Reconciling Corporation Book and Tax Net Income, Tax Years 1995-2001

Data Release

Differences in accounting rules for financial (book) and tax reporting purposes can lead to differences in the amount of income reported to shareholders and tax authorities. The differences in book and taxable income are reconciled for tax reporting purposes in Schedule M-1 of Form 1120. The Spring 2002 *Statistics of Income Bulletin* contained a detailed explanation of Schedule M-1 reconciliation with data for Tax Years 1996–1998 [1]. This article provides an overview of an updated and expanded set of Schedule M-1 tabulations for Tax Years 1995–2001.

Schedule M-1 Reconciliation

Figure A lists the line items of Form 1120 Schedule M-1. Schedule M-1 begins with a company's "net income (loss) per books," which represents the after-tax amount of income reported to shareholders. The next line is the company's Federal income tax expense per books, which is added back to the company's book net income to obtain the amount of pretax book income. Other additions are then made for items included in taxable net income but not included in book net income, and for book expenses that do not reduce taxable net income in the current year. The first of the income items is the "excess of capital losses over capital gains," and represents losses on the sale of capital assets (such as securities) that a company is not permitted to deduct for tax purposes in the current year, but which are fully reflected as a loss in a company's book income.

On the other income item line, "income subject to tax not recorded on books this year," corporations report income which is currently recognized for tax purposes but not for financial accounting. For tax purposes, when a payment is received, a company generally recognizes it as income. However, for financial reporting, the company is required to recognize payments received in advance as income during the future periods when the company provides the service or goods. An example of this type of transaction is rental payments that a company receives in advance. Under financial accounting rules, a company is required to recognize the advance rental payments as income pro-rata over the time period of the lease, while tax rules classify the entire amount as income in the current period. If the rental period spanS more than one accounting period, a temporary difference arises but reverses in a later tax year, leading to a difference in that later tax year, which the company reports on another line on Schedule M-1 as "income recorded on books this year not included on this return."

As part of "expenses recorded on books this year not deducted on this return," corporations report expenses or the portion of expenses that are greater for book income than for taxable income. An example of such a transaction is any book expense for travel and entertainment in excess of the deductible limits set for tax reporting. Also reported here, and separately identified, is any difference in depreciation to the extent book depreciation exceeds tax depreciation. Such differences in depreciation are usually due to the reversal of previous excess tax depreciation, and will be discussed in more detail below.

While the first set of items in the first column of Schedule M-1 captures accounting differences that lead to higher levels of taxable than book income, at least in the near term, the second set of items records other aspects of tax and financial reporting, which result in a decrease in taxable income. On line 7, "income recorded on books this year not included on this return," a company records items of book income that are not recognized as taxable net income in the current year. Examples of such income include tax-exempt interest (which by definition is excluded from the calculation of taxable net income, though fully recognized as income for financial accounting purposes) and income recognized as taxable in a prior period that was not considered income under Generally Accepted Accounting Principles (GAAP), such as prepaid rent.

The final set of accounting differences reported on Schedule M-1 (Line 8) is the amount by which tax deductions exceed their respective charges against book income. An important element of these types of expenses is depreciation, which is itemized on Schedule M-1. For financial reporting purposes, property, plant, and equipment are generally depreciated, using

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Figure A

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

1 Net income (loss) per books (after-tax)
Additions:
2 Federal income tax (expense per books)
3 Excess of capital losses over capital gains
4 Income subject to tax not recorded on books this year
5 Expenses recorded on books this year not deducted on this return
Depreciation
Travel and entertainment
Contributions carryover
6 Equals: Book income after additions

Subtractions:
7 Income recorded on books this year not included on this return
Tax-exempt interest
8 Deductions on this return not charged against book income this year
Depreciation
Contributions carryover
9 Equals: Total subtractions

10 Book income (after additions and subtractions) equal to tax net income before net operating loss deduction and special deductions

NOTE: Schedule M-1 line numbers are included for reference. Line 10 should equal tax net income reported on line 28, page 1, Form 1120; see text for discussion.

the straight-line method over an estimate of each asset's expected useful life, to some residual value. In calculating taxable net income, corporations can use accelerated methods of depreciation following procedures given by the tax code, typically over a shorter life and to no residual value. In the near term, other things equal, taxable income is less than financial accounting income because the tax deduction for depreciation is greater than the depreciation expense charged against earnings. However, at some point, the amount of depreciation allowed for tax purposes on these assets will fall below that reported for financial accounting purposes, reversing the relation between the two measures of income. Such reversals are reported as "expenses recorded on books this year not deducted on this return" and included in the itemization for depreciation.

Included as a deduction not charged as an expense are the effects of the differential treatment of stock-based compensation. When employees exercise stock options the difference between the exercise price and the market price is treated as compensation for tax purposes and is deductible. However, under certain circumstances, GAAP through 2004 did not require these expenses to be recognized as compensation in the calculation of book net income. In such cases, the reduction in taxes payable from the allowed tax deduction is treated as a contribution of capital to the corporation, and is not recognized as a reduction of tax expense [2].

The Schedule M-1 reconciliation does not include the net operating loss deduction or other special deductions, such as the deduction for dividends received, because these two items are subtracted from tax net income in order to determine "income subject to tax," the actual tax base. Unlike pre-tax book income or tax net income, income subject to tax is not negative. These deductions create a larger difference between book income and income subject to tax for companies with positive tax net income. A company's ultimate tax liability is calculated by applying the rate schedule to income subject to tax, with additional taxes potentially levied (for example, by the alternative minimum tax) and offset by the use of credits (such as the foreign tax credit).

The Magnitude of Book Tax Adjustments, 1995-2001

Figure B provides annual totals for each line item in any Schedule M-1 for all active corporation returns (other than Forms 1120S, 1120-REIT, and 1120-RIC) and for the subset of returns with net income, as well as additional information on total assets, net operating loss deductions, special deductions, and income tax before and after credits. Figure C provides a plot of pre-tax book income (the sum of Schedule M-1 lines 1 and 2) and tax net income [3]. The values provided for tax net income, taken from line 28 of Form 1120, do not match the values reported in the Spring 2002 *Statistics of Income Bulletin* article. In the previous article, tax net income was calculated from Schedule M-1. Recent research has shown that the value for tax net income derived from Schedule M-1 can differ from line 28 due to the presence of intercompany dividends, the imputation of Schedule M-1 lines 1 and 2 for businesses filing Form 1120-L, and returns filed with a blank Schedule M-1 [4]. Because these inconsistencies affect the reported amount of tax net income on Schedule M-1, aggregate comparisons of book tax differences should use tax net income as reported on Form 1120, page 1, line 28, and available in SOI's Publication 16, *Corporation Income Tax Returns.* These accounting inconsistencies can lead to Schedule M-1 tax net income, as determined by adding and subtracting adjustments to book net income, differing from tax net income reported on line 28. As a result, the details of Schedule M-1 may not add to the difference between book net income and tax net income as reported in these tables.

During the 7-year period from 1995–2001, pretax book income, measured as the sum of "net income (loss) per books" and "Federal income tax," grew from $628.7 billion in 1995 to a peak of $853.7 billion in 1999. However, Tax Years 2000 and 2001 show a dramatic change from prior years. In 2000, pretax book income declined to $784.1 billion, and fell further to $221.3 billion in 2001, a 1-year decline of 71.8 percent. During this same period, tax net income, as reported on line 28 of Form 1120, peaked 2 years earlier than pretax book income, in 1997, at $607.5 billion, declined to $517.9 billion in 2000, and then fell to $270.8 billion in 2001, a 1-year decline of 47.7 percent. In the aggregate, the steep decline in book profits during 2001 led to tax net income exceeding book income for the year.

For firms with positive net income [5], the peak patterns in book and taxable net income are more similar than for all firms. Book pretax income peaked in 2000 (at $1,110.6 billion dollars) as did tax net income (at $859.5 billion). While both book pretax income and tax net income decline sharply in 2001 (to $814.9 billion and $709.0 billion, respectively, 1-year declines of 26.6 percent and 17.5 percent), aggregate book pretax income for firms with positive net income remains larger than aggregate tax net income. In contrast to the aggregate decline in pretax book income of all firms of 71.8 percent, the decline in pretax book income of firms with positive net income is only 26.6 percent. This suggests that the incidence of tax net income exceeding book pretax income is primarily due to firms with current-year losses, which contemporaneously reported even larger losses to their shareholders.

The pattern of decline in 2000 and 2001 has also been identified in analyses using publicly available data. Hanlon and Shevlin (2004), in an analysis of the financial statements of publicly traded firms, estimate taxable income exceeds book income in both 2001 and 2002. They also report that this pattern is only temporary, with book income exceeding taxable income by more than 50 percent in 2003 [6].

Recent Developments

On January 28, 2004, the IRS proposed a new Schedule M-3, which will require a more detailed reconciliation of the sources and characteristics of differences between book and tax net income than contained in Schedule M-1. In addition to greater

Figure B

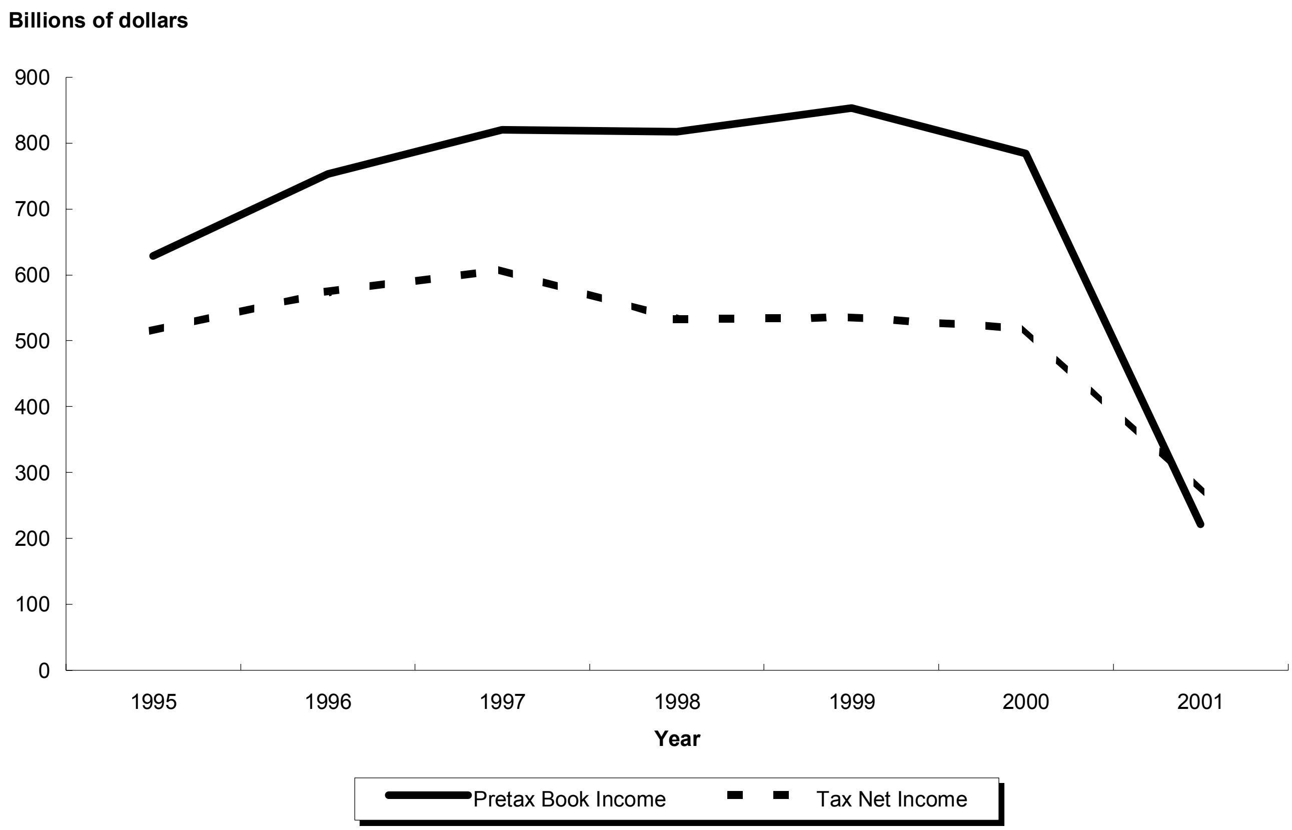
Returns of Active Corporations, Other than Forms 1120S, 1120-REIT, and 1120-RIC: Selected Schedule M-1 and Tax Return Items, Tax Years 1995-2001

[Money amounts are in thousands of dollars]

Item	1995	1996	1997	1998	1999	2000	2001
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
All returns							
Number of returns	**2,312,332**	**2,317,886**	**2,248,065**	**2,249,970**	**2,198,740**	**2,172,705**	**2,136,756**
Total assets	21,739,741	23,511,429	26,398,629	29,539,701	32,202,634	36,892,293	39,088,341
Net income (loss) per books	455,690	553,497	599,870	600,319	600,127	516,667	59,728
Federal income tax	172,965	199,197	219,712	216,419	253,537	267,409	161,591
Excess of capital losses over capital gains	7,781	8,646	14,204	15,404	21,785	20,869	35,177
Income subject to tax not recorded on books this year	254,185	298,656	348,626	372,892	405,478	501,662	499,598
Expenses recorded on books this year not deducted on this return	504,461	525,583	590,910	697,518	733,155	958,393	1,126,614
Depreciation	98,622	97,709	111,705	125,235	126,499	141,009	156,072
Travel and entertainment	8,084	8,771	9,127	9,914	10,002	10,747	9,948
Income recorded on books this year not included on this return	278,249	320,284	384,592	472,270	523,506	677,680	522,330
Tax-exempt interest	21,010	20,492	20,123	22,455	22,972	22,205	21,112
Deductions on this return not charged against book income this year	517,522	574,240	656,745	743,899	809,100	944,726	955,829
Depreciation	151,985	154,489	177,232	205,270	212,646	229,469	270,189
Net Income (less deficit)	514,751	574,554	607,541	532,246	535,289	517,937	270,774
Net operating loss deduction	57,090	55,019	60,289	52,638	64,781	77,079	60,332
Special deductions	23,612	20,750	24,258	24,109	30,910	27,060	21,824
Total Income tax before credits	198,578	223,454	239,134	230,913	241,431	265,645	220,496
Total Income tax after credits	156,184	170,362	183,916	181,058	192,473	203,408	166,334
Returns with net income							
Number of returns	**1,262,386**	**1,284,278**	**1,239,047**	**1,239,493**	**1,199,747**	**1,144,496**	**1,088,221**
Total assets	19,294,749	21,143,256	23,547,359	24,862,404	27,241,130	30,458,794	30,086,819
Net income (loss) per books	551,056	658,001	709,870	721,440	780,385	841,566	614,563
Federal income tax	174,834	203,015	222,707	218,735	252,014	269,053	200,322
Excess of capital losses over capital gains	5,439	5,701	10,176	7,322	14,377	9,574	14,276
Income subject to tax not recorded on books this year	224,352	272,190	314,768	330,463	348,358	430,593	384,616
Expenses recorded on books this year not deducted on this return	411,969	420,309	458,480	509,786	543,027	596,561	578,231
Depreciation	87,839	85,147	94,311	98,229	98,303	96,816	94,149
Travel and entertainment	6,398	7,078	7,286	7,722	7,606	7,672	6,541
Income recorded on books this year not included on this return	235,242	272,121	333,587	361,581	440,941	529,503	376,333
Tax-exempt interest	19,547	19,430	19,050	20,428	20,589	19,844	15,954
Deductions on this return not charged against book income this year	410,163	464,393	510,575	546,366	587,916	649,077	603,086
Depreciation	126,922	130,761	144,746	149,908	165,103	159,406	165,329
Net Income	641,754	714,272	765,753	736,810	783,499	859,531	709,004
Net operating loss deduction	57,087	55,015	59,718	52,636	64,767	77,061	60,299
Special deductions	22,105	19,915	23,211	22,144	28,543	24,513	16,754
Total Income tax before credits	198,087	223,159	238,609	230,073	240,682	265,166	219,759
Total Income tax after credits	155,703	170,076	183,460	180,277	191,841	202,986	165,807

Figure C

Pretax Book and Tax Net Income for Active Corporations, Tax Years 1995-2001



detail on the source of the financial statement income number and the items causing differences in reported income amounts, the form requires firms to separately identify temporary and permanent components of the differences. Schedule M-3 is applicable only to firms with total assets of $10 million or more and is effective with Tax Year 2004 filings [7].

Data Sources and Limitations, Form 1120, Tax Years 1995–2001

Estimates for Tax Years 1995–2001 are based on samples of corporation income tax returns with accounting periods ending July of one year through June of the following year. For example, Tax Year 1996 includes accounting periods of July 1996 to June 1997. These returns represent domestic corporations filing Form 1120 or 1120-A; foreign corporations with income "effectively connected" with a U.S. business filing Form 1120-F; life insurance companies filing Form 1120-L; and property and casualty insurance companies filing Form 1120-PC. While life insurance companies are included in the tabulations, Form 1120-L does not include a Schedule M-1, and these returns will report a book-tax difference in the aggregate. Form 1120S (S corporation returns), regulated investment companies filing Form 1120-RIC, and real estate investment trusts filing Form 1120-REIT were excluded from the tabulations.

A stratified probability sample was used to produce the statistics. Sample sizes vary by year with stratifications based on combinations of total assets and a measure of income at rates ranging from 0.25 percent to 100 percent. More detail for individual years is available in S*tatistics of Income--Corporation Income Tax Returns*, Publication 16.

Notes and References

[1] Plesko, G. A., "Reconciling Corporation Book and Tax Net Income, Tax Years 1996-1998," *SOI Bulletin,* Spring 2002, pp. 1-16.

[2] The financial accounting rules were changed in 2004 and become effective during 2005. See Financial Accounting Standards Board, *Statement of Financial Accounting Standards, Number 123 (Revised 2004), Share-Based Payment* Number 263-C, (Norwalk, Financial Accounting Standards Board) December 2004.

[3] Schedule M-1 tax net income (after additions and subtractions to pre-tax book income) should equal the amount of tax net income reported on line 28, page 1, Form 1120. In practice, however, this is often not the case. See Boynton, C.; DeFilippes, P.; Lisowsky, P.; and Mills, L., Consolidation Anomalies in Form 1120 Corporate Tax Return Data, 104 *Tax Notes*, July 26, 2004 pp. 405- 417, particularly the discussion (page 407) of the editing by SOI of page 1 line 28 tax net income to correct for improper inclusion of intercompany dividends that should have been eliminated in consolidation.

[4] SOI computes amounts for Schedule M-1 lines 1 and 2 for Form 1120-L from the statutory accounting statement (NAIC Annual Statement) filed with Form 1120-L. SOI does not compute any Schedule M-1 book-tax differences for Form 1120-L.

[5] Consistent with other SOI corporation income tax return tabulations, the classification into "firms with Net Income" is based on the value of tax net income reported on Form 1120, page 1, line 28.

[6] See Hanlon, M. and Shevlin, T., "Book-Tax Conformity for Corporate Income: An Introduction to the Issues," forthcoming Tax Policy and the Economy #18, Cambridge, MA, National Bureau of Economic Research.

[7] For a critical examination of Schedule M-1 see Mills, L. and Plesko, G.A., "Bridging the Reporting Gap: A Proposal for More Informative Reconciling of Book and Tax Income," *National Tax Journal* 56:4, December 2003, pp. 865 – 893. A description of the development and benefits of Schedule M-3 can be found in Boynton, C. and Mills, L., "The Evolving Schedule M-3: A New Era of Corporate Show and Tell?," *National Tax Journal*, September 2004, pp. 757-769.

SOURCE: IRS, Statistics of Income Winter 2004-2005 Bulletin, Publication 1136.