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Tax Scholars Discuss Corporate Disclosure, Book-Tax Reporting

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Tax administrators, academics, and professionals at an April 25 Tax Policy Center conference discussed differences between book and tax income and suggested various ways to respond to the trend, including disclosure of corporate tax returns. As a whole, corporations are increasingly reporting more income on their financial statements (book income) than they are on their tax returns.

The issue of disclosure of corporate tax information is not a new one. However, lawmakers and academics are giving it greater attention now as a result of the corporate financial scandals of the past year. Senate Finance Committee Chair Charles E. Grassley, R-Iowa, sparked even more debate last July when he asked Treasury and the Securities and Exchange Commission to examine whether the government should require companies to disclose their tax information.

While the revival of the issue is still in an early stage of discussion, tax scholars came together at a day-long panel discussion to examine options lawmakers have to reconcile book and tax income differences and what consequences policy decisions might have on tax planning and financial reporting.

The range of solutions to the book-tax disparity issue were varied, mostly because the stated goals were mixed. Objectives ranged from improving tax administration and compliance to providing investors with better information about a company's financial condition. Options for requiring greater tax information disclosure include full disclosure, a summary disclosure of the first four pages of Form 1120, expanding Schedule M-1, disclosing tax shelter information, and conforming book and tax income reporting systems.

Michelle Hanlon of the University of Michigan summed up the reasons for the increase in book and tax income differences. She attributed the disparity to the use of stock options (that are deducted from taxable income but are not reported as book income), a tax cushion reserved for expected tax assessments, and intraperiod tax allocation.

Enhancing Public Disclosure

Doug Shackelford of the University of North Carolina and Joel Slemrod of the University of Michigan presented a paper they wrote with David Lenter of the University of Michigan, arguing that greater transparency would help clarify the company's tax payments to enable investors to compare book and tax income differences.

Slemrod added that disclosure is "critical to the enforcement" of tax policy. But he and Shackelford also said some proposals, such as full disclosure, would go too far. Jane Gravelle of the Congressional Research Service suggested several comprehensive proposals, including one to require firms to report interest they deduct on tax returns on their financial statements.

At least one legislative proposal has surfaced on Capitol Hill since the beginning of the new debate. House Ways and Means Committee member Lloyd Doggett, D-Texas, has introduced legislation he says would close the "corporate accountability" gap between book and tax income and curb abusive tax shelters. H.R. 1556 would require firms to make tax information — including their net corporate income tax, the amount

RANGEL CRITICIZES PROPOSED EITC PRECERTIFICATION PROGRAM

House Ways and Means Committee ranking minority member Charles B. Rangel, D-N.Y., in a letter to Treasury Secretary John Snow last week defended the rights of taxpayers filing for the earned income tax credit. Rangel said he plans to introduce legislation that would ban the "crude form of profiling" the IRS would impose on EITC recipients.

In his letter to Snow, Rangel expressed his "strong" opposition to the proposed precertification program. "It is unconscionable that the IRS would be asked to begin pre-audits of EITC tax credit taxpayers, beginning on July 1, 2003, without the explicit authorization of the Congress," Rangel argued. The plan would impose an "unjustified increased burden" on the working poor and create "serious" taxpayer confusion and unfairness in the nation's voluntary tax system.

Rangel said he plans to introduce a bill to preserve the rights of low-income taxpayers by barring the implementation of the precertification program. "We cannot allow the Bush Administration to pick on the little guy — working families — while it pushes for more and more tax breaks for the wealthy," Rangel said. ■

— Sonya V. Harmon

shown as federal income tax expense on annual SEC statement, taxable income as shown on the corporate return, adjusted book income, the difference between taxable income and adjusted book income and an explanation of the difference — publicly available.

"It wasn't clear to me that you could do these [proposals]," Shackelford said, adding later that disclosure would produce both positive and negative results. He said public scrutiny of corporate tax returns could compel firms to limit "overly aggressive" tax and book planning, but it could also encourage tax planning if shareholders pressure firms to reduce tax liabilities. He questioned whether disclosure would improve regulation of financial (nontax) information, given that the Justice Department and the SEC already have access to tax returns in some cases.

Slemrod said disclosure is 'critical to the enforcement' of tax policy.

Bill Gentry of Columbia University said the disclosure would have negative consequences for tax policies if the information is not well understood. As an example, he pointed to the alternative minimum tax system lawmakers created after the public learned that some corporations did not pay taxes. "Naming names might be the road to more things like the AMT," Gentry said.

Eugene Steuerle of the Urban Institute expressed concern about forming "solutions" without having a clear objective. "If you push too far (toward disclosure) without knowing the reason why, then you actually threaten compliance with the tax system," Steuerle said.

Fred Murray of the Tax Executives Institute raised numerous concerns about public disclosure of tax returns. He said investors may not be able to discern meaning from what would be "truckloads" of tax return information, but firms' competitors would certainly gain access to proprietary information about the company that they would otherwise not have. He said TEI is studying the issue and the various disclosure proposals.

Disclosing Information to the IRS

Eric Solomon of the Treasury Department said public disclosure of tax returns might not help curb abusive transactions. "The IRS, not the public, enforces the tax laws," Solomon said. "In my opinion, it's more important to have transparency to the IRS." He said many tax shelters are "loss generators," a tax loss without a book income loss.

Solomon added that there may be ways to fix the Schedule M-1 to accomplish the same goals as the current book-tax filter in Treasury's new disclosure regulations.

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Ed Outslay of Michigan State University said tax practitioners are worried Congress might apply the wrong fix, such as codification of the economic substance doctrine. He said practitioners consider Treasury's shelter regulations a more reasonable approach.

Ken Kies of Clark/Bardes Consulting said the final disclosure regulations issued by Treasury are "close to striking the right balance" between curbing abusive tax shelters without unduly burdening taxpayers. "I never ever said there isn't a corporate tax shelter problem," Kies said, adding they are the "exception," not the rule.

Kies also said the auditing regulators "completely blew it" on new auditor independence rules, which permit accounting firms to continue to provide tax services to the firms they audit.

Brian Meighan of the Joint Committee on Taxation reviewed Enron's tax returns, including its Schedule M-1, and said the information did not reveal Enron's use of abusive transactions, which JCT staffers learned about from opinion letters and promotional materials sent to the committee. He added that JCT staffers were "less than enamored" of Enron's financial reporting of rate reconciliation, which provided little information.

Meighan said he doubts disclosure would affect the cost-benefit analysis firms use to decide whether to enter into an abusive transaction. He also suggested that the IRS focus on the permanent differences between book and tax income, rather than temporary disparities. "The real money is in permanent differences," he said.

Conforming Book-Tax Reporting

Panelists and audience members expressed interest in a new proposal advocating expansion of Schedule M-1. Lillian F. Mills of the University of Arizona and George A. Plesko of the Massachusetts Institute of Technology unveiled the proposal they say would enable better book-tax income reconciliation. The report also analyzes the benefits, and drawbacks, of public disclosure of such data.

Mills said she and Plesko "felt compelled to recommend revisions" to the schedule because they thought it lacked detail. The authors said the

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existing Schedule M-1 has remained essentially unchanged since its introduction in 1963, so they propose expanding it to allow for more complex reconciliation issues.

Mills said book and tax income differ for two main reasons: (1) income measurement differences, and (2) consolidation differences. Regarding income measurement, Mills said income differs for book and tax reporting because of differences in timing and scope. Also, stock option deductions are not disputed in audits, but they are difficult for investors or the IRS to identify.

Consolidation is a problem because Schedule M-1 starts with net book income according to corporate books and records, Mills said. Firms generally consolidate worldwide income on financial statements, but generally need to consolidate only U.S.-source income and repatriated foreign-source dividend income on tax returns.

According to Plesko and Mills, the revised Schedule M-1 would identify the entity, reconcile the income by preserving existing categories and providing additional details, and enumerate the tax. Benefits of the revision include improvements to tax administration and assistance for tax policy analyses, the authors said. However, Mills and Plesko said the revision could prove difficult for taxpayers who already prepare supporting schedules and provide reconciliation for IRS exams. Revising the Schedule M-1 could also burden small domestic firms that ignore most consolidation items.

Teed said an expanded Schedule M-1 could benefit the IRS and Treasury by enhancing the use of enforcement resources to address high-risk compliance issues.

Richard Teed, who is with the IRS's Large and Midsize Business Division, shared his views of the Mills-Plesko proposal, stressing that the IRS remains committed to protecting the privacy of tax return data.

But, Teed said, an expanded Schedule M-1 could benefit the IRS and Treasury by enhancing the use of enforcement resources to address high-risk compliance issues. Also, the IRS Coordinated Industry Case Program would benefit from enhanced planning with taxpayers, he said. Other beneficiaries of the revision include the IRS Statistics of Income Division and the academic community.

Teed added that the proposal could assist the IRS in cracking down on abusive tax avoidance transactions. Also, improved voluntary disclosure could benefit the IRS as well as the Securities and Exchange Commission, he said.

Finally, Teed told conference attendees that the IRS is working on a corporate e-file platform that could be used by large and midsize businesses to comply with revised reporting requirements. Also, the IRS is "checking" section 1502 requirements to determine if additional Treasury regulations are necessary for reporting specifics. ■

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