



DEPARTMENT OF THE TREASURY OFFICE OF PUBLIC AFFAIRS

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SCHEDULE M-3 FREQUENTLY ASKED QUESTIONS

The Treasury Department and Internal Revenue Service are in the process of finalizing the instructions to Schedule M-3. In advance of finalizing the instructions, Treasury and IRS have assembled the following “Frequently Asked Questions” and responses regarding Schedule M-3, Net Income (Loss) Reconciliation For Corporations With Total Assets of \$10 Million or More, to assist corporations, practitioners, and programmers preparing to implement Schedule M-3. The following guidance will be incorporated into the final Schedule M-3 instructions. The responses below reflect the intent of Treasury and the IRS as of July 7, 2004. However, some modifications to this guidance may be necessary before the Schedule M-3 instructions are finalized.

Q-1: If Schedule M-3 is final, why does the form say “Draft”?

A-1: The final version of Schedule M-3 has been released early as a draft to assist corporations, practitioners, and programmers preparing to implement Schedule M-3. Most annual tax forms are released by the IRS in final form between October 15 and December 31 of the year the form is effective to accommodate revisions to the form necessitated by legislative or regulatory changes, or changes to lines on the form that reference other forms revised as a result of legislation or regulations. Treasury and IRS do not expect any further changes to Schedule M-3 and anticipate that the final version of Schedule M-3 eligible for filing will be available and posted on www.irs.gov in early December 2004.

Q-2: When is Schedule M-3 effective?

A-2: Schedule M-3 is effective for taxable years ending on or after December 31, 2004.

Q-3: Who is required to file Schedule M-3?

A-3: Any corporation (or U.S. consolidated tax group) required to file Form 1120, U.S. Corporation Income Tax Return, that reports on Schedule L of Form 1120 total assets at the end of the corporation's (or U.S. consolidated tax group's) taxable year that equal or exceed \$10 million. (This is the same criterion used to determine whether a corporation is within the jurisdiction of the IRS' Large and Mid-Size Business Division (LMSB)).

Q-4: Must a corporation complete all parts of Schedule M-3 for any taxable year the corporation is required to file Schedule M-3?

A-4: Yes. However, a corporation is required to complete only Part I and Columns B and C of Parts II and III for the corporation's transition year (the first taxable year the corporation is required to file Schedule M-3). Columns A and D of Parts II and III are optional for the corporation's transition year. The corporation must complete Schedule M-3 in its entirety for all other taxable years the corporation is required to file Schedule M-3.

Q-5: If a corporation chooses not to complete Columns A and D of Parts II and III in the corporation's transition year, how is Part II, Line 34, reconciled for the U.S. consolidated tax group in the transition year?

A-5: Part II, Line 34, for the U.S. consolidated tax group is reconciled in the following manner in the transition year: (i) the amount reported on Part I, Line 11, must be reported in Part II, Line 34, Column A; (ii) Part II, Lines 1 through 33, Columns A and D, must be left blank; (iii) Part III, Columns A and D, must be left blank; and (iv) Part II, Line 34, Column D, must equal the sum of Part II, Line 34, Columns A, B, and C.

Q-6: Is each member of a U.S. consolidated tax group required to file its own Schedule M-3?

A-6: Part I of Schedule M-3 must be completed once to report the consolidated information and activity for the entire U.S. consolidated tax group. However, Parts II and III of Schedule M-3 must be completed separately by each member of the U.S. consolidated tax group to reflect each member's own activity. The parent company must complete all parts of Schedule M-3 by including: (i) the consolidated information for the U.S. consolidated tax group in Part I; and (ii) its own separate (i.e., non-consolidated) company information in Parts II and III. Each subsidiary corporation in the U.S. consolidated tax group must complete Parts II and III on its own separate Schedule M-3 to reflect its own activity. Additionally, Parts II and III must be completed on a consolidating Schedule M-3 in order to consolidate all the Schedule M-3 information of the entire U.S. consolidated tax group. For example, if a U.S. consolidated tax group consists of a parent and three subsidiaries, it is anticipated that six Schedule M-3s must be completed and attached to the tax return of the group as follows:

- Parts I, II, and III of a Schedule M-3 by the parent reflecting Part I information for the entire consolidated group and its own activity in Parts II and III;
- Parts II and III of Schedule M-3 by each of the three subsidiaries reflecting their respective activity;

- Parts II and III of a consolidating Schedule M-3 to account for items such as differences between financial statement net income and taxable income related to intercompany transactions and adjustments made at the consolidated group level that are not attributable to any specific member of the U.S. consolidated tax group (e.g., disallowance of net capital losses, contribution deduction carryovers, and limitation of contribution deductions); and
- One consolidated Schedule M-3 with Parts I, II, and III resulting from consolidating those Schedule M-3s described above.

Q-7: Are differences between financial statement net income and taxable income attributable to any reportable transaction (as described in Treas. Reg. § 1.6011-4(b)) required to be separately disclosed on Schedule M-3?

A-7: Yes. Each difference attributable to any reportable transaction (other than a transaction described in Treas. Reg. § 1.6011-4(b)(6); see also Rev. Proc. 2004-45) must be separately stated and adequately disclosed on Part II, Line 12, Items relating to reportable transactions, regardless of whether the difference would otherwise be reported elsewhere on Part II or on Part III. If a reportable transaction gives rise to two or more items of difference, each difference must be separately stated and adequately disclosed on a supporting schedule. Additionally, the description of each difference must reference the specific, identified reportable transaction disclosed on Form 8886, Reportable Transaction Disclosure Statement.

Q-8: If a corporation was required to complete Schedule M-3 in the preceding taxable year and the corporation reports on Schedule L of Form 1120 total assets at the end of the current taxable year of less than \$10 million, is the corporation required to file Schedule M-3 for the current taxable year?

A-8: No. The corporation may either (i) continue to complete Schedule M-3; or (ii) file Schedule M-1. However, if the corporation chooses to file Schedule M-1 and, in a subsequent taxable year, the corporation is required to complete Schedule M-3, the corporation will be required to complete Schedule M-3 in its entirety in that subsequent taxable year (including Columns A and D of Parts II and III). Treasury and IRS currently are evaluating whether a corporation should be required to continue to file Schedule M-3 once it has filed Schedule M-3 for the first time.

Q-9: If a corporation prepares financial statements on an accrual basis and the corporation uses an overall cash method of accounting for federal income tax purposes, must the corporation's total assets at the end of the corporation's taxable year be determined on an accrual basis or on a cash basis for purposes of determining whether the corporation has total assets at the end of the current taxable year of \$10 million or more?

A-9: The corporation's total assets must be determined on an accrual basis, i.e., the same basis as the corporation's financial statements, for purposes of determining whether the corporation has total assets at the end of the current taxable year of \$10 million or more.

Q-10: Is an insurance company that files Form 1120PC or Form 1120L required to complete Schedule M-3?

A-10: Schedule M-3 is not required for any member of a U.S. consolidated tax group if the parent company of the U.S. consolidated tax group is an insurer that files Form 1120PC (U.S. Property and Casualty Insurance Company) or Form 1120L (U.S. Life Insurance Company Income Tax Return), regardless of whether any members of the group file Form 1120. If the parent company of a U.S. consolidated tax group files Form 1120, all members of the group must file Schedule M-3. However, if any member of that group files Form 1120PC or Form 1120L, that member may either (i) fully complete Schedule M-3 as if the member filed Form 1120; or (ii) complete Schedule M-3 by including the sum of all differences between the member's net income (or loss) per the income statement and taxable income ("differences") (regardless of whether the difference would otherwise be reported elsewhere on Part II or on Part III) on Part II, Line 30, Other income (loss) items with differences, and separately state and adequately disclose each difference in a supporting schedule. Any member of the U.S. consolidated tax group that files Form 1120PC or Form 1120L and is required to file Schedule M-3 (in accordance with the preceding sentence) may classify all differences as permanent in Column C or identify differences as temporary or permanent, as appropriate.

Q-11: When will the instructions to Schedule M-3 be finalized?

A-11: It is anticipated that the instructions to Schedule M-3 will be finalized in September 2004.

Q-12: Does Treasury and IRS intend to incorporate Schedule M-3 into other forms?

A-12: Yes. Upon finalizing the instructions to Schedule M-3 for Form 1120, Treasury and IRS will begin analyzing and developing a Schedule M-3 for Form 1065 (U.S. Return of Partnership Income), Form 1120S (U.S. Income Tax Return For An S Corporation), Form 1120PC, and Form 1120L. A comment period will be provided similar to that provided for the Form 1120 Schedule M-3.

Q-13: Does Treasury and IRS intend to update Schedule M-3 annually?

A-13: There is no specific timeframe for updating Schedule M-3. Schedule M-3 will be updated as necessary to ensure that Schedule M-3 obtains information on emerging issues and evolving business trends.

Q-14: If a portion of an item of income, gain, loss, expense, or deduction is treated the same for income statement and federal income tax purposes and a portion of the item gives rise to a difference, does the corporation report all amounts attributable to the item on one line of Parts II or III, as applicable, or is the portion of the item without a difference reported on Part II, Line 31, Other income (loss) items with no differences or Part III, Line 40, Other expense/deduction items with no differences, as applicable, and the portion of the item with a difference reported on the applicable line of Parts II or III?

A-14: All amounts attributable to the item must be reported on the applicable line of Parts II or III and not segregated between that line and Part II, Line 31, or Part III, Line 40, as applicable. For example, if a corporation incurs \$200 of meals and entertainment expenses that were deducted in computing net income per the income statement, and \$50 of the \$200 is subject to the 50% limitation under §274(n), the corporation must report all of its meals and entertainment expenses on Part III, Line 11, Meals and entertainment. Specifically, the corporation reports \$200 in Column A, \$25 in Column B and/or C, as applicable, and \$175 in Column D. The corporation should not report the \$150 of meals and entertainment expenses that were deducted in computing net income per the income statement and are fully deductible for U.S. federal income tax purposes on Part III, Line 40, Other expense/deduction items with no differences, and the \$50 subject to the limitation under §274(n) on Part III, Line 11, Meals and entertainment.

Q-15: Can differences below a certain dollar amount be combined together on Schedule M-3?

A-15: No. Every item of difference must be separately stated and adequately disclosed on Schedule M-3. The final Schedule M-3 instructions will not provide a specific dollar or ratio threshold for materiality.

Q-16: If a U.S. consolidated tax group is controlled by a foreign corporation, financial statements are prepared for the U.S. consolidated tax group, and the foreign corporation prepares financial statements that includes the activity of all members of the foreign corporation's worldwide group (including the U.S. consolidated tax group), what are the appropriate financial statements for purposes of completing Part I?

A-16: The financial statements for the U.S. consolidated tax group must be used for purposes of completing Part I. If no financial statements are prepared for the U.S. consolidated tax group, the U.S. consolidated tax group must enter the net income per the books and records of the U.S. consolidated tax group on Part I, Line 11, Net income (loss) per income statement of includible corporations.

Q-17: If the parent company of a U.S. consolidated tax group is not a publicly traded company but prepares financial statements for the U.S. consolidated tax group, and a member of the U.S. consolidated tax group is a publicly traded company that prepares its own separate financial statements, what are the appropriate financial statements for purposes of completing Part I?

A-17: The financial statements of the parent company of the U.S. consolidated tax group are the appropriate financial statements for purposes of completing Part I.

Q-18: How must a corporation report on Schedule M-3 the corporation's distributive share of income or loss from a partnership, trust, or other flow-through entity that is reported on Schedule K-1?

A-18: The corporation must report the corporation's distributive share of income or loss from a partnership, trust, or other flow-through entity that is reported on Schedule K-1 in the following manner, even if the amount does not result in a difference between the net income (or loss) per the income statement and taxable income:

- Separately report for each Schedule K-1 received the sum of all amounts included in Part I, Line 11, Net income (loss) per income statement of includible corporations, in Column A, Part II, Line 9, Income (loss) from U.S. partnerships, Part II, Line 10, Income (loss) from foreign partnerships, or Part II, Line 11, Income (loss) from other pass-through entities, as applicable.
- With the exception of capital gains and losses, separately report in Column B and/or Column C for each Schedule K-1 received each separately stated item on Schedule K-1 for which a separate line is provided on Schedule M-3, Part II, Line 1 through 29, or Part III, Line 1 through 38 (e.g., Part II, Line 13, Tax-exempt interest, and Part III, Line 19, Charitable contribution of cash and tangible property). Otherwise, report the amount in Column B and/or Column C of Part II, Line 9, 10, or 11, as applicable.
- Report the sum of all net capital gains reported for all Schedule K-1s received on Part II, Line 25, Gross capital gain from includible corporations, and the sum of all net capital losses reported on all Schedule K-1s received on Part II, Line 26, Gross capital loss from includible corporations.

Q-19: Who must complete Part II, Line 14, Total accrual to cash adjustment, and what must be included on this line?

A-19: This line is completed only by a corporation with financial statements (or books and records, if permitted) prepared using an accrual method of accounting that uses an overall cash method of accounting for federal income tax purposes (or vice-versa). The corporation must report on Line 14 a single amount net of all adjustments attributable to the use of the different overall methods of accounting (e.g., adjustments related to accounts receivable, accounts payable, compensation, and accrued liabilities). Differences not attributable to the use of the different overall methods of accounting must be reported on the appropriate line of Schedule M-3 (e.g., depreciation).

Q-20: What must be included on Part II, Line 17, Inventory valuation adjustments?

A-20: Any amounts related to inventory valuation, for example, cost-flow assumptions, additional costs required to be capitalized to ending inventory (including depreciation), inventory shrinkage accruals, inventory obsolescence reserves, and lower of cost or market write-downs must be included on Part II, Line 17. Excluded from this line are section 481(a) adjustments related to inventory valuation, which must be reported on Part II, Line 19, Section 481(a) adjustments.

Q-21: What must be included on Part II, Line 23, Income statement gain/loss on disposition of assets other than inventory?

A-21: All gains and losses on the disposition of assets other than inventory that are included in the net income (loss) per income statement of includible corporations reported on Part I, Line 11, even if there are no differences between the gain or loss included in net income (or loss) per the income statement and taxable income must be included on Part II, Line 23. Thus, unless otherwise required to be reported on a separate line of Part II, such gains and losses must be

reported on Part II, Line 23, Column A, and reversed in Part II, Line 23, Columns B and/or C, as applicable. The corresponding gains and losses for U.S. federal income tax purposes are reported on Part II, Lines 24-27, as applicable, unless required to be reported elsewhere on Part II.

Q-22: Must Part III, Lines 1-6, regarding current and deferred U.S., state, and foreign income taxes, be completed by each member of the U.S. consolidated tax group?

A-22: No. Part III, Lines 1-6, must be completed in accordance with how tax expense is expressed in the financial statements (or the books and records, if applicable) of the members of the U.S. consolidated tax group and reported on Part I, Line 11, and consequently, Part II, Line 34, Column A. Because Part I, Line 11, is an amount of consolidated net income after tax per the financial statements (or the books and records, if applicable), and because each corporation included in the U.S. consolidated tax group must complete its own Schedule M-3, Part III, Lines 1 through 6 must report in each corporation's Schedule M-3 what has been included in Part I, Line 11, and Part II, Line 34, Column A. In circumstances, for example, where the current and deferred U.S., state, and foreign income tax expense for the U.S. consolidated tax group is not shared or allocated among all members of the U.S. consolidated tax group but is retained in the parent company's financial statements (or books and records, if applicable), then only the parent company is required to report amounts in Part III, Lines 1 through 6, of its own Schedule M-3.

Q-23: What must be included on Part III, Line 10, Other equity-based compensation?

A-23: Any amounts for equity-based compensation other than incentive and nonqualified stock option compensation (reported on Part III, Line 8 and 9, respectively) including, for example, compensation attributable to employee stock purchase plans (ESPPs), phantom stock options, phantom stock units, stock warrants, stock appreciation rights, and restricted stock must be included on Part III, Line 10.