Reducing the Tax Gap from Underreporting of Small Businesses through Book-Tax Disclosures: Lessons from the Schedule M-3

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1. Introduction

Taxpayers underpaying the taxes they legally owe is always going to be a problem in a voluntary tax system, like the one employed in the United States. This does not mean however that Congress and the Internal Revenue Service should not continue to strive to decrease the amount of taxes owed that go unpaid. To put it another way, Congress and the IRS should always be on the lookout for ways to increase taxpayer compliance with the tax rules as they exist.

The difference in what a taxpayer owes and what they actually pay is referred to as the "tax gap." Congress and the IRS periodically implement new rules in attempts to reduce the tax gap. Even more frequently, scholars and industry experts make recommendations of means by which to reduce the tax gap. This paper seeks to add to the discussion of reducing the tax gap as it pertains to business income taxes by pointing out areas that might benefit from further research as well as providing a few barebones recommendations. Specifically, this paper recommends expanding the already existing Schedule M-3 to smaller companies and including some parts of the Schedule M-3 on the Schedule M-1 for companies not required to file a Schedule M-3. This paper also suggests considering incentivizing businesses to receive some level of review of their financial statements by an independent Certified Public Accountant.

This paper proceeds as follows. Part 2 provides a discussion of the tax gap. The tax gap is defined, what makes up the tax gap is analyzed, and finally, examples of others' proposals to reduce the tax gap are examined. Part 3 provides a discussion of book-tax conformity. Book-tax conformity is defined, examples of prior book-tax conformity proposals are analyzed, and lessons are drawn from the prior proposals. Part 4 makes recommendations of possible ways to help reduce the tax gap and concludes.

2. The Tax Gap

a. Tax Gap Defined

The "tax gap" is the term used to define the difference in the total true tax owed by all taxpayers and the actual tax amounts paid by all taxpayers.[1] The tax gap is viewed as a measure of "the annual amount of 'noncompliance' with the Code."[2] The IRS periodically estimates the tax gap through a complicated statistical analysis of audits and various other indicators of tax noncompliance that they believe contribute to the tax gap.[3] The IRS then reports the tax gap in gross and net amounts. The gross tax gap is defined as the "amount of true tax liability that is not paid voluntarily and timely."[4] The net tax gap is defined as the "gross tax gap less tax that subsequently will be paid, either paid voluntarily or collected through IRS administrative and enforcement activities" or more simply as, "the portion of the gross tax gap that will not be paid."[5] The IRS then further breaks down the tax gap and reports it based on the type of tax, the type of taxpayer, and the method of noncompliance (either from non-filing, underreporting, or underpayment) that the gap stems from.[6]

For the tax years 2011 through 2013, the IRS estimated the annual gross tax gap at $441 billion.[7] The annual net tax gap was estimated at $381 billion.[8] For all tax types, underreporting

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[1] Kyle D. Logue & Gustavo G. Vettori, *Narrowing the Tax Gap Through Presumptive Taxation*, 2 COLUM. J. TAX L. 100, 101 (2011).
[2] Dave Rifkin, *An Overview of the Tax Gap*, 86 TAX MAG. 27, 27 (2008).
[3] *See* INTERNAL REVENUE SERVICE, FEDERAL COMPLIANCE RESEARCH: TAX GAP ESTIMATES FOR TAX YEARS 2011-2013 1 (2019) (hereinafter TAX GAP 2011-2013); *id.*
[4] TAX GAP 2011-2013 *supra* note 3 at 4.
[5] *Id.*
[6] *Id.* at 4-5.
[7] *Id* at 8.
[8] *Id.*

was the largest method of tax noncompliance.[9] Relevant to the discussion of this paper, $147 billion of the annual total tax gap for 2011 through 2013 came from underreporting of income by businesses in one form or another.[10] That is one-third of the total tax gap for those years coming from underreporting by businesses.

b. Prior Tax Gap Proposals

Means and methods of reducing the tax gap have been the subject of numerous research projects.[11] One recent proposal has come from Fred Forman and former IRS Commissioner Charles Rossotti.[12] At a general level, the Rossotti proposal has two main parts. First, it calls for additional reporting of income information from third parties.[13] These reports would be similar to the Form 1099's that are required to be filed by individuals and businesses engaging in certain activities with taxpayers.[14] Under the Rossotti proposal, banks would be required to report deposits and receipts from businesses and individuals to the IRS; taxpayers would then be required to

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[9] *Id.*

[10] *Id.* $110 billion of the $147 billion came from business income from either passthrough or disregarded entities that would have been reported on individual tax returns. $26 billion came from large corporations, defined as corporations with $10 million or more in assets. The final $11 billion came from small corporations, defined as corporations with less than $10 million in assets.

[11] *See generally e.g.*, W. Edward Afield, *Dining with Tax Collectors: Reducing the Tax Gap Through Church – Government Partnerships*, 7 RUTGERS BUS. L.J. 53 (2010) (providing a unique proposal to reduce the tax gap by having the IRS partner with religious institutions to portray paying taxes as a moral issue); Logue *supra* note 1 (analyzing the possibility of changing the U.S. tax code to one that taxes businesses based on some form of gross receipts in an effort to reduce or eliminate the underreporting tax gap); Charles O. Rossotti, *Recover $1.6 Trillion, Modernize Tax Compliance and Assistance*, 166 TAX NOTES FEDERAL 1411 (Mar. 2, 2020) (proposing a plan to reduce the tax gap by updating the audit technology and processes that the IRS currently utilizes and increasing the types of income that must be reported to the IRS by third parties) (hereinafter Rossotti 1).

[12] *See* Rossotti 1 *supra* note 11; Charles O. Rossotti & Fred L. Forman, *Recover $1.6 Trillion, Modernize Tax Compliance and Assistance: The How-To*, 168 TAX NOTES FEDERAL 1961 (Sept. 14, 2020) (hereinafter Rossotti 2).

[13] *See* Rossotti 1 *supra* note 11; Rossotti 2 *supra* note 12.

[14] *See* Rossotti 1 *supra* note 11; Rossotti 2 *supra* note 12.

reconcile the bank reports to their tax returns.[15] The second, and more fiscally costly, part of the proposal is to update the technology available to the IRS and increase its workforce.[16] The proposed additions would require increasing the IRS's budget by an estimated 50%[17] and would allow the IRS to more easily identify tax returns for audit and process returns faster.[18] There have been other similar proposals that call for improving the IRS's capability to enforce the tax rules through additional IRS funding.[19] While I agree that the IRS needs more enforcement funding, proposals like Rossotti's face a major hurdle in that giving additional funding to the IRS is a politically unfavorable proposition.[20]

Funding the IRS has historically been an afterthought for Congress.[21] The IRS's budget has routinely been decreased over the last decade by about 20 percent (adjusted for inflation) over that time period.[22] This is due, at least in part, to the way the budget rules used by Congress work.[23] Under the scorekeeping guidelines established by the Balanced Budget Act of 1997, last updated in 2015, costs attributable to greater enforcement of tax laws are not includable in Congressional budgetary projections, only changes to the tax law itself can be counted in projections.[24] This means that any proposed increases in IRS enforcement appropriations will not be offset by projected increases in revenues coming from the increased enforcement. A politician proposing to

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[15] *See* Rossotti 1 *supra* note 11; Rossotti 2 *supra* note 12.
[16] *See* Rossotti 1 *supra* note 11; Rossotti 2 *supra* note 12.
[17] *See* James W. Wetzler, *Can Tax Enforcement Raise Big Bucks?*, 169 TAX NOTES FEDERAL 597, 601 (Oct. 26, 2020).
[18] *See* Rossotti 1 *supra* note 11; Rossotti 2 *supra* note 12.
[19] *See e.g.*, Sarin and Summers, *Shrinking the Tax Gap: Approaches and Revenue Potential*, NBER Working Paper No. 26475 (2019).
[20] *See* Wetzler *supra* note 17.
[21] Charles P. Rettig, *Overview: IRS Examination Process*, 16 J. TAX PRAC. & PROC. 15, 15 (2014).
[22] CONGRESSIONAL BUDGET OFFICE, TRENDS IN THE INTERNAL REVENUE SERVICE'S FUNDING AND ENFORCEMENT 8 (July 2020).
[23] *See* Wetzler *supra* note 17.
[24] *See* CONGRESSIONAL BUDGET OFFICE *supra* note 22 at 21.

increase the IRS's enforcement budget would only be able to project the total cost of the plan without projecting the potential inflows that would result from additional compliance. Congress could change the scorekeeping guidelines to allow enforcement projections to be counted[25] however, this may be unlikely since these rules were established for legitimate reasons.[26] This makes proposals for reducing the tax gap that rely on increasing the IRS's enforcement budget potentially difficult to get passed. It may be beneficial then to examine the feasibility of proposals that seek to reduce the tax gap through either tax law changes or require only small amounts of IRS funding. This paper suggests a few proposals that may fit within these types of plans. These proposals begin with a discussion of book-tax conformity.

3. Book-Tax Conformity

a. What is Book-Tax Conformity?

Book-tax conformity refers to the idea that the net income reported by a company on its financial statements should equate to the net income reported by the company for tax purposes.[27] Under the corporate tax code it is possible, and probable, that a corporation's book and tax net income will differ. This is because the financial accounting rules[28] and tax rules diverge on treatment and calculation of certain items of income and expense.

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[25] *See* Wetzler *supra* note 17.

[26] *See* CONGRESSIONAL BUDGET OFFICE *supra* note 22 at 21. The rule against including enforcement projections was created "in large part to avoid crediting uncertain potential savings as an offset against certain upfront spending."

[27] Linda M. Beale, *Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor*, 24 VA. TAX REV. 301, 305 (2004).

[28] In the United States the financial accounting rules are called Generally Accepted Accounting Principles (GAAP) and are published in Accounting Standard Codifications (ASC). Internationally, the financial accounting rules used in many developed countries are called International Financial Reporting Standards (IFRS).

Understanding the reasons for the differences in book and tax net income begins with understanding what a tax base is. As defined by The Tax Foundation, a "tax base is the total amount of income, property, assets, consumption, transactions, or other economic activity subject to taxation by a tax authority."[29] In simpler terms, the tax base is the final number that a tax is assessed on. For United States business income tax purposes,[30] the tax base begins with a company's book income.[31] Book income is then adjusted when other tax code provisions require it, or when "the method used does not clearly reflect income,"[32] to arrive at the final tax base.[33]

Some examples of common transactions where the tax code provides for different treatment than GAAP are: calculation of cost of goods sold,[34] timing and deductibility of paid

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[29] *Tax Basic: What is a Tax Base?*, TAX FOUNDATION https://taxfoundation.org/tax-basics/tax-base/ (last visited Oct. 24, 2020).

[30] In this article I will refer to United States business income tax generally. Large variances exist between the tax treatment of different business entities (particularly as between pass-through and corporate entities). However, it is sufficient for purposes of this article to generally reference all income taxes that have a tax base derived from financial statements in the same form.

[31] *See* I.R.C. § 446(a) (2018) (stating "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books").

[32] I.R.C. § 446(b) (2018).

[33] Code section 446 has never been interpreted to mean that taxable income begins with book income — section 446 is often litigated and interpreted by the IRS regarding specific transactions not addressed in the code or for changes in the general method of accounting used by a taxpayer. However, other than the commonsense reason for starting the taxable income calculation with book income (what other number would you base taxable income off?), this interpretation of section 446 is consistent with the history of the tax code prior to the enactment of section 446 in 1954, see Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35, 109-10 (2003).

[34] Cost of goods sold differences can arise for numerous reasons including different treatments of obsolete inventory; generally expenseable at obsolescence for book purposes (see ASC 330) but only after certain dispositions for tax purposes (see 26 C.F.R. § 1.471-2(c)). Code section 263A, requiring capitalization of certain general operating expenses also frequently results in costs of goods sold differences.

expenses,[35] disallowance or nonexistence of expenses,[36] excepting certain income from tax,[37] gain or loss on the sale of assets,[38] amounts taken for depreciation on assets,[39] and net operating and capital loss carrybacks and carryforwards.[40] The list of potential book and tax differences is seemingly never ending but these are some of the most common and easily explainable differences.

Book and tax differences can be further classified as either temporary or permanent differences. Temporary differences are differences where, given a long enough timeline, book and tax income will eventually converge (the differences exist only because of differences in the timing of recognizing transactions between book and tax).[41] Permanent differences are differences where, regardless of how long of a timeline there is, book and tax income will never converge (the differences occur because a transaction is denied or isn't recognized under either book or tax).[42] From the book-tax differences listed above, depreciation differences and net operating loss carrybacks and carryforwards are examples of temporary differences. Disallowance of deductions or exception from income are examples of permanent differences. In theory, temporary differences will have a net zero effect on the differences in book and tax net income since the differences will

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[35] *See e.g.*, business start-up expenses which are deductible immediately for financial accounting purposes (*see* FASB ASC 740-10-25-25) but for tax purposes are deductible up to $5,000, subject to phase-outs, in the initial year of the business with the excess expenses amortized over 180 months (I.R.C. §195).

[36] *See e.g.*, I.R.C §274 limiting or eliminating expenses paid for meals and entertainment.

[37] *See e.g.*, I.R.C. §103 excepting interest on municipal bonds from federal income tax.

[38] *See e.g.*, I.R.C. §1031 allowing deferral of gain on asset transfer where certain requirements of asset exchange are met.

[39] Tax depreciation is calculated according to fixed lives and rates of deprecation (*see* I.R.C. §168). GAAP depreciation is calculated according to more flexible standards that seek to allocate the cost of an asset over its useful life (*see* FASB ASC 360-10-35-4).

[40] *See* I.R.C. 172 allowing carrybacks and carryforwards of net operating losses that otherwise would not be recognizes for tax purposes in the current year. This is opposed to financial accounting which allows businesses to have net operating losses in their current year.

[41] *See* Michelle Hanlon & Terry Shevlin, *Book-Tax Conformity for Corporate Income: An Introduction to the Issues*, in 19 TAX POLICY AND THE ECONOMY 101, 105

[42] *See id.*

eventually be rectified. In reality certain code provisions allow for seemingly never-ending deferral where certain conditions are satisfied.[43] Permanent differences will result in book and tax income never converging, as the name implies.

Differences in book and tax income are what results in the situations of companies reporting net income on their financial statements and yet reporting little to no net income on their tax return. These incongruities in the two net income numbers have led some to perceive the United States corporate income tax structure as unfair or to view large corporations as tax cheats. Aside from the public perception of book-tax differences as evidence of a broken tax system, there have been some who have speculated that high degrees of book-tax differences may be an indicator of tax fraud.[44] It is from these two beliefs that many of the proposals for book-tax conformity have arisen.

b. Book-Tax Conformity Proposals: Past and Present

Proposals for book-tax conformity have come in many different varieties and have been around for a long time. Proposals have ranged from complete book-tax conformity to partial conformity to merely providing more disclosure of book-tax differences. How the proposals function depends on the evil the proposal is trying to rectify. Book-tax conformity proposals can be put into three general categories: proposals to rectify perceived unfairness, proposals to create

[43] *See e.g.*, I.R.C. § 1031 allowing deferral of gain where business property is sold in exchange for other business property.

[44] *See e.g.*, Mitchell L. Engler, *Corporate Tax Shelters and Narrowing the Book/Tax GAAP,* 2001 COLUM. BUS. L. REV. 539 (2001); Linda M. Beale, *Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor*, 24 VA. TAX REV. 301 (2004); Luppino *supra* note 33.

a simplified tax base, and proposals to increase disclosure of book-tax differences. The second two types of proposals are relevant to this paper as they have the goal of increasing tax compliance.

i. Proposals to Rectify Perceived Unfairness

While not directly relevant to the topic of this paper, book-tax conformity proposals to rectify perceived unfairness share many of the same pitfalls as proposals to create a simplified tax base so I will briefly introduce them here.[45] These proposals often focus on creating 100% book-tax conformity or as close to 100% as possible. Examples of these kinds of proposals are the then Democratic primary candidates Joe Biden's and Elizabeth Warren's 2020 presidential campaign proposals. Both of these proposals have been examined in depth[46] and so they will only be briefly explained here.

The Biden book-tax conformity plan has been proposed as a form of alternative minimum tax.[47] Under the Biden proposal, corporations would pay a 15% minimum tax on their global book

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[45] I say "perceived" unfairness because, as discussed in more depth later, "[b]ook income and taxable income differ because they are prepared for different purposes and audience — and the differences are not inherently bad." Kyle Pomerleau, *Joe Biden's Alternative Minimum Book Tax*, TAX NOTES (Oct. 5, 2020), https://www.taxnotes.com/tax-notes-federal/corporate-taxation/joe-bidens-alternative-minimum-book-tax/2020/10/05/2d056.

[46] *See e.g.*, MERMIN ET AL., AN UPDATED ANALYSIS OF FORMER VICE PRESIDENT BIDEN'S TAX PROPOSALS (Oct. 15, 2020), https://www.taxpolicycenter.org/publications/updated-analysis-former-vice-president-bidens-tax-proposals/full; KYLE POMERLEAU, AN ANALYSIS OF SENATOR WARREN'S 'REAL CORPORATE PROFITS TAX' (Apr. 18, 2019) https://taxfoundation.org/elizabeth-warren-corporate-tax-plan/ ;Jennifer Epstein, *Biden to Target Tax-Avoiding Companies Like Amazon With Minimum Federal Levy*, BLOOMBERG (Dec. 4, 2019, 12:25 PM), https://www.bloomberg.com/news/articles/2019-12-04/biden-to-target-tax-avoiding-companies-with-minimum-federal-levy

[47] An alternative minimum tax is one that "operates alongside the regular income tax" and "requires some taxpayers to calculate their liability twice — once under the rules for the regular income tax and once under the [alternative minimum tax] rules — and then pay the higher amount." *Key Elements of the U.S. Tax System: What is the AMT?*, TAX POLICY CENTER (https://www.taxpolicycenter.org/briefing-book/what-amt) (last visited Nov. 1, 2020).

income.[48] The Biden proposal could potentially allow for certain tax specific deductions to still apply, namely the foreign tax credit[49] and net operating loss carryforwards.[50] There could potentially be an exclusion of the first $100 million of income under the Biden proposal. [51]

The Warren proposal was very similar to the Biden proposal. The primary differences were that the tax rate would have been 7%, there was a $100 million net income exemption, and there were presumably no allowable book-tax differences or credits.[52] This would have made the Warren proposed tax more of an *additional* minimum tax as opposed to an alternative minimum tax as corporations presumably would have paid this tax on top of their normal tax liability.

Both the Biden and Warren proposed taxes are a form of book-tax conformity as far as their minimum tax calculation is concerned. The Biden and Warren book-tax conformity proposals are primarily designed to raise additional revenue by making very large companies pay additional taxes based on their book income. While this paper seeks to propose methods of increasing compliance for companies smaller than those that would be affected by the Biden and Warren

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[48] *See* MERMIN *supra* note 46 at 12.
[49] The foreign tax credit is provided under I.R.C § 904 and is designed "to mitigate international double taxation" by reducing a taxpayer's tax due with "a dollar-for-dollar credit for foreign income taxes imposed on a particular item of foreign-source income." Robert J. Peroni, *A Hitchhiker's Guide to Reform of the Foreign Tax Credit Limitation*, 56 SMU L. REV. 391, 391-92 (2003). Credits are not book-tax differences but can still result in a perceived unfairness to the tax code since it reduces the amount of US income tax paid.
[50] *See* MERMIN *supra* note 46 at 12.
[51] It is unclear if the $100 million income exemption is still part of the Biden proposal. *See* EPSTEIN *supra* note 46 (reporting in December 2019 that the Biden minimum tax would only be imposed on "companies that reported net income of more than $100 million). *But see* MERMIN *supra* note 46 (providing an in-depth analysis of the Biden proposal in October 2020 but making no mention of the $100 million income exclusion).
[52] *See* Team Warren, *I'm Proposing a Big New Idea: The Real Corporate Profits Tax*, MEDIUM (Apr. 11, 2019), https://medium.com/@teamwarren/im-proposing-a-big-new-idea-the-real-corporate-profits-tax-29dde7c960d (there were no mentions of allowable book-tax differences or credits in the Warren proposal. However, she did not win the 2020 Democratic Primary so they may have been part of a more in-depth plan had she won).

proposals, the Biden and Warren proposals are relevant in that they share many of the same downfalls as book-tax proposals intended to create a simpler tax base.

ii. Proposals to Create a Uniform or Simple Tax Base

Some proposals are aimed at creating a uniform tax base for creating simplicity in the tax code. These proposals often focus on creating only partial book-tax conformity. An example of this kind of proposal is the Organisation for Economic Cooperation and Development (OECD) proposal for taxation of the digitalized economy. An in-depth review of the OECD proposal is beyond the scope of this paper and is being addressed by numerous other works as the OECD continues to discuss and adjust their proposal. Instead, only a brief overview of the OECD proposal is provided here as it relates to the topic of this paper.

The OECD proposal is designed to address concerns about manipulation of international tax rules that have allowed companies to shift their digital profits to potentially wrong jurisdictions.[53] The proposal is still being discussed but as it stands now the plan is to use a form of book-tax conformity to reallocate profits to the correct jurisdictions and to assess a tax based on consolidated financial statements.[54] Part of the reasoning for using a form of book-tax conformity is that consolidated financial statements are readily available and not as easily manipulated.[55] The OECD has acknowledged that some book-tax differences will need to remain for the plan to

[53] *See* Mindy Herzfeld, *Taxing Corporations on Financial Statement Earnings: Current Proposals, Long-Standing Concerns*, (forthcoming).
[54] *See id.*
[55] *See id.*

provide a proper measure of taxable income.[56] Exactly what book-tax differences should be allowed is an ongoing discussion.[57]

There have historically been other proposals similar to the new OECD proposal — proposals designed to simplify the tax base in an attempt to increase tax compliance. Scholarly works following the accounting scandals of the early 2000's called for such proposals.[58] President George W. Bush's 2005 Advisory Panel on Federal Tax Reform considered the idea of taxing book income.[59] On the non-U.S. front, the European Union (EU) has previously considered assessing tax on some form of book income.[60] While the 2003 EU proposal was concerned with making compliance with the multitude of tax rules of the EU's member nations simpler, simplifying compliance could potentially lead to greater compliance.[61]

iii. Pitfalls of Traditional Book-Tax Conformity Proposals

Regardless of the reason for the proposal, book-tax conformity proposals have been reviewed numerous times over the years in scholarly and other works.[62] All of the reviews of book-

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[56] *See id.*
[57] *See id.*
[58] *See id.*
[59] *See* THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM (Nov. 2005). While the primary goal of the Advisory Panel's report was not merely to simplify the tax base to increase tax compliance, the Panel did conclude that "non-compliance has been steadily rising over the past two decades, a troubling indicator that our tax code's growing complexity is inviting more cheating."
[60] *See Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee – An Internal Market Without Company Tax Obstacles: Achievements, Ongoing Initiatives and Remaining Challenges*, COM (2003) 726 final.
[61] *See id.*
[62] *See e.g.*, Linda M. Beale, *supra* note 44; Harold Dubroff et al., *Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles*, 47 ALB. L. REV. 354 (1983); Mindy Herzfeld *supra* note 53; David Prochazka & Jan Molin, *Book-Tax Conformity: The Review of Recent Research and Its Implication for the IFRS Adoption in Europe*, 14 EJOURNAL TAX RES. 96 (2016); Kyle Pomerleau *supra* note 45.

tax conformity proposals find both pros and cons to aligning the book and tax rules. Many of the pros have been discussed above. Among them are greater perceived fairness in the tax system,[63] increased simplicity,[64] and improved efficiency.[65]

All of the reviews also find faults with book-tax conformity. The typically cited arguments against book-tax conformity are: legitimate reasons exist for book-tax differences,[66] it would result in improper deference to non-governmental entities to create the tax rules,[67] and potentially decreased tax revenues, or at least greater ability of companies to defer taxes.[68]

Many of the reviews of book-tax conformity proposals come to the conclusion that the potential negative effects outweigh the potential positive effects, at least where complete book-tax

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[63] A portion of the American population perceives the book-tax differences allowed by the corporate tax code as unfair, *see* Team Warren, *supra* note 52 (promising to "ensure every corporation pays their *fair* share" (emphasis added)). Eliminating this perceived unfairness could then increase what has been called "vertical equity" which in turn could result in greater tax compliance from the taxpayers who now see the tax code as more fair, *see* Lisette van der Hel – van Dijk & Maarten Siglé, *Managing Compliance Risks of Large Businesses: A Review of the Underlying Assumptions of Co-Operative Compliance Strategies*, 13 EJOURNAL OF TAX RES. 760, 764 (2015).

[64] *See* Beale, *supra* note 44 at 359-63 (identifying simplicity as one of the factors considered when grading a tax system and noting that the decrease in tax rules resulting from book-tax conformity would increase simplicity).

[65] *See* Prochazka *supra* note 62 at 98-102 (analyzing research papers that suggest book-tax conformity would result in a more efficient tax system).

[66] *See* Pomerleau *supra* note 45 (pointing out that book income is designed for users of financial statements who need the information to make decisions regarding interacting with the business, either through investing or lending, whereas the tax code is designed for a variety of effects including incentivizing or disincentivizing certain transactions, providing government support to taxpayers, and ensuring that taxpayers are able to pay taxes assessed).

[67] *See* Herzfeld *supra* note 53 (explaining that in most countries, including the United States, the body creating tax rules is separate from the body creating accounting rules. Specifically, in the United States, the entity that creates accounting rules is a non-governmental non-profit organization (FASB) and the entity creating the tax rules is the U.S. Congress. Book-tax conformity would require one of those two entities to subsume the duties of the other).

[68] *See* Pomerleau *supra* note 45 (pointing to certain tax deductions that otherwise don't exist for book purposes to say that book-tax conformity is not guaranteed to increase tax revenues).

conformity is proposed.[69] Where the proposals require less strict book-tax conformity, or place additional safeguards, the pros and cons begin to become more in line.[70]

iv. The Third Category of Book-Tax Proposal: Increased Disclosure for Increased Compliance

The third category of book-tax proposals avoid many of the pitfalls of the other two categories since they do not call for changes to the book or tax rules. Instead, they seek to ferret out tax shelters or otherwise generally increase compliance with the already existing tax rules by requiring more disclosure of book-tax differences.

An example of this kind of proposal came after the major accounting fraud scandals of the early 2000's.[71] In 2003 Lillian Mills and George Plesko suggested expanding the Schedule M-1 as it existed at the time.[72] The Schedule M-1 as it existed in 2003, and since inception in 1963, was a form attached to the form 1120 Corporate Income Tax Return designed to reconcile income or loss per books with income or loss per the tax return.[73] The Schedule M-1 achieved this reconciliation by having corporations: first report their net book income; then add back the amount of federal income tax reported on the current tax return to determine pre-tax book income; and finally, add or subtract book-tax differences, reported in broad categories like "income subject to tax not

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[69] *See e.g.*, Beale *supra* note 44 at 473; Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L.J. 423, 483-84 (2009).
[70] *See* Prochazka *supra* note 62 at 111-12 (concluding that more research may be necessary to properly weigh the pros and cons of book-tax conformity).
[71] *See* Luppino *supra* note 33 (examining the Enron accounting scandal of the early 2000's and the use of book-tax differences to perpetuate fraud).
[72] *See generally* Lillian F. Mills & George A. Plesko, *Bridging the Reporting Gap: A Proposal for More Informative Reconciling of Book and Tax Income* (MIT Sloan, Working Paper 4289-03, 2003). Others made similar proposals around the same time *see e.g.*, Peter C. Canellos & Edward D. Kleinbard, *Disclosing Book-Tax Differences*, 96 TAX NOTES 999 (August 12, 2002).
[73] *Id.* at 24.

recorded on books this year."[74] The IRS described the role of the Schedule M-1 as providing additional indicators to the IRS of tax returns that may need to be audited.[75]

Mills and Plesko argued that the limited disclosures required by the Schedule M-1 hampered the IRS's ability to carry out the stated goal of the Schedule M-1.[76] To better enable the IRS to identify tax returns that should be audited, and to better understand the effects of book-tax differences generally, Mills and Plesko argued for an expanded Schedule M-1.[77] They theorized that requiring additional disclosure would also result in greater voluntary compliance from corporate taxpayers.[78]

On January 28, 2004, the IRS released a draft of their proposed Schedule M-3 — which was in effect the expanded Schedule M-1 that Mills and Plesko argued for.[79] The Schedule M-3 became effective for taxable years ending on or after December 31, 2004.[80]

c. Schedule M-3

Generally speaking, companies that report assets of $10 million or more are required to file Schedule M-3.[81] Companies that report assets of less than $10 million still use the less detailed Schedule M-1.[82] The Schedule M-3 has remained largely unchanged since its introduction in

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[74] *Id.* at 24-29.
[75] *Id.* at 29.
[76] *Id.* at 33-35.
[77] *Id.* at 29-30. *See id* at 51-53 for their proposed expanded Schedule M-1.
[78] *Id.*
[79] Press Release, U.S. Dep't of the Treasury, Treasury and IRS Release Instructions for Schedule M-3 (Mar. 11, 2004), https://www.treasury.gov/press-center/press-releases/Pages/js1232.aspx.
[80] Press Release, U.S. Dep't of the Treasury, Schedule M-3: Frequently Asked Questions (July 7, 2004), https://www.irs.gov/pub/irs-utl/m-3_faq.pdf.
[81] *See* INTERNAL REVENUE SERVICE, INSTRUCTIONS FOR SCHEDULE M-3 (FORM 1120) (2019). Although the Schedule M-3 cited here is only for C corporations, the Schedule M-3 can now be required for most any company type as explained below.
[82] *See id.*

2004.[83] Part I of the Schedule M-3 contains questions pertaining to the company's financial information and a brief summary of the company's book income.[84] Some of the questions in Part I pertain to the company's filings with the SEC, whether or not the company received a "certified audited non-tax-basis income statement," and what accounting standard was used to prepare the company's financial statements.[85] Part II contains a detailed schedule requiring corporations to list items of book and tax income or loss, and reconcile the book and tax numbers by showing the individual permanent and temporary differences that led to the overall book-tax difference.[86] Part III is similar to Part II except that it reconciles items of expenses/deductions for book and tax.[87] Depending on the types of book-tax differences an entity reports on their schedule M-3, there may be additional, more detailed reconciliation forms that must be filed.[88]

Some of the biggest changes in the area of the Schedule M-3 came from expanding who is required to file Schedule M-3. When the Schedule M-3 was introduced, only C corporations with assets of $10 million or more were required to file the Schedule M-3.[89] In 2005, the IRS announced that property and casualty insurance companies filing Form 1120-PC, life insurance companies

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[83] *Compare* INTERNAL REVENUE SERVICE, SCHEDULE M-3 (FORM 1120): NET INCOME (LOSS) RECONCILIATION FOR CORPORATIONS WITH TOTAL ASSETS OF $10 MILLION OR MORE (2004) (hereinafter 2004 M-3), *with* INTERNAL REVENUE SERVICE, SCHEDULE M-3 (FORM 1120): NET INCOME (LOSS) RECONCILIATION FOR CORPORATIONS WITH TOTAL ASSETS OF $10 MILLION OR MORE (DEC. 2019) (hereinafter 2019 M-3).
[84] *See* 2019 M-3, *supra* note 83.
[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] *See e.g.*, INTERNAL REVENUE SERVICE, FORM 8916-A: SUPPLEMENTAL ATTACHMENT TO SCHEDULE M-3 (2019). Form 8916-A provides a more detailed reconciliation of cost of goods sold differences and is filed as a supplement to the overall cost of goods sold difference number reported on Schedule M-3. Form 8916-A is one of the few changes/additions made to Schedule M-3 since its initial creation, *see* John Ledbetter & Lucinda Van Last, *Schedule M-3 Update for 2007*, 85 TAXES – THE TAX MAGAZINE 39, 40-41 (2007).
[89] Ledbetter *supra* note 88 at 39.

filing Form 1120-L, and S corporations filing Form 1120-S with total assets of $10 million or more would be required to file Schedule M-3.[90] Later that same year, the IRS announced that partnerships filing Form 1065 would be required to file Schedule M-3 if they had either: 1) $10 million or more in total assets, 2) $10 million or more in "adjusted total assets," 3) $35 million or more in total receipts, or 4) a "reportable partner."[91] This means that, for the most part, businesses with assets of $10 million or more are currently required to file Schedule M-3.

The Schedule M-3 threshold of $10 million in assets seems to have been determined primarily based on the IRS threshold for the Large and Mid-Sized Business (LMSB) division.[92] Between June 2000 and July 2001 — the time period of particular relevance for the working group tasked with creating the Schedule M-3 — C corporations with assets of $10 million or more, companies that would be required to file a Schedule M-3, accounted for only 2.16 percent of all C corporations (47,056 out of 2,172,705).[93] It is important to note that on top of the working group's report only containing data for the time period of June 2000 through July 2001, their report also does not contain data on entities other than C corporations that would be required to file Schedule M-3.

While the IRS has expanded the Schedule M-3 filing requirement to other entity types, the IRS does not seem to have considered, at least publicly, requiring smaller companies, those with assets of less than $10 million, to file a Schedule M-3. There also does not seem to have been any consideration of including parts of the Schedule M-3 on the Schedule M-1 that smaller companies

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90 *Id.* at 39-40.
91 *Id.* at 40.
92 Charles Boynton & Lillian Mills, *The Evolving Schedule M-3: A New Era of Corporate Show and Tell?*, 57 NAT'L TAX J. 757, 767-68. The LMSB is now the "Large Business and International" (LB&I) division.
93 *Id* at 767.

do file. Additionally, there seems to be a lack of scholarly consideration of these issues. If Mills and Plesko were right that increased disclosure of book-tax differences might result in greater compliance, then perhaps expanding the Schedule M-3 requirements to small and medium sized businesses could help reduce the portions of the tax gap coming from underreporting in those businesses.

4. Recommendations and Conclusion

a. Extending the Schedule M-3 to Smaller Companies

There has been a lot of discussion throughout the history of the U.S. tax code surrounding creating some level of book-tax conformity. Only a small portion of this discussion has revolved around further disclosure of book-tax differences — as opposed to attempting to bring the book and tax rules into some level of conformity — to increase compliance with the tax rules. This seems particularly true for the period after the introduction of the Schedule M-3. This may be because the Schedule M-3 was viewed as having addressed the specific issue it set out to rectify.[94]

Further research may be warranted into first determining if the Schedule M-3 did result in greater compliance, either voluntarily or through the IRS audit process. It may then be worthwhile to consider whether lessons from the greater compliance produced by the Schedule M-3 can be applied in other instances to lower the tax gap that results from business underreporting.

Unfortunately, trying to prove that a taxpayer did *not* commit fraud is difficult if not impossible. Any conclusions would likely be based on inferences from speculative data rather than empirically proven. There have been a few research articles that have theorized some reduction in tax shelter transactions after the introduction of the Schedule M-3. They are largely based on

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[94] *Id.*

conjecture and are often side discussions of larger topics.[95] Additionally, there seems to be little to no research into the effect on voluntary compliance that the Schedule M-3 has or has not had. Voluntary compliance would be particularly desirable since it would not require additional funding for the IRS to conduct audits based on data received from the Schedule M-3.

A few studies have found a positive correlation between increased disclosures and increased voluntary compliance with the tax code.[96] These studies were all focused on the efficacy of OECD recommendations regarding greater disclosure of international transactions of multinational businesses. The conducting of multinational operations, and the reporting of those operations, is much more complex than is involved for domestic small and medium businesses. This makes the application of the findings in these studies dubious regarding the proposals of this paper. However, these studies still found an increase in voluntary compliance where greater disclosure was required and so they should not be deemed completely irrelevant to the issue at hand. This, coupled with a number of articles calling for public disclosure of at least the Schedule M-3 (based on the theory that it will result in greater compliance due to public pressure), [97] suggests that greater disclosure of book and tax amounts could result in greater tax compliance.

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[95] *See e.g.*, Joshua D. Blank, *Reconsidering Corporate Tax Privacy*, 11 N.Y.U. J.L. & BUS. 31 at 113 (2014) (citing to statements from Congressional hearings, other articles, and the IRS calling the Schedule M-3 a "Rosetta Stone" or a "vital roadmap" and that it "would enable [the IRS] to identify taxpayers that 'engaged in aggressive transactions and therefore should be audited.")

[96] *See e.g.*, Preetika Joshi, *Does Private Country-by-Country Reporting Deter Tax Avoidance and Income Shifting? Evidence from BEPS Action Item 13* (forthcoming); Lisa De Simone & Marcel Olbert, *Real Effects of Private Country-by-Country Disclosure* (forthcoming); Jing Huang et al., *Does Private Country-by-Country Reporting Improve the Tax and Earnings Information Environment for Investors?*

[97] *See e.g.*, Joshua D. Blank, *Reconsidering Corporate Tax Privacy*, 11 N.Y.U. J.L & BUS. 31 (2014).

Presuming the Schedule M-3 filing requirement did result in greater tax compliance as projected, it may be beneficial to consider if that effectiveness could be carried to smaller companies. If the primary motivation for limiting the Schedule M-3 to companies with assets of $10 million or more was only because it fit the IRS's divisional thresholds, perhaps a new primary motivation of tax compliance generally would warrant expanding the M-3 to smaller companies.

b. Borrowing from the Schedule M-3

Apart from requiring smaller businesses to file a Schedule M-3, parts of the Schedule M-3 could be borrowed and applied to all business tax filings. The parts that could be borrowed would not require much additional effort from taxpayers to comply with. The lessons from the Schedule M-3 could also be borrowed and adapted to promote further voluntary compliance.

The questions contained in Part I of the Schedule M-3 pertaining to the types of SEC filings made by the company and the level of review from an independent financial accountant provided to the company were created for a reason.[98] These questions were created to allow the IRS to ascertain the level of reliability of the book financial statements, the starting point of all taxable income calculations for businesses.[99] Theoretically, when accompanied by a reconciliation of book and tax differences, more reliable book numbers will result in more reliable tax numbers.[100] It is for this reason that this paper suggests including questions relating to the quality of a company's financial statements, similar to those in the Schedule M-3, regardless of size or entity type.

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[98] Charles Boynton & William Wilson, *A Review of Schedule M-3: The Internal Revenue Service's new Book-Tax Reconciliation Tool*, 25 PETROLEUM ACCT. FIN. MGMT. J. 1 (2006)
[99] *Id.*
[100] If you have a reliable starting point (book income) and are required to show, in a detailed manner, how you got to a different endpoint (taxable income), it is reasonable to assume that it is more difficult to arrive at an unscrupulous taxable income without being detected.

If the theory is correct that an increase in reliable book numbers will result in an increase in reliable tax numbers then perhaps including questions about the reliability of a company's financial statement for all companies, regardless of size or entity type, could result in greater compliance. This might function by both allowing the IRS to better identify tax returns for audit and potentially increase voluntary compliance since businesses would know that the IRS is aware of the level of reliability of their financial statements. It may also be beneficial to incentivize companies to receive some level of independent financial accountant review of financial statements to increase financial statement reliability.

A simple example of an incentive that could be provided where small companies receive some level of financial statement review from an independent CPA could be a simplified IRS examination process at the beginning of IRS audits. The IRS could agree to conduct only a high-level review of a company's audited financial statements in the event of an IRS audit with further IRS review only being conducted if irregularities are found. A more thorough but still simplified audit process could be done for companies that get some review from a CPA but not a full-blown financial audit. These simplified audit incentives should only be given to small companies, perhaps using the $10 million asset threshold that exists currently, for two reasons. First, larger companies probably do not need additional incentivizing to get some level of CPA review of their financial statements. They probably already get some level of CPA review since they likely have more complex financial statements than small companies. Second, because smaller companies are likely less complex than larger companies, it is potentially more difficult for them to hide discrepancies in book numbers and to hide them from the CPA performing the review.

This is just one barebones example of an incentive that could be provided. There likely are many other ways to incentivize small companies to get reviews of their financial statements from an independent CPA that would work just as well or better.

c. Conclusion

Closing the tax gap should be of great concern to tax analysts and proponents of tax reform. For the tax years 2011 through 2013, $381 billion of taxes went uncollected. Of that $381 billion, $121 billion came from underreporting of taxes from businesses other than large corporations. While proposals exist for reducing the tax gap, many of them are likely to be politically undesirable as they require additional funding to be given to the IRS to increase enforcement of the tax laws. This paper suggests that perhaps the tax gap, as it pertains to small businesses, could potentially be reduced by requiring greater disclosure of book-tax differences for small businesses. This could be done by expanding the Schedule M-3 to smaller businesses or by borrowing portions of the Schedule M-3 for the Schedule M-1, which many small businesses already file. While this may increase the IRS's ability to determine what small businesses are not in tax compliance and audit them, more relevant to the discussion of politically favorable proposals, it may also result in additional voluntary compliance with the tax code. This additional voluntary compliance would serve to decrease the tax gap without requiring any additional government expenditures.