarding Schedule M-3 reporting, and review returns of those taxpayers that prepare their own returns that include Schedule M-3. Based on our members' significant experience with the Schedule M-3, we offer the following comments of a technical nature, as well as our views regarding the level of burden on taxpayers and practitioners, and suggestions for change.

### **Purpose and Development of Schedule M-3**

Schedule M-3 was developed by the Internal Revenue Service (IRS) and Department of the Treasury (Treasury) to replace Schedule M-1 for certain business filers, with a view towards increasing transparency and standardization in the reporting of book to tax differences. It was first required to be filed by certain corporations filing Form 1120 for tax years ended December 31, 2004. Subsequently, that initial Schedule M-3 served as a model for developing unique Schedules M-3 for certain corporations filing Forms 1120-S, 1120-PC, and 1120-L, certain partnerships filing Form 1065, and certain foreign corporations filing Form 1120-F. Reporting requirements were further expanded by requiring additional detail for certain Schedule M-3 filers on Forms 8916 and 8916-A, and for all Schedule M-3 filers on Form 1120 (Schedule B) and Form 1065 (Schedule C). We use "Schedule M-3" in this letter to refer generally and collectively to all these filing requirements, unless otherwise specifically noted as to a particular form or schedule.

### **Role of External Stakeholders**

IRS and Treasury used a collaborative approach in developing and expanding Schedule M-3, enlisting stakeholders, such as AICPA, for their review of the Schedule M-3 concepts and the various

draft schedules and related instructions, comments on the estimated burden that would be imposed on taxpayers and their advisers, and suggestions for change. Announcement 2010-75, released in September 2010 with other Schedule UTP guidance, announced the creation by IRS of a working group to study and revise Schedule M-3, and stated that the group would work with external stakeholders to develop appropriate revisions to Schedule M-3. The AICPA is pleased to be asked once again for our input as IRS considers revisions to Schedule M-3.

### **Request for Meeting of IRS and External Stakeholders**

The AICPA believes that IRS, Treasury and external stakeholders found the collaboration for the initial design and expansion of Schedule M-3 to be enlightening and productive, and believes that similar collaboration would be useful in its revisions of Schedule M-3. In the interest of time, we include below some initial comments and suggestions for revisions. Consistent with previous collaboration efforts, we recommend that IRS meet with stakeholders soon to discuss in more detail Schedule M-3 and taxpayer burden and duplication. Such a meeting might then lead to the formation of a smaller working group that can address specific revisions to Parts I, II, and III of Schedule M-3.

### **Request for Current IRS Use of Schedule M-3 Data**

As the AICPA develops additional data for such future meetings and discussions with IRS, it would help us in focusing our comments and suggestions if IRS would provide us with information regarding how IRS and Treasury are currently using the data from Schedule M-3. For example, it would be helpful to know how the Large Business and International Division (LB&I) is using Schedule M-3 data to help select returns and issues for examination, one of the primary purposes of Schedule M-3.

### **Examination Experiences**

The AICPA understands and supports the IRS objective of increasing the transparency, certainty, consistency, and efficiency of the tax compliance process. The Schedule M-3 concept of standardization to support risk assessment assumes that all filers consistently understand the IRS's interpretation and apply often ambiguous instructions. Our collective experiences suggest this may not be a valid assumption.

Taxpayers were told that their examination burden would be reduced through the IRS's use of data gathered by Schedule M-3. Our collective experiences, however, indicate that there has been little change in the examination approach for those taxpayers outside of the Compliance Assurance Program (CAP), with examiners still requesting complete book to tax detail for all general ledger accounts. Anecdotal evidence suggests that some examining agents are of the view that Schedule M-1 was more useful because it provided more detail descriptions of the book to tax differences, aligned to taxpayers' general ledgers, and on a general ledger account-by-account basis the audit was simpler to manage and audit trails were easier to document. Further, some examining agents have expressed to taxpayers their opinion that the separate-company Schedules M-3 in a consolidated return are not useful. In such cases, we find the examiner only looks at the consolidated Schedule M-3 and,

typically does this review only at a cursory level for activity outside the “other items with differences.” This is usually followed by an Information Document Request (IDR) for the detail of the book to tax differences in the Schedule M-3 lines for “other items with differences.”

### **Increased Reporting Burden and Duplication**

Many taxpayers incur a significant amount of extra return preparation time related to properly reporting column (a), *Income (Loss) or Expense per Income Statement*, of Parts II and III. The majority of taxpayers’ general ledger income/expense accounts do not map directly to the 60+ categories for this column, resulting in the need for manual reclassifications and adjustments, for example, when a single account must be disaggregated to show two or more amounts on different lines of Schedule M-3. In addition, many accounts which may initially be automatically mapped by the tax preparation software to the appropriate line may then have to be manually adjusted to comply with the Schedule M-3 instructions; for example, to reclassify and aggregate amounts related to a reportable transaction, or for accounts in which there are no book to tax differences which must be reclassified and aggregated in Part II, line 28, all of which can only be determined after the return is substantially complete. Since a separate Schedule M-3 is required for each corporation, this analysis and resulting adjustments must be made for each corporation in a consolidated return, as well as reviewed and analyzed at the consolidated level.

Similarly, many taxpayers spend extra time during tax return preparation because of column (d), *Income (Loss) or Deduction per Tax Return*, of Parts II and III, which duplicates information found in other parts of the return. For example, taxable income computed via column (d) of Schedule M-3 (Form 1120) must agree with taxable income before net operating loss (NOL) and special deductions reported on Form 1120, page 1, line 28. Ensuring that taxable income totals agree requires some additional time. Many taxpayers must then spend significant amounts of additional time to reconcile individual line items, such as interest income, which appropriately, but perhaps not understandably, may be different between Schedule M-3 and Form 1120, page 1. For example, a Schedule M-3 filer reports interest income from a partnership on Form 1120, page 1, line 5, *Interest*, but does not include this same amount in *Interest Income* on Schedule M-3, Part I, line 13. Instead, this amount must be combined with other partnership items and included in either line 9 or 10 of Schedule M-3, Part II, depending on whether it is from a U.S. or foreign partnership. Such differences must be reconciled, explained, and documented, requiring additional time which yields little, if any, added value.

Taxpayers that report cost of goods sold on Schedule M-3, Part II, line 17 must spend significant additional time providing supporting data in Part I of Form 8916-A, *Supplemental Attachment to Schedule M-3*. There is substantial variation regarding how taxpayers interpret the instructions and, as a result, the level of detail provided for book and adjustment amounts. It appears that the information is not being used by IRS examiners.

Each of the above highlight some of the areas that taxpayers perceive as increased administrative and reporting burden resulting from Schedule M-3. With reduced resources, increased time pressures, not understanding why the book data is needed, and the perception that IRS does not use such data, a

taxpayer might place a higher priority on properly calculating, reporting, and paying the final tax liability than it places on making presentational reclassifications and adjustments on Schedule M-3.

We also find that some of the supporting data requested by the Schedule M-3 instructions for various lines might more appropriately be requested by an examiner through an IDR. For example, a new line, *Research and development costs*, was added to the 2010 Schedule M-3. The requested supporting data appears to be the data used by IRS to audit the research credit. Obtaining data through the Schedule M-3 for risk assessment regarding the research credit might more appropriately be handled through a targeted question, on Schedule B (Form 1120). This new line is another example of increased burden imposed by the Schedule M-3 in terms of the additional amount of time that a taxpayer will incur to obtain the amounts to report in column (a), as most taxpayers do not separately report “book” research expenditures.

### **Revisions/Eliminations to Certain Schedule M-3 Lines**

We question the addition of new reporting requirements for the Schedule M-3, such as the new line added for research and development (R&D) expenditures, at a time when many practitioners and taxpayers question the continued usefulness of the Schedule M-3 in light of the Service’s request for reporting of uncertain tax positions (UTPs). While the IRS has recently provided a frequently asked question (FAQ) on its website which attempts to provide a simplified procedure for reporting R&D expenditures on Schedule M-3, we nevertheless believe this new R&D line expands the original purpose of the Schedule M-3, rather than reducing duplication and burden. Thus, despite the FAQ, we recommend elimination of the R&D cost expenditures line.

There are several additional line items in Parts II and III, for example *Items related to reportable transactions*, that we suggest be eliminated or revised, and will provide additional comments and details after we complete further analysis. Line items that were of some import to Treasury and/or IRS at the time Schedule M-3 was designed are no longer significant today, for example, because of fewer taxpayer reportable transactions or because IRS has developed other ways to obtain the information, such as Schedule UTP. Different line items, or additional questions, may now be more helpful for IRS risk analysis.

### **Initial Suggested Revisions to Schedule M-3**

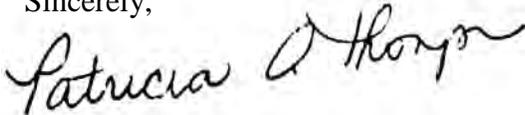
The AICPA will provide further recommendations in future correspondence. However, as our initial reply to the IRS request, and based partially on the above discussion, we suggest that the following Schedule M-3 revisions be considered:

- Eliminate required completion of columns (a) and (d) of Parts II and III of Schedule M-3
- Eliminate and revise certain lines on Parts II and III of Schedule M-3 (more detail will be provided through future communications)
- Revise supporting detail required for certain lines in Parts I, II and III of Schedule M-3 (more detail will be provided through future communications)

- As an alternative to revising Parts II and III, replace them with an expanded Schedule M-1 that would be used by all business taxpayers
- Eliminate Form 8916-A
- Expand the use of Schedule B (Form 1120) and Schedule C (Form 1065) for risk assessment in lieu of adding new lines and requesting additional supporting detail on Schedule M-3 (e.g., eliminate the R&D expenditures line from Schedule M-3, Part III, and replace it with a useful question on Schedule B/C)
- Allow a consolidated group of corporations that all file Form 1120, but that also includes one corporation that files a Form 1120-PC, to file as only a Form 1120 consolidated group, and not as a “mixed” group, that otherwise requires sub-consolidations and Form 8916, *Reconciliation of Schedule M-3 Taxable Income with Tax Return Taxable Income for Mixed Groups*

The AICPA looks forward to continuing our discussions with IRS regarding Schedule M-3 and hopes that a meeting can be arranged soon. Please feel free to contact Linda S. Gurene, Chair of the AICPA Schedule M-3 Task Force, at [linda.gurene02@ey.com](mailto:linda.gurene02@ey.com), or (210) 242-7231; Benson S. Goldstein, AICPA Senior Technical Manager, at [bgoldstein@aicpa.org](mailto:bgoldstein@aicpa.org), or (202) 434-9279; or Michelle R. Koroghlanian, AICPA Technical Manager at [mkoroghlanian@aicpa.org](mailto:mkoroghlanian@aicpa.org), or (202) 434-9268.

Sincerely,



Patricia A. Thompson, CPA  
Chair, Tax Executive Committee

cc: Ms. Deborah Palacheck, Senior Advisor, Internal Revenue Service, Large Business and International Division



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July 7, 2011

The Honorable Douglas H. Shulman  
Commissioner of Internal Revenue  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

Re: *Comments on Schedule M-3 — Reducing Burden and Duplication*

Dear Commissioner Shulman:

Upon release of the final version of Schedule UTP, *Uncertain Tax Position Statement*, for 2010, the IRS announced the creation of an internal working group to study and revise the Schedule M-3, *Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More*.<sup>1</sup> The Announcement explains that “the implementation of Schedule UTP is likely to reduce the need for some of the information currently reported on the Schedule M-3.”<sup>2</sup> The IRS working group is expected to work with external stakeholders to develop revisions to Schedule M-3.

As the preeminent association of in-house business tax professionals worldwide, Tax Executives Institute (TEI) appreciates the opportunity to submit comments on the burdens and utility of Schedule M-3. Our approximately 7,000 members represent 3,000 of the leading corporations in the United States, Canada, Europe, and Asia. Members of TEI are responsible for managing the tax affairs of their companies and must contend daily with financial and tax reporting requirements — and the differences between them captured and reported on Schedule M-3 — arising from the operation of business enterprises. TEI represents a cross-section of the business community, and is dedicated to developing and effectively implementing sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike.

### **Purpose of Schedule M-3**

Schedule M-3 replaced Schedule M-1 for certain Form 1120, *U.S. Corporation Income Tax Return*, filers, effective for tax years ended December 31, 2004. The initial Schedule M-3 was subsequently used as a

<sup>1</sup> Announcement 2010-75, 2010-41 I.R.B. 428.

<sup>2</sup> *Id.* at 431.

model for similar schedules for partnerships filing Form 1065 and corporations filing Forms 1120-L, 1120-PC, and 1120-S. A special Schedule M-3 applies to foreign corporations filing Form 1120-F.

Schedule M-3 provides the IRS with information about corporation and partnership financial statements (hereinafter “book income”) and reconciles the differences between book income, losses, and expenses and tax income, losses, and deductions. Schedule M-3, Part I, identifies the source of book income, and reconciles the financial reporting entity to the tax reporting entity by listing the affiliated entities that are included in the financial reporting entity but not in the consolidated tax reporting entity (and vice versa). Part I of the form also asks questions about a corporation’s or partnership’s financial statements; reconciles financial statement net income (loss) to the corporation’s or partnership’s net income for the U.S. group; and reconciles worldwide assets and liabilities of entities included for financial statement purposes but not the tax return (and vice-versa). Schedule M-3, Parts II and III, require disclosure of amounts for selected “tax-sensitive” book items; disclosure of related permanent and temporary book-to-tax differences for the items; and shows the income, loss, or deduction amount per the filer’s Form 1120 (or 1065). Some Schedule M-3 filers (principally life and property and casualty insurers) must also file Form 8916, *Reconciliation of Schedule M-3 Taxable Income with Tax Return Taxable Income for Mixed Groups*. Finally, Form 8916-A, *Supplemental Attachment to Schedule M-3*, may be required to report additional detail on costs of goods sold, interest income, and interest expense. Unless the context requires otherwise, the comments in this letter are directed to the forms collectively as “Schedule M-3.”

In developing Schedule M-3, the IRS and Treasury Department reached out to stakeholders, including TEI, for input on the schedule’s design, instructions, and potential burdens. TEI was pleased to participate and commends the IRS for working collaboratively with stakeholders to review the utility and burdens of the Schedule. The Schedule is now “seasoned” by several years of compliance and examination experience, so a review of the burdens and utility is timely, especially with the introduction of Schedule UTP.

To develop its recommendations, TEI chartered a task force of members to share both their expertise in the compliance burdens spawned by Schedule M-3 and their experience with how agents employ the schedule as an examination tool. Members of the group would be pleased to meet with the IRS working group to elaborate on our comments and recommendations.

### **Schedule M-3 Reporting Burdens**

A. *Implementation.* The primary challenge in implementing Schedule M-3 is mapping book income accounts to produce column (a), *Income (Loss) or Expense per Income Statement*, of Parts II and III of the schedule. This mapping may vary from the mapping required to produce other lines or forms in the return. Indeed, for most taxpayers, very few general ledger accounts for income or expense will map directly to the lines or categories in column (a) of Parts II and III of Schedule M-3. As a result, significant time was required, whether by tax department personnel or outside vendors, to review and map each account. Since nearly all Schedule M-3

filers must e-file their returns, the data entry requirements to produce the form depends on the tax software used. In many cases, new book accounts (or sub-accounts) were created in order to disaggregate book amounts and map specific transactions or amounts to different lines of column (a) in Parts II and III. In other cases, manual workarounds (*e.g.*, spreadsheet-based worksheets) were developed in order to make the required reclassifications to arrive at the column (a) amount and to ensure that related book-tax differences were also mapped to the correct lines of columns (b) and (c).

Quantifying the direct costs for the initial implementation of Schedule M-3 reporting is difficult. Companies that outsource tax return preparation often have fixed-fee arrangements so the incremental costs of implementing Schedule M-3 were unavailable. Some taxpayers reported an increase in their license or consulting fees for the implementation and subsequent tax year(s), but the portion directly attributable to Schedule M-3 preparation is not available.<sup>3</sup> Companies that undertook mapping their general ledgers to the tax compliance software to produce the new Schedule M-3 reported that personnel from several departments, but most often the tax department, spent many hours on the exercise. One small company, for example, devoted one third of its total tax department personnel for two weeks, and some personnel for up to four weeks, to map the general ledger. A larger company with 170 subsidiaries, multiple general ledgers, and multiple enterprise resource planning (ERP) systems, required between five and six weeks' time from a significant portion of its tax department to complete the initial mapping. Although the costs of company tax department, general accounting, and information technology personnel are frequently part of corporate overhead costs — and thus difficult to quantify incrementally — every taxpayer represented in our task force concurred that the exercise imposed significant burdens requiring a redirection of many work hours from compliance, reporting, or other tax-related activities.

B. *Ongoing Compliance Burdens.* On an annual basis, the burden of complying with Schedule M-3 depends on the scope of revisions to a taxpayer's charts of accounts or the Schedule M-3. The "internal" reconciliation of Parts II and III, column (d), *Income (Loss) or Deduction per Tax Return*, to other lines (or forms) of Form 1120 is also a source of additional burdens.

i. Charts of Account. Many taxpayers have charts of accounts that run a hundred pages or more. While many but not all accounts are standardized across business units (or lines of business), the business units (and thus the general ledger accounts) are not always organized by legal entity. Indeed, there can be multiple general ledgers (or business divisions) within a single entity or even general ledgers that overlap legal entities. Moreover, every business unit will customize its accounts to reflect the industry, transactions, and businesses processes and practices. Hence, every year, the tax department must review every new account added or deleted by the accounting department(s) for every business unit (and legal entity) to ensure proper mapping of the general ledger accounts to the lines on each of the forms in the tax return (Form 1120, Form 4562) as well as to column (a) of Parts II and III of Schedule M-3. One taxpayer described the process as a surely not unique source of continuing friction between the

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<sup>3</sup> Indeed, no taxpayers reported decreases in consulting fees following the implementation year.

tax and accounting departments since the tax department will frequently request the addition of new accounts in order to disaggregate accounts to better map transactions to individual lines of the tax return forms, especially the M-3. Regrettably, even where new tax-sensitive general ledger accounts are created, the tax department must monitor accounting department entries and often make myriad reclassification adjustments to the accounts (as reflected in the tax compliance software) or create supplemental spreadsheets to develop the corrected Schedule M-3 column (a) starting point.

One small company with six entities reported that one third of its department spends one to two days per year reviewing the charts of account and updating the mapping of the general ledger to the tax compliance software (or supplemental spreadsheets) for Schedule M-3 alone. Larger companies (100 or more entities) reported that several persons spend one to two weeks reviewing and revising account mapping related solely to Schedule M-3 requirements. One large company with 700 entities estimated that 750 to 900 hours per year are required to review and revise the mapping of general-ledger accounts for preparation of Schedule M-3.

In addition to ordinary course (or operational or day-to-day) accounting needs, another source of changes to a group's charts of account are acquisitions and dispositions of businesses, whether by asset or stock purchases. Regardless of whether the acquired company retains its preexisting chart of accounts or converts its accounting system to the acquiring company's chart of accounts, the tax department must ensure that the acquired company's accounts map to the acquiring company's tax compliance software. The burden of implementing the Schedule M-3 reporting for the acquired company is equivalent to a new Schedule M-3 implementation because there are rarely economies of scale or automated processes for the general ledger mapping exercise. Each account and line must be analyzed and mapped to ensure the totals (actually, multiple subtotals and totals arising from the requirements of different tax forms) tie out. Thus, considerable time is devoted to integrating acquired businesses into a consolidated group's Schedule M-3 tax return reporting.

ii. Changes to Schedule M-3. Any change to the Schedule M-3 form inevitably requires significant taxpayer effort to review and remap book accounts to the tax compliance software (as well as any supplemental spreadsheets or other manual workaround solutions prepared to supplement the tax compliance or examination processes). For example, recently the IRS revised Schedule M-3 to require reporting of research and development (R&D) related expenses on a separate line from the rest of Part III columns (a) and (d). The revision to break out "R&D costs" on line 35 of Part III column (a), combined with the additional requirement to provide a detail schedule by functional expense for the aggregate amount reported, was extremely burdensome for companies reporting R&D. Indeed, there is such a significant difference between amounts reported as R&D expenditures in the financial statements, section 174 R&D expenses, and costs qualifying for the research credit that considerable compliance time was already spent grouping "R&D costs" from multiple general ledger accounts. The Schedule M-3 reporting change exacerbated the compliance challenge.

Indeed, whenever Schedule M-3 changes, it is not just the new line that requires scrutiny. Every account from which book income or expense is reclassified must be reviewed and

remapped and totals for all accounts before and after the reconfiguration must be compared to ensure that no account is duplicated or omitted. Moreover, the related book-tax differences must also be remapped for purposes of reporting on the M-3 since the calculation of the book-tax difference is a separate process for each account. As important, for most taxpayers the calculation of the book-tax difference (*i.e.*, the old Schedule M-1 amount) is generally separate from how amounts are reported on the Schedule M-3.

iii. Reconciliation of Parts II and III, column (d) *Income (Loss) or Deduction per Tax Return*, with other lines (forms) of Form 1120. Every taxpayer expends significant amounts of additional time in tax compliance for every entity and for the consolidated group as a whole to complete column (d) of Parts II *Income (Loss) per Tax Return*, and III, *Deduction per Tax Return*. The total on Schedule M-3, Part II, line 30, column (d), must reconcile with taxable income before net operating loss deductions on Form 1120, page 1, line 28, for each entity as well as the consolidated group. Moreover, since column (d) of Parts II and III must reconcile with other lines of Form 1120 (mostly page 1, but also other schedules such as Form 4562, *Depreciation and Amortization*, and Form 4797, *Sales of Business Property*), taxpayers spend significantly more time reconciling individual line items.

One of the more vexing challenges is reconciling taxable income from partnership interests with lines on Form 1120. For example, interest income from a partnership is reported on line 5 of the Form 1120, but that amount is combined with other partnership items and reported on lines 9 or 10 of Part II of Schedule M-3. Hence, line 13, column (d) of Part II of Schedule M-3 *never* agrees with line 5 of the 1120. As a result, while taxpayers rely on the tax compliance software to ensure the amounts reconcile, they must often develop supporting schedules each year (or during examination) to prove that the amounts reported by the partnership are indeed as reported by the corporate partner. Even more elaborate and time-consuming reconciliations are required to tie out the amounts for gains and losses from property reported on lines 23(a)-(g) of Part II of Schedule M-3 and related lines 8 and 9 of Form 1120 and Form 4797. None of the reconciliation schedules is necessary for the proper determination or examination of a taxpayer's tax liability because they are prepared solely for reconciling lines on the Form 1120 (or detail form) with the Schedule M-3. The various reclassifications to reconcile between the M-3 and other lines neither add assurance nor serve as an internal control over the proper determination of the book and tax differences, which is the core activity in determining the proper amount of taxable income and tax liability.

iv. Miscellaneous Burdens from Schedule M-3. Other redundant reporting burdens imposed by Schedule M-3 include:

- The required "white paper" supporting detail for Part I, lines 5(a) and 7(a) of Schedule M-3, duplicate the information reported on Forms 5471.
- Part I of Form 8916-A duplicates the information reported on Form 1120, Schedule A, relating to Cost of Goods Sold. Moreover, there is considerable room for interpreting the information requested on lines 2(a) to (n), as well as

lines 3 to 5 of Form 8916-A. More important, the information provided on the form does not seem to be used by examiners.

### **Examination Experience**

When Schedule M-3 was being developed, taxpayers were told that it would provide the IRS with a window to assess the compliance risk in tax returns. Specifically, standardized reporting of book amounts (column (a)) and book-tax differences (in columns (b) and (c)) was intended to provide visibility into returns and help the IRS select taxpayers and issues for examination. As a result, taxpayers, especially those under continuous examination, held reasonable expectations that they would face reduced examination burdens.

Regrettably, few or no taxpayers report realization of the expected examination efficiencies or reduced cycle time.<sup>4</sup> Indeed, despite the standardized lines of column (a) in Parts II and III, there remains significant variation among taxpayers in mapping their general ledgers to the various lines on Schedule M-3. Indeed, even within the same industry, taxpayers may use different book accounting methods and thus will not account for the same transaction in the same way. Hence, even with the same reporting lines for column (a) on Parts II and III of Schedule M-3, the IRS may not be able to develop a standardized mechanism for return and issue selection.

Following the implementation of Schedule M-3, examination teams have generally taken one of two examination approaches. Under the first approach — hereinafter the “modified Schedule M-1 examination” — examiners request the detailed working papers for the permanent and temporary differences reported in columns (b) and (c) of Parts II and III of Schedule M-3. Prior to the introduction of Schedule M-3, taxpayers had longstanding methods to compute and track the book and tax differences in their general ledger accounts. Those accounting procedures and processes were generally left undisturbed by the introduction of Schedule M-3 because the process to produce the book and tax differences is tried and true. More important, the audit trail generally ties directly to the general ledger with far fewer of the reclassification “hoops” that taxpayers must jump through to produce Schedule M-3. During examinations, agents will look at the Part I reconciliation and may, in limited cases, ask for reconciliations between column (d) of Parts II and III of Schedule M-3 and other lines of other forms of the tax return. The bulk of the examination is spent confirming the workpapers computing and summarizing the book tax differences in columns (b) and (c).

Where agents employ a modified M-1 examination approach, the purpose and uses of much of the required Schedule M-3 information (including Form 8916A supplemental information), especially columns (a) and (d), is unclear if not irrelevant. Moreover, taxpayers report that agents who follow this approach complain that it is far more difficult to track traditional book-tax differences. The taxpayer-produced Schedule M-1 generally provided a more detailed description of the book-tax difference, aligned with the general ledger, and

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<sup>4</sup> To be sure, taxpayers in the Compliance Assurance Process (CAP) program report significant examination efficiencies but even CAP taxpayers believe that excessive time is devoted to explaining Schedule M-3 reclassifications and reconciliations.

generally required fewer steps (reclassifications, especially) to reach the tax return amount and related book-tax difference amount. In effect, the audit trail is easier for taxpayers to produce and for examiners to follow. The Schedule M-3, however, requires taxpayers to map first to the column (a) book amount, which in many cases requires significant numbers of reclassifications from other accounts. The related book-tax difference must also be remapped and the audit trail requires further checking and cross-checking to ensure that all related amounts tie out to the lines on Schedule M-3.<sup>5</sup>

The second examination approach employed by agents post Schedule M-3 consists of highly detailed scrutiny of the Part II and III column (a) amounts as well as detailed reconciliations of every column (d) amount with every line of the tax return. In these examinations, the book-tax differences in columns (c) and (d) of Parts II and III may be examined, but the time spent on the column (a) amounts is, in most taxpayers' experience, unusual and *disproportionate* to the task of examining *tax* compliance. In effect, examiners are spending considerable time auditing and verifying *book income* amounts and tracing the path of every item from the general ledger through various reclassifications to their ultimate destination on Schedule M-3. This level of scrutiny is unnecessary, especially since large taxpayers have significant internal controls to ensure the integrity of the book amounts. Moreover, for most taxpayers the book amounts and the internal controls have already been examined by the company's independent accountants.

Although the IRS cannot draw systemic conclusions from anecdotal evidence, one CAP taxpayer's experience is illustrative of the challenges that remain. The agents on the case expected every single asset with a book-tax depreciation difference to be accounted for separately in its Schedule M-3 detail. For example, if the book life for an asset was 15 years and the tax life was 5 years, each such asset could be grouped together for the column (a), Part III amount, but assets could not be grouped if there were a different book or tax life. In addition, where the difference in the book-tax amounts was attributable to a basis difference (*e.g.*, carryover or substituted basis for tax versus a fresh start or fair market value for book or vice versa) the agent expected a separate book account and M-3 detail line. In other words, the agents

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<sup>5</sup> Schedule M-3 was developed and released at the same time that the IRS implemented its Modernized e-File (MeF) system. Because of the limitations of the MeF system, taxpayers are required to file a "stacked" return, *i.e.*, a separate return and Schedule M-3 for each includible corporation, with a consolidating Schedule M-3. The requirement to aggregate all business divisions into a single entity and the inability to use a columnar format for the separate general ledgers (and legal entities) that feed into the book amounts and tax differences exacerbates the audit challenge. In response to the IRS workgroup's question F about improving the consolidation and sub-consolidation processes, one taxpayer described the return preparation and audit challenges, as follows:

Prior to M-3, we prepared our Schedule M-1 on a divisional basis consistent with how the books are maintained. Now we must do Schedule M-3 on a legal entity basis. This requires much time to consolidate divisions into legal entities. Our legal entities generally consist of a number of divisions, each of which has a separate set of books and separate accounting system. Preparing book-tax differences based on the way the books are kept is simple and leaves a good audit trail. Prior to Schedule M-3, when we prepared Schedule M-1 the white paper attachments in the return contained each book-tax difference by reporting entity with separate books. This made it very efficient for an IRS auditor to spot book-tax differences and to ask for more information since a particular Schedule M-1 item could be easily traced to a set of books.

expected the column (a) book amount for the depreciation line on Schedule M-3 to be broken into as many components as might be required to account for each applicable code section creating a basis or depreciation difference, or as might be required to report different book and tax lives. Regrettably, the “book” calculation for the depreciation of many assets may be based on entirely different assumptions, amounts, and calculations that may not correlate directly to a “book” amount for a particular asset’s tax depreciation calculation (*e.g.*, leased assets). As a result, most taxpayers maintain (and most agents accept) that the depreciation differences must be determined by examining and comparing the tax and book fixed asset ledger details. This particular agent seemed to believe that all the differences should, in effect, be captured and reported on a Schedule M-3 supplemental schedule (or “white paper” detail).

Regardless of which examination approach is used, there is a consensus that the introduction of the Schedule M-3 has not produced the promised examination efficiencies or reductions in audit cycle time. Indeed, there is a sense that examinations are either less focused — seeking detailed reconciliations between Schedule M-3 column (d) and lines on other forms (especially page 1 of Form 1120) — or focused on the wrong things, such as verifying in minute detail the “book” amounts for column (a) of Parts II and III.

### **Recommended Revisions to Schedule M-3**

The introduction of Schedule UTP suggests that Schedule M-3 has not fully achieved its goals of increasing transparency, efficiency, and consistency in tax reporting.<sup>6</sup> Moreover, given our members’ reported examination experiences, we are uncertain about the utility of Schedule M-3 as a risk-assessment diagnostic tool. Because Schedule UTP substantially duplicates the purpose of Schedule M-3,<sup>7</sup> the IRS should consider abandoning Schedule M-3 as the Schedule

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<sup>6</sup> IR-2004-14, January 28, 2004, included the following statements from Treasury Department and IRS officials about Schedule M-3’s purposes and intended effects:

“The proposed Schedule M-3 will make differences between financial accounting net income and taxable income more transparent. This will help agents determine from the return whether the return should be audited and identify the differences that matter most in the audit of the return. We see benefits to taxpayers and the IRS from the new Schedule: a reduction in unnecessary audits and a swifter focus on those differences that are more likely to arise when taxpayers take aggressive positions or engage in aggressive transactions. In addition, the increased transparency will have a deterrent effect,” stated Treasury Assistant Secretary for Tax Policy Pam Olson.

“The new Schedule will let the IRS sharpen and improve monitoring of corporate compliance,” said IRS Commissioner Mark W. Everson. “Our objective is to identify and resolve potential audit issues promptly. This information will help us do so.”

“These changes will enable us to focus our compliance resources on returns and issues that need to be examined and avoid those that do not,” said Deborah M. Nolan, IRS Large and Mid-Size Business Division Commissioner. “Increasing the transparency of corporate tax returns is critical to our objectives to provide certainty to taxpayers sooner and to improve overall compliance.”

<sup>7</sup> In prepared remarks on April 12, 2010, before Tax Executives Institute’s 60th Midyear Conference in Washington, D.C., Commissioner Shulman said the goals of Schedule UTP are to:

UTP process evolves and the IRS and taxpayers become familiar with the use of Schedule UTP as a disclosure and risk-assessment tool. Schedule M-3, Part I, of course, provides a useful top-down summary from the consolidated financial statements to the consolidated group's net income per the tax return. (Even before Schedule M-3 was introduced, many IRS examination teams requested such reconciliations.) Hence, although Part I should be streamlined (*e.g.*, by eliminating the requirement for detailed "white paper" schedules for lines 5-7 with the return), it should likely be retained even if the rest of the form were eliminated.

Since the questions posed by the IRS workgroup suggest that the IRS may not be ready to abandon Schedule M-3, we offer the following suggestions for reducing taxpayer burdens and, we believe, increasing the Schedule's utility.

- *Replace Schedule M-3, Parts II and III with a more flexible Schedule M-1 format.* We question whether the individual lines of Parts II and III add anything of value to the IRS examination process. The 38 lines of each Part (including the subparts of Part II, lines 23 and 29), in effect, require taxpayers to disaggregate and re-aggregate their accounts and *create* books and records (general ledger accounts or subaccounts) *solely* to facilitate completion of a tax schedule. Rather than compel taxpayers to report their book accounts and related tax differences by shoehorning all the amounts into specified lines, taxpayers should be permitted to use broader financial statement classifications or other natural starting points for columns (a)-(d). For example, taxpayers should be permitted to use Sales, Cost of Goods Sold, Selling General & Administrative, and interest income and expense for column (a) as they do in their financial statements.<sup>8</sup> The differences reported in columns (b) and (c) for Parts II and III to reconcile the amounts to taxable income might still be classified as either permanent or temporary differences. The column (d) amount would be the net tax amounts for the broader groupings but should *not* be expected to reconcile to specific tax return lines or forms.<sup>9</sup> As with Schedule M-1,

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- create certainty sooner for taxpayers;
  - cut down the time it takes to find issues and complete an audit, which benefits both the IRS and taxpayers;
  - ensure that both the IRS and taxpayer spend time discussing the law as it applies to the facts, rather than looking for information;
  - help IRS prioritize taxpayers for examination;
  - help IRS prioritize selection of issues during an audit; and
  - obtain key information regarding uncertain tax positions without getting into the heads of taxpayers or their advisors, as it relates to quantifying risk.

<sup>8</sup> Many taxpayers must comply with SEC reporting requirements and thus have adopted XBRL reporting categories for their book income amounts. Such taxpayers may prefer to use those categories as the starting column.

<sup>9</sup> There are certain line items on column (d) of Parts II and III that *never* agree with amounts on page 1 of Form 1120. Agents routinely request the production of burdensome reconciliation spreadsheet schedules to confirm what the tax compliance software may not produce directly. Several taxpayers reported agents requested the details about how the taxpayer's compliance software produced the amounts reported on the Schedule M-3. In one case, the software vendor said that it would provide the detail only if all persons with access to proprietary software code signed a nondisclosure agreement and agreed to destroy the data upon conclusion of the examination. In another case, the vendor acknowledged that the requested details could be produced as long as the taxpayer purchased an

however, the total taxable income in Part II, column (d), should reconcile to taxable income before net operating loss and other special deductions (*e.g.*, line 28 of Form 1120 or the related line on other forms). In addition, taxpayers should be able to produce detailed book and tax differences that align with their general ledgers.

- *Eliminate Form 8916-A, Supplemental Attachment to Schedule M-3.* This form requires detailed breakout of Cost of Goods Sold, Interest Income, and Interest Expense. The Form requires taxpayers to create sub-account upon sub-account to capture the book amount starting point in order to reach the taxable income end point. More important, the schedule duplicates Form 1120, Schedule A.
- *Eliminate or Significantly Reduce the Number of Required “White Paper” Schedules Supporting Schedule M-3 Lines.* The Schedule M-3 requires taxpayers to provide supporting data for many lines of the Schedule M-3. It is unclear why these so-called white paper schedules should be supplied with the tax return since the process for identifying and accounting for book and tax differences for many accounts is different and generally separate from the Schedule M-3 process. The details are almost always requested on examination so it is unclear what purpose is served by including them with the filed return. In other cases, the detailed white paper schedules duplicate information included elsewhere in the return, For example, lines 5a and 7a of Part I require white paper schedules that duplicate the information reported on Forms 5471.
- *Eliminate Lines Relating to Reportable Transactions.* Reportable transactions must be separately disclosed in the tax return. In addition, Schedule UTP will likely provide additional information about reportable transactions. It is unclear why amounts relating to reportable transactions should be separately identified and reported on Schedule M-3 when other, more direct disclosures of such high-risk transactions are required in the return. Complete details about reportable transactions, including book and tax differences and the general ledger sources are routinely requested by examiners and can be supplied on examination.
- *Eliminate the New Line for Reporting R&D Expenditures.* Some taxpayers use a cost-center approach while others use a project-by-project approach in accounting for R&D expenditures and qualifying costs for the research credit. Because of the myriad differences in company accounting practices, we believe the IRS would be better able to assess the tax risks of qualifying R&D activities by asking targeted questions on Schedule B of Form 1120 rather than requesting detailed numbers on the tax return. The detailed numbers can be, and under the Tiered-Issue examination approach always are, requested and supplied on examination. Indeed, depending on the taxpayer’s accounting approach, IRS agents will likely employ different procedures and craft different information document requests to verify a taxpayer’s credit claims. As a result, little is gained by compelling taxpayers to report R&D expenditures on Schedule M-3.

- *Update the MeF System to Permit More Flexible Reporting.* The MeF system, which requires taxpayers to file a “stacked” tax return with a separate Schedule M-3 for each legal entity, requires taxpayers to consolidate divisional general ledgers (as well as book and tax differences for each ledger) into the aggregate amounts reported on Schedule M-3. The consolidation of separate division ledgers into entity amounts leads to many book amounts (column (a) of Parts II and III of Schedule M-3) and book-tax differences (columns (b) and (c) of Parts II and III) being aggregated in a fashion that impairs the efficient examination of the taxpayer’s books. Although a recommendation to revamp the current MeF reporting, *e.g.*, to permit attaching larger PDF files with separate divisional columns, may nominally be beyond the scope of the IRS workgroup, the IRS should consider *how* information is provided as well as *what* information is required.

### Conclusion

Tax Executives Institute appreciates the opportunity to present its recommendations for potential changes to Schedule M-3. We would appreciate the opportunity to meet with the IRS working group and provide additional details or respond to questions it may have. In the interim, if you have any questions about the submission, please do not hesitate to contact Eli Dicker or Jeffery P. Rasmussen of the Institute’s legal staff at 202.638.5601 or edicker@tei.org or jrasmussen@tei.org.

Respectfully submitted,

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