

Book to Tax

Terms:

Book Accounting: Accounting used on a company's audited financial statements. Balance Sheets (assets, liabilities and equity) and income statements should be reported using U.S. GAAP.

Tax Accounting: Income and deductions reported on tax return in accordance with the rules in the I.R.C. and attending regulations.

M-1 adjustments: reconciliation of book and taxable income (income and deductions.) Differences exist because of the difference in GAAP and tax law.

Deferred tax assets and deferred tax liabilities: book assets or book liabilities involving deferred tax amounts. These deferred tax assets and deferred tax liabilities develop due to timing differences of income and deductions for book and tax purposes.

Typical M-1 adjustments:

- Federal income tax expense: deductible for book but not tax;
- Depreciation deductions: different amounts and/or methodology;
- Travel and entertainment expenses: limitations on deduction for tax;
- Sec. 263A: more costs typically capitalized into inventory for tax than for book;
- Bad debts: reserve taken for book, but deduction allowed only once bad debt actually occurs;
- Capital loss: tax deduction limited to amount of capital gains (for corporations.)
- Sale of fixed assets: due to the difference in tax and book depreciation (or some other reason for the book/tax difference in the basis of assets), the amount of gain realized on the sale of fixed assets differs between book and tax.
- Transfer pricing adjustments to ensure that taxpayer's income is in compliance with an existing APA.

Advance Pricing Agreements:

Tested party results bench-marked to comparables' published financial statements. Typical TPMs focus on requiring tested parties' book income amounts to fall within the book income profit ranges of the comparables.

Examples of adjustments IRS exam auditors can make after an APA is signed:

- Items of domestic issues which are listed on the M-1, e.g. 263A issues;
- Adjustments which ensure that the taxpayer's records are kept in accordance with GAAP. These adjustments could impact both book and taxable income;
- IRS examiners, through review of the annual report, can ensure that the taxpayer is in compliance with the TPM;
- Assuming that the taxpayer's books and M-1s are in compliance with the TPM, IRS examiners cannot make adjustments which impact taxpayer's transfer prices on the covered transactions.