TESTIMONY OF
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BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
JUNE 13, 2006

Chairman Grassley, Ranking Member Baucus, and members of the Committee, thank you for inviting me to testify on the advisability of public disclosure of U.S. corporate federal income tax returns. While I am a lawyer in private practice with the firm of Cleary Gottlieb Steen and Hamilton LLP, my testimony today grows out of my personal work in the public interest to improve our federal business tax system, and does not represent the views of my firm or its clients.

In brief, I believe that there are strong policy and practical reasons *not* to mandate the public disclosure of the entirety of corporate tax returns. On the other hand, I believe that there is a completely persuasive case for requiring public companies to release to the public their consolidated Schedule M-3's — a new IRS schedule first adopted for 2004 tax returns, the purpose of which is to reconcile a corporation's financial statement and taxable incomes.[1]

The M-3 can be understood as a relatively simple Rosetta Stone that maps the relationship between a corporation's financial statements, on the one hand, and its taxable income and tax balance sheet, on the other. The Schedule M-3 divides a corporation's income and deductions into 30 or so categories, and then requires the taxpayer to reconcile the amount in each category for tax purposes with the comparable amount attributable to that category for financial statement purposes.

[1] For convenience, I include in my references to Schedule M-3 the revised Schedule L as well; the former is an income statement reconciliation, and the latter a balance sheet reconciliation that relies on the same basic reconciliation principles.

Don't Mandate the Release of the Entirety of Corporate Tax Returns.

A very recent IRS News Release describing its corporate tax return e-filing program revealed that General Electric's 2005 tax return was the electronic equivalent of a 24,000 page document.[2] I hope that the IRS knows what to do with those 24,000 pages; I am reasonably confident, by contrast, that no public investor, securities analyst or policy expert would. Making such a return public thus would sacrifice the confidentiality of a taxpayer's commercial information for very little benefit to the public. In fact, the only group that I can see that would benefit from the public release of tax returns of similar heft conceivably might be competitors; in theory, they could invest the resources required to develop systems to mine the data contained in such returns to discover important information relating to a corporation's strategic and budgetary decisions.

For these reasons, I believe that this Committee ought not to pursue the idea of requiring a corporation to release to the public all or substantially all of its federal income tax return. The Schedule M-3, however, is different, both in its size, in its lack of confidential commercial data, and in the utility of the information its public release would convey to investors and policymakers alike.

Investors Will Directly Benefit From Public M-3's

U.S. financial statement accounting principles and the Internal Revenue Code have similar objectives — to measure the changes in a corporation's financial results and condition from period to period — but operate largely independently of each other. As such, financial accounting principles and the federal income tax system are rival models that each

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2 IR-2006-84 (May 31, 2006), reprinted 2006 TNT 105-5.

attempt to describe the entirety of private economic activity. Each model in turn is conditioned by decades of its own internal history and its responses to different external pressures.

Before the Schedule M-3, the IRS was accustomed to reviewing a corporation's financial results almost entirely through the prism of its federal income tax return.[3] Now that the Schedule M-3 has been developed, the IRS for the first time can see a corporation's financial performance with binocular vision. In other words, by pondering the sources of any differences between financial statement and taxable income, and the underlying transactions from which those differences spring, the IRS can more easily develop an accurate perception of the three-dimensional reality of a company's economic performance and tax profile, and thereby tailor its audit examination of the company accordingly.

Similarly, investors and policymakers today are conditioned to view the financial performance of publicly-held corporations solely through the prism of financial accounting conventions, and corporate managers of course manage with a view to achieving financial accounting targets. In the absence of any other viewpoint, investors and managers alike often confuse a corporation's financial statements with the underlying economic reality that those accounting principles seek to model: that is, they treat the model as if it were reality.

Investors deserve the same sort of stereoscopic insights into public companies' performances that the IRS now enjoys. The public disclosure of the Schedule M-3's of publicly-held companies would permit just that.[4] At the same time, the public release of a public

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[3] I have previously described the inadequacies of the Schedule M-3's predecessor, the Schedule M-1, in "Disclosing Book-Tax Differences," 96 *Tax Notes* 999 (August 12, 2002).

[4] Technically, a corporation must file as part of its federal income tax return a separate Schedule M-3 for every subsidiary in its group. I envision, however, that public companies would be required to disclose only a single consolidated Schedule M-3 at the parent company level, because that consolidated schedule would correspond with the consolidated GAAP financial statements to which investors have access.

company's Schedule M-3 (which, after all, is just a set of relatively high level book-tax reconciliation information by category of income and expense) should not expose that company to the risk of revealing proprietary commercial information to competitors — especially when compared to the geographic and business segment information already available to the public in SEC filings. Similarly (and certainly with the development of appropriate headings), publicly-available Schedule M-3's should not cause investor confusion or reasonably be mistaken for some alternative means of reporting financial results. The public release of the consolidated Schedule M-3 thus would not expose material proprietary *commercial* information to public scrutiny, but would still have direct and material *financial* benefits for investors.

Investors today do not enjoy the more nuanced understanding of corporate financial results that the Schedule M-3 would provide. In addition, they know shockingly little about the cash tax liabilities of public corporations, because the financial statement "current" tax liability provision is not equivalent to cash taxes paid and payable in respect of that year. Corporations today often reflect in their financial statement tax provisions reserves for "contingent" tax liabilities — that is, the expected cost of resolving ongoing or anticipated disputes with tax authorities. The existence of these reserves, and the relatively subjective standards applicable to setting them (and releasing them), at least theoretically present a possible opportunity for earnings management. More generally, in the absence of any transparency on tax matters, investors have no ability to question how tax practices and behavior might affect the quality of corporate earnings.

To address these points, I recommend that the release of public corporations' Schedule M-3's be accompanied by a simple reconciliation of cash taxes paid to a company's tax provision.[5] The combined public disclosure of the consolidated Schedule M-3 and the accompanying reconciliation schedule of cash taxes paid to the financial statement current tax provision would permit investors to bring stereoscopic vision to bear on corporate financial performance, would reduce any potential for corporate earnings management through the timing of additions to, and releases from, tax reserves, and would permit a more pointed analysis of the quality of a company's tax expenses and appetite for tax risk.[6] These are powerful reasons to proceed with the idea.

<u>Public M-3's Will Modestly Help Tax Administration.</u>

The public release of Schedule M-3's also can be expected to have a modestly helpful impact on curbing corporate tax shelter activities. The development of the M-3 of course was an enormously important step forward for the administration of the corporate tax system. In fact, in my view, it was the most important innovation in corporate tax compliance in the last decade or more. But the direct beneficiary of this development — the IRS — does not need public disclosure in order to reap the benefits of using the Schedule M-3 to perform more targeted audit examinations of corporate taxpayers.

Nonetheless, at the margin, Schedule M-3 disclosure might dampen some corporate enthusiasm for tax shelter transactions. The Schedule M-3 in fact requires a corporate taxpayer to list each "Reportable Transaction" in which it has engaged. The public release of the consolidated Schedule M-3 thus might make plain to investors that the source of a company's enhanced after-tax earnings was the wholesale pursuit of aggressive tax trades, and managers in

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[5] The Schedule M-3 does not contain such a reconciliation table because the IRS already has the information: the IRS knows the cash taxes paid by a corporation from the face of its return.

[6] I understand that FASB currently is considering requiring a similar reconciliation schedule that would show changes from period to period in a corporation's tax contingency reserve, to be effective as of 2007. My understanding, however, is that FASB has not yet adopted this proposal as a final rule.

turn might therefore become less interested in following such strategies. By the same token, the public release of the M-3 also should make more apparent those cases, like that of Enron, where corporations design complex structures to hold assets "off balance sheet" that they simultaneously view as owned by themselves for tax purposes. In practice, however, the principal importance of the M-3 in the battle against corporate tax shelters is the information that the M-3 already provides to the IRS, not the information its public release might offer investors.

Public M-3's Will Improve the Quality of Tax and Accounting Systems as a Whole.

The final reason to release the Schedule M-3's of publicly-held companies is the benefits that public release of the Schedule will have to the tax and financial accounting systems as a whole, and to citizens' understanding of the tax burdens that many corporations shoulder. Many policymakers today are troubled by the fact that the gap between corporate pre-tax financial statement income and taxable income as reported to the IRS exceeded $200 billion in 2002 (the most recent year for which data was available). Some of these policymakers believe that this gap can only be explained by substantial and as yet undetected corporate tax shelter activity (a belief that, I at least, do not share). Other observers, by contrast, are concerned that releasing the Schedule M-3's of publicly-held companies will create opportunities for random public flagellations of corporations that have done nothing wrong, because there are many logical and harmless reasons why taxable income can diverge from financial statement income.

These conflicting perspectives in fact coexist because of a single underlying fact, which is that *no one knows* all the sources of this $200 billion book-tax earnings gap.[7] If the Schedule M-3's of publicly-held companies were available to the public, the current collective

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[7] Desai, "The Divergence Between Book and Tax Income," in J. Poterba, ed., *Tax Policy and the Economy* (17), 169-206 (MIT Press 2003).

uncertainty as to the reasons for the book-tax earnings gap would dissipate. We could replace wild suppositions about the source of book-tax earnings differences with actual facts, susceptible of being cataloged and analyzed, and citizens would have a fair picture of how and why corporate taxable incomes differ from financial statement earnings.

Armed with hard information, the designers and maintainers of each rival model (financial accounting and tax) in turn might learn something from the other. That is, there is nothing necessarily wrong with the financial statement income of any particular industry regularly exceeding its aggregate taxable income, but that fact might lead this Committee, for example, as one of the institutions responsible for maintaining the U.S. tax system, to review whether current tax law accurately captures the industry's annual economic results — or, just as legitimately, that fact might lead FASB to review whether current financial accounting standards might not be the model that is in need of an overhaul.

Good quality data derived from publicly-available Schedule M-3's about book-tax differences thus would enable academics and the maintainers of each system (financial statement and tax) to revisit whether one model or the other might require *recalibration*. Fresh vantage points will lead to increased perspective, and with that better vision will come greater insight into how to capture all the complexity of modern economic activity in both financial income statements and tax returns.

SCHEDULE M-3 (Form 1120)

Department of the Treasury
Internal Revenue Service

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

▶ Attach to Form 1120.
▶ See separate instructions.

OMB No. 1545-0123

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 . . . . ☐☐☐☐☐☐☐☐☐

4	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	**4**	
5a	Net income from nonincludible foreign entities (attach schedule)	**5a**	( )
b	Net loss from nonincludible foreign entities (attach schedule and enter as a positive amount) . .	**5b**	
6a	Net income from nonincludible U.S. entities (attach schedule)	**6a**	( )
b	Net loss from nonincludible U.S. entities (attach schedule and enter as a positive amount) . . .	**6b**	
7a	Net income of other includible corporations (attach schedule)	**7a**	
b	Net loss of other includible corporations (attach schedule)	**7b**	( )
8	Adjustment to eliminations of transactions between includible corporations and nonincludible entities (attach schedule)	**8**	
9	Adjustment to reconcile income statement period to tax year (attach schedule)	**9**	
10	Other adjustments to reconcile to amount on line 11 (attach schedule)	**10**	
11	**Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10	**11**	

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 **Total income (loss) items.** Combine lines 1 through 26				
28 **Total expense/deduction items** (from Part III, line 36)				
29 Other income (loss) and expense/deduction items with no differences				
30 **Reconciliation totals.** 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) ☐ Consolidated group (2) ☐ Parent corporation (3) ☐ Consolidated eliminations (4) ☐ 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	**Total expense/deduction items.** Combine lines 1 through 35. Enter here and on Part II, line 28				