

**PRESENT LAW AND BACKGROUND RELATING  
TO CORPORATE TAX REFORM:  
ISSUES OF CONFORMING BOOK AND TAX INCOME  
AND CAPITAL COST RECOVERY**

Scheduled for a Public Hearing  
Before the  
SUBCOMMITTEE ON SELECT REVENUE MEASURES  
of the  
HOUSE COMMITTEE ON WAYS AND MEANS  
on May 9, 2006

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



May 8, 2006  
JCX-16-06

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## INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing for May 9, 2006, on Corporate Tax Reform. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides an overview of business taxation in the United States and reviews the differences between income reporting for financial reporting purposes by domestic public corporations and income measurement for computing income tax liability. This document also provides a description of present law and background relating to capital cost recovery under the income tax.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Corporate Tax Reform: Issues of Conforming Book and Tax Income and Capital Cost Recovery* (JCX-16-06), May 8, 2006.

## I. EXECUTIVE SUMMARY

Businesses can operate through a variety of legal forms, including C corporations, general partnerships, limited partnerships, limited liability companies, S corporations, and sole proprietorships. Both tax and non-tax concerns dictate a business's choice of entity.

The income of a C corporation is taxed directly to the corporation, and distributions of the corporation's after-tax income are taxed to the shareholders as dividends, although generally at a preferential rate. The income of pass-through entities such as partnerships, limited liability companies, and S corporations is not generally taxed at the entity level; instead, items of income and loss pass through to the partners, who include the items in calculating their own taxable income.

In considering corporate tax reform, questions about the differences between financial accounting and Federal income tax accounting may arise and some tax reform proposals may involve eliminating some or all book-tax differences. It has been argued that book-tax conformity may act as a deterrent to aggressive tax positions and abusive tax shelters. In addition, book-tax conformity may promote simplification and reduced compliance costs within the corporate income tax system. However, there may be circumstances in which corporations are not motivated to maximize net income for financial statement purposes and therefore may be able to use the greater latitude afforded by financial accounting principles to inappropriately reduce taxable income. This raises questions about the ability of book-tax conformity proposals to apply consistent rules to similarly situated taxpayers. Finally, book-tax conformity proposals may limit the Congress's ability to administer fiscal and social policy via the tax law.

Another area which may be the subject of tax reform proposals is the treatment of cost recovery. Cost recovery refers to the process by which a taxpayer recoups the cost of its investment in business or other income-producing property. Examples of cost recovery methods include straight-line depreciation, accelerated depreciation, and expensing, the latter two of which can be used as a tax policy tool to encourage investment. Another form of investment incentive is an investment tax credit.

Each of the cost recovery methods described above results in the same amount of nominal tax deductions over the life of the asset; the incentive effects of accelerated depreciation and expensing, relative to straight-line depreciation, are caused by accelerating deductions (and thus deferring the payment of tax), which increases the net present value of cash flows related to the investment. In contrast, an investment tax credit reduces the amount of nominal tax deductions over the life of the asset. However, depending on the parameters used in any given investment tax credit proposal, the net present value of cash flows related to the investment (and thus the magnitude of the incentive effect) may be higher or lower than under accelerated depreciation or expensing.

For financial accounting purposes, differences in timing of deductions (such as those created by the cost recovery methods described above) generally do not impact the amount of total tax expense or the effective tax rate reported in a corporation's financial statements. However, permanent changes in the total amount of tax (such as those produced by an investment tax credit) do affect a corporation's total tax expense and effective tax rate.

## II. OVERVIEW OF BUSINESS TAXATION

### A. In General

Businesses may be organized in a number of different ways. Owners of a business sometimes conduct their activities as “sole proprietorships,” which do not involve legal entities separate from the owner. However, for a variety of business or other reasons, a business will often be conducted through a separate legal entity. Common reasons to use a separate legal entity are the protection of limited liability accorded by State law to the owners of qualifying entities (but generally not to sole proprietors), and an improved ability to access capital markets for investment capital.

The tax consequences of using a separate entity depend on the type of entity through which the business is conducted. Partnerships, certain closely-held companies that elect to be taxed under subchapter S, and limited liability companies that are treated as partnerships are treated for Federal income tax purposes as pass-through entities whose owners take into account the income (whether or not distributed) or loss of the entity on their own tax returns. Generally, an entity whose ownership interests are publicly traded is not entitled to be treated as a partnership.

In contrast, the income of a C corporation<sup>2</sup> is taxed directly at the corporate level. Shareholders are taxed on dividend distributions of the corporation’s after-tax income. Shareholders are also taxed on any gain (including gain attributable to undistributed corporate income) on the disposition of their shares of stock of the corporation. Thus, the income of a C corporation may be subject to tax at both the corporate and shareholder levels.<sup>3</sup>

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<sup>2</sup> A C corporation is a corporation that is subject to subchapter C of the Code, which provides rules for corporate and shareholder treatment of corporate distributions and adjustments. C corporations are generally subject to the corporate-level tax rate structure set forth in section 11 of the Code.

<sup>3</sup> Specialized investment entities organized as C corporations, such as regulated investment companies and real estate investment trusts, and certain interests in debt instruments, such as real estate mortgage investment conduits, are effectively subject to only one level of tax notwithstanding that their ownership interests are publicly traded. Other specialized entities which are beyond the scope of this discussion include cooperatives and tax-exempt organizations.

## B. Federal Income Tax Rates

U.S. individuals (citizens and residents) are taxed at graduated statutory rates ranging from 10 percent (for taxable income of up to \$7,550 for single filers and up to \$15,100 for married taxpayers filing joint returns or surviving spouses) to 35 percent (for taxable income over \$336,550) for taxable year 2006. The intermediate rates are 15 percent, 25 percent, 28 percent, and 33 percent. The maximum tax rate on net long-term capital gains generally is 15 percent.<sup>4</sup> Dividends received by an individual from domestic corporations and qualified foreign corporations are taxed at the same rates that apply to capital gains.<sup>5</sup>

C corporations are taxed at statutory rates ranging from 15 percent (for taxable income up to \$50,000) to 35 percent (for taxable income over \$10,000,000). The intermediate rates are 25 percent and 34 percent. The benefit of graduated rates below 34 percent is phased out for corporations with taxable income between \$100,000 and \$335,000, and the benefit of the 34 percent rate is phased out for corporations with taxable income in excess of \$15,000,000. Corporate long-term capital gains are taxed at the same rates as corporate ordinary income. Thus, the maximum tax rate for corporate net long-term capital gains is 35 percent.

In addition, present law imposes a minimum tax on individuals and corporations to the extent their minimum tax liability exceeds their regular tax liability.<sup>6</sup> The alternative minimum tax ("AMT") is imposed on corporations at the rate of 20 percent on the alternative minimum taxable income ("AMTI") in excess of a \$40,000 phased-out exemption amount, and on individuals at a rate of 26 percent for the first \$175,000 of AMTI in excess of a phased-out exemption amount and at a rate of 28 percent for amounts in excess of such amount.<sup>7</sup> AMTI is the taxpayer's regular taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. In general, the AMT applies a lower tax

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<sup>4</sup> Net gain from the sale of collectibles is taxed at a maximum 28 percent rate, while certain gain from the sale or exchange of depreciable real estate (i.e., "unrecaptured section 1250 property") is taxed at a maximum 25 percent rate. Under present law, for taxable years beginning after 2008, the maximum tax rate applicable to net long-term capital gains (other than collectibles or unrecaptured section 1250 property) will increase from 15 percent to 20 percent.

<sup>5</sup> Under present law, for taxable years beginning after 2008, dividends received by an individual are taxed at ordinary income rates.

<sup>6</sup> A corporation with average gross receipts of less than \$7.5 million for the prior three taxable years is exempt from the corporate minimum tax. The \$7.5 million threshold is reduced to \$5 million for the corporation's first three-taxable year period.

<sup>7</sup> Under present law, the exemption amount for taxable year 2006 is \$45,000 in the case of married individuals filing a joint return. The exemption amount is completely phased out for married individuals filing a joint return with AMTI in excess of \$330,000 and for a corporation with AMTI in excess of \$310,000. For taxable year 2005, the exemption amount for married individuals filing a joint return was \$58,000; various proposals which would increase the exemption amounts and the phaseout amounts for individuals for taxable year 2006 are currently before the Congress.

rate to a broader tax base. Specifically, the regular tax base is increased for AMT purposes by adding back certain items treated as tax preferences, and disallowing certain deductions and credits.

## C. Choice of Entity

### In general

The choice of business structure can have an impact on the liability of the owners of the business, the tax treatment of income and deductions, and on the options available to the business for financing projects. In practice, this results in considerable variation in the choice of entity structure: in 2003, there were 2.0 million C corporation tax returns, 3.3 million S corporation tax returns, 2.4 million partnership returns, and 19.7 million non-farm sole proprietorship returns.

### C corporations

A corporation is a business entity organized under a Federal or State statute, or under a statute of a Federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation.<sup>8</sup> The Code taxes a corporation as an entity separate from its shareholders. A C corporation's income generally is taxed when earned at the corporate level and is taxed again at the individual level when distributed as dividends<sup>9</sup> to its shareholders. Corporate deductions and credits reduce only corporate income and are not passed through to shareholders.

Corporate income that is not distributed to shareholders is generally subject to current tax at the corporate level only.<sup>10</sup> To the extent that income retained at the corporate level is reflected in an increased share value, the shareholder may be taxed at capital gains rates upon sale or exchange (including certain redemptions) of the stock or upon liquidation of the corporation. In addition, foreign investors are generally exempt from U.S. income tax on capital gains, but are subject to withholding tax on dividends. Tax-exempt investors are not generally subject to tax on corporate distributions or on sales or exchanges of corporate stock.

Appreciated corporate assets are generally subject to corporate level tax if they are distributed to the shareholders, yielding the same tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders.

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<sup>8</sup> Treas. Reg. sec. 301.7701-2(b)(1).

<sup>9</sup> Distributions with respect to stock that exceed corporate earnings and profits are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock which, in general, are taxed to the shareholder at capital gains rates.

<sup>10</sup> An "accumulated earnings tax" can be imposed on certain earnings in excess of \$250,000 (\$150,000 for certain service corporations in certain fields) accumulated beyond the reasonable needs of the business (secs. 531-537). A "personal holding company tax" is imposed on certain undistributed personal holding company income, generally where the corporation meets certain closely held stock requirements and more than 60 percent of the adjusted ordinary gross income (as defined) consists of certain passive-type income such as dividends, interest, and similar items (secs. 541-547).



In general, amounts paid as reasonable compensation to shareholders who are also employees are deductible by the corporation,<sup>11</sup> and are taxed as ordinary income at the individual level (unless a specific exclusion applies). On the other hand, amounts paid as dividends to shareholders generally are not deductible by the corporation and are taxed as income to the shareholders (generally at the same preferential rates as apply to capital gains, for dividends received prior to 2009).

In general, interest paid by a C corporation is deductible but dividends paid are not.<sup>12</sup> This creates a tax incentive favoring debt over equity in a corporation's capital structure. The distinction between debt and equity depends on a number of factors. This determination requires an examination of the substance of the instrument. The analysis of whether an instrument is debt or equity for Federal income tax purposes is not identical to the analysis of whether such instrument will be characterized as debt or equity for financial reporting purposes. As a result, financial instruments are sometimes specifically structured to obtain desired differing treatment for tax and financial reporting purposes.

A C corporation is generally the entity of choice if a corporation anticipates a public offering, because publicly traded partnerships are generally taxed as corporations, and S corporations (discussed below) are not permitted to have more than 100 shareholders.

## **Partnerships**

### Advantages of pass-through treatment

Business owners may choose to operate or invest through a "pass-through" entity, such as a partnership, limited liability company, or S corporation, either to avoid corporate tax treatment, or for non-tax business reasons. Noncorporate tax treatment may be preferred because: (1) owners may not wish business earnings to be subject to two levels of tax (once when earned, and again when distributed); (2) the average or marginal tax rates for the individual shareholders may be lower than that of the corporation; and (3) owners may wish to use losses generated by the business to offset income from other sources.

### Federal income tax treatment of partnerships

Partnerships generally are treated for Federal income tax purposes as pass-through entities, not subject to tax at the entity level.<sup>13</sup> Items of income (including tax-exempt income), gain, loss, deduction and credit of the partnership are taken into account in computing the tax of

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<sup>11</sup> Annual compensation in excess of \$1 million that is payable to the chief executive officer or the four other most highly compensated employees of a public corporation is not deductible unless the compensation qualifies as performance-based compensation or another exception applies. Sec. 162(m).

<sup>12</sup> If certain requirements are satisfied, dividends paid on stock held by an employee stock ownership plan are deductible by the corporation. Sec. 404(k).

<sup>13</sup> Sec. 701.

the partners (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners). Each partner takes into income such partner's distributive share of the partnership's taxable income and the separately allocable items of income, gain, loss, deduction, and credit.<sup>14</sup> A partner's deduction for partnership losses is limited to the amount of the partner's adjusted basis in his or her partnership interest.<sup>15</sup> To the extent a loss is not allowed due to a limitation, it generally is carried forward to the next year. A partner's basis in the partnership interest generally equals the sum of (1) such partner's capital contribution to the partnership, (2) the partner's distributive share of partnership income, and (3) the partner's share of partnership liabilities, less (1) such partner's distributive share of losses allowed as a deduction and (2) any partnership distributions.<sup>16</sup>

Partnerships provide partners with a significant amount of flexibility to vary their respective shares of partnership income. Unlike corporations, partnerships may allocate items of income, gain, loss, deduction and credit among the partners, provided the allocations have substantial economic effect. In general, an allocation is permitted to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation, and the allocation substantially impacts the dollar amounts to be received by the partners from the partnership independent of tax consequences.

#### Limited liability companies

In the last 30 years,<sup>17</sup> States have enacted laws providing for another form of entity, the limited liability company ("LLC"). LLCs are generally treated as partnerships for Federal income tax purposes. They are neither partnerships nor corporations under applicable State law, but they generally provide limited liability to their owners for obligations of the business. Under regulations promulgated in 1996, any domestic non-publicly traded unincorporated entity with two or more members generally may elect to be treated as either a partnership or a corporation for Federal income tax purposes, while any single-member unincorporated entity may elect to be treated as a corporation or to be disregarded (i.e., treated as not separate from its owner<sup>18</sup>) for

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<sup>14</sup> Sec. 702(a).

<sup>15</sup> Sec. 704(d). In addition, "passive loss" and "at-risk" limitations limit the extent to which certain types of income can be offset by partnership deductions. These limitations do not apply to corporate partners (except certain closely held corporations) and may not be important to individual partners who have partner level "passive income" from other investments.

<sup>16</sup> Sec. 705.

<sup>17</sup> The first LLC statute was enacted in Wyoming in 1977. All States (and the District of Columbia) now have an LLC statute, though the tax treatment of LLCs for State tax purposes may differ.

<sup>18</sup> Thus, where the single member is an individual, such a disregarded LLC will be treated as a sole proprietorship.

Federal income tax purposes.<sup>19</sup> These regulations, known as the “check-the-box” regulations, were a response, in part, to the growth of LLCs.

### **S corporations**

An S corporation provides the Federal income tax advantage of pass-through treatment, and also retains the non-tax advantages of corporate status under Federal securities laws and State law. An S corporation and its shareholders are generally treated, for Federal income tax purposes, more like a partnership and its partners than like a C corporation and its shareholders. In order to make an election to be treated as an S corporation, a corporation must meet certain requirements primarily regarding its capital structure and the identity of its shareholders.

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock. Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock.<sup>20</sup> Although there are limitations on the types of shareholders and stock structure an S corporation may have, there is no limit on the asset size of such a corporation (as there is no limit on the size of a C corporation or partnership).

For Federal income tax purposes, an S corporation is generally not subject to tax at the corporate level.<sup>21</sup> Items of income (including tax-exempt income), gain, loss, deduction and credit of the corporation are taken into account in computing the tax of the shareholders (under the corporation’s method of accounting and regardless of whether the income is distributed to the shareholders). A shareholder’s deduction for corporate losses is limited to the sum of the shareholder’s adjusted basis in the S corporation stock and the indebtedness of the corporation to such shareholder. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year. The shareholder’s basis in the S corporation stock (and debt) is reduced by the shareholder’s share of losses and (in the case of stock) by distributions and is increased by the shareholder’s share of the corporation’s income.<sup>22</sup>

There are two principal exceptions to the general pass-through treatment of S corporations. Both are applicable only if the corporation was previously a C corporation and are generally intended to prevent avoidance of otherwise applicable C corporation tax consequences. First, an S corporation is subject to tax on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments), if the corporation has subchapter C earnings and profits and has gross receipts more than 25 percent of which are passive investment

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<sup>19</sup> Treas. Reg. sec. 301.7701-3.

<sup>20</sup> Sec. 1362.

<sup>21</sup> Secs. 1363 and 1366.

<sup>22</sup> Sec. 1367.

income for the year.<sup>23</sup> Second, for the first 10 years after a corporation that was previously a regular C corporation elects to be an S corporation, certain net “built-in” capital gains of the corporation attributable to the period in which it was a C corporation are subject to tax at the corporate level.<sup>24</sup>

In general, an S corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder’s basis in the stock of the corporation or the corporation was formerly a C corporation and has undistributed earnings and profits.<sup>25</sup> To the extent of such earnings and profits, corporate distributions are treated as dividends of C corporations and generally are subject to tax as such in the hands of the shareholders.

Notwithstanding that they both provide for pass-through treatment, there are several significant Federal tax differences between S corporations and partnerships. First, corporate liabilities (other than those owed to its shareholders) are not included in a shareholder’s basis for the interest in an S corporation. Thus, unlike a partner who can take deductions supported by certain partnership indebtedness, S corporation shareholders who wish to obtain similar types of deductions are required to individually borrow and contribute or re-lend such amounts to the S corporation. Further, S corporations may have only one class of stock, and thus do not offer the same flexibility as partnerships to allocate income and losses to different investors.

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<sup>23</sup> Sec. 1375. If the S corporation continues to have C corporation earnings and profits and has gross receipts more than 25 percent of which are passive investment income in each year for three consecutive years, the S corporation election is automatically terminated (sec. 1362(d)(3)).

<sup>24</sup> Sec. 1374.

<sup>25</sup> Sec. 1368.

### **III. SELECTED ISSUES RELATED TO TAXATION OF C CORPORATIONS**

#### **A. Differences in Financial Accounting and Federal Income Tax Accounting**

##### **1. In general**

In considering corporate tax reform, questions about differences between the accounting methods employed for financial reporting purposes and those used in calculating taxable income (“book-tax differences”) may arise. Some tax reform proposals may involve eliminating some or all book-tax differences. Some have noted that the divergence of book and tax reporting requirements increase complexity for corporations. Some have also questioned whether a single system could serve both financial reporting and tax purposes.

This section describes some of the common book-tax differences and how they are reported to the IRS and the Securities and Exchange Commission (“SEC”). These differences, along with the general principles underlying book and tax accounting, are examined in the context of potential proposals for complete or partial book-tax conformity.

The Financial Accounting Standards Board (“FASB”) establishes and interprets the financial accounting standards which govern U.S. Generally Accepted Accounting Principles (“GAAP”) and which are used by publicly traded companies in compiling their annual reports filed with the SEC. The primary purpose of financial reporting is to provide information about a company to investors and creditors. By contrast, corporations calculate their taxable income in accordance with the Code. The primary purpose of tax accounting is to measure income for the purpose of levying the Federal income tax. The tax laws also have been used as instruments of social and fiscal policy. The Code generally requires that a corporation’s taxable year and overall method of accounting conform to those used for financial reporting purposes.<sup>26</sup> However, many specific differences are permitted (and, in some cases, required) between financial accounting and tax accounting.

##### **2. Common book-tax differences**

Many book-tax differences are caused by the timing of income or expense recognition under the two systems. Timing differences are often referred to as “temporary” differences because, over time, the total income and expense recognition with respect to these items will be the same under the two systems. For example, expenses are generally accrued under GAAP if they are probable and their amount can be reasonably estimated; in contrast, expenses generally are not deductible for tax purposes until all events have occurred which determine the fact of liability and the amount of the liability can be determined with reasonable accuracy.<sup>27</sup> These general principles often result in the recognition of accrued expenses in earlier years for GAAP

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<sup>26</sup> Secs. 441 and 446.

<sup>27</sup> Sec. 461(h).

purposes than for tax purposes; however, eventually the same amount of expenses will be reported under both systems.<sup>28</sup>

The treatment of capital costs is another prominent temporary difference; accelerated depreciation and expensing for small businesses generally result in deductions for capital costs being reflected in taxable income earlier than in book income.<sup>29</sup> Other examples include bad debts, an estimate of which must be accrued for book purposes while no tax deduction is permitted until an account is actually written off, and nonqualified deferred compensation expenses, which are accrued as the employee earns them for book purposes but generally are not deductible for tax purposes until paid.

In addition to the temporary differences caused by the timing of income and expense recognition, some book-tax differences are caused by the inclusion of an item of income or expense for one system but not the other. These are referred to as “permanent differences.” Permanent differences include the interest on tax-exempt bonds, nondeductible meals and entertainment expenses, fines and penalties, and compensation in excess of tax deductible limits, each of which is taken into account as income or expense in determining financial accounting income but not taxable income.

Book income and taxable income may also permanently differ as a result of the rules governing consolidated filing of financial reports and tax returns by related corporations. For tax purposes, only domestic subchapter C corporations owned at least 80 percent (determined by both voting power and value) by a parent corporation may be included in the parent corporation’s consolidated filing.<sup>30</sup> Financial accounting requires consolidation of subsidiaries in which the parent company has direct or indirect financial control, regardless of whether the subsidiaries are domestic corporations.<sup>31</sup> Thus, consolidated financial statements generally

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<sup>28</sup> If a GAAP estimate ultimately proves incorrect, the company will generally adjust its books when the correct amount is determined. For example, corporations often accrue a contingency reserve for ongoing legal disputes. Any ultimate payment under a judgment or settlement is generally not deductible until paid, at which time the book accrual is adjusted (“trued up”) to reflect the actual amount of the payment.

<sup>29</sup> The straight-line method of depreciation is generally used for financial accounting purposes. The straight-line method and several accelerated cost recovery methods are discussed in a later section of this pamphlet.

<sup>30</sup> Furthermore, inclusion of such corporations is elective for tax purposes, though once an election is made all such corporations must be included.

<sup>31</sup> While exceptions apply, holding more than 50 percent of voting power is generally considered to constitute financial control. In addition, non-corporate entities such as partnerships are consolidated for financial accounting purposes if the parent company has financial control.

include the income of foreign subsidiaries and controlled subsidiaries owned less than 80 percent by the parent. These entities are not included in the parent's consolidated tax return.<sup>32</sup>

Some book-tax differences are the result of differing classification of balance sheet entries for book and tax purposes. For example, a financial instrument may be classified as either debt or equity for one system, with the opposite treatment under the other system. In such a case, payments on the instrument would be treated differently (for example, as interest payments or as dividend payments) in the calculation of book income and taxable income.

### **3. Reporting of book-tax differences to the IRS**

Effective for tax years ending on or after December 31, 2004, the IRS requires corporations with total assets in excess of \$10 million to file Schedule M-3, a detailed reconciliation between net income per financial statements and taxable income.<sup>33</sup> The level of detail required by schedule M-3 is significantly greater than that required by Schedule M-1, which was required for years prior to the effective date of Schedule M-3.<sup>34</sup> Treasury officials have suggested that the more detailed disclosure will help IRS auditors determine which book-tax differences deserve the most focus and also will have a deterrent effect on aggressive tax positions.<sup>35</sup>

### **4. Financial accounting for book-tax differences**

Under GAAP, income tax expense is generally recognized when the income to which it relates is recognized, regardless of when the income is actually taxed. Thus, temporary book-tax differences generally do not affect the total tax expense reported by a corporation. For example, in the absence of permanent book-tax differences, a corporation which has \$100 of book income

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<sup>32</sup> However, certain passive income of foreign subsidiaries and the distributive share of foreign pass-through entities (which may or may not be consolidated for GAAP purposes) will be reflected on the tax return as income of the parent or investor company. In addition, certain distributions from certain non-consolidated entities are included in the parent company's taxable income even though such entities are not included in the consolidated tax return.

<sup>33</sup> The IRS is authorized to prescribe the forms which must be used and the information which must be provided by taxpayers when filing their income tax returns. (Sec. 6011(a)).

<sup>34</sup> Schedule M-1 is still in use for certain taxpayers, including those corporations not required to file Schedule M-3. See appendix for copies of Schedule M-1 and Schedule M-3. While all book-tax differences must be reported, some of the most common items include cost recovery, bad debts, and nonqualified deferred compensation.

<sup>35</sup> IRS News Release IR-2004-14, January 28, 2004.

before taxes in Year 1 and \$100 of book income before taxes in Year 2 will book \$35 of income tax expense in each year regardless of how much tax is actually paid in each of the two years.<sup>36</sup>

The temporary differences created as a result of accelerated cost recovery for tax purposes provide an example. Consider a corporation with \$200 of gross receipts in each of Years 1 and 2, and a \$200 capital expenditure in Year 1 for a piece of equipment the cost of which is eligible for immediate expensing for tax purposes but must be depreciated over two years (\$100 per year) for book purposes. Assuming no other book-tax differences, the corporation will have book income before taxes of \$100 (\$200 gross receipts less \$100 book depreciation) in Year 1 and in Year 2. The corporation will have taxable income of zero (\$200 gross receipts less \$200 cost recovery) and a tax liability of zero in Year 1. The corporation will have taxable income of \$200 (\$200 gross receipts, with no remaining cost recovery) and tax liability of \$70 in Year 2. Note that the total pre-tax income for the two years combined is \$200 for both book and tax purposes, and that the \$200 of taxable income over the two years results in \$70 of income tax. For book purposes, the total \$70 of tax is recognized in the years in which the income to which it relates is recognized, which in this case is 50 percent in each year.<sup>37</sup> Accordingly, the corporation will accrue a \$35 tax expense in each year.

Unlike temporary differences, permanent book-tax differences do affect the total amount of tax expense reported under GAAP. For example, consider a corporation which has \$600 of gross income but incurs a \$100 fine during the year. Net book income before taxes is, therefore, \$500. Because the fine is not deductible for tax purposes, the taxable income is \$600 and the corporation will owe \$210 in Federal income tax.<sup>38</sup> The \$100 book-tax income difference related to the nondeductible fine is permanent, so its effect (an additional \$35 in tax expense) is reflected in the financial statements in the period in which the permanent item (i.e., the nondeductible fine) occurs. For the year, the corporation reports \$210 of tax expense and net income after taxes of \$290.<sup>39</sup>

The distinction between temporary and permanent book-tax differences is reflected in the corporation's effective tax rate, which is a term financial accountants use to refer to the company's total tax expense (per books) divided by pretax book income. A corporation which has only temporary differences and no permanent differences will generally have an effective tax rate in each year equal to the statutory tax rate. However, because permanent differences change the total amount of tax to be paid over time, they also cause a company's effective tax rate to

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<sup>36</sup> The examples in this pamphlet assume a Federal income tax rate of 35 percent on all corporate taxable income. In addition, all other income taxes, including foreign and State income taxes, are ignored.

<sup>37</sup> This is consistent with the financial accounting objective of matching the costs of generating income with the income to which the costs relate by reporting them in the same accounting period.

<sup>38</sup> \$600 taxable income at 35 percent tax rate results in \$210 tax.

<sup>39</sup> \$500 net income before taxes, reduced by \$210 tax expense, results in \$290 net income after taxes.



differ from the statutory rate. In the example above involving the permanent difference for a nondeductible fine, the company's effective Federal tax rate for the year is 42 percent rather than 35 percent.

## 5. Fundamental principles creating book-tax differences under present law

Book income and taxable income differ, in part, because of the different fundamental purposes they serve.

The primary purpose of financial reporting is to provide information about a company to investors and creditors.<sup>40</sup> Accordingly, the system of financial reporting values accuracy and conservatism. The system is tolerant of judgment and estimates in some cases, even though they might differ somewhat from one practitioner to the next, in an effort to present the most accurate picture of a company's financial position and income.<sup>41</sup>

The primary purpose of tax accounting is to measure income for the purpose of levying the income tax. The system favors objectivity, administrability, and consistency among taxpayers. For this reason, the use of judgment and estimates is generally avoided. The tax laws are also used as a fiscal and social policy tool, creating incentives for certain taxpayer behaviors which the Congress wishes to encourage. Such incentives, while serving what are considered to be important policy objectives, generally create deviations between book income and taxable income.

These differences of purpose between financial accounting and tax accounting were noted by Justice Blackmun in *Thor Power Tool Company v. Commissioner*:

The presumption petitioner postulates is insupportable in light of the vastly different objectives that financial and tax accounting have. The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in

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<sup>40</sup> Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises* (November 1978), lists three objectives of financial reporting. In short, they are (1) to provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions; (2) to provide information to help those persons in assessing the amounts, timing, and uncertainty of prospective cash flows; and (3) to provide information about the economic resources of an enterprise, the claims to those resources, and the effects of events that change its resources and claims thereto.

<sup>41</sup> It is thought that the judgment of a practitioner who is intimately familiar with a company's financial circumstances, even though it may not be exactly the same as another practitioner, may present a more accurate reflection of those circumstances than would the application of an objective rule.

measurement [should] be in the direction of understatement rather than overstatement of net income and net assets.” In view of the Treasury’s markedly different goals and responsibilities understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

This difference in objectives is mirrored in numerous differences of treatment. Where the tax law requires that a deduction be deferred until “all the events” have occurred that will make it fixed and certain, *United States v. Anderson*, 269 U.S. 422, 441, 46 S.Ct. 131, 134, 70 L.Ed. 347 (1926), accounting principles typically require that a liability be accrued as soon as it can reasonably be estimated. Conversely, where the tax law requires that income be recognized currently under “claim of right,” “ability to pay,” and “control” rationales, accounting principles may defer accrual until a later year so that revenues and expenses may be better matched. Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty. This is as it should be. Reasonable estimates may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm’s overall financial health; but the accountant’s conservatism cannot bind the Commissioner in his efforts to collect taxes. “Only a few reserves voluntarily established as a matter of conservative accounting,” Mr. Justice Brandeis wrote for the Court, “are authorized by the Revenue Acts.” *Brown v. Helvering*, 291 U.S., at 201-202, 54 S.Ct., at 360.

Finally, a presumptive equivalency between tax and financial accounting would create insurmountable difficulties of tax administration. Accountants long have recognized that “generally accepted accounting principles” are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions. “Generally accepted accounting principles,” rather, tolerate a range of “reasonable” treatments, leaving the choice among alternatives to management. Such, indeed, is precisely the case here. Variances of this sort may be tolerable in financial reporting, but they are questionable in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax. If management’s election among “acceptable” options were dispositive for tax purposes, a firm, indeed, could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay. Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable.<sup>42</sup>

## **6. Discussion of issues related to book-tax conformity**

Reform proposals seeking to increase conformity between book and tax accounting may take various forms, including complete conformity, partial conformity, or the requirement that a

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<sup>42</sup> 439 U.S. 522, 542-544 (1979).

corporation employ a certain book accounting method as a condition of employing that method for tax purposes.

One potential feature of these proposals which may be attractive is the creation of a “healthy tension” between a company’s desire to have high book income and its desire to have low taxable income. Assuming this tension exists under any given proposal, management will be constrained in taking aggressive positions for either book or tax purposes, because such positions by definition will either cost the company additional tax dollars (in the case of aggressive book positions) or result in diminished book income (in the case of aggressive tax positions). In addition, the greater flexibility of the GAAP rules in allowing judgment and estimates might be deemed acceptable for the tax system because the tension serves to keep judgment calls balanced between potential overstatement and understatement of income. It has been suggested that book-tax conformity could be an effective tool in discouraging the use of corporate tax shelters. In 1999, a Treasury department report stated that eliminating the book-tax disparity would “significantly limit the allure and benefit of corporate tax shelters to public corporations.”<sup>43</sup> The staff of the Joint Committee on Taxation, in its report on the investigation of Enron Corporation and related entities, noted that the difference between tax and financial accounting created an incentive for the company to engage in such transactions.<sup>44</sup>

In addition, book-tax conformity proposals may represent simplification and reduce compliance costs since the appropriate treatment of conformed items of income and loss would have to be determined only once, rather than two or more times (including potentially for the alternative minimum tax) under the current system.

Opponents of conformity proposals may argue that the differing fundamental principles on which the book and tax accounting systems are based, as discussed above, offer sufficient reason to maintain the status quo. Furthermore, the benefits of conformity may be limited by the existence of many potential circumstances under which the healthy tension does not exist because the company is not motivated to report higher book income. In these cases, companies may instead use the relative flexibility of GAAP rules to minimize book (and therefore taxable) income with no negative consequences.<sup>45</sup>

One potential category of corporations not motivated to maximize financial accounting profits may be corporations which are not publicly traded and which do not rely on financial statements for borrowing purposes. In addition, some publicly traded corporations may not be

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<sup>43</sup> U.S. Department of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals*, July 1999.

<sup>44</sup> For a summary of the Joint Committee staff’s findings on this issue, see Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003, pp. 8-10.

<sup>45</sup> For example, if taxable income were conformed to book income, corporations not motivated to maximize book income may exercise judgment under GAAP to create reserves or write down the value of depreciated assets in order to reduce book (and therefore taxable) income.

motivated to maximize profits in particularly profitable years because they perceive steady earnings growth over a period of years as more valued by investors than a pattern of earnings which peaks and then falls. Still other public companies may view investor behavior as not driven by financial accounting net income. Because the primary purpose of GAAP is to convey information, a company's net income number may be less important than the overall package of information conveyed. In a book-tax conformity environment, corporations that choose accounting methods which minimize book and taxable income would be free to provide to investors supplemental information such as the amount by which net income would be higher if the alternative method were chosen. In some industries, even this may be seen as unnecessary because investors may rely more on other financial data (such as gross revenue) rather than net income.

On the other side of the healthy tension, proponents of book-tax conformity may see the desire to keep taxable income lower as moderating aggressive behavior in financial accounting. However, it should be noted that companies with large tax loss carryforwards may have little or no incentive to minimize current-year taxable income, freeing them to take aggressive accounting positions.

The consideration of book-tax conformity proposals requires judgments regarding the role of fiscal and social policy in the Federal tax law. Generally, economic and social incentives enacted by Congress in the Code result in book-tax differences because such policies represent departures from the GAAP goal of calculating income in the most accurate way for investors. Accordingly, whichever tax incentives remain untouched by a book-tax conformity proposal will necessarily be outside the scope of the proposal or will otherwise constitute an exception to the proposal.

A related consideration is the question of who would promulgate the rules governing calculation of a conformed book and taxable income. Proposals which levy a tax on financial accounting income, determined under GAAP, could be criticized for placing the determination of Federal revenues in the hands of FASB. Alternatively, proposals which rely on the Congress to set out new accounting standards to be used for both financial accounting and tax purposes would contradict decades of practice in the accounting and auditing fields, as sanctioned by the Securities and Exchange Commission.<sup>46</sup>

In addition to the policy arguments for and against book-tax conformity, administrative issues may arise in attempting to define specific details of conformity proposals. A fundamental question for any such proposal is to whom the proposal would apply. In particular, resolution of consolidation issues may be difficult. Under present law, foreign subsidiaries of U.S. parent corporations are generally eligible for deferral and are not included in the consolidated U.S. tax

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<sup>46</sup> “The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission’s policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.” (Excerpted from “Facts about FASB” on the website of the Financial Accounting Standards Board, <http://www.fasb.org/facts/index.shtml#mission>, last accessed May 8, 2006.)

return of the parent corporation even though they are included in the U.S. parent's consolidated financial statements. Thus, a proposal that maintains deferral for earnings of foreign subsidiaries might necessarily involve sacrificing book-tax conformity as it relates to consolidation. In addition, decisions would have to be made regarding fundamentally different treatment of noncorporate business entities between book and tax systems.

Many of these difficulties do not arise under proposals with more limited scope, such as those in which a corporation must employ a certain book accounting method as a condition of employing that method for tax purposes. For example, under present law the use of the last-in-first-out ("LIFO") inventory accounting method is predicated on using that method for financial reporting purposes. While such a proposal avoids the issues of consolidation differences and treatment of noncorporate entities, the concept may be more easily applied to overall accounting methods (like LIFO) rather than to potentially abusive transactions. Because abusive tax shelters often involve a series of transactions, each of whose tax consequences are combined to produce the inappropriate result, it may be difficult to define the scope of a transaction to which a book treatment limitation would apply.

## B. Cost Recovery

### 1. In general

One important area in which the tax rules and financial accounting rules differ is cost recovery. Cost recovery also raises other issues in addition to book-tax divergence. The choice of cost recovery rules has an effect on the after-tax rate of return from business assets. As a matter of policy, should these rules be neutral as to a taxpayer's choice whether or in which assets to invest? Alternatively, should cost recovery rules be used to encourage investment generally or investment in particular kinds of assets? To address these questions, this section first describes the concept of cost recovery and provides numerical examples to illustrate certain economic and tax effects of various forms of cost recovery rules. Then this section summarizes the present law tax rules and the financial accounting rules for cost recovery.

### 2. Concept of cost recovery<sup>47</sup>

In business taxation, cost recovery refers to the process by which a taxpayer recoups the cost of its investment in business or other income-producing property.<sup>48</sup> The tax rules permit this recoupment through the allowance of deductions for depreciation. In his opinion in the 1927 U.S. Supreme Court case *United States v. Ludey*, Justice Brandeis provided the following explanation of depreciation:

The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be

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<sup>47</sup> Portions of this discussion are drawn from Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* (3d. ed. 1999) at ¶23.1.

<sup>48</sup> The tax rules allow cost recovery both for tangible assets and for intangible property such as copyrights and patents with limited useful lives. The term "depreciation" sometimes is used only when referring to cost recovery for tangible property, while "amortization" is used in describing cost recovery for intangible property such as patents and copyrights. Section 167(a), however, which allows a depreciation deduction for "the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business, or of property held for the production of income," encompasses both tangible and intangible property.

deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties.<sup>49</sup>

The American Institute of Certified Public Accountants (AICPA) has provided a similar explanation:

Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year.<sup>50</sup>

Both Justice Brandeis's and the AICPA's explanations refer to salvage value. Although for many years the tax rules required taxpayers to estimate the salvage value of depreciable assets and permitted depreciation deductions only to the extent that a taxpayer's cost basis in an asset exceeded the asset's salvage value, since 1981 the depreciation rules have ignored salvage values, and a taxpayer is permitted to take deductions for the depreciation of an asset until its adjusted basis in the asset has been reduced to zero.

The Supreme Court and the AICPA explanations differ in their description of the role of valuation in determining depreciation allowances. Justice Brandeis writes that a business's depreciation deduction for a year "represents the reduction, during the year, of the capital assets through wear and tear." The AICPA definition, by contrast, states that depreciation accounting "is a process of allocation, not of valuation." The AICPA's statement is a more accurate reflection of the role of valuation in the present tax rules than is Justice Brandeis's (which was written in 1927). The amount of a depreciation deduction allowed to a taxpayer in any given year for a capital asset generally does not reflect the actual reduction in the value of that asset in that year.

Valuation can be seen, however, as part of the theoretical basis of the depreciation allowance. Justice Brandeis writes that the theory of this allowance is that by using up an asset over time, a taxpayer makes a "gradual sale" of that asset, and the depreciation deduction in a given year measures the cost of the portion of the asset "sold" in that year. This "gradual sale" theory reflects the tension between the principles of realization and income measurement. Under an ideal income tax, tax liability would be determined in part by changes in the value of a taxpayer's assets even in the absence of a realization event such as a sale of those assets. In fact, however, changes in asset value generally do not affect tax liability unless there is a realization event. If a depreciation deduction were a proxy for the decline in the value of an asset that a taxpayer does not sell, the allowance of the deduction might be seen as moving the tax rules toward true income measurement and away from realization. Justice Brandeis rationalized this departure from realization through the fiction of a partial sale of an asset each year, with the

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<sup>49</sup> 274 U.S. 295, 300-301 (1927).

<sup>50</sup> AICPA, Accounting Terminology Bulletin No. 1 (1953).

value of the portion fictionally sold represented by the amount of depreciation allowed as a deduction. The amount of a depreciation deduction under present law, though, generally does not approximate the decline in value of a taxpayer's assets (or, if it does approximate economic depreciation, it does so coincidentally). Consequently, in any year, the depreciation allowance for a particular asset may cause a taxpayer's taxable income attributable to that asset to be either more or less than the taxpayer's economic income from the asset.

The fact that depreciation deductions cause a mismeasurement of economic income from an asset when those deductions do not reflect the decline in value of the asset might not, in itself, be cause for concern. As described previously, if salvage value is ignored and a taxpayer is permitted to recover over time the entire cost of an asset, its depreciation deductions over the life of an asset will be the same, and its taxable income from the cash flow generated by the asset will be the same, regardless of the manner in which the taxpayer allocates those deductions over time. As will be illustrated next, however, the timing of depreciation deductions can vary greatly depending on the particulars of the chosen rules, and timing differences can have a significant effect on the real cost of a taxpayer's tax liability.

### **3. Examples: methods of cost recovery**

The following examples illustrate the economic and tax effects of several possible methods of cost recovery: (1) straight-line depreciation, a method in which a taxpayer's depreciation deduction for a given asset is the same each year; (2) accelerated depreciation, under which a taxpayer's depreciation allowance for an asset is greatest in the first year in which the asset is used and declines over time; (3) expensing, in which a taxpayer is permitted to deduct the entire cost of an asset in the year in which the taxpayer acquires the asset; and (4) use of a tax credit to provide cost recovery or recovery of amounts different from the cost of the asset.<sup>51</sup>

Each example assumes the following facts. A taxpayer buys a machine for \$10,000. The machine is used for five years. It generates \$3,000 net cash flow annually. It has no salvage value. The taxpayer's tax rate is 35 percent. The discount rate is 6 percent. The taxpayer is assumed to derive other taxable income so that any net decrease in income tax liability (shown in each table as a negative number) attributable to the machine can be used to offset the taxpayer's tax liability from its other income sources. The present value (PV) figures in the tables are derived by assuming that nominal dollars are paid (in the case of taxes) or received (in the case of cash flow) at the end of each year and by discounting these nominal dollars back to when the machine was purchased, the beginning of year one. Thus, nominal year one dollars paid or received are discounted one year in deriving the present value of those dollars, nominal year two dollars are discounted two years, and so forth.

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<sup>51</sup> These examples provide a comparison of the cash flow and tax effects of the different methods of cost recovery. Other issues such as the relative complexity of each method, record-keeping and administrability aspects of each method, and the use of methods in combination with each other also would have to be taken into account in selecting among cost recovery methods.



**Table 1.—Straight Line Depreciation**

	<b>Unrecovered Cost</b>	<b>Dollars Received</b>	<b>Cost Recovery</b>	<b>Taxable Income</b>	<b>35-Percent Tax</b>	<b>PV of Tax Liability</b>	<b>After-Tax Cash Flow</b>	<b>PV of After-Tax Cash Flow</b>
Year 1	\$10,000	\$3,000	\$2,000	\$1,000	\$350	\$330	\$2,650	\$2,500
Year 2	8,000	3,000	2,000	1,000	350	311	2,650	2,358
Year 3	6,000	3,000	2,000	1,000	350	294	2,650	2,225
Year 4	4,000	3,000	2,000	1,000	350	277	2,650	2,099
Year 5	2,000	3,000	2,000	1,000	350	262	2,650	1,980
End/total	\$0	\$15,000	\$10,000	\$5,000	\$1,750	\$1,474	\$13,250	\$11,162

**Table 2.—Accelerated Depreciation**

	<b>Unrecovered Cost</b>	<b>Dollars Received</b>	<b>Cost Recovery</b>	<b>Taxable Income</b>	<b>35 Percent Tax</b>	<b>PV of Tax Liability</b>	<b>After-Tax Cash Flow</b>	<b>PV of After-Tax Cash Flow</b>
Year 1	\$10,000	\$3,000	\$4,000	-\$1,000	-\$350	-\$330	\$3,350	\$3,160
Year 2	6,000	3,000	2,400	600	210	187	2,790	2,483
Year 3	3,600	3,000	1,440	1,560	546	458	2,454	2,060
Year 4	2,160	3,000	1,080	1,920	672	532	2,328	1,844
Year 5	1,080	3,000	1,080	1,920	672	502	2,328	1,740
End/total	\$0	\$15,000	\$10,000	\$5,000	\$1,750	\$1,349	\$13,250	\$11,287

**Table 3.–Expensing**

	<b>Unrecovered Cost</b>	<b>Dollars Received</b>	<b>Cost Recovery</b>	<b>Taxable Income</b>	<b>35 Percent Tax</b>	<b>PV of Tax Liability</b>	<b>After-Tax Cash Flow</b>	<b>PV of After-Tax Cash Flow</b>
Year 1	\$10,000	\$3,000	\$10,000	-\$7,000	-\$2,450	-\$2,311	\$5,450	\$5,142
Year 2	0	3,000	0	3,000	1,050	934	1,950	1,735
Year 3	0	3,000	0	3,000	1,050	882	1,950	1,637
Year 4	0	3,000	0	3,000	1,050	832	1,950	1,545
Year 5	0	3,000	0	3,000	1,050	785	1,950	1,457
End/total	\$0	\$15,000	\$10,000	\$5,000	\$1,750	\$1,122	\$13,250	\$11,516

**Economic and tax results**

Several observations can be made about these examples. First, in each example, by the end of year five, the last year in which the machine is used, the taxpayer has recovered the entire cost of the machine, \$10,000. Second, measured in nominal or total combined annual dollars, the total amount of cash flow (\$15,000), income after cost recovery (\$5,000), and tax paid (\$1,750) is the same under each of the three methods of depreciation. Third, the amount of the taxpayer’s total eventual tax liability expressed in present value terms at the outset of the taxpayer’s investment – the number printed at the bottom of the third to last column of each example – varies significantly among the three examples. The present value of after-tax cash flows likewise varies among the examples. The initial present value of all future tax liabilities attributable to the income generated by the machine is greatest under straight-line depreciation, somewhat less under accelerated depreciation, and least under expensing. The present value of after-tax cash flows is the smallest under straight-line depreciation, greater under accelerated depreciation, and greater again under expensing. The reason for these relationships is that expensing accelerates cost recovery relative to accelerated and straight-line depreciation, and accelerated depreciation yields more up-front cost recovery than does straight-line. In the end, the entire cost of the machine is recovered under all three methods, but front-loading of depreciation deductions and the concomitant lessening of a taxpayer’s tax liability in the early years increase the present value of cash flows.

**Tax depreciation compared with economic depreciation**

In the examples above, straight-line depreciation is the least favorable method of cost recovery for taxpayers. An even less taxpayer-favorable rule might require a taxpayer to wait until an asset is used up or sold before recovering any portion of the cost of the asset. The rate of cost recovery – straight-line, accelerated, or immediate deduction – is not the only variable that affects the present values of taxes and cash flows associated with an asset. The period over which costs are recovered also has an effect on these present values.

To analyze how closely any combination of recovery rates and periods replicates economic depreciation, the pattern of an asset’s economic depreciation must be understood. Under the assumption that an asset produces level cash flows over its useful life – not always a realistic assumption because of the declining efficiency of some assets and, relatedly, because of increasing maintenance costs as some assets age – the asset declines in value more slowly in its early years than in its later years.

The value of an asset or, put differently, the amount someone would pay for the asset, at any time is the value at that time of all income the asset is expected to generate in the future. An asset’s value, in other words, is the present value of its expected future cash flows. The decline in value of an asset from the beginning of one year to the end of that year – the asset’s economic depreciation – is represented by the difference between the present values of the expected future cash flows at the beginning and at the end of the year.

Assume an asset generates \$1,000 in cash flow each year for five years, and assume a discount rate of 6 percent. The value at the beginning of year one of the future cash flows (\$1,000 each year for five years) is \$4,212; this is the amount a taxpayer would pay for the asset. By the end of year one, the value of the future cash flows (\$1,000 each year for four years) declines to \$3,465. In its first year of use, the asset thus has declined in value by \$747. The pattern of depreciation over the five years is illustrated in the following table:

**Table 4.–Economic Depreciation**

<b>Year</b>	<b>PV at Beginning</b>	<b>PV at End</b>	<b>Depreciation</b>
1	\$4,212	\$3,465	\$747
2	3,465	2,673	792
3	2,673	1,833	840
4	1,833	943	890
5	943	0	943

As can be seen in this table, the depreciation in the value of the asset is smallest during the first year and increases with each subsequent year. For an asset that generates constant cash flows, therefore, tax depreciation rules that matched economic depreciation would backload cost recovery to a greater extent than straight-line depreciation rules do.

## **Expensing as an incentive for capital investment**

Matching economic depreciation is only one possible goal of cost recovery rules. Another possible goal is to provide an incentive for capital investment. Expensing – under which, as illustrated previously, a current deduction is allowed for the entire cost of an asset – is one way to provide this incentive.<sup>52</sup> Under certain assumptions, including that tax rates are the same at the beginning and at the end of an investment, allowing a current deduction for the cost of an investment is equivalent to exempting from tax the return on the investment.

A simple example can illustrate this point. Assume a taxpayer earns \$1,000 in taxable income (in addition to taxable income from other sources) and invests the amount remaining after tax is imposed on the \$1,000. The asset yields a 10-percent return and is sold after one year. The tax rate is 35 percent. In the first scenario, no deduction is allowed for the cost of an investment, but the return on the investment is exempt from tax. The taxpayer therefore is taxed on the \$1,000 when it is earned and is left with \$650 ( $\$1,000 - .35(\$1,000)$ ) to invest. The \$650 investment yields a 10-percent return. After one year, the investment has grown to \$715, and when the investment is sold, the proceeds are exempt from tax. In the second scenario, the taxpayer is allowed a deduction for an investment (that is, the taxpayer is allowed to expense the investment) but is taxed when the proceeds from the investment are used for consumption. The deduction for the cost of the investment (which can be used to as an offset against other taxable income) has the effect of eliminating the tax on the \$1,000 of earnings, and the taxpayer can invest the entire \$1,000. After one year, the investment is worth \$1,100. The taxpayer sells the investment (and does not use the proceeds for a deductible investment). The \$1,100 in proceeds therefore is subject to a 35-percent tax, and the taxpayer is left with \$715 ( $\$1,100 - .35(\$1,100)$ ) after tax. The taxpayer is in the same position as where no deduction was allowed for the initial investment but the return on the investment was free of tax.

## **Tax credit as an incentive for capital investment**

Expensing is one way of providing an incentive for capital investment. Another method is through the use of tax credits. For much of the period from 1962 through 1985, the tax rules included an investment tax credit for the purchase of tangible property and certain other kinds of property for use in a business or profit-seeking activity. The credit amount initially was seven percent of the cost of the property and was increased to 10 percent.<sup>53</sup> The following table shows the effects of a five-percent income tax credit under the assumptions used in Tables 1 through 3: A machine with a five-year life is purchased for \$10,000, the machine generates annual cash flow (net of expenses) of \$3,000, and the discount rate is six percent. As is shown in the table, the five-percent investment credit generates a \$500 tax savings (five percent of \$10,000) in year one and requires the taxpayer to reduce its basis in the machine by \$500 in that year (from

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<sup>52</sup> Any method of cost recovery that is faster than economic depreciation provides a tax incentive for investment in the property for which the recovery method is available.

<sup>53</sup> See Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* (3d. ed. 1999) at ¶27.2.1.

\$10,000 to \$9,500). The table assumes the taxpayer then is required to use straight-line depreciation in recovering its remaining cost.

**Table 5.—Investment Tax Credit**

	<b>Unrecovered Cost</b>	<b>Dollars Received</b>	<b>Cost Recovery</b>	<b>Taxable Income</b>	<b>35 Percent Tax</b>	<b>PV of Tax Liability</b>	<b>After-Tax Cash Flow</b>	<b>PV of After-Tax Cash Flow</b>
Year 1	\$9,500*	\$3,000	\$1,900	\$1,100	-\$115**	-\$108	\$3,115	\$2,939
Year 2	7,600	3,000	1,900	1,100	385	343	2,615	2,327
Year 3	5,700	3,000	1,900	1,100	385	323	2,615	2,196
Year 4	3,800	3,000	1,900	1,100	385	305	2,615	2,071
Year 5	1,900	3,000	1,900	1,100	385	288	2,615	1,954
End/total	\$0	\$15,000	\$9,500***	\$5,500	\$1,425	\$1,151	\$13,575	\$11,487

\* After initial basis reduction for 5-percent investment credit equaling \$500.

\*\* Including \$500 investment credit.

\*\*\* Not including \$500 initial basis reduction from investment tax credit.

Table 5 reveals that under the assumptions of the depreciation examples discussed above, the combination of the investment tax credit and straight-line depreciation produces a greater present value after-tax cash flow than does accelerated depreciation in the absence of the investment credit, and it produces slightly less present value after-tax cash flow than does expensing. More broadly, however, through the choice of, among other features, a credit rate, an investment credit can be designed to replicate the economic and tax results of a given set of depreciation rules.

The most favorable cost recovery method described above, expensing, can, as discussed previously, have the same after-tax effects as would exempting from tax the return on an investment. Certain rules (including investment credits) can produce a result better than exemption. From 1981 until 1986, “the tax benefits of the combination of the investment tax credit and accelerated depreciation were more generous for some equipment than if the full cost of the investment were deducted immediately – a result more generous than exempting all earnings on the investment from taxation.”<sup>54</sup> This result had the effect of encouraging

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<sup>54</sup> Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 98.

investment in equipment qualifying for generous treatment even if the investment would have been unprofitable in the absence of the tax rules.

#### **4. Present-law tax rules**

##### **In general**

The present-law cost recovery rules are not as simple as any of the stylized approaches described above (though the pattern of cost recovery in the accelerated depreciation example matches the pattern of cost recovery under one permitted method of depreciation described below), but they do include features of some of the approaches. The cost recovery rules do not match tax depreciation with economic depreciation. In most circumstances, the rules permit accelerated depreciation, and in some cases require (or permit) straight-line depreciation. In some cases the rules permit limited expensing.

##### **Depreciation provisions**

A taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system (“MACRS”). Under MACRS, different types of property are generally assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from three to 25 years. The depreciation methods generally applicable to tangible personal property are, as the MACRS name suggests, forms of accelerated depreciation. The permitted methods are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.<sup>55</sup>

Recovery periods for real property generally are longer than those for personal property, and the depreciation method is less favorable to taxpayers. In general, the recovery periods applicable to real property are 39 years for non-residential real property and 27.5 years for residential rental property. The depreciation method for real property is the straight-line method.

Under MACRS, a taxpayer is permitted to recover its full basis in depreciable property over the applicable recovery period; there is no need to estimate salvage value. Moreover, under MACRS the applicable recovery period need not (and typically does not) correspond to the actual economic life of the asset subject to depreciation. In general, however, MACRS generally provides for longer recovery periods for longer lived assets.

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<sup>55</sup> For certain property, including tangible property used predominantly outside the United States, tax-exempt use property, tax-exempt bond-financed property, and certain other property, the MACRS “alternative depreciation system” of section 168(g) applies, generally increasing recovery periods and requiring straight-line depreciation.

## **Expensing provisions**

Since 1958, the Code has permitted limited expensing. Under present-law section 179, a taxpayer with a sufficiently small amount of annual investment costs may elect to deduct at least a portion of those costs currently. For taxable years beginning in 2003 through 2007, the maximum amount a taxpayer may expense is \$100,000 of the cost of qualifying property placed in service for the taxable year.<sup>56</sup> In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The \$100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$400,000. The \$100,000 and \$400,000 amounts are indexed for inflation.<sup>57</sup> Certain additional rules govern section 179 computations and eligibility and the coordination of section 179 with other rules.<sup>58</sup>

## **5. Cost recovery financial accounting rules**

### **In general**

For financial accounting purposes, the straight-line method of depreciation is generally used for cost recovery. Thus, the cost of a capital asset is generally recovered in equal expense amounts during each year of its depreciable life.<sup>59</sup> Therefore, use of a cost recovery method other than straight-line (or a different recovery period) for tax purposes will produce book-tax differences.

### **Book-tax differences**

Straight-line depreciation (over a different recovery period), accelerated depreciation, and expensing each produce only temporary book-tax differences. The pattern and length of cost

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<sup>56</sup> Additional section 179 incentives are provided for qualified property used by a business in the New York Liberty Zone (sec. 1400L(f)), an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)).

<sup>57</sup> For taxable years beginning in 2008 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000.

<sup>58</sup> The amount eligible to be expensed for a taxable year may not exceed the taxable income derived in that year from the active conduct of a trade or business (determined without regard to section 179). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under certain rules prescribed by the Secretary.

<sup>59</sup> Recovery periods for financial accounting purposes are generally intended to reflect an asset's useful life, and therefore often differ from the recovery periods used for tax purposes.

recovery deductions for tax purposes differ from those for book purposes, but over the life of the property the cumulative deductions will be the same for book and tax.

Temporary differences do not affect the total amount of tax expense reported by a corporation for the year. However, temporary differences do affect the amount of cash taxes paid by the corporation for the year. In order to keep the total tax expense constant, corporations book an accrued tax expense (or benefit) to reflect the portion of the year's tax expense which will be paid (or refunded) in a future year. This accrual is known as deferred tax expense (or benefit) and results in an asset (or liability) on the company's balance sheet. These balance sheet items are referred to as deferred tax assets and deferred tax liabilities.

Table 6 reflects the financial accounting results where the straight-line method of depreciation is used for both book and taxable income, using the same facts as those employed in table 1, above. Because the cost recovery method and recovery period are identical, book and taxable income are equal in each year. The company's cash tax expense is equal to its book tax expense, which (in the absence of permanent differences) is 35 percent of book income.

**Table 6.—Example Using Straight-Line Depreciation for Both Book and Tax**

	<b>Book Income</b>	<b>Taxable Income</b>	<b>Book-Tax Difference</b>	<b>Deferred Tax Expense</b>	<b>Current (Cash) Tax Expense</b>	<b>Total Tax Expense</b>	<b>Effective Tax Rate</b>
Year 1	\$1,000	\$1,000	\$0	\$0	\$350	\$350	35%
Year 2	1,000	1,000	0	0	350	350	35%
Year 3	1,000	1,000	0	0	350	350	35%
Year 4	1,000	1,000	0	0	350	350	35%
Year 5	1,000	1,000	0	0	350	350	35%
Totals	\$5,000	\$5,000	\$0	\$0	\$1,750	\$1,750	35%

Table 7 reflects the financial accounting results if accelerated depreciation is permitted for tax purposes while straight-line depreciation is used for financial accounting. While the pattern of income differs, the cumulative taxable income over the five-year period is equal to cumulative book income. Because the capital costs are recovered earlier under accelerated depreciation, taxable income is less than book income in the early years and greater than book income in the later years.

On an annual basis, the temporary book-tax differences are accounted for by accruing deferred tax expense. For example, in year one, book income exceeds taxable income by \$2,000. That difference represents the excess of tax depreciation deductions over book depreciation expense in year one. Because this difference will exactly offset over the life of the asset, it is also offset for financial accounting purposes when calculating income tax expense. This offset is accomplished by accruing a deferred tax expense equal to 35 percent of the book-tax difference,



or \$700. Following across the row, the \$1,000 taxable loss produces a current tax benefit (negative expense) of \$350 as calculated in Table 2. Netting the deferred tax expense of \$700 against the current tax benefit of \$350, the total tax expense on the financial statements in year one is \$350, or 35 percent of book income.

**Table 7.— Example Using Straight-Line Depreciation for Book;  
Accelerated Depreciation for Tax**

	<b>Book Income</b>	<b>Taxable Income</b>	<b>Book-Tax Difference</b>	<b>Deferred Tax Expense</b>	<b>Current (Cash) Tax Expense</b>	<b>Total Tax Expense</b>	<b>Effective Tax Rate</b>
Year 1	\$1,000	-\$1,000	\$2,000	\$700	-\$350	\$350	35%
Year 2	1,000	600	400	140	210	350	35%
Year 3	1,000	1,560	-560	-196	546	350	35%
Year 4	1,000	1,920	-920	-322	672	350	35%
Year 5	1,000	1,920	-920	-322	672	350	35%
Totals	\$5,000	\$5,000	\$0	\$0	\$1,750	\$1,750	35%

While the net present value of cash flows under the accelerated depreciation method is higher than under the straight-line method (see Tables 1 and 2), the tax expense and effective tax rates reported on the financial statements are unchanged under the two methods, in each year and on a cumulative basis.

### **Investment tax credit**

In contrast to the straight-line depreciation, accelerated depreciation, and expensing methods of cost recovery, an investment tax credit reduces the total cash taxes paid over the life of an asset as well as the total tax expense and effective tax rate reported on the financial statements.

Table 8 reflects the financial accounting results of a five-percent investment tax credit, using the same facts as Table 5 above.<sup>60</sup> Contrary to the examples in Tables 6 and 7, the \$500 investment tax credit in year one is a permanent reduction in the company's tax expense.

During year one, book depreciation exceeds tax depreciation by \$100, but the tax basis of the capital asset is reduced by \$500 under the investment tax credit rules. Thus, the book basis of the asset exceeds the tax basis of the asset by \$400 at the end of year one. To reflect the

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<sup>60</sup> See discussion of Table 5, above, for calculation of taxable income and current (cash) tax expense figures in Table 8.

future book depreciation expense in excess of tax deductions, a \$140 deferred tax expense (35 percent of the basis difference) is accrued in year one. When netted against the cash tax benefit of \$115, total tax expense for year one is only \$25, or 2.5 percent of year one book income. The effective tax rate is reduced because the tax expense has been permanently reduced by the investment tax credit.

Over the life of the asset, as the temporary difference from year one reverses and the company experiences no further permanent book-tax differences, the effective tax rate returns to 35 percent of book income each year. However, on a cumulative basis, because the total tax expense has been reduced, the average effective tax rate over the life of the asset, for financial statement purposes, is reduced as well.

**Table 8.—Example Using Straight-Line Depreciation for Book;  
5 Percent Investment Tax Credit for Tax**

	<b>Book Income</b>	<b>Taxable Income</b>	<b>ITC Basis Adjustment</b>	<b>Book Tax Difference</b>	<b>Deferred Tax Expense</b>	<b>Current (Cash) Tax Expense</b>	<b>Total Tax Expense</b>	<b>Effective Tax Rate</b>
Year 1	\$1,000	\$1,100	-\$500	-\$400	\$140	-\$115	\$25	2.5%
Year 2	1,000	1,100	0	100	-35	385	350	35.0%
Year 3	1,000	1,100	0	100	-35	385	350	35.0%
Year 4	1,000	1,100	0	100	-35	385	350	35.0%
Year 5	1,000	1,100	0	100	-35	385	350	35.0%
Totals	\$5,000	\$5,500	-\$500	\$0	\$0	\$1,425	\$1,425	28.5%

## **6. Summary of economic and accounting consequences of cost recovery alternatives**

As demonstrated above, straight-line depreciation, accelerated depreciation, and expensing differ only in the timing of deductions. By altering the timing of deductions (and therefore the timing of payment of tax), these alternatives do not change the total amount of tax paid over the life of the asset or the tax expense reported in a taxpayer's financial statements, but they do have important economic effects by impacting the net present value of future cash flows from the investment.

An investment tax credit system, depending on its parameters, can be designed to produce either a higher or lower net present value of future cash flows than the timing methods described above, and therefore may be more or less desirable to taxpayers than those methods.<sup>61</sup>

<sup>61</sup> Important parameters impacting the comparison include, in particular, the credit percentage and which cost recovery method is used to recover remaining basis after the credit.

While the impact on net present value of future cash flows can be higher or lower, the investment tax credit results in less total tax paid over the life of an asset, and lower tax expense reported in a taxpayer's financial statements.

# APPENDIX

**SCHEDULE M-3  
(Form 1120)**

## Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More

OMB No. 1545-0123

Department of the Treasury  
Internal Revenue Service

▶ Attach to Form 1120.  
▶ See separate instructions.

2005

Name of corporation (common parent, if consolidated return)

Employer identification number

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

- 1a** Did the corporation file SEC Form 10-K for its 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.** Go 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 income statement.  
 **No.** Skip lines 2a through 3c and enter the corporation's net income (loss) per its books and records on line 4.
- 2a** Enter the income statement period: Beginning \_\_\_\_/\_\_\_\_/\_\_\_\_ Ending \_\_\_\_/\_\_\_\_/\_\_\_\_
- b** Has the corporation's income statement been restated for the income statement period on line 2a?  
 **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)  
 **No.**
- c** Has the corporation's income statement been restated for any of the five income statement periods preceding the period on line 2a?  
 **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)  
 **No.**
- 3a** Is any of the corporation's voting common stock publicly traded?  
 **Yes.**  
 **No.** If "No," go to line 4.
- b** Enter the symbol of the corporation's primary U.S. publicly traded voting common stock.
- c** Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock.
- |  |           |     |
|--|-----------|-----|
| <b>4</b> Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1                      | <b>4</b>  |     |
| <b>5a</b> Net income from nonincludible foreign entities (attach schedule)   | <b>5a</b> | ( ) |
| <b>b</b> Net loss from nonincludible foreign entities (attach schedule and enter as a positive amount)                           | <b>5b</b> |     |
| <b>6a</b> Net income from nonincludible U.S. entities (attach schedule)  | <b>6a</b> | ( ) |
| <b>b</b> Net loss from nonincludible U.S. entities (attach schedule and enter as a positive amount)                              | <b>6b</b> |     |
| <b>7a</b> Net income of other includible corporations (attach schedule)  | <b>7a</b> |     |
| <b>b</b> Net loss of other includible corporations (attach schedule)   | <b>7b</b> | ( ) |
| <b>8</b> Adjustment to eliminations of transactions between includible corporations and nonincludible entities (attach schedule) | <b>8</b>  |     |
| <b>9</b> Adjustment to reconcile income statement period to tax year (attach schedule)   | <b>9</b>  |     |
| <b>10</b> Other adjustments to reconcile to amount on line 11 (attach schedule)  | <b>10</b> |     |
| <b>11</b> <b>Net income (loss) per income statement of includible corporations.</b> Combine lines 4 through 10                   | <b>11</b> |     |

For Privacy Act and Paperwork Reduction Act Notice, see the Instructions for Forms 1120 and 1120-A.

Cat. No. 37961C

Schedule M-3 (Form 1120) 2005

Name of corporation (common parent, if consolidated return) Employer identification number

If consolidated return, check applicable box: (1)  Consolidated group (2)  Parent corporation (3)  Consolidated eliminations (4)  Subsidiary corporation

Name of subsidiary (if consolidated return) Employer identification number

**Part II Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return**

Income (Loss) Items	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1	Income (loss) from equity method foreign corporations			
2	Gross foreign dividends not previously taxed . . .			
3	Subpart F, QEF, and similar income inclusions . . .			
4	Section 78 gross-up . . . . .			
5	Gross foreign distributions previously taxed . . . . .			
6	Income (loss) from equity method U.S. corporations . . .			
7	U.S. dividends not eliminated in tax consolidation . . .			
8	Minority interest for includible corporations . . . . .			
9	Income (loss) from U.S. partnerships (attach schedule) . . .			
10	Income (loss) from foreign partnerships (attach schedule)			
11	Income (loss) from other pass-through entities (attach schedule) . . . . .			
12	Items relating to reportable transactions (attach details)			
13	Interest income . . . . .			
14	Total accrual to cash adjustment . . . . .			
15	Hedging transactions . . . . .			
16	Mark-to-market income (loss) . . . . .			
17	Cost of goods sold . . . . .			
18	Sale versus lease (for sellers and/or lessors) . . . . .			
19	Section 481(a) adjustments . . . . .			
20	Unearned/deferred revenue . . . . .			
21	Income recognition from long-term contracts . . . . .			
22	Original issue discount and other imputed interest			
23a	Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities			
23b	Gross capital gains from Schedule D, excluding amounts from pass-through entities . . . . .			
23c	Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses . . . . .			
23d	Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses			
23e	Abandonment losses . . . . .			
23f	Worthless stock losses (attach details) . . . . .			
23g	Other gain/loss on disposition of assets other than inventory			
24	Disallowed capital loss in excess of capital gains . . . . .			
25	Utilization of capital loss carryforward . . . . .			
26	Other income (loss) items with differences (attach schedule)			
27	<b>Total income (loss) items.</b> Combine lines 1 through 26 . . . . .			
28	<b>Total expense/deduction items</b> (from Part III, line 36) . . . . .			
29	Other income (loss) and expense/deduction items with no differences . . . . .			
30	<b>Reconciliation totals.</b> Combine lines 27 through 29 . . . . .			

**Note.** Line 30, column (a), must equal the amount on Part I, line 11, and column (d) must equal Form 1120, page 1, line 28.

Name of corporation (common parent, if consolidated return)	Employer identification number ⋮
If consolidated return, check applicable box: (1) <input type="checkbox"/> Consolidated group (2) <input type="checkbox"/> Parent corporation (3) <input type="checkbox"/> Consolidated eliminations (4) <input type="checkbox"/> Subsidiary corporation	
Name of subsidiary (if consolidated return)	Employer identification number ⋮

**Part III Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Expense/Deduction Items**

Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 U.S. current income tax expense . . . . .				
2 U.S. deferred income tax expense . . . . .				
3 State and local current income tax expense . . . . .				
4 State and local deferred income tax expense . . . . .				
5 Foreign current income tax expense (other than foreign withholding taxes) . . . . .				
6 Foreign deferred income tax expense . . . . .				
7 Foreign withholding taxes . . . . .				
8 Interest expense . . . . .				
9 Stock option expense . . . . .				
10 Other equity-based compensation . . . . .				
11 Meals and entertainment . . . . .				
12 Fines and penalties . . . . .				
13 Judgments, damages, awards, and similar costs . . . . .				
14 Parachute payments . . . . .				
15 Compensation with section 162(m) limitation . . . . .				
16 Pension and profit-sharing . . . . .				
17 Other post-retirement benefits . . . . .				
18 Deferred compensation . . . . .				
19 Charitable contribution of cash and tangible property . . . . .				
20 Charitable contribution of intangible property . . . . .				
21 Charitable contribution limitation/carryforward . . . . .				
22 Domestic production activities deduction . . . . .				
23 Current year acquisition or reorganization investment banking fees . . . . .				
24 Current year acquisition or reorganization legal and accounting fees . . . . .				
25 Current year acquisition/reorganization other costs . . . . .				
26 Amortization/impairment of goodwill . . . . .				
27 Amortization of acquisition, reorganization, and start-up costs . . . . .				
28 Other amortization or impairment write-offs . . . . .				
29 Section 198 environmental remediation costs . . . . .				
30 Depletion . . . . .				
31 Depreciation . . . . .				
32 Bad debt expense . . . . .				
33 Corporate owned life insurance premiums . . . . .				
34 Purchase versus lease (for purchasers and/or lessees) . . . . .				
35 Other expense/deduction items with differences (attach schedule) . . . . .				
36 <b>Total expense/deduction items.</b> Combine lines 1 through 35. Enter here and on Part II, line 28 . . . . .				

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

1	Net income (loss) per books . . . . .		7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books . . . . .			Tax-exempt interest \$ .....	
3	Excess of capital losses over capital gains . . . . .			.....	
4	Income subject to tax not recorded on books this year (itemize): .....		8	Deductions on this return not charged against book income this year (itemize):	
5	Expenses recorded on books this year not deducted on this return (itemize):		a	Depreciation . . . . . \$ .....	
a	Depreciation . . . . . \$ .....		b	Charitable contributions \$ .....	
b	Charitable contributions \$ .....			.....	
c	Travel and entertainment \$ .....		9	Add lines 7 and 8 . . . . .	
6	Add lines 1 through 5 . . . . .		10	Income (page 1, line 28)—line 6 less line 9	