

A REVIEW OF SCHEDULE M-3: THE INTERNAL REVENUE SERVICE'S NEW BOOK-TAX RECONCILIATION TOOL*

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Introduction

In the late 1990s, the Department of Treasury (Treasury) began to focus in earnest on the growing difference between financial statement income and tax return income (the book-tax gap). A Treasury report in 1999 and Treasury testimony in 2000 by then Assistant Secretary (Tax Policy) Jonathan Talisman noted that book-tax income differences increased significantly over the 1991 to 1997 period. Both the report and the testimony viewed the 1990s book-tax gap as a possible indicator of corporate tax shelter activity, but also noted the deficiencies in Schedule M-1.¹

This article explains the reasons for the creation of the recently developed Schedule M-3, in particular, how this new book-tax reconciliation tool will

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¹ Charles Boynton, Portia DeFilippes, and Ellen Legel, "Prelude to Schedule M-3: Schedule M-1 Corporate Book-Tax Difference Data 1990-2003." *Tax Notes*, Vol. 109, No.12, (December 19, 2005), p.1579.

improve the IRS risk analysis and audit selection process and the examination process. The article also discusses the most important aspects of the new form.

Problems with Schedule M-1

The starting point for calculating taxable income on any type of business entity tax return is income as reported in the entity's books and records. In the case of large and medium size business, these books and records are usually maintained in accordance with financial accounting rules. Because numerous book-tax adjustments must be made to reconcile the differences between financial accounting based books and records and the presentation required for federal income tax return purposes, some sort of reconciliation is necessary. Schedule M-1, *Reconciliation of Income (Loss) per Books with Income per Return* fulfilled this role for corporate tax returns of all sizes for over forty years.

As financial and tax issues became increasingly complex, it became apparent to Treasury and the Internal Revenue Service (IRS) that Schedule M-1 needed to be significantly updated. While book-tax differences are routinely scrutinized by IRS examiners, the Schedule M-1 disclosures became increasingly aggregated and more difficult and time consuming to examine. In the case of large corporations, this aggregation by taxpayers and the lack of specific detail required by the instructions to Schedule M-1 rendered the schedule nearly useless as an analytical tool for purposes of determining audit risk. Most of the detail was contained in schedules to the summary Schedule M-1 that would be seen only if and when a return was chosen for examination.

In addition, there was no uniformity in the manner in which Schedule M-1 was prepared. Each corporation used its own method of presentation. Line items were frequently combined and/or netted. Most importantly, there was no identifiable starting point for the book-tax reconciliation since there was no clear definition of "book income" for purposes of completing Schedule M-1. Often "book income" was different than GAAP income as shown in the financial statements. In short, it became clear that Schedule M-1 was not adequate to the task of identifying book-tax differences in large and complex business entities.

In a 2003 article published in the *National Tax Journal*, professors Lillian F. Mills of the University of Arizona and George A. Plesko of the Massachusetts Institute of Technology proposed a redesign of Schedule M-1 to increase the transparency of the corporate tax return book-tax reconciliation

and to improve data interpretability.² The Mills-Plesko (2003) Schedule M-1 recommendations are largely reflected in Schedule M-3, particularly in Part I.³

The Development of Schedule M-3 for Large and Midsize Corporations

Effective for tax years ending on or after December 31, 2004, the IRS replaced Schedule M-1 with the new Schedule M-3 for corporations with assets of \$10 million or more. Corporations with assets of less than \$10 million continue to use Schedule M-1.⁴

Schedule M-3 provides a complete reconciliation from financial accounting net income to taxable income in a standardized and detailed format. The transition from Schedule M-1 to Schedule M-3 will involve taxpayer costs the first year in terms of accounting systems and staff time. Schedule M-3 should not significantly increase taxpayer burden after the transition to the new accounting systems is complete. In fact, Schedule M-3 should lead to a net taxpayer burden reduction over the long term because the Service will be able to focus its resources on the greatest compliance risks and accurately limit the scope of examinations.

The Form 1120 Schedule M-3 has three parts. Part I reconciles from the worldwide financial statement net income amount reported to shareholders to the financial statement net income amount of the consolidated tax return group (includible corporations). As will be discussed, if a corporation has certified financial statements, it must begin with those statements. In other words, Schedule M-3 provides a consistent and clearly defined financial net income starting point. This lack of a consistent starting point for all taxpayers in Schedule M-1 was a serious short-coming.

²Lillian F. Mills and George A. Plesko, "Bridging the Reporting Gap: A Proposal for More Informative Reconciling of Book and Tax Income," *National Tax Journal*, Vol. LVI, No. 4, (December 2003), p.865.

³ See Footnote 1.

⁴ Schedule M-3 was developed by and is intended to primarily impact taxpayers under the jurisdiction of the Large and Midsize Business (LMSB) division of the IRS. LMSB serves corporations, subchapter S corporations, and partnerships with assets greater than \$10 million. However, in some cases, certain partnerships with assets of less than \$10 million under the jurisdiction of the Small Business and Self-Employed (SBSE) division may be required to file the Schedule M-3, as discussed in more detail later in this article.

Parts II and III reconcile financial statement net income of includible corporations to taxable income reported on Form 1120, page 1, line 28. Part II reconciles income and gain/loss items. Part III reconciles expense and deduction items. Unlike Schedule M-1, Schedule M-3 clearly differentiates temporary and permanent differences.

For tax year 2006, the IRS is extending the filing requirement for Schedule M-3 to other returns, including partnerships, Subchapter S corporations, and insurance companies. These new Schedule M-3s are based largely upon the format used for the Form 1120 M-3 and modified as appropriate. Therefore, a discussion of some of the more significant Form 1120 M-3 line items is useful to understanding the overall impact of Schedule M-3.

Part I: Financial Information and Net Income (Loss) Reconciliation

While Schedule M-3, in its entirety, provides significant improvements to transparency as opposed to Schedule M-1, Part I of Schedule M-3 is particularly noteworthy because of its correction of what was arguably Schedule M-1's most serious deficiency—the lack of an identifiable starting point. Schedule M-3 remedies this problem by providing a detailed and standardized method of reconciliation. This improvement provides greatly improved transparency. For example, in the case of the Schedule M-3 for corporations, Part I, line 11, “Net income (loss) per income statement of includible corporations” is equivalent to Schedule M-1 line 1, “Net income (loss) per books”. The difference is that Schedule M-3, line 11 is preceded by detailed lines of reconciliation to the worldwide income reported to shareholders. This important change is discussed in some detail below.

Line 1

Line 1 creates an order of preference or “pecking order” for financial statements to be used as a starting point. The idea is that only the most reliable financial information should be used.

- 1a Did the corporation file SEC Form 10-K for an income statement period ending with or within this tax year?
 - Yes. Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
 - No. Skip to line 1b.
- b Did the corporation prepare a certified audited income statement for that period?
 - Yes. Skip line 1c and complete lines 2a through 11 with respect to that income statement.
 - No. Go to line 1c.
- c Did the corporation prepare an income statement for that period?
 - Yes. Complete lines 2a through 11 with respect to that statement.
 - No. Skip lines 2a through 3c and enter the corporation's net income loss per its books and records on line 4.

The IRS considers SEC filed financial statements to be the most reliable of the three categories presented on Part I. Therefore, if SEC financial statements are filed, they must be used as the starting point for Schedule M-3. Moreover, because these statements are publicly filed and available without necessitating taxpayer contact, the Service can use these statements in performing pre-audit review and analysis. This will enable Service personnel to perform time saving audit steps prior to contacting the taxpayer, and, in some cases, may result in the decision that an audit is not necessary.

A certified audited income statement is considered a “second choice” financial statement and may be used only if the corporation did not file a Form 10-K with the SEC for the particular tax year. These statements are considered reliable, but not as reliable as statements filed with the SEC.

If, and only if, none of the foregoing is produced by a corporation, the starting point for Schedule M-3 is income per the corporation’s books and records or financial statements which are neither filed with the SEC nor subject to a certified audit. This is considered the last choice and the least reliable of the three choices.

Regardless of the type of income statement prepared, if a taxpayer is selected for audit, an IRS examiner will use Schedule M-3 to as a pre-audit analysis tool. This will typically involve reviewing the financial statements, including footnote disclosures, and taking note of any material book-tax differences and large, unusual, or questionable items. The examiner will then typically develop a list of expected book-tax differences that would be expected to be reported on Schedule M-3.

Part I, Line 4

- 4 Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1

Prior to the implementation of Schedule M-3, there was little consistency in how large, multinational corporations reported financial net income on Schedule M-1. The amount might reflect financial net income for the worldwide group, the U.S. consolidated tax group, or a combination of both. This often made reconciling to an understandable starting point a very difficult and time-consuming task for auditors.

Part I, Line 4 provides a uniform and understandable starting point for the income statement source provided in question 1 above. This consistency enhances the usefulness of Schedule M-3 as a pre-audit analytical tool and saves time that would otherwise be spent by auditors and taxpayers reconciling to the financial statements.

Line 5

- 5a Net income from nonincludible foreign entities (attach schedule).
- b Net loss from nonincludible foreign entities (attach schedule and enter as positive amount).

Line 5 provides taxpayers a mechanism to remove income or loss of foreign entities which are included in the financial statement amount of line 4 that are *not* in the consolidated tax group. The instructions to Schedule M-3 require that a supporting schedule be attached that provides the name, EIN (if applicable), and financial statement net income (loss) for each such entity. The IRS will, understandably, be interested in ensuring that these removals are proper. In addition, a comparison of these supporting attachments and Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, may identify areas of audit risk.

Line 6

- 6a Net income from nonincludible U.S. entities (attach schedule).
- b Net loss from nonincludible U.S. entities (attach schedule and enter as positive amount).

Line 6 provides a mechanism to remove income or loss of U.S. entities included in the financial statement amount on line 4 but which do not meet the test for inclusion in the consolidated tax group. Usually, these are subsidiaries owned more than 50 percent but less than 80 percent. They may also include U.S. partnerships consolidated for financial accounting but not for tax accounting purposes.

Taxpayers are instructed to attach a supporting schedule to provide identifying information for each nonincludible U.S. entity whose income or loss is removed on line 6.

This is considered a high audit risk area. If a taxpayer is removing an entity from a U.S. consolidated tax group, the IRS may want to ascertain whether that entity has a tax return filing requirement and, if so, whether the entity filed a return. The Service may apply various analytical techniques in an attempt to gauge risk in this area, such as inspecting the attached schedule and making a year to year comparative analysis of the entities to ensure that income or losses were properly removed.

Line 7

- 7a Net income of other includible corporations (attach schedule).
- b Net loss of other includible corporations (attach schedule).

Line 7 provides taxpayers a mechanism to add income or loss of US entities which meet the test for inclusion in the tax return but are not included in the financial statement amount on line 4. In addition to entering the amounts on line 7, a supporting schedule must be attached which provides the name, tax identification number, and net income (loss) per the financial statement or books and records for each. These are entities that are included in the tax return but not included in financial statement income, and therefore, were not reviewed as part of a certified audit. The lack of exposure to a certified audit alone increases compliance risk. Moreover, the IRS can be expected to be particularly interested in the income and expenses of loss entities, since these were included for tax purposes but not for financial statement (line 4) purposes.

The information on line 7 lends itself to a variety of pre-audit analytical techniques. For example, the preparation of a comparative analysis of the entities from the attached supporting schedule might indicate whether or not they were consistently included in the consolidated return. A comparison of the supporting schedule with the Form 851 affiliation schedule might indicate inconsistencies in consolidation. In an audit scenario, an auditor might check to see whether the inclusion of a previously unidentified loss corporation meets the requirements of consolidation for tax purposes.

Line 8

- 8 Adjustment to eliminations of transactions between includible corporations and nonincludible entities (attach schedule).

This line eliminates intercompany transactions that relate to non-includible entities removed in lines 5 and 6 or are included in line 7, leaving only intercompany items that relate to includible entities. Generally, for those corporations removed on Lines 5 and 6, this line will add back dividends received by the U.S. consolidated tax group and adjust for minority interests. The instructions to the form indicate that all of the transactions relating to consolidation and elimination entries for nonincludible foreign entities, nonincludible U.S. entities, and other includible corporations are to be listed by transaction on an attached schedule.

This will enable the IRS to review the transactions for any unusual or questionable items, *prior* to contacting the taxpayer.

Line 9

- 9 Adjustment to reconcile income statement period to tax year (attach schedule).

This item is self explanatory. If the taxpayer's tax period differs from the financial statement, this line will highlight those reconciling items. While this

is a simple concept, the lack of information regarding this item on the Schedule M-1 sometimes made reconciliation difficult and time consuming.

Line 10

10 Other adjustments to reconcile amount on line 11 (attach schedule).

Line 10 is a “catch-all” line used to highlight any other reconciling differences not captured in lines 5, 6, 7, 8, and 9. A major use of line 10 is to capture intercompany dividends and certain other intercompany items that insurance subsidiaries must include in book income reported for line 11 under insurance statutory accounting rules. Any items reported on line 10 not required by statutory accounting indicate potential audit risk.

Line 11

11 Net income (loss) per income statement of includible corporations. Combine lines 4 through 11.

This is the net financial statement income (or loss) of the consolidated tax group before any book/tax differences are accounted for using Parts II and Parts III of Schedule M-3.

What is important and noteworthy about the foregoing is that unlike Schedule M-1, which starts with financial statement income and leaves it up to the IRS to accept or audit the result, the Schedule M-3 requires 10 separate lines of information be provided to illustrate how that number is computed. This saves the IRS time and trouble by not having to figure out how the taxpayer came up with Line 11 (or to at least minimize that effort) and should result in a net resource saving for taxpayers by reducing the extent to which the IRS will need to request this information.

Schedule M-3, Parts II and III

Parts II and III reconcile financial net income of includible corporations to taxable income reported on Form 1120, page 1, line 28. Part II generally reconciles items of income, gain, and loss. Part III deals with expense and deduction items.

Parts II and III contain four columns to identify and differentiate the book and tax aspects of each line item. Column (a) represents financial statement income or expense amounts maintained in the corporation's books and records, using the income statement source determined in Part I. Column (d) represents amounts as reflected in the tax return. For each line item, the difference between the amount shown in column (a) and the amount shown in column (d) is shown either as a temporary difference in column (b) or as a permanent difference in column (c). The clear statement of both the book and tax amounts as well as the reconciling differences aids the IRS in setting materiality thresholds for the reconciling differences shown.

The detail required by Parts II and III is particularly enhanced by the differentiation of temporary and permanent differences. Temporary (timing) differences occur because tax laws require the recognition of some items of income and expense in different periods than are required for book purposes. Temporary differences originate in one period and reverse or terminate in one or more subsequent periods. Temporary differences between book and tax are questions of "when" not "if". There are four basic categories of temporary differences:

1. Income recognized in financial statements before it is taxable;
2. Income reported as taxable before it is recognized in financial statements;
3. Expenses recognized in financial statements before they are deducted on the tax return; and,
4. Expenses deductible on the tax return before they are recognized on financial statements.

By their very nature, such items become issues regarding the correct year for the item's inclusion in income or deduction as an expense. From a tax administration standpoint (excluding reporting errors as discussed later), they are largely concerns of time value of money.

Over the lifetime of an entity, cycle of a specific transaction, or depreciable life of an asset, temporary differences between book and tax net to zero. As such, the examination of purely temporary differences will generally be a lower priority in risk analysis. Of course, materiality and length of time before a temporary difference turns will be considered, due to the time value of money. For example, a \$10 million temporary difference that doesn't reverse for 10 years may be worth investigating, depending on the facts and circumstances.

In contrast to temporary differences, permanent differences are annual adjustments that arise as a result of fundamental permanent differences in financial and tax accounting rules. These differences result from transactions that will not reverse in subsequent periods. In financial statement reporting under GAAP, permanent differences are not considered in the FAS No. 109 computation of deferred tax assets and liabilities, but do have a direct impact on the effective tax rate. Therefore, permanent differences have the potential to substantially influence reported earnings per share computations, and, in the case of public companies, stock prices. Accordingly, permanent differences of a comparable size generally have a greater audit risk than temporary differences.

Schedule M-3's introduction of detailed reporting requirements for permanent and timing differences is another significant improvement over Schedule M-1 as well as an important enhancement to overall transparency. When examining Schedule M-1, the character of a particular book-tax difference usually was not determinable without further investigation. Often this required contacting the taxpayer, resulting in some degree of burden to both taxpayers and the IRS. In addition, the reporting of the book and tax amounts allows the IRS to consider the relative magnitude of the differences before contacting the taxpayer.

Expansion of Schedule M-3 Filing Requirements

Effective for tax years ending on or after December 31, 2006, Schedule M-3 will be required for certain filers of Forms 1120-L, 1120-PC, 1120S, and Form 1065. While each Schedule M-3 associated with the particular form will be tailored to the accounting and tax particulars of the entity type, preparers of those returns will note the similarities with the Form 1120 Schedule M-3. This was done deliberately in order to promote consistency across tax return platforms. This consistency enables a particular issue occurring in multiple entity types to be more readily identified and analyzed. In addition, the use of common nomenclature and formatting in all versions of Schedule M-3 should facilitate the ability of software vendors to write programs to incorporate the new forms, and should, in general, make the forms easier to understand. Using the Form 1120 Schedule M-3 as a starting point also made the task of creating the new forms easier for the IRS drafting team, since the team already had experience and stakeholder feedback with respect to the Form 1120 Schedule M-3.

Schedule M-3 for Form 1065

The new Form 1065 Schedule M-3 entails a degree of differentiation from the Form 1120 M-3, particularly in the determination of who must file. Because oil and gas firms frequently make use of partnerships to conduct their upstream activities, a discussion of the highlights of the new Form 1065 Schedule M-3 follows.

As noted, the Form 1120 Schedule M-3 was used as the model for the development of the Form 1065 Schedule M-3 as well as the versions of Schedule M-3 for other large business entities. While the IRS believed the \$10 million asset criterion used for Form 1120 would be suitable for determining the Schedule M-3 filing requirement for other entities, it was believed that this measure would not be sufficient for partnerships. First, it was noted that many large corporations increasingly conduct business through partnerships. The partnerships may not meet the \$10 million end of year assets threshold. Nevertheless, these partnerships may have a material impact on the tax profiles of their corporate partners. Moreover, it was noted that many tax shelters use partnerships in a manner that would not necessarily meet the \$10 million asset criterion, yet involve very large and complex transactions.

Accordingly, partnerships (or other entities filing Form 1065) that meet *any one or more* of the following criteria will be required to file Schedule M-3 for tax years ending on or after December 31, 2006. These criteria include two asset threshold tests, a total receipts test, and an ownership test.

Asset Threshold Tests

As in the case of corporate taxpayers filing Forms 1120, 1120-PC, 1120-L, or 1120-S, a partnership will be required to file Schedule M-3 if it has \$10 million or more total assets at the end of the tax year. In addition, a partnership will be required to file Schedule M-3 if it has \$10 million or more in adjusted total assets at the end of the year. The term “adjusted total assets” means *total assets at the end of the tax year before capital distributions, losses, and any other adjustments that reduce total partnership capital*.

The drafters of the Form 1065 Schedule M-3 noted that partnership capital and end of year total assets can vary widely within a tax year for a variety of reasons unique to partnerships, such as technical terminations, capital account revaluations, and the ease with which capital can flow in and out of a partnership without tax impact. Partnerships, particularly those controlled by

large business entities engaging in complex business activities, may begin and end the year with few assets but move many high value transactions through the partnership during the year. In addition, it might be relatively easy to manipulate total assets at the end of the year by simply making distributions before year end. Therefore, it was determined that the single static year end asset measure used for corporations would not be a sufficient measure for partnerships.⁵

Total Receipts Test

A partnership will be required to file Schedule M-3 if it has \$35 million or more in total receipts. This test was added largely for the same reasons the “adjusted total assets” test was added. It was believed that if a partnership has \$35 million in total receipts that it is certainly an active entity economically even if it has less than \$10 million in total assets.

Ownership Test

A partnership will be required to file Schedule M-3 if it is has a “reportable entity partner”. A reportable entity partner is a partner who itself was required to file Schedule M-3 on its most recently filed tax return and who owns, directly or indirectly, 50 percent or more of the partnership on any day of the partnership tax year. Because partnerships are essentially nothing more than an aggregation of their partners, transparency is improved by requiring partnerships which are substantially owned by reportable entity partners to file Schedule M-3. Many large corporations are complex enterprises that include both a parent corporation, subsidiaries, and partnerships effectively controlled through the subsidiaries. The absence of an ownership test could enable and motivate some taxpayers to engage in a Schedule M-3 version of “off-balance-sheet financing.” That is, taxpayers who do not want to disclose book tax differences on Schedule M-3 might be motivated to form partnerships and

⁵ While there are exceptions (e.g., the disguised sale rules of section 707(a)(2)(B)), generally, Internal Revenue Code section 721(a) provides that no gain or loss is recognized by either the partnership or the partner upon contribution of property or money to a partnership. Similarly, section 731(a) provides for non-recognition of gain or loss to all parties when partnership property or money is distributed. Accordingly, it is very easy to move assets in and out of a partnership within the tax year and avoid a static end of year assets threshold.

transfer activities to the partnerships which otherwise would be reported on the corporate Schedule M-3.

Impact on Oil and Gas Taxpayers

Companies in the exploration and production (E&P) segment of the petroleum industry can be expected to have significant differences between income for book and tax purposes due to the varying unique methods of accounting used. E&P companies generally use one of two methods of accounting for financial reporting purposes: 1) the successful efforts Method, and 2) the full cost method. The following are some examples of book tax differences that may be expected to occur.

The Successful Efforts Financial Accounting Method

Under the successful efforts method, costs incurred in searching for, acquiring, and developing oil and gas reserves are capitalized if they directly result in producing reserves. Costs which are attributable to activities that do not result in finding, acquiring, or developing specific reserves are charged to expense.

For example, under the successful efforts method, acquisition costs are capitalized to an unproven property until proved reserves are found or until the property is abandoned or impaired (a partial abandonment). If adequate reserves are discovered, the property is reclassified from unproven property to proven property. For tax purposes, acquisition costs are handled the same way, except the cost cannot be partially written off as an impairment expense. The property must be abandoned before any cost may be written off. In the case of a corporation filing Form 1120, these differences would be reported on Schedule M-3, Part II, line 23e, abandonment losses.

Another example is the treatment of intangible drilling and development costs (IDC) of drilling a well. These costs are treated differently under the successful efforts financial accounting method depending on whether a well is classified as an exploratory well or a developmental well. An exploratory well is a well drilled in an unproven area. A developmental well is a well drilled to produce from a proven reservoir. If an exploratory well is a dry hole, the costs incurred in drilling the well are expensed for financial accounting purposes. If the exploratory well is successful, the drilling costs are capitalized to wells and related equipment and facilities. In the case of developmental wells, the costs incurred in drilling are capitalized to related equipment and facilities even if a dry hole is drilled.

For federal income tax purposes, drilling costs for both exploratory and development wells are capitalized unless an election is made to expense them in accordance with section 263(c). In the case of domestic IDC, most taxpayers can and will elect to expense such costs currently. Thus, a book tax difference will almost always occur in the case of domestic IDC. Foreign IDC, on the other hand, must be capitalized and amortized over a 10-year period. Because this period may differ from the units of production method used to recover such costs under the successful efforts method, another book-tax difference may arise with respect to foreign IDC.

Integrated oil companies who elect to expense domestic IDC may only expense 70 percent of the IDC incurred. The remaining domestic IDC, 30 percent, must be capitalized and amortized over a 5-year period, requiring, yet again, a book-tax reconciling entry. Dry hole costs for either type of well may be expensed for tax purposes unless the taxpayer capitalizes IDC.

The costs associated with tangible well equipment and facilities are capitalized for financial accounting purposes under the successful efforts method regardless of the type of well drilled. For tax purposes, certain costs associated with such equipment (for example, installation costs) are eligible for treatment as deductible IDC. Tax depreciation methods usually allow for a more accelerated rate of depreciation than financial accounting depreciation (the latter of which relies largely on a units of production method based on crude oil production and reserves). All of these differences produce differences to be reconciled on Schedule M-3, Part III.

Another unique book-tax difference involves depletion. Even if a taxpayer uses cost depletion for both book and tax purposes, an M-3 entry will almost always be necessary. Although the cost depletion formula is the same for book and tax purposes, the amount for the basis used in the computation of cost depletion will vary due to the difference in items capitalized and due to the difference in reserve estimates used for financial vs. tax purposes. Of course, if the taxpayer uses percentage depletion for tax purposes, there will always be a book tax difference (unless the amounts are the same by sheer coincidence).

The Full Cost Financial Accounting Method

Under the full cost method, all costs incurred in exploring, acquiring, and developing oil and gas reserves in a cost center are capitalized. For example, geological and geophysical (G&G) studies—successful and unsuccessful—are capitalized for financial accounting purposes. For tax purposes, successful G&G costs are capitalized and unsuccessful G&G costs are expensed. An M-3 entry would be necessary to account for the difference.

Exploratory dry hole costs are capitalized for financial accounting purposes under the full cost method. For tax purposes, all dry hole costs (exploratory or developmental) are capitalized unless the taxpayer elects to expense them. Since most taxpayers elect to expense these costs for tax purposes, the difference would need to be shown on Schedule M-3.

As in the case of the successful efforts method, the calculation of depletion on the full cost method will differ from the method used for tax purposes and will therefore usually require an adjustment to be shown on Form 1120 Schedule M-3, Part III, line 30.

Schedule M-3 and Oil and Gas Partnerships

As previously noted, the Form 1065 Schedule M-3 was largely designed by using the Form 1120 Schedule M-3 as a starting point and modifying it as appropriate to serve the reconciliation needs of partnerships. The process of modification was largely one of deletion. Thus, the Form 1065 Schedule M-3 is shorter than the version used for corporations but is otherwise very similar.

The IRS involved various interested stakeholders in the Form 1065 Schedule M-3 design process. Some stakeholders took note of the fact that the depletion expense shown on Part III, line 23, had not been deleted on the draft Form 1065 Schedule M-3 despite the fact that oil and gas depletion is not deducted on the partnership tax return. Rather, the partnership supplies information to each partner who then calculates the depletion deduction on his own return.

Because the partner level depletion computation is unique to the oil and gas industry, Form 1065 Schedule M-3 Part III, line 23 was retained but divided into two parts. Line 23(a) is labeled “Depletion—Oil & Gas.” Column (d), “deduction per tax return” was grayed out, since the deduction does not appear on the partnership tax return. Nevertheless, it was decided to retain the line item for oil and gas depletion because it provides useful information for use in risk analysis.

First, while the depletion deduction is usually, but not always,⁶ calculated by the partner rather than the partnership, certain other determinations with regard to depletion are made by the partnership. For example, the partnership must make adjustments to the partners’ capital accounts for depletion taken

⁶ Electing large partnerships, which file Form 1065-B do in fact compute oil and gas depletion at the partnership level. See IRC section 776(a).

with respect to each of the partnership's oil and gas properties.⁷ The partnership makes such adjustments by using the actual depletion claimed by the partners on their returns with respect to those properties, or can "simulate" depletion from oil and gas properties at the partnership level and then reduce the partners' capital accounts by the partners' shares of the partnership computed simulated depletion allowance. Knowing the amount of depletion computed for financial accounting purposes can be useful in performing an audit risk analysis with respect to the proper maintenance of capital accounts and can provide useful risk analysis regarding whether the information reported to the partners for use in their own calculations is reasonably correct.

Second, other types of depletion, such as timber depletion, are reported at the partnership level. Because it is not unusual for taxpayers to have more than one type of depletion deduction in a given return, it is necessary to differentiate oil and gas depletion from other depletions.

Conclusion

The increased transparency provided by Schedule M-3 will enable the IRS to perform risk analysis more quickly and accurately. The electronic filing of tax returns will further advance this effort, as electronic filing and processing of returns will better enable the IRS to use computer based analytical techniques. The IRS has set a goal of having 80% of tax returns filed electronically by 2007. While much of this goal is based upon voluntary electronic filing, new regulations require corporations with assets of \$50 million or more and who file at least 250 information returns in a tax year to begin electronically filing for years ending on or after December 31, 2005. This requirement will extend to corporations with assets of \$10 million or more for tax years ending on or after December 31, 2006. All of these electronically filed tax returns will include Schedule M-3.

As more taxpayers file Schedule M-3, and particularly as these tax returns are filed electronically, the IRS will enhance its ability to differentiate tax returns and issues that may (or may not) require examination. This will lead to a net reduction in taxpayer burden as better decisions can be made in the return selection process. In the case of tax returns that are selected for examination, the transparency that is associated with Schedule M-3 should make examinations begin earlier (when records associated with return transactions are readily available and the memories of key personnel are fresh), be more limited in scope, and proceed more quickly, saving resources for taxpayers and the IRS.

⁷ See Treas. Reg. section 1.704-1(b)(2)(iv)(k)(2).