



American Institute of CPAs
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, or (210) 242-7231; Benson S. Goldstein, AICPA Senior Technical Manager, at bgoldstein@aicpa.org, or (202) 434-9279; or Michelle R. Koroghlanian, AICPA Technical Manager at 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