

# 2006 Draft

## Instructions for Schedule M-3 (Form 1120S)

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

Section references are to the Internal Revenue Code unless otherwise noted.

#### General Instructions

##### Purpose of Schedule

Schedule M-3 Part I asks certain questions about the corporation's financial statements and reconciles financial statement net income (loss) for the consolidated financial statement group to income (loss) per the income statement for the U.S. tax return.

Schedule M-3 Parts II and III reconcile financial statement net income (loss) for the U.S. tax return (per Schedule M-3, Part I, line 10) to total income (loss) on Form 1120S, page 3, Schedule K, line 18.

##### Who Must File

Schedule M-3 is effective for any tax year ending on or after December 31, 2006. For purposes of determining whether a corporation with a 52-53-week tax year must file Schedule M-3, such corporation's tax year is deemed to end or close on the last day of the calendar month nearest to the last day of the 52-53 week tax year. (For further guidance on 52-53 week tax years, see Regulations section 1.441-2(c)(1).) Any corporation required to file Form 1120S, U.S. Income Tax Return for an S Corporation, that reports on Schedule L of Form 1120S total assets at the end of the corporation's tax year that equal or exceed \$10 million must complete and file Schedule M-3 in lieu of Schedule M-1, Reconciliation of Income (Loss) per Books With Income (Loss) per Return. A U.S. corporation filing Form 1120S that is not required to file Schedule M-3 may voluntarily file Schedule M-3 in place of Schedule M-1. A corporation filing Schedule M-3 must check the box on Form 1120S, page 1, item \_\_\_\_, indicating that Schedule M-3 is attached (whether required or voluntary). A corporation filing Schedule M-3 must not file Schedule M-1.

##### *Example 1.*

- A.** U.S. corporation A owns U.S. subsidiary Q and foreign subsidiary F. For its 2006 tax year, A prepares consolidated financial statements with Q and F that report total assets of \$12 million. A files a U.S. federal income tax return with Q (a corporation that has made a qualified subchapter S subsidiary election) and reports total assets on Schedule L of \$8 million. A's U.S. tax group is not required to file Schedule M-3 for the 2006 tax year.
- B.** U.S. corporation C owns U.S. subsidiary D. For its 2006 tax year, C prepares consolidated financial statements with D but C and D file separate U.S. federal income tax returns. The consolidated accrual basis financial statements for C and

D report total assets at the end of the taxable year of \$12 million after intercompany eliminations. C reports separate company total year-end assets on its Schedule L of \$7 million. D reports separate company total year-end assets on its Schedule L of \$6 million. Neither C nor D is required to file Schedule M-3 for the 2006 tax year.

### **Other Issues Affecting Schedule M-3 Filing Requirements**

If a corporation was required to file Schedule M-3 for the preceding tax year but reports on Schedule L of Form 1120S total assets at the end of the current tax year of less than \$10 million, the corporation is not required to file Schedule M-3 for the current tax year. The corporation may either (a) file Schedule M-3, or (b) file Schedule M-1, for the current tax year. However, if the corporation chooses to file Schedule M-1 for the current tax year, and for a subsequent tax year the corporation is required to file Schedule M-3, the corporation must complete Schedule M-3 in its entirety (Part I and all columns in Parts II and III) for that subsequent tax year.

For purposes of determining for Schedule M-3 whether the corporation has total assets at the end of the current tax year of \$10 million or more, the corporation's total assets must be determined on an overall accrual method of accounting unless both of the following apply: (a) the tax return of the corporation is prepared using an overall cash method of accounting, and (b) no includible entity in the U.S. tax return prepares or is included in financial statements prepared on an accrual basis.

### **Affect on Schedule L**

Total assets shown on Schedule L, line 15, column (d), must equal the total assets of the corporation as of the last day of the tax year, and must be the same total assets reported by the corporation in the financial statements, if any, used for Schedule M-3. If the corporation prepares financial statements, Schedule L must equal the sum of the financial statement total assets for the corporation. If the corporation does not prepare financial statements, Schedule L must be based on the corporation's books and records. The Schedule L balance sheet may show tax-basis balance sheet amounts if the corporation is allowed to use books and records for Schedule M-3 and the corporation's books and records reflect only tax-basis amounts.

### **Entity Considerations for Schedule M-3**

For purposes of Schedule M-3, references to the classification of an entity (for example, as a corporation, a partnership, or a trust) are references to the treatment of the entity for U.S. federal income tax purposes. An entity that generally is disregarded as separate from its owner for U.S. federal income tax purposes (disregarded entity) must not be separately reported on Schedule M-3. Instead, any item of income, gain, loss, deduction, or credit of a disregarded entity must be reported as an item of its owner.

This section also applies to Qualified Subchapter S Subsidiaries (QSubs). Since a QSub is a disregarded entity, for purposes of Schedule M-3, Schedule L and the tax return in general, the subsidiary is deemed to have liquidated into the parent S corporation. As such, all QSubs are treated as divisions of the S corporation parent and they must not be separately reported on Schedule M-3.

### **Reportable Entity Partner Reporting Responsibilities**

For the purposes of the 2006 Form 1065 Schedule M-3 instructions, a reportable entity partner with respect to a partnership filing Form 1065 is an entity that (1) owns or is deemed to own, directly or indirectly, under these instructions a 50 percent or greater interest in the income, loss or capital of the partnership on any day of the tax year on or after June 30, 2006, and (2) was required to complete Schedule M-3 on its most recently filed US federal income tax return or return of income filed prior to that day.

For the purposes of the 2006 Form 1065 Schedule M-3 instructions: (1) the parent corporation of a consolidated tax group is deemed to own all corporate and partnership interests owned or deemed to be owned under these instructions by any member of the tax consolidated group; (2) the owner of a disregarded entity is deemed to own all corporate and partnership interests owned or deemed to be owned under these instructions by the disregarded entity; (3) the owner of 50 percent or more of a corporation by vote on any day of the corporation tax year is deemed to own all corporate and partnership interests owned or deemed to be owned under these instructions by the corporation during the corporation tax year; (4) the owner of 50 percent or more of partnership income, loss, or capital on any day of the partnership tax year is deemed to own all corporate and partnership interests owned or deemed to be owned under these instructions by the partnership during the partnership tax year; and (5) the beneficial owner of 50 percent or more of the beneficial interest of a trust or nominee arrangement tax year is deemed to own all corporate and partnership interests owned or deemed to be owned under these instructions by the trust or nominee arrangement.

Effective June 30, 2006, and at all times thereafter, a reportable entity partner with respect to a partnership (as defined under the 2006 Form 1065 Schedule M-3 instructions) must report the following to the partnership on June 30, 2006, or if later, within 30 days of first becoming a reportable entity partner and, after first reporting to the partnership under these instructions, thereafter within 30 days of the date of any change in the interest in the partnership it owns or is deemed to own, directly or indirectly, under these instructions, in the partnership: its name, its mailing address, its taxpayer identification number (TIN or EIN) if applicable, its entity or organization type, the state or country in which it is organized, the date on which it first became a reportable entity partner, the date with respect to which it is reporting, the interest in the partnership it owns or is deemed to own in the partnership, directly or indirectly (as defined under these instructions), and any change in that interest as of the date with respect to which it is reporting.

On the 2006 Form 1065 Schedule M-3, page 1, at check box D, a partnership must report the name, EIN or TIN if any, and maximum percentage of deemed ownership of each reportable entity partner if there are one or two reportable entity partners for the tax year of the partnership, and, if there are more than two reportable entity partners for the tax year of the partnership, the two reportable entity partners with the largest maximum percentage of deemed ownership for the tax year of the partnership. The maximum percentage of deemed ownership for a reportable entity partner for a tax year of the partnership is the maximum percentage interest deemed owned under these instructions by the reportable entity partner in the partnership's capital, profit, or loss on any day during the tax year of the partnership.

Example X1

- A. On September 16, 2007, A, an LLC filing a Form 1065 for 2007, is owned 50 percent by U.S. corporation Z which files Form 1120-S. A owns 50 percent of each of B, C, D, and E, each also an LLC filing a Form 1065 for calendar year 2007. Z was first required to complete Form 1120-S Schedule M-3 for its corporate tax year ended December 31, 2006, and filed its Form 1120-S with Schedule M-3 for 2006 on September 15, 2007. As of September 16, 2007, Z was a reportable entity partner with respect to A and, through A, with respect to B, C, D, and E. On October 5, 2007, Z reports to A, B, C, D, and E, as it is required to do, that Z is a reportable entity partner directly owning (with respect to A) or deemed to own indirectly (with respect to B, C, D, and E) a 50 percent interest. Therefore, because Z was a reportable entity partner for 2007, each of A, B, C, D, and E is required to complete Form 1065 Schedule M-3 for 2007, regardless of whether they would otherwise be required to complete Schedule M-3 for that year.

### **Completion of Schedule M-3**

A corporation required to file Schedule M-3 must complete the form in its entirety. At the time the Form 1120S is filed, all applicable questions must be answered on Part I, all columns must be completed on Parts II and III, and all numerical data required by Schedule M-3 must be provided at the time the Form 1120S is filed. Any schedule required to support a line item on Schedule M-3 must be attached at the time Schedule M-3 is filed and must provide the information required for that line item.

### **Specific Instructions for Part I**

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

##### **When To Complete Part I**

Part I must be completed for any tax year for which the corporation files Schedule M-3.

##### **Line 1. Questions Regarding the Type of Income Statement Prepared**

For Schedule M-3, Part I, lines 1 through 10, use only the financial statements of the U.S. corporation filing the U.S. federal income tax return. If no financial statements are prepared for the U.S. corporation filing Form 1120S Schedule M-3, the U.S. corporation must enter “No” on questions 1a and 1b, skip Part I, lines 2a through 2c, and enter the net income (loss) per the books and records of the U.S. corporation on Part I, line 3.

##### **Line 2. Questions Regarding Income Statement Period and Restatements**

Enter the beginning and ending dates on line 2a for the corporation’s annual income statement period ending with or within this tax year.

The questions on Part I, lines 2b and 2c, regarding income statement restatements refer to the worldwide consolidated income statement issued by the corporation filing the U.S. federal income tax return. Answer “Yes” on lines 2b and/or 2c if the corporation’s annual income statement has been restated for any reason. Attach a short explanation of the reasons for the restatement in net income for each annual income statement period that is restated, including the original amount and restated amount of each annual statement period’s net income. The attached schedule is not required to report restatements on an

entity-by-entity basis.

**Line 3. Worldwide Consolidated Net Income (Loss) per Income Statement**

Report on Part I, line 3, the worldwide consolidated net income (loss) per the income statement (or books and records, if applicable) of the corporation.

In completing Schedule M-3, the corporation must use financial statement amounts from the financial statement type checked “Yes” on Part I, line 1, or from its books and records if Part I, line 1b is checked “No”.

If a corporation prepares financial statements, the amount on line 3 must equal the financial statement net income (loss) for the income statement period ending with or within the tax year as indicated on line 2a.

If the corporation prepares financial statements and the income statement period differs from the corporation’s tax year, the income statement period indicated on line 2a applies for purposes of Part I, lines 3 through 7.

If the corporation does not prepare financial statements, check “No” on Part I, line 1b, and enter the net income (loss) per the books and records of the U.S. corporation on Part I, line 3.

Report on Part I, lines 4a through 9, as instructed below, all adjustment amounts required to adjust worldwide net income (loss) reported on this Part I, line 3 (whether from financial statements or books and records), to net income (loss) of the corporation that must be reported on Part I, line 10.

**Line 4. Net Income (Loss) of Nonincludible Foreign Entities**

Remove the financial statement net income (line 4a) or loss (line 4b) of each foreign entity that is included in the consolidated financial statement group and is not an includible entity in the U.S. tax return (nonincludible foreign entity). In addition, on Part I, line 7, adjust for consolidation eliminations and correct for minority interest and intercompany dividends for any nonincludible foreign entity. Do not remove in Part I the financial statement net income (loss) of any nonincludible foreign entity accounted for in the financial statements on the equity method.

Attach a supporting schedule that provides the name, EIN (if applicable), and net income (loss) per the financial statement or books and records included on line 3 that is removed on this line 4 for each separate nonincludible foreign entity. The amounts of income (loss) detailed on the supporting schedule should be reported for each separate nonincludible foreign entity without regard to the effect of consolidation or elimination entries. If there are consolidation or elimination entries relating to nonincludible foreign entities whose income (loss) is reported on the attached schedule that are not reportable on Part I, line 7, the net amounts of all such consolidation and elimination entries must be reported on a separate line on the attached schedule, so that the separate financial accounting income (loss) of each nonincludible foreign entity remains separately stated. For example, if the net income (after consolidation and elimination entries) of a nonincludible foreign sub-consolidated group is being reported on line 4a, the attached supporting schedule should report the income (loss) of each separate nonincludible

foreign legal entity from each such entity's own financial accounting net income statement or books and records, and any consolidation or elimination entries (for intercompany dividends, minority interests, etc.) not reportable on Part I, line 7, should be reported on the attached supporting schedule as a net amount on a line separate and apart from lines that report each nonincludible foreign entity's separate net income (loss).

#### **Line 5. Net Income (Loss) of Nonincludible U.S. Entities**

Remove the financial statement net income (line 5a) or loss (line 5b) of each U.S. entity that is included in the consolidated financial statement group and is not an includible entity in the U.S. tax return (nonincludible U.S. entity). In addition, on Part I, line 7, adjust for consolidation eliminations and correct for minority interest and intercompany dividends between any nonincludible U.S. entity and any includible entity. Do not remove in Part I the financial statement net income (loss) of any nonincludible U.S. entity accounted for in the financial statements on the equity method.

Attach a supporting schedule that provides the name, EIN, and net income (loss) per the financial statement or books and records included on line 3 that is removed on this line 5 for each separate nonincludible U.S. entity. The amounts of income (loss) detailed on the supporting schedule should be reported for each separate nonincludible U.S. entity without regard to the effect of consolidation or elimination entries. If there are consolidation or elimination entries relating to nonincludible U.S. entities whose income (loss) is reported on the attached schedule that are not reportable on Part I, line 7, the net amounts of all such consolidation and elimination entries must be reported on a separate line on the attached schedule, so that the separate financial accounting income (loss) of each nonincludible U.S. entity remains separately stated. For example, if the net income (after consolidation and elimination entries) of a nonincludible U.S. sub-consolidated group is being reported on line 5a, the attached supporting schedule should report the income (loss) of each separate nonincludible U.S. legal entity from each such entity's own financial accounting net income statement or books and records, and any consolidation or elimination entries (for intercompany dividends, minority interests, etc.) not reportable on Part I, line 7, should be reported on the attached supporting schedule as a net amount on a line separate and apart from lines that report each nonincludible U.S. entity's separate net income (loss).

#### **Line 6. Net Income (Loss) of Other Includible Entities**

Include the financial statement net income (line 6a) or loss (line 6b) of each includible entity in the U.S. tax return that is not included in the consolidated financial statement group and therefore not included in the income reported on Part I, line 3. Also include on this line 6 the financial statement income of any disregarded entity that is not included in the income reported on Part I, line 3 (other includible entities). In addition, on Part I, line 7, adjust for consolidation eliminations and correct for minority interest and intercompany dividends for any other includible entity and such other includible entities.

Attach a supporting schedule that provides the name, EIN, and net income (loss) per the financial statement or books and records included on this line 6 for each separate other includible entity. The amounts of income (loss) detailed on the supporting schedule should be reported for each separate other includible entity without regard to the effect of consolidation or elimination entries solely between or among the entities listed. If there are consolidation or elimination entries relating to such other includible entities

whose income (loss) is reported on the attached schedule that are not reportable on Part I, line 7, the net amounts of all such consolidation and elimination entries must be reported on a separate line on the attached schedule, so that the separate financial accounting income (loss) of each other includible entity remains separately stated. For example, if the net income (after consolidation and elimination entries) of a sub-consolidated U.S. group of other includible entities is being reported on line 6a, the attached supporting schedule should report the income (loss) of each separate other includible entity from each entity's own financial accounting net income statement or books and records, and any consolidation or elimination entries (for intercompany dividends, minority interests, etc.) not reportable on Part I, line 7, should be reported on the attached supporting schedule as a net amount on a line separate and apart from lines that report each other includible entity's separate net income (loss).

### **Line 7. Adjustment to Eliminations of Transactions Between Includible Entities and Nonincludible Entities**

Adjustments on Part I, line 7, to reverse certain financial accounting consolidation or elimination entries are necessary to ensure that transactions between includible entities and nonincludible U.S. or foreign entities are not eliminated, in order to report the correct total amount on Part I, line 10. Also, additional consolidation entries and eliminations entries may be necessary on Part I, line 7, related to transactions between includible entities that are in the consolidated financial statement group and other includible entities that are not in the consolidated financial statement group but that are reported on Part I, line 6, in order to report the correct total amount on Part I, line 10.

Include on Part I, line 7, the total of the following: (i) amounts of any adjustments to consolidation entries and elimination entries that are contained in the amount reported on Part I, line 3, required as a result of removing amounts on Part I, line 4 or 5; and (ii) amounts of any additional consolidation entries and elimination entries that are required as a result of including amounts on Part I, line 6. This is necessary in order that the consolidation entries and intercompany eliminations entries included in the amount reported on Part I, line 10, are only those applicable to the financial net income (loss) of includible entities for the financial statement period. For example, adjustments must be reported on line 7 to remove minority interest and to reverse the elimination of intercompany dividends included on Part I, line 3, that relate to the net income of entities removed on Part I, line 4 or 5, because the income to which the consolidation or elimination entries relate has been removed. Also, for example, consolidation or elimination entries must be reported on line 7 to eliminate any intercompany dividends between entities whose income is included on Part I, line 6, and other entities included in the U.S. federal income tax return.

If a corporate owner of an interest in another entity (entity): (1) accounts for the interest in entity in the owner corporation's separate general ledger on the equity method, and (2) fully consolidates entity in the owner corporation's consolidated financial statements, but entity is not includible in the owner corporation's U.S. federal income tax return, then, as part of reversing all consolidation and elimination entries for the nonincludible entity, the corporate owner must reverse on Schedule M-3, Part I, line 7, the elimination of the equity income inclusion from entity. If the owner corporation does not account for entity on the equity method on its own general ledger, it will not have eliminated the equity income for consolidated financial statement purposes, and therefore will have no elimination of equity income to reverse.

The attached supporting schedule for Part I, line 7, must identify the type (e.g., minority interest, intercompany dividends, etc.) and amount of consolidation or elimination entries reported, as well as the names of the entities to which they pertain. It is not necessary, but it is permitted, to report intercompany eliminations that net to zero on Part I, line 7, such as intercompany interest income and expense.

**Line 8. Adjustment to Reconcile Income Statement Period to Tax Year**

Include on line 8 any adjustments necessary to the income (loss) of includible entities to reconcile differences between the corporation's income statement period reported on line 2a and the corporation's tax year. Attach a schedule describing the adjustment.

**Line 9. Other Adjustments Required To Reconcile to Amount on Line 10**

Include on line 9 any other adjustments to reconcile net income (loss) on Part I, line 3, with net income (loss) on Part I, line 10.

For any adjustments reported on Part I, line 9, attach a supporting schedule that provides, for each entity to which an adjustment relates: the name and EIN of the entity, the amount of net income included in Part I before any adjustments on line 9, the amount of net income included on Part I, line 10, and the amount of the net adjustment

**Line 10. Net Income (Loss) per Income Statement of the Corporation**

Report on line 10 the net income (loss) per the income statement (or books and records, if applicable) of the corporation. Amounts reported in column (a) of Parts II and III (see instructions below) must be reported on the same accounting method as is used to report the amount of net income (loss) per income statement of the corporation on Part I, line 10.

Do not, in any event, report on this line 10 the net income of entities not included in the U.S. federal income tax return for the tax year. For example, it is not permissible to remove the income of non-includible entities on lines 4 and/or 5, above, then to add back such income on lines 6 through 9, such that the amount reported at line 10 includes the net income of entities not includible in the U.S. federal income tax return. A principal purpose of Schedule M-3 is to report on this Part I, line 10, only the financial accounting net income of only the entities included in the U.S. federal income tax return.

Whether or not the corporation prepares financial statements, Part I, Line 10, must include all items that impact the net income (loss) of the corporation even if they are not recorded in the profit and loss accounts in the corporation's general ledger, including, for example, all post-closing adjusting entries (including workpaper adjustments) and dividend income or other income received from non-includible entities.

**Example 2.** U.S. corporation P files a Form 1120S U.S. tax return and prepares certified audited income statements for GAAP. P owns 100% of the stock of U.S. corporations DS1 through DS75, between 51% and 99% of the stock of U.S. corporations DS76 through DS100, and 100% of the stock of foreign entities FS1 through FS50. P eliminates all dividend income from DS1 through DS100 and FS1 through FS50 in financial



statement consolidation entries. Furthermore, P eliminates the minority interest ownership, if any, of DS76 through DS100 in financial statement consolidation entries.

P must check “Yes” on Part I, line 1a. On Part I, line 3, P must report the consolidated net income for the consolidated financial statement group of P, DS1 through DS100, and FS1 through FS50. P must remove the net income (loss) of FS1 through FS50 on Part I, lines 4a or 4b, as applicable, and remove on Part I, lines 5a or 5b, as applicable, any net income (loss) from DS1 through DS75 where a QSub election has not been made by P. P must remove the net income (loss) before minority interests of DS76 through DS100 on Part I, lines 5a or 5b, as applicable. P must reverse on Part I, line 7, the elimination of any transactions between the includible entity (P and any QSubs) and the nonincludible entities (DS1 through DS75 with no QSub election, DS76 through DS100 and FS1 through FS50), including dividends received from non-QSub DS1 through DS75, DS76 through DS100 and FS1 through FS50 and the minority interest’s share of the net income (loss) of DS76 through DS100.

P reports on Part I, line 10, the consolidated financial statement net income (loss) attributable to the corporation and QSubs. Intercompany transactions between the corporation and the QSubs that had been eliminated in the net income amount on line 3 remain eliminated in the net income amount on line 10. Transactions between the corporation and the nonincludible entities that are eliminated in the net income amount on line 3 are included in the net income amount on line 10 since the elimination of those transactions were reversed on line 7.

### ***Example 3.***

1. U.S. corporation P owns 60% of corporation DS1 which is fully consolidated in P’s financial statements. P does not account for DS1 in P’s separate general ledger on the equity method. DS1 has net income of \$100 (before minority interests) and pays dividends of \$50, of which P receives \$30. The dividend is eliminated in the consolidated financial statements. In its financial statements, P consolidates DS1 and includes \$60 of net income (\$100 less the minority interest of \$40) on Part I, line 3.

P must remove the \$100 net income of DS1 on Part I, line 5a. P must reverse on Part I, line 7, the elimination of the \$40 minority interest net income of DS1. In addition, P reverses its elimination of the \$30 intercompany dividend in its financial statements on Part I, line 7. The net result is that P includes the \$30 dividend from DS1 at Part I, line 10, and on Part II, line 6, column (a). P’s taxable dividend income from DS1 must be reported on Part II, line 6, column (d)..

2. U.S. corporation S owns 60% of the capital and profits interests in U.S. LLC N. C does not account for N in P’s separate general ledger on the equity method. N has net income of \$100 (before minority interests) and makes no distributions during the tax year. S treats N as a corporation for financial statement purposes and as a partnership for U.S. federal income tax purposes. In its financial statements, S consolidates N and includes \$60 of net income (\$100 less the minority interest of \$40) on Part I, line 3.

S must remove the \$100 net income of N on Part I, line 5a. S must reverse on Part I, line 7, the elimination of the \$40 minority interest net income of N. The result is that S includes no income for N on either Part I, line 10, or on Part II, line 7, column (a). S's taxable income from N must be reported by S on Part II, line 8, Income (loss) from U.S. partnerships.

3. U.S. corporation P owns 60% of corporation DS1, which is fully consolidated in P's financial statements. P accounts for DS1 in P's separate general ledger on the equity method. DS1 has net income of \$100 (before minority interests) and pays dividends of \$50, of which P receives \$30. The dividend reduces P's investment in DS1 for equity method reporting on P's separate general ledger where P includes its 60% equity share of DS1 income, which is \$60. In its financial statements, P eliminates the DS1 equity method income of \$60 and consolidates DS1, including \$60 of net income (\$100 less the minority interest of \$40) on Part I, line 3.

P must remove the \$100 net income of DS1 on Part I, line 5a. P must reverse on Part I, line 7, the elimination of the \$40 minority interest net income of DS1 and the elimination of the \$60 of DS1 equity income. The net result is that P includes the \$60 of equity method income from DS1 at Part I, line 10, and on Part II, line 5, column (a). P's taxable dividend income from its investment in DS1 must be reported on Part II, line 6, column (d).

4. U.S. corporation C owns 60% of the capital and profits interests in U.S. LLC N. C accounts for N in C's separate general ledger on the equity method. N has net income of \$100 (before minority interests) and makes no distributions during the tax year. C treats N as a corporation for financial statement purposes and as a partnership for U.S. federal income tax purposes. For equity method reporting on C's separate general ledger, C includes its 60% equity share of N income, which is \$60. In its financial statements, C eliminates the \$60 of N net income (\$100 less the minority interest of \$40) on Part I, line 3.

C must remove the \$100 net income of N on Part I, line 5a. C must reverse on Part I, line 7, the elimination of the \$40 minority interest net income of N and the elimination of the \$60 of N equity method income. The result is that C includes the \$60 of equity method income for N on Part I, line 10, and on Part II, line 7, column (a). C's taxable income from N must be reported by C on Part II, line 7, column (d).

**Example 4.** U.S. corporation P owns 100% of the stock of QSub corporation DS1. DS1 is included in P's federal income tax return, even though DS1 is not included in P's consolidated financial statements on either a consolidated basis or on the equity method. DS1 has current year net income of \$100 after taking into account its \$40 interest payment to P. P has net income of \$1,040 after recognition of the interest income from DS1. Because DS1 is an includible corporation, 100% of the net income of both P and DS1 must be reported on Form 1120S of P's U.S. federal income tax return, and the intercompany interest income and expense must be removed by consolidation elimination entries.

P must report its financial statement net income of \$1,040 on Part I, line 3, and reports DS1's net income of \$100 on Part I, line 6. Then, in order to reflect the full consolidation of the financial accounting net income of P and DS1 at Part I, line 10, Net income (loss) per income statement of the corporation, the following consolidation and elimination entry is reported on Part I, line 7: offsetting entries to remove the \$40 of interest income received from DS1 included by P on line 3, and to remove the \$40 of interest expense of DS1 included in line 6 for a net change of zero. The result is that Part I, line 10, reports \$1,140: \$1,040 from line 3, and \$100 from line 6. Stated another way, Part I, line 10, includes the entire \$1,000 net income of P, measured before recognition of the intercompany interest income from DS1 and the consolidation of DS1 operations, plus the entire \$140 net income of DS1, measured before interest expense to P. P's U.S. federal income tax group is not required to include on the attached supporting schedule for Part I, line 7 the offsetting adjustment to the intercompany elimination of interest income and interest expense (though it is permitted to do so).

### **Specific Instructions for Parts II and III**

#### **General Format of Parts II and III**

For each line item in Parts II and III, report in column (a) the amount of net income (loss) included in Part I, line 10, and report in column (d) the amount included in total income (loss) on Form 1120S, page 3, Schedule K, line 18.

#### **When To Complete Columns (a) and (d)**

A corporation is not required to complete columns (a) and (d) of Parts II and III for the first tax year the corporation is required to file Schedule M-3 and for all subsequent years the corporation is required to file Schedule M-3, the corporation must complete Schedule M-3 in its entirety. Accordingly, the corporation must complete columns (a) and (d) of Parts II and III for all tax years subsequent to the first tax year the corporation is required to file Schedule M-3.

If, for any tax year (or tax years) prior to the first tax year a corporation is required to file Schedule M-3, a corporation voluntarily files Schedule M-3 in lieu of Schedule M-1, then in those voluntary filing years the corporation is not required to complete columns (a) and (d) of Parts II and III. In addition, in the first tax year the corporation is required to file Schedule M-3 the corporation is not required to complete columns (a) and (d) of Parts II and III.

If a corporation chooses not to complete columns (a) and (d) of Parts II and III in the first tax year the corporation is required to file Schedule M-3 (or in any year in which the corporation voluntarily files Schedule M-3), then Part II, line 26, is reconciled by the corporation in the following manner:

1. Report the amount from Part I, line 10, on Part II, line 26, column (a);
2. Leave blank Part II, lines 1 through 25, columns (a) and (d);
3. Leave blank Part III, columns (a) and (d); and
4. Report on Part II, line 26, column (d), the sum of Part II, line 26, columns (a), (b), and (c).

**Note.** Part II, line 26, column (d), must equal the amount on Form 1120S, page 3, Schedule K, line 18.

### **When To Complete Columns (b) and (c)**

Columns (b) and (c) of Parts II and III must be completed for any tax year for which the corporation files Schedule M-3.

For any item of income, gain, loss, expense, or deduction for which there is a difference between columns (a) and (d), the portion of the difference that is temporary must be entered in column (b) and the portion of the difference that is permanent must be entered in column (c).

If financial statements are prepared by the corporation in accordance with generally accepted accounting principles (GAAP), differences that are treated as temporary for GAAP must be reported in column (b) and differences that are permanent (that is, not temporary for GAAP) must be reported in column (c). Generally, pursuant to GAAP, a temporary difference affects (creates, increases, or decreases) a deferred tax asset or liability.

If the corporation does not prepare financial statements, or the financial statements are not prepared in accordance with GAAP, report in column (b) any difference that the corporation believes will reverse in a future tax year (that is, have an opposite effect on total income (loss) in a future tax year (or years) due to the difference in timing of recognition for financial accounting and U.S. federal income tax purposes) or is the reversal of such a difference that arose in a prior tax year. Report in column (c) any difference that the corporation believes will not reverse in a future tax year (and is not the reversal of such a difference that arose in a prior tax year).

If the corporation is unable to determine whether a difference between column (a) and column (d) for an item will reverse in a future tax year or is the reversal of a difference that arose in a prior tax year, report the difference for that item in column (c).

**Example 5.** For the 2006, 2007, and 2008 tax years, corporation A has total assets on the last day of the tax year as reported on Schedule L, line 15, column (d), of \$8 million, \$11 million, and \$12 million, respectively. A is required to file Schedule M-3 for its 2007 and 2008 tax years.

For its 2006 tax year, A voluntarily files Schedule M-3 in lieu of Schedule M-1 and does not complete columns (a) and (d) of Parts II and III.

For A's 2007 tax year, the first tax year that A is required to file Schedule M-3, A is only required to complete Part I and columns (b) and (c) of Parts II and III.

For A's 2008 tax year, A is required to complete Schedule M-3 in its entirety.

**Example 6.** Corporation B is a U.S. corporation that files a U.S. tax return and prepares GAAP financial statements. In prior years, B acquired intellectual property (IP) and goodwill through several corporate acquisitions. The IP is amortizable for both U.S. federal income tax and financial statement purposes. In the current year, B's annual amortization expense for IP is \$9,000 for U.S. federal income tax purposes and \$6,000 for financial statement purposes. In its financial statements, B treats the difference in IP amortization as a temporary difference. The goodwill is not amortizable for U.S. federal income tax purposes and is subject to impairment for financial statement purposes. In the current year, B records an impairment charge on the goodwill of \$5,000. In its financial statements, B treats the goodwill impairment as a permanent difference. B must report the amortization attributable to the IP on Part III, line 22, and report \$6,000 in column (a), a temporary difference of \$3,000 in column (b), and \$9,000 in column (d). B must

report the goodwill impairment on Part III, line 20, and report \$5,000 in column (a), a permanent difference of (\$5,000) in column (c), and \$0 in column (d).

## **Reporting Requirements for Parts II and III**

### **General Reporting Requirements**

If an amount is attributable to a reportable transaction described in Regulations section 1.6011-4(b) the amount must be reported in columns (a), (b), (c), and (d), as applicable, of Part II, line 10, Items relating to reportable transactions, regardless of whether the amount would otherwise be reported on Part II or Part III of Schedule M-3. Thus, if a taxpayer files Form 8886, Reportable Transaction Disclosure Statement, the amounts attributable to that reportable transaction must be reported on Part II, line 10.

A corporation is required to report in column (a) of Parts II and III the amount of any item specifically listed on Schedule M-3 that is in any manner included in the corporation's current year financial statement net income (loss) or in an income or expense account maintained in the corporation's books and records, even if there is no difference between that amount and the amount included in total income(loss) unless (a) otherwise provided in these instructions or (b) the amount is attributable to a reportable transaction described in Regulations section 1.6011-4(b) and is therefore reported on Part II, line 10. For example, with the exception of interest income reflected on a Schedule K-1 received by a corporation as a result of the corporation's investment in a partnership or other pass-through entity, all interest income included on Part I, Line 10, whether from affiliated companies, third parties, banks, or other entities, whether from foreign or domestic sources, whether taxable or exempt from tax and whether classified as some other type of income for U.S. federal income tax purposes (such as dividends), must be included on Part II, line 11, column (a). Likewise, all fines and penalties included in Part I, line 10, paid to a government or other authority for the violation of any law for which fines or penalties are assessed must be included on Part III, line 9, column (a), regardless of the government authority that imposed the fines or penalties, regardless of whether the fines or penalties are civil or criminal, regardless of the classification, nomenclature, or terminology attached to the fines or penalties by the imposing authority in its actions or documents.

If a corporation would be required to report in column (a) of Parts II and III the amount of any item specifically listed on Schedule M-3 in accordance with the preceding paragraph, except that the corporation has capitalized the item of income or expense and reports the amount in its financial statement balance sheet or in asset and liability accounts maintained in the corporation's books and records, the corporation must report the proper tax treatment of the item in columns (b), (c), and (d), as applicable.

Furthermore, in applying the two preceding paragraphs, a corporation is required to report in column (a) of Parts II and III the amount of any item specifically listed on Schedule M-3 that is included in the corporation's financial statements or exists in the corporation's books and records, regardless of the nomenclature associated with that item in the financial statements or books and records. Accurate completion of Schedule M-3 requires reporting amounts according to the substantive nature of the specific line items included in Schedule M-3 and consistent reporting of all transactions of like substantive nature that occurred during the tax year. For example, all expense amounts that are included in the financial statements or exist in the books and records that represent some form of "Bad debt expense," must be reported on Part III, line 25, in column (a), regardless of whether the amounts are recorded or stated under different nomenclature in

the financial statements or the books and records such as: “Provision for doubtful accounts”; “Expense for uncollectible notes receivable”; or “Impairment of trade accounts receivable.” Likewise, as stated in the preceding paragraph, all fines and penalties must be included on Part III, line 9, column (a), regardless of the terminology or nomenclature attached to them by the corporation in its books and records or financial statements.

With limited exceptions, Part II includes lines for specific items of income, gain, or loss (income items). (See Part II, lines 1 through 21.) If an income item is described in Part II, lines 1 through 21, report the amount of the item on the applicable line, regardless of whether there is a difference for the item. If there is a difference for the income item, or only a portion of the income item has a difference and a portion of the item does not have a difference, and the item is not described in Part II, lines 1 through 21, report and describe the entire amount of the item on Part II, line 22..

With limited exceptions, Part III includes lines for specific items of expense or deduction (expense items). (See Part III, lines 1 through 28.) If an expense item is described on Part III, lines 1 through 28, report the amount of the item on the applicable line, regardless of whether there is a difference for the item. If there is a difference for the expense item, or only a portion of the expense item has a difference and a portion of the item does not have a difference and the item is not described in Part III, lines 1 through 28, report and describe the entire amount of the item on Part III, line 29.

If there is no difference between the financial accounting amount and the taxable amount of an entire item of income, loss, expense, or deduction and the item is not described or included in Part II, lines 1 through 21, or Part III, lines 1 through 28, report the entire amount of the item in column (a) and (d) of Part II, line 25, Other income (loss) and expense/deduction items with no differences.

**Separately stated and adequately disclosed.** Each difference reported in Parts II and III must be separately stated and adequately disclosed. In general, a difference is adequately disclosed if the difference is labeled in a manner that clearly identifies the item or transaction from which the difference arises. For further guidance about adequate disclosure, see Regulations section 1.6662-4(f), Rev. Proc. 2004-45, 2004-31 I.R.B. 140 and Rev. Proc. 2005-75, 2005-50 I.R.B. 1137. If a specific item of income, gain, loss, expense, or deduction is described on Part II, lines 7 through 21, or Part III, lines 1 through 28, and the line does not indicate to “attach schedule” or “attach details,” and the specific instructions for the line do not call for an attachment of a schedule or statement, then the item is considered separately stated and adequately disclosed if the item is reported on the applicable line and the amount(s) of the item(s) are reported in the applicable columns of the applicable line. See the instructions beginning on page \_\_\_ for specific additional information required to be provided for amounts reported on Part II, lines 1 through 6.

Except as otherwise provided, differences for the same item must be combined or netted together and reported as one amount on the applicable line of Schedule M-3. However, differences for separate items must not be combined or netted together. Each item (and corresponding amount attributable to that item) must be separately stated and adequately disclosed on the applicable line of Schedule M-3, or any schedule required to be attached even if the amounts are below a certain dollar amount.

**Example 7.** Corporation C is a calendar year taxpayer that placed in service ten depreciable fixed assets in 2002. C was required to file Schedule M-3 for its 2006 tax

year and is required to file Schedule M-3 for its 2007 tax year. C's total depreciation expense for its 2007 tax year for five of the assets is \$50,000 for income statement purposes and \$70,000 for U.S. federal income tax purposes. C's total annual depreciation expense for its 2007 tax year for the other five assets is \$40,000 for income statement purposes and \$30,000 for U.S. federal income tax purposes. In its financial statements, C treats the differences between financial statement and U.S. federal income tax depreciation expense as giving rise to temporary differences that will reverse in future years. C must combine all of its depreciation adjustments. Accordingly, C must report on Part III, line 24, for its 2007 tax year income statement depreciation expense of \$90,000 in column (a), a temporary difference of \$10,000 in column (b), and U.S. federal income tax depreciation expense of \$100,000 in column (d).

**Example 8.** Corporation D is a calendar year taxpayer that was required to file Schedule M-3 for its 2006 tax year and is required to file Schedule M-3 for its 2007 tax year. On December 31, 2007, D establishes three reserve accounts in the amount of \$100,000 for each account. One reserve account is an allowance for accounts receivable that are estimated to be uncollectible. The second reserve is an estimate of coupons outstanding that may have to be paid. The third reserve is an estimate of future warranty expenses. In its financial statements, D treats the three reserve accounts as giving rise to temporary differences that will reverse in future years. The three reserves are expenses in D's 2007 financial statements but are not deductions for U.S. federal income tax purposes in 2007. D must not combine the Schedule M-3 differences for the three reserve accounts. D must report the amounts attributable to the allowance for uncollectible accounts receivable on Part III, line 25, Bad debt expense, and must separately state and adequately disclose the amounts attributable to each of the other two reserves, pending litigation and warranty costs, on a required, attached schedule that supports the amounts at Part III, line 29.

**Example 9.** Corporation E is a calendar year taxpayer that was required to file Schedule M-3 for its 2006 tax year and is required to file Schedule M-3 for its 2007 tax year. On January 2, 2007, E establishes an allowance for uncollectible accounts receivable (bad debt reserve) of \$100,000. During 2007, E increased the reserve by \$250,000 for additional accounts receivable that may become uncollectible. Additionally, during 2007 E decreases the reserve by \$75,000 for accounts receivable that were discharged in bankruptcy during 2007. The balance in the reserve account on December 31, 2007, is \$275,000. The \$100,000 amount to establish the reserve account and the \$250,000 to increase the reserve account are expenses on E's 2007 financial statements but are not deductible for U.S. federal income tax purposes in 2007. However, the \$75,000 decrease to the reserve is deductible for U.S. federal income tax purposes in 2007. In its financial statements, E treats the reserve account as giving rise to a temporary difference that will reverse in future tax years. E must report on Part III, line 25, for its 2007 tax year income statement bad debt expense of \$350,000 in column (a), a temporary difference of (\$275,000) in column (b), and U.S. federal income tax bad debt expense of \$75,000 in column (d).

**Example 10.** Corporation F is a calendar year taxpayer that was required to file Schedule M-3 for its 2006 tax year and is required to file Schedule M-3 for its 2007 tax year. During 2007, F incurs \$200 of meals and entertainment expenses that F deducts in computing net income per the income statement. \$50 of the \$200 is subject to the 50% limitation under section 274(n). In its financial statements, F treats the limitation on deductions for meals and entertainment as a permanent difference. Because meals and entertainment expenses are specifically described in Part III, line 8, Meals and

entertainment, F must report all of its meals and entertainment expenses on this line, regardless of whether there is a difference. Accordingly, F must report \$200 in column (a), \$25 in column (c), and \$175 in column (d). F must not report the \$150 of meals and entertainment expenses that are deducted in F's financial statement net income and are fully deductible for U.S. federal income tax purposes on Part II, line 25, Other income (loss) and expense/deduction items with no differences, and the \$50 subject to the limitation under section 274(n) on Part III, line 8.

## **Part II. Reconciliation of Net Income (Loss) per Income Statement of the Corporation With Total Income (Loss) per Return**

### **Lines 1 Through 6. Additional Information for Each Corporation**

For any item reported on Part II, lines 1, and 3 through 5, attach a supporting schedule that provides the name of the entity for which the item is reported, the type of entity (corporation, partnership, etc.), the entity's EIN (if applicable), and the item amounts for columns (a) through (d). See the instructions for Part II, lines 2 and 6, for the specific information required for those particular lines.

#### **Line 1. Income (Loss) From Equity Method Foreign Corporations**

Report on line 1, column (a), the income statement income (loss) included in Part I, line 10, for any foreign corporation accounted for on the equity method and remove such amount in column (b) or (c), as applicable. Report the amount of dividends received and other taxable amounts received or includible from foreign corporations on Part II, lines 2 through 4, as applicable.

#### **Line 2. Gross Foreign Dividends Not Previously Taxed**

Except as otherwise provided in this paragraph, report on line 2, column (d), the amount (before any withholding tax) of any foreign dividends included in current year total income (loss) on Form 1120S, page 3, Schedule K, line 18 and report on line 2, column (a), the amount of dividends from any foreign corporation included in Part I, line 10. Do not report any amounts that are reported on Part II, line 3, or dividends that were previously taxed and must be reported on Part II, line 4. (See the instructions below for Part II, lines 3 and 4.) Report withholding taxes on Part III, line 29, Other expense/deduction items with differences, or Part II, line 25, Other income (loss) and expense/deduction items with no difference, as applicable.

For any dividends reported on Part II, line 2, that are received on a class of voting stock of which the corporation directly or indirectly owned 10% or more of the outstanding shares of that class at any time during the tax year, report on an attached supporting schedule the name of the dividend payer, the class of voting stock on which the dividend was paid, the payer's EIN (if applicable), and the item amounts for columns (a) through (d).

#### **Line 3. Subpart F, QEF, and Similar Income Inclusions**

Report on line 3, column (d), the amount included in income under section 951 (relating to Subpart F), gains or other income inclusions resulting from elections under sections 1291(d)(2) and 1298(b)(1), and any amount included in income pursuant to section 1293 (relating to qualified electing funds). The amount of Subpart F income corresponds to the total of the amounts reported by the corporation on line 6, Schedule I, of all Forms 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. The amount of qualified electing fund income corresponds to the total of the amounts reported



by the corporation on line 3(a), Part II, of all Forms 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.

Also include on line 3 PFIC mark-to-market gains and losses under section 1296. Do not report such gains and losses on Part II, line 14,.

**Line 4. Gross Foreign Distributions Previously Taxed**

Report on line 4, column (a), any distributions received from foreign corporations that were included in Part I, line 10, and that were previously taxed for U.S. federal income tax purposes. For example, include in column (a) amounts that are excluded from income under sections 959 and 1293(c). Remove such amount in column (b) or (c), as applicable. Report the full amount of the distribution before any withholding tax. Report withholding taxes on Part III, line 29, Other expense/deduction items with differences, or Part II, line 25, Other income (loss) and expense/deduction items with no differences, as applicable. Since previously taxed foreign distributions are not currently taxable, line 4, column (d) is shaded. (Also, see instructions above for Part II, line 2)

**Line 5. Income (Loss) From Equity Method U.S. Corporations**

Report on line 5, column (a), the income statement income (loss) included in Part I, line 10, for any U.S. corporation accounted for on the equity method and remove such amount in column (b) or (c), as applicable. Report on Part II, line 6, dividends received from any U.S. corporation accounted for on the equity method.

**Line 6. U.S. Dividends Not Eliminated in Tax Consolidation**

Report on line 6, column (a), the amount of dividends included in Part I, line 10, that were received from any U.S. corporation. Report on line 6, column (d), the amount of any U.S. dividends included in total income (loss) on Form 1120S, page 3, Schedule K, line 18 (that is, taxable dividends received from any U.S. corporation that is not a QSub.).

For any dividends reported on Part II, line 6, that are received on classes of voting stock in which the corporation directly or indirectly owned 10% or more of the outstanding shares of that class at any time during the tax year, report on an attached supporting schedule for Part II, line 6, the name of the dividend payer, the class of voting stock on which the dividend was paid, the payer's EIN (if applicable), and the item amounts for columns (a) through (d).

**Line 7. Income (Loss) From U.S. Partnerships and Line**

**8. Income (Loss) From Foreign Partnerships**

For any interest owned by the corporation that is treated as an investment in a partnership for U.S. federal income tax purposes (other than an interest in a disregarded entity), report amounts on Part II, line 7 or 8, as described below:

1. In column (a), the sum of the corporation's distributive share of income or loss from a U.S. or foreign partnership that is included in Part I, line 10;
2. In column (b) or (c), as applicable, the sum of all differences, if any, attributable to the corporation's distributive share of income or loss from a U.S. or foreign partnership; and

3. In column (d), the sum of all amounts of income, gain, loss, or deduction attributable to the corporation's distributive share of income or loss from a U.S. or foreign partnership (i.e., the sum of all amounts reportable on the corporation's Schedule(s) K-1 received from the partnership (if applicable)), without regard to any limitations computed at the partner level (e.g., limitations on utilization of charitable contributions, capital losses, and interest expense).

For each partnership reported on line 7 or 8, attach a supporting schedule that provides the name, EIN (if applicable), end of year profit-sharing percentage (if applicable), end of year loss-sharing percentage (if applicable), and the amount reported in column (a), (b), (c), or (d) of lines 7 or 8, as applicable.

**Example 11.** U.S. corporation H is a calendar year taxpayer that was required to file Schedule M-3 for its 2006 tax year and is required to file Schedule M-3 for its 2007 tax year. H has an investment in a U.S. partnership USP. H prepares financial statements in accordance with GAAP. In its financial statements, H treats the difference between financial statement net income and taxable income from its investment in USP as a permanent difference. For its 2007 tax year, H's financial statement net income includes \$10,000 of income attributable to its share of USP's net income. H's Schedule K-1 from USP reports \$5,000 of ordinary income, \$7,000 of long-term capital gains, \$4,000 of charitable contributions, and \$200 of section 179 expense. H must report on Part II, line 7, \$10,000 in column (a), a permanent difference of (\$2,200) in column (c), and \$7,800 in column (d).

### **Line 9. Income (Loss) From Other Pass-Through Entities**

For any interest in a pass-through entity (other than an interest in a partnership reportable on Part II, line 7 or 8, as applicable) owned by the corporation (other than an interest in a disregarded entity), report the following on line 9:

1. In column (a), the sum of the corporation's distributive share of income or loss from the pass-through entity that is included in Part I, line 10;
2. In column (b) or (c), as applicable, the sum of all differences, if any, attributable to the pass-through entity; and
3. In column (d), the sum of all taxable amounts of income, gain, loss, or deduction reportable on the corporation's Schedules K-1 received from the pass-through entity (if applicable).

For each pass-through entity reported on line 9, attach a supporting schedule that provides that entity's name, EIN (if applicable), the corporation's end of year profit-sharing percentage (if applicable), the corporation's end of year loss-sharing percentage (if applicable), and the amounts reported by the corporation in column (a), (b), (c), or (d) of line 9, as applicable.

### **Line 10. Items Relating to Reportable Transactions**

Any amounts attributable to any reportable transactions (as described in Regulations section 1.6011-4) must be included on Part II, line 10, regardless of whether the difference, or differences, would otherwise be reported elsewhere in Part II or Part III. Thus, if a taxpayer files Form 8886 for any reportable transaction described in Regulations section 1.6011-4 the amounts attributable to that reportable transaction must be reported on Part II, line 10. In addition, all income and expense amounts attributable to a reportable transaction must be reported on Part II, line 10, columns (a) and (d), even if there is no difference between the financial statement amounts and the taxable amounts.

Each difference attributable to a reportable transaction must be separately stated and adequately disclosed. A corporation will be considered to have separately stated and adequately disclosed a reportable transaction on line 10 if the corporation sequentially numbers each Form 8886 and lists by identifying number on the supporting schedule for Part II, line 10, each sequentially numbered reportable transaction and the amounts required for Part II, line 10, columns (a) through (d).

In lieu of the requirements of the preceding paragraph, a corporation will be considered to have separately stated and adequately disclosed a reportable transaction if the corporation attaches a supporting schedule that provides the following for each reportable transaction:

1. A description of the reportable transaction disclosed on Form 8886 for which amounts are reported on Part II, line 10;
2. The name and tax shelter registration number, if applicable, as reported on lines 1a and 1b, respectively, of Form 8886; and
3. The type of reportable transaction (i.e., listed transaction, confidential transaction, transaction with contractual protection, etc.) as reported on line 2 of Form 8886.

If a transaction is a listed transaction described in Regulations section 1.6011-4(b)(2), the description also must include the description provided on line 3 of Form 8886. In addition, if the reportable transaction involves an investment in the transaction through another entity such as a partnership, the description must include the name and EIN (if applicable) of that entity as reported on line 5 of Form 8886.

**Example 12.** Corporation J is a calendar year taxpayer that was required to file Schedule M-3 for its 2006 tax year and is required to file Schedule M-3 for its 2007 tax year. J incurred seven different abandonment losses during its 2007 tax year. One loss of \$12 million results from a reportable transaction described in Regulations section 1.6011-4(b)(5), another loss of \$5 million results from a reportable transaction described in Regulations section 1.6011-4(b)(4), and the remaining five abandonment losses are not reportable transactions. J discloses the reportable transactions giving rise to the \$12 million and \$5 million losses on separate Forms 8886 and sequentially numbers them X1 and X2, respectively. J must separately state and adequately disclose the \$12 million and \$5 million losses on Part II, line 10. The \$12 million loss and the \$5 million loss will be adequately disclosed if J attaches a supporting schedule for line 10 that lists each of the sequentially numbered forms, Form 8886-X1 and Form 8886-X2, and with respect to each reportable transaction reports the appropriate amounts required for Part II, line 10, columns (a) through (d). Alternatively, J's disclosures will be adequate if the description provided for each loss on the supporting schedule includes the names and tax shelter registration numbers, if any, disclosed on the applicable Form 8886, identifies the type of reportable transaction for the loss, and reports the appropriate amounts required for Part II, line 10, columns (a) through (d). J must report the losses attributable to the other five abandonment losses on Part II, line 21e, regardless of whether a difference exists for any or all of those abandonment losses.

**Example 13.** Corporation K is a calendar year taxpayer that was required to file Schedule M-3 for its 2006 tax year and is required to file Schedule M-3 for its 2007 tax year. K enters into a transaction with contractual protection that is a reportable transaction described in Regulations section 1.6011-4(b)(4). This reportable transaction

is the only reportable transaction for K's 2007 tax year and results in a \$7 million capital loss for both financial statement purposes and U.S. federal income tax purposes. Although the transaction does not result in a difference, K is required to report on Part II, line 10, the following amounts: (\$7 million) in column (a), zero in columns (b) and (c), and (\$7 million) in column (d). The transaction will be adequately disclosed if K attaches a supporting schedule for line 10 that (a) sequentially numbers the Form 8886 and refers to the sequentially-numbered Form 8886-X1 and (b) reports the applicable amounts required for line 10, columns (a) through (d). Alternatively, the transaction will be adequately disclosed if the supporting statement for line 10 includes a description of the transaction, the name and tax shelter registration number, if any, and the type of reportable transaction disclosed on Form 8886.

#### **Line 11. Interest income**

Report on Part II, line 11, column (a), the total amount of interest income included on Part I, line 10, and report on Part II, line 11, column (d), the total amount of interest income included on Form 1120S, page 3, Schedule K, line 18, that is not required to be reported elsewhere on Schedule M-3. In columns (b) or (c), as applicable, adjust for any amounts treated for U.S. federal income tax purposes as interest income that are treated as some other form of income in the financial statements, or vice versa. For example, adjustments to interest income resulting from adjustments made in accordance with instructions for Part II, line 16, should be made in columns (b) and (c) of this line 11.

Do not report on this line 11 amounts reported in accordance with instructions for Part II, lines 7, 8, 9, 10, and 20.

#### **Line 12. Total Accrual to Cash Adjustment**

This line is completed by a corporation that prepares financial statements (or books and records, if permitted) using an overall accrual method of accounting and uses an overall cash method of accounting for U.S. federal income tax purposes (or vice-versa). With the exception of amounts required to be reported on Part II, line 10, the corporation must report on Part II, line 12, a single amount net of all adjustments attributable solely to the use of the different overall methods of accounting (e.g., adjustments related to accounts receivable, accounts payable, compensation, accrued liabilities, etc.), regardless of whether a separate line on Schedule M-3 corresponds to an item within the accrual to cash reconciliation. Differences not attributable to the use of the different overall methods of accounting must be reported on the appropriate lines of Schedule M-3 (e.g., a depreciation difference must be reported on Part III, line 24).

**Example 14.** Corporation L is a calendar year taxpayer that was required to file Schedule M-3 for its 2006 tax year and is required to file Schedule M-3 for its 2007 tax year. L prepares financial statements in accordance with GAAP using an overall accrual method of accounting. L uses an overall cash method of accounting for U.S. federal income tax purposes. L's financial statements for the year ending December 31, 2007, report accounts receivable of \$35,000, an allowance for bad debts of \$10,000, and accounts payable of \$17,000 related to current year acquisition and reorganization legal and accounting fees. In addition, for L's year ending December 31, 2007, L reported financial statement depreciation expense of \$15,000 and depreciation for U.S. federal income tax purposes of \$25,000. For L's 2007 tax year using an overall cash method of accounting, L does not recognize the \$35,000 of revenue attributable to the accounts receivable,

cannot deduct the \$10,000 allowance for bad debt, and cannot deduct the \$17,000 of accounts payable. In its financial statements, L treats both the difference in overall accounting methods used for financial statement and U.S. federal income tax purposes and the difference in depreciation expense as temporary differences. L must combine all adjustments attributable to the differences related to the overall accounting methods on Part II, line 12. As a result, L must report on Part II, line 12, \$8,000 in column (a) (\$35,000 - \$10,000 - \$17,000), (\$8,000) in column (b), and zero in column (d). L must not report the accrual to cash adjustment attributable to the legal and accounting fees on Part III, line 18, Current year acquisition or reorganization legal and accounting fees. Because the difference in depreciation expense does not relate to the use of the cash or accrual method of accounting, L must report the depreciation difference on Part III, line 24, Depreciation, and report \$15,000 in column (a), \$10,000 in column (b), and \$25,000 in column (d).

### **Line 13. Hedging Transactions**

Report on line 13, column (a), the net gain or loss from hedging transactions included in net income per the income statement. Report in column (d) the amount of income (loss) from hedging transactions as defined in section 1221 (b)(2). Use columns (b) and (c) to report all differences caused by treating hedging transactions differently for financial accounting purposes and for U.S. federal income tax purposes. For example, if a portion of a hedge is considered ineffective under GAAP but still is a valid hedge under section 1221(b)(2), the difference must be reported on line 13. The hedge of a capital asset, which is not a valid hedge for U.S. federal income tax purposes but may be considered a hedge for GAAP purposes, must also be reported here.

Report hedging gains and losses computed under the mark-to-market method of accounting on line 13 and not on Part II, line 14.

Report any gain or loss from inventory hedging transactions on line 13 and not on Part II, line 15.

### **Line 14. Mark-to-Market Income (Loss)**

Report on line 14 any amount representing the mark-to-market income or loss for any securities held by a dealer in securities, a dealer in commodities having made a valid election under section 475(e), or a trader in securities or commodities having made a valid election under section 475(f). "Securities" for these purposes are securities described in section 475(c)(2) and section 475(e)(2). "Securities" do not include any items specifically excluded from sections 475(c)(2) and 475(e)(2), such as certain contracts to which section 1256(a) applies.

Report hedging gains and losses computed under the mark-to-market method of accounting on Part II, line 13, Hedging transactions, and not on line 14.

### **Line 15. Cost of Goods Sold**

Report on line 15 any amounts deducted as part of cost of goods sold during the tax year, regardless of whether the amounts would otherwise be reported elsewhere in Part II or Part III. However, do not report the items mentioned in the next paragraph on this line 15. Examples of amounts that must be included on line 15 are amounts attributable to

inventory valuation, such as amounts attributable to cost-flow assumptions, additional costs required to be capitalized (including depreciation) such as section 263A costs, inventory shrinkage accruals, inventory obsolescence reserves, and lower of cost or market (LCM) write-downs.

Do not report the following on this line 15:

- Amounts reportable on Part II, line 10;
- Any gain or loss from inventory hedging transactions reportable on Part II, line 13;
- Mark-to-market income or (loss) associated with the inventories of dealers in securities under section 475 reportable on Part II, line 14;
- Section 481(a) adjustments related to cost of goods sold or inventory valuation reportable on Part II, line 17;
- Fines and penalties reportable on Part III, line 9; and
- Judgments, damages, awards and similar costs, reportable on Part III, line 10.

For the amount reported on Part II, line 15, attach Form \_\_\_\_ and report each amounts for each item listed on the Form in columns (a) through (d). In addition, attach a schedule for the amount reported on line 7 (below), All other items with differences, that separately states and adequately discloses each item.

The items to be reported on Form \_\_\_\_ are:

- 1) differences attributable to cost flow assumptions (e.g. differences in LIFO computations);
- 2) differences attributable to section 263A costs (LIFO taxpayers using the simplified production method or the simplified resale method should report the amount of additional § 263A costs computed after LIFO computations. LIFO taxpayers not using a simplified § 263A method should report costs attributable to additional § 263A prior to performing LIFO computation.);
  - a. stock option expense
  - b. other equity based compensation
  - c. meals and entertainment
  - d. parachute payments
  - e. compensation with section 162(m) limitation
  - f. pension and profit sharing
  - g. other post-retirement benefits
  - h. deferred compensation
  - i. Section 198 environmental remediation costs
  - j. amortization
  - k. depletion
  - l. depreciation
  - m. corporate owned life insurance premiums
  - n. other sections 263A costs

- 3) inventory shrinkage accruals;
- 4) excess inventory and obsolescence reserves; and
- 5) lower of cost or market write-downs;
- 6) other items with no differences
- 7) all other items with differences

If the taxpayer does not distinguish between inventory obsolescence reserves and lower of cost or market write-downs in its general ledger, report all amounts relating to these reserves on the supporting schedule line for excess inventory and obsolescence reserves.

**Example 15:**

Corporation C is a calendar year taxpayer that placed in service ten depreciable fixed assets in 2000. C was required to file Schedule M-3 for its 2005 tax year and is required to file Schedule M-3 for its 2006 tax year. C's total depreciation expense for its 2006 tax year for five of the assets is \$50,000 for income statement purposes and \$70,000 for U.S. federal income tax purposes. C's total annual depreciation expense for its 2006 tax year for the other five assets is \$40,000 for income statement purposes and \$30,000 for U.S. federal income tax purposes. In addition, C incurs \$200 of meals and entertainment expenses that C deducts in computing net income per the income statement. All \$200 of is subject to the 50% limitation under section 274(n). In its financial statements, C treats the \$50,000 depreciation and \$100 of the meals and entertainment as other costs in computing Cost of Goods Sold. Accordingly, C must include on Part II, line 17, in column (a), the \$50,000 of depreciation and \$100 of meals and entertainment. C must also include a temporary difference of \$20,000 in column (b) a permanent difference of \$(50) in column (c) and \$70,050 in column (d) [\$70,000 depreciation and \$50 meals]. In addition, C must report: on Part III, line 31, for its 2006 tax year income statement, depreciation expense of \$40,000 in column (a), a temporary difference of \$(10,000) in column (b) and \$30,000 in column (d); and on Part III, line 11, meals and entertainment expense of \$100 in column (a), a permanent difference of \$(50) in column (c), and \$50 in column (d). All other COGS items would be added to the amounts included on Part II, line 17 detailed in this example and reported on Part II, line 17, in the appropriate columns.

**Line 16. Sale Versus Lease (for Sellers and/or Lessors)**

(Also see the instructions at Part III, line 28, for purchasers and/or lessees.)

Asset transfer transactions with periodic payments characterized for financial accounting purposes as either a sale or a lease may, under some circumstances, be characterized as the opposite for tax purposes. If the transaction is treated as a lease, the seller/lessor reports the periodic payments as gross rental income and also reports depreciation expense or deduction. If the transaction is treated as a sale, the seller/lessor reports gross profit (sale price less cost of goods sold) from the sale of assets and reports the periodic

payments as payments of principal and interest income.

On Part II, line 16, column (a), report the gross profit or gross rental income for financial income purposes for all sale or lease transactions that must be given the opposite characterization for U.S. federal income tax purposes. On Part II, line 16, column (d), report the gross profit or gross rental income for federal income tax purposes. Interest income amounts for such transactions must be reported on Part II, line 11, Interest income, in column (a) or (d), as applicable. Depreciation expense for such transactions must be reported on Part III, line 24, Depreciation, in column (a) or (d), as applicable. Use columns (b) and (c) of Part II, lines 11 and 16, and Part III, line 24, as applicable to report the differences between column (a) and (d).

**Example 16.** Corporation M sells and leases property to customers. M is a calendar year taxpayer that was required to file Schedule M-3 for its 2006 tax year and is required to file Schedule M-3 for its 2007 tax year. For financial accounting purposes, M accounts for each transaction as a sale. For U.S. federal income tax purposes, each of M's transactions must be treated as a lease. In its financial statements, M treats the difference in the financial accounting and the U.S. federal income tax treatment of these transactions as temporary. During 2007, M reports in its financial statements \$1,000 of sales and \$700 of cost of goods sold with respect to 2007 lease transactions. M receives periodic payments of \$500 in 2007 with respect to these 2007 transactions and similar transactions from prior years and treats \$400 as principal and \$100 as interest income. For financial income purposes, M reports gross profit of \$300 (\$1,000 - \$700) and interest income of \$100 from these transactions. For U.S. federal income tax purposes, M reports \$500 of gross rental income (the periodic payments) and (based on other facts) \$200 of depreciation deduction on the property. On its 2007 Schedule M-3, M must report on Part II, line 11, \$100 in column (a), (\$100) in column (b), and zero in column (d). In addition, M must report on Part II, line 16, \$300 of gross profit in column (a), \$200 in column (b), and \$500 of gross rental income in column (d). Lastly, M must report on Part III, line 24, \$200 in column (b) and (d).

#### **Line 17. Section 481(a) Adjustments**

With the exception of a section 481(a) adjustment that is required to be reported on Part II, line 10, for reportable transactions, any difference between an income or expense item attributable to an authorized (or unauthorized) change in method of accounting made for U.S. federal income tax purposes that results in a section 481(a) adjustment must be reported on Part II, line 17, regardless of whether a separate line for that income or expense item exists in Part II or Part III.

**Example 17.** Corporation N is a calendar year taxpayer that was required to file Schedule M-3 for its 2006 tax year and is required to file Schedule M-3 for its 2007 tax year. N was depreciating certain fixed assets over an erroneous recovery period and, effective for its 2007 tax year, N receives IRS consent to change its method of accounting for the depreciable fixed assets and begins using the proper recovery period. The change in method of accounting results in a positive section 481(a) adjustment of \$100,000 that is required to be spread over four tax years, beginning with the 2007 tax year. In its financial statements, N treats the section 481(a) adjustment as a temporary difference. N must report on Part II, line 17, \$25,000 in columns (b) and (d) for its 2007 tax year and each of the subsequent three tax years (unless N is otherwise required to recognize the remainder of the 481(a) adjustment earlier). N must not report the section 481(a)



adjustment on Part III, line 24.

**Line 18. Unearned/Deferred Revenue**

Report on line 18, column (a), amounts of revenues included in Part I, line 10, that were deferred from a prior financial accounting year. Report on line 18, column (d), amounts of revenues recognizable for U.S. federal income tax purposes in the current tax year that are recognized for financial accounting purposes in a different year. Also report on line 18, column (d), any amount of revenues reported on line 18, column (a), that are recognizable for U.S. federal income tax purposes in the current tax year. Use columns (b) and (c) of line 18, as applicable, to report differences between column (a) and (d).

Line 18 must not be used to report income recognized from long-term contracts. Instead, use line 19.

**Line 19. Income Recognition From Long-Term Contracts**

Report on line 19 the amount of net income or loss for financial statement purposes (or books and records, if applicable) or U.S. federal income tax purposes for any contract accounted for under a long-term contract method of accounting.

**Line 20. Original Issue Discount and Other Imputed Interest**

Report on line 20 any amounts of original issue discount (OID) and imputed interest. The term “original issue discount and other imputed interest” includes, but is not limited to:

1. The difference between issue price and the stated redemption price at maturity of a debt instrument, which may be wholly or partially realized on the disposition of a debt instrument under section 1273;
2. Amounts that are imputed interest on a deferred sales contract under section 483;
3. Amounts treated as interest or OID under the stripped bond rules under Section 1286; and
4. Amounts treated as OID under the below-market interest rate rules under Section 7872.

**Line 21a. Income Statement Gain/loss on Sale, Exchange, Abandonment, Worthlessness, or Other Disposition of Assets Other Than Inventory and Pass-Through Entities**

Report on line 21a, column (a) all gains and losses on the disposition of assets except for (a) gains and losses on the disposition of inventory, and (b) gains and losses allocated to the corporation from a pass-through entity (e.g., on Schedule K-1) that are included in the net income (loss) per income statement of the corporation reported on Part I, line 10. Reverse the amount reported in column (a) in column (b) or (c), as applicable. The corresponding gains and losses for U.S. federal income tax purposes are reported on Part II, lines 21b through 21g, as applicable.

**Line 21b. Gross Capital Gains From Schedule D, Excluding Amounts From Pass-Through Entities**

Report on line 21b, gross capital gains reported on Schedule D, excluding capital gains from pass-through entities, which must be reported on Part II, lines 7, 8, or 9, as applicable.

**Line 21c. Gross Capital Losses From Schedule D, Excluding Amounts From Pass-Through Entities, Abandonment Losses, and Worthless Stock Losses**

Report on line 21c, gross capital losses reported on Schedule D, excluding capital losses from (a) pass-through entities, which must be reported on Part II, lines 7, 8, or 9, as applicable; (b) abandonment losses, which must be reported on Part II, line 21e; and (c) worthless stock losses, which must be reported on Part II, line 21f.

**Line 21d. Net Gain/Loss Reported on Form 4797, Line 17, Excluding Amounts From pass-Through Entities, Abandonment Losses, and Worthless Stock Losses**

Report on line 21d the net gain or loss reported on line 17 of Form 4797, Sales of Business Property, excluding amounts from (a) pass-through entities, which must be reported on Part II, lines 7, 8, or 9, as applicable; (b) abandonment losses, which must be reported on Part II, line 21e; and (c) worthless stock losses, which must be reported on Part II, line 21f.

**Line 21e. Abandonment Losses**

Report on line 21e any abandonment losses, regardless of whether the loss is characterized as an ordinary loss or a capital loss.

**Line 21f. Worthless Stock Losses**

Report on line 21f any worthless stock loss, regardless of whether the loss is characterized as an ordinary loss or a capital loss. Attach a schedule that separately states and adequately discloses each transaction that gives rise to a worthless stock loss and the amount of each loss.

**Line 21g. Other Gain/Loss on Disposition of Assets Other Than Inventory**

Report on line 21g any gains or losses from the sale or exchange of property other than inventory and that are not reported on lines 21b through 21f.

**Line 22. Other Income (Loss) Items With Differences**

Separately state and adequately disclose on Part II, line 22, all items of income (loss) with differences that are not otherwise listed on Part II, lines 1 through 21. Attach a schedule that itemizes the type of income (loss) and the amount of each item.

If any “comprehensive income” as defined by Statement of Financial Accounting Standards (SFAS) No. 130 is reported on this line, describe the item(s) in detail. Examples of sufficiently detailed descriptions include “Foreign currency translation adjustments” and “gains and losses on available-for-sale securities.”

**Line 24. Total Expense/ Deduction Items**

Report on Part II, line 24, columns (a) through (d), as applicable, the negative of the amounts reported on Part III, line 30, columns (a) through (d). For example, if Part III, line 30, column (a), reflects an amount of \$1 million then report on Part II, line 24, column (a), (\$1 million). Similarly, if Part III, line 30, column (b), reflects an amount of (\$50,000), then report on Part II, line 24, column (b), \$50,000.

**Line 25. Other Items With No Differences**

If there is no difference between the financial accounting amount and the taxable amount

of an entire item of income, gain, loss, expense, or deduction and the item is not described or included in Part II, lines 1 through 22, or Part III, lines 1 through 29, report the entire amount of the item in columns (a) and (d) of line 25. If a portion of an item of income, loss, expense, or deduction has a difference and a portion of the item does not have a difference, do not report any portion of the item on line 25. Instead, report the entire amount of the item (i.e., both the portion with a difference and the portion without a difference) on the applicable line of Part II, lines 1 through 22, or Part III, lines 1 through 29. See Example 10 on page \_\_\_\_.

**Line 26. Reconciliation Totals. Combine lines 23 through 25.**

If a corporation chooses not to complete columns (a) and (d) of Parts II and III in the first tax year the corporation is required to file Schedule M-3 (or for any year in which the corporation voluntarily files Schedule M-3), Part II, line 26, is reconciled by the corporation in the following manner:

1. Report the amount from Part I, line 10, on Part II, line 26, column (a);
2. Leave blank Part II, lines 1 through 25, columns (a) and (d);
3. Leave blank Part III, columns (a) and (d); and
4. Report on Part II, line 26, column (d), the sum of Part II, line 26, columns (a), (b), and (c).

**Part III. Reconciliation of Net Income (Loss) per Income Statement of the Corporation With Total Income (Loss) per Return — Expense/ Deduction Items**

**Lines 1 Through 6. Income Tax Expense**

If the corporation does not distinguish between current and deferred income tax expense in its financial statements (or its books and records, if applicable), report income tax expense as current income tax expense using lines 1, 3, and 5, as applicable.

**Line 7. Equity-Based Compensation**

Report on line 7 any amounts for equity-based compensation or consideration that are reflected as expense in the financial statements (column (a)) or deducted in the U.S. federal income tax return (column (d)) other than amounts reportable elsewhere on Schedule M-3, Parts II and III. Examples of amounts reportable on line 7 include payments attributable to stock options (including incentive stock options and nonqualified stock options), employee stock purchase plans (ESPPs), phantom stock options, phantom stock units, stock warrants, stock appreciation rights, and restricted stock, regardless of whether such payments are made to employees or non-employees, or as payment for property or compensation for services.

**Line 8. Meals and Entertainment**

Report on line 8, column (a), any amounts paid or accrued by the corporation during the tax year for meals, beverages, and entertainment that are accounted for in financial accounting income, regardless of the classification, nomenclature, or terminology used for such amounts, and regardless of how or where such amounts are classified in the corporation's financial income statement or the income and expense accounts maintained in the corporation's books and records. Report only amounts not otherwise reportable elsewhere on Schedule M-3, Parts II and III (e.g., Part II, line 15).

**Line 9. Fines and Penalties**

Report on line 9 any fines or similar penalties paid to a government or other authority for the violation of any law for which fines or penalties are assessed. All fines and penalties expensed in financial accounting income (paid or accrued) must be included on this line 9, column (a), regardless of the government or other authority that imposed the fines or penalties, regardless of whether the fines and penalties are civil or criminal, regardless of the classification, nomenclature, or terminology used for the fines or penalties by the imposing authority in its actions or documents, and regardless of how or where the fines or penalties are classified in the corporation's financial income statement or the income and expense accounts maintained in the corporation's books and records. Also report on line 9, column (a), the reversal of any overaccrual of any amount described in this paragraph. See section 162(f) for additional guidance.

Report on line 9, column (d), any such amounts as are described in the preceding paragraph that are includible in taxable income, regardless of the financial accounting period in which such amounts were or are included in financial accounting net income. Complete columns (b) and (c), as appropriate.

Do not report on this Part III, line 9, amounts required to be reported in accordance with instructions for Part III, line 10.

Do not report on this Part III, line 9, amounts recovered from insurers or any other indemnitors for any fines and penalties described above.

**Line 10. Judgments, Damages, Awards, Similar Costs**

Report on line 10, column (a), the amount of any estimated or actual judgments, damages, awards, settlements, and similar costs, however named or classified, included in financial accounting income, regardless of whether the amount deducted was attributable to an estimate of future anticipated payments or actual payments. Also report on line 10, column (a), the reversal of any overaccrual of any amount described in this paragraph.

Report on line 10, column (d), any such amounts as are described in the previous paragraph that are includible in taxable income, regardless of the financial accounting period in which such amounts were or are included in financial accounting net income. Complete columns (b) and (c), as appropriate.

Do not report on this Part III, line 10, amounts required to be reported in accordance with instructions for Part III, line 9.

Do not report on this Part III, line 10, amounts recovered from insurers or any other indemnitors for any judgments, damages, awards, or similar costs described above.

**Line 11. Pension and Profit-Sharing**

Report on line 11 any amounts attributable to the corporation's pension plans, profit-sharing plans, and any other retirement plans.

**Line 12. Other Post-Retirement Benefits**

Report on line 12 any amounts attributable to other post-retirement benefits not

otherwise includible on Part III, line 11, for example, retiree health and life insurance coverage, dental coverage, etc.

**Line 13. Deferred Compensation**

Report on line 13, column (a), any compensation expense included in the net income (loss) amount reported in Part I, line 10 that is not deductible for U.S. federal income tax purposes in the current tax year and that was not reported elsewhere on Schedule M-3, column (a). Report on line 13, column (d), any compensation deductible in the current tax year that was not included in the net income (loss) amount reported in Part I, line 10 for the current tax year and that is not reportable elsewhere on Schedule M-3. For example, report originations and reversals of deferred compensation subject to section 409A on line 13.

**Line 15. Charitable Contribution of Intangible Property**

Report on line 15 any charitable contribution of intangible property, for example, contributions of:

- Intellectual property, patents (including any amounts of additional contributions allowable by virtue of income earned by donees subsequent to the year of donation), copyrights, trademarks;
- Securities (including stocks and their derivatives, stock options, and bonds);
- Conservation easements (including scenic easements or air rights);
- Railroad rights of way;
- Mineral rights; and
- Other intangible property.

**Line 16. Current Year Acquisition or Reorganization Investment Banking Fees**

Report on line 16 any investment banking fees paid or incurred in connection with a taxable or tax-free acquisition of property (e.g., stock or assets) or a tax-free reorganization. Report on this line any investment banking fees incurred at any stage of the acquisition or reorganization process including, for example, fees paid or incurred to evaluate whether to investigate an acquisition, fees to conduct an actual investigation, and fees to consummate the acquisition. Also include on this line 16 investment banking fees incurred in connection with the liquidation of a subsidiary, a spin-off of a subsidiary, or an initial public stock offering.

**Line 17. Current Year Acquisition or Reorganization Legal and Accounting Fees**

Report on line 17 any legal and accounting fees paid or incurred in connection with a taxable or tax-free acquisition of property (e.g., stock or assets) or tax-free reorganization. Report on this line any legal and accounting fees incurred at any stage of the acquisition or reorganization process including, for example, fees paid or incurred to evaluate whether to investigate an acquisition, fees to conduct an actual investigation, and fees to consummate the acquisition. Also include on this line 17 legal and accounting fees incurred in connection with the liquidation of a subsidiary, a spin-off of a subsidiary, or an initial public stock offering.

**Line 18. Current Year Acquisition/Reorganization Other Costs**

Report on line 18 any other fees paid or incurred in connection with a taxable or tax-free

acquisition of property (e.g., stock or assets) or a tax-free reorganization not otherwise reportable on Schedule M-3 (e.g., Part III, line 16 or 17). Report on this line any fees paid or incurred at any stage of the acquisition or reorganization process including, for example, fees paid or incurred to evaluate whether to investigate an acquisition, fees to conduct an actual investigation, and fees to consummate the acquisition. Also include on this line 18 other acquisition/reorganization costs incurred in connection with the liquidation of a subsidiary, a spin-off of a subsidiary, or an initial public stock offering.

**Line 19. Amortization/ Impairment of Goodwill**

Report on line 19 amortization of goodwill or amounts attributable to the impairment of goodwill.

**Line 20. Amortization of Acquisition, Reorganization, and Start-Up Costs**

Report on line 20 amortization of acquisition, reorganization, and start-up costs. For purposes of column (b), (c), and (d), include amounts amortizable under sections 167, 195, or 248.

**Line 21. Other Amortization or Impairment Write-Offs**

Report on line 21 any amortization or impairment write-offs not otherwise includible on Schedule M-3.

**Line 22. Section 198 Environmental Remediation Costs**

Report on line 22, column (a), any amounts attributable to environmental remediation costs included in the net income per the income statement. Report in columns (b), (c), and (d), as applicable, any deductible amounts attributable to environmental remediation costs described in section 198 that are paid or incurred during the current tax year.

**Line 23a. Depletion – Oil & Gas**

Report on line 23a, column (a), any oil and gas depletion included in Part I, line 10.

**Line 23b. Depletion – Other than Oil & Gas**

Report on line 23b any depletion expense/deduction other than oil and gas that is not required to be reported elsewhere on Schedule M-3 (e.g., on Part II, lines, 7, 8, 9, or 15).

**Line 24. Depreciation**

Report on line 24 any depreciation expense that is not required to be reported elsewhere on Schedule M-3 (e.g., on Part II, lines, 7, 8, 9, or 15).

**Line 25. Bad Debt Expense**

Report on line 25, column (a), any amounts attributable to an allowance for uncollectible accounts receivable or actual write-offs of accounts receivable included in net income per the income statement. Report in column (d) the amount of bad debt expense deductible for federal income tax purposes in accordance with section 166.

**Line 26. Interest Expense**

Report on Part III, line 26, column (a), the total amount of interest expense included on Part I, line 10, and report on Part III, line 26, column (d), the total amount of interest deduction included on Form 1120S, page 3, Schedule K, line 18, that is not reported elsewhere on Schedule M-3. In columns (b) or (c), as applicable, adjust for any amounts treated for U.S. federal income tax purposes as interest deduction that are treated as some

other form of expense in the financial statements, or vice versa. For example, adjustments to interest expense /deduction resulting from adjustments made in accordance with instructions for Part III, line 28, Purchase versus lease (for purchasers and/or lessees), should be made in columns (b) and (c), as applicable, of this line 26.

Do not report on this line 26 amounts reported in accordance with instructions for (i) Part II, lines 7, 8 and 9, Income (loss) from U.S. partnerships, foreign partnerships and other pass-through entities, and (ii) Part II, line 10, Items relating to reportable transactions.

**Line 27. Corporate Owned Life Insurance Premiums**

Report on line 27 all amounts of insurance premiums attributable to any life insurance policy if the corporation is directly or indirectly a beneficiary under the policy or if the policy has a cash value. Report in column (d) the amount of the premiums that are deductible for federal income tax purposes.

**Line 28. Purchase Versus Lease (for Purchasers and/or Lessees)**

Note: Also see the instructions at Part II, line 16, for sellers and/or lessors.

Asset transfer transactions with periodic payments characterized for financial accounting purposes as either a purchase or a lease may, under some circumstances, be characterized as the opposite for tax purposes.

If a transaction is treated as a lease, the purchaser/lessee reports the periodic payments as gross rental expense. If the transaction is treated as a purchase, the purchaser/lessee reports the periodic payments as payments of principal and interest and also reports depreciation expense or deduction with respect to the purchased asset.

Report on Part III, line 28, column (a), gross rent expense for a transaction treated as a lease for income statement purposes but as a sale for U.S. federal income tax return purposes. Report on Part III, line 28, column (d), gross rental deductions for a transaction treated as a lease for U.S. federal income tax purposes but as a purchase for income statement purposes. Report interest expense or deduction amounts for such transactions on Part III, line 26, in column (a) or (d), as applicable. Report depreciation expense or deductions for such transactions on Part III, line 24, in column (a) or (d), as applicable. Use columns (b) and (c) of Part III, lines 24, 26, and 28, as applicable, to report the differences between column (a) and (d) for such recharacterized transactions.

**Example 18.** U.S. corporation X acquired property in a transaction that, for financial accounting purposes, X treats as a lease. X is a calendar year taxpayer that was required to file Schedule M-3 for its 2006 tax year and is required to file Schedule M-3 for its 2007 tax year. For U.S. federal income tax purposes, because of its terms, the transaction is treated for U.S. federal income tax purposes as a purchase and X must treat the periodic payments it makes partially as payment of principal and partially as payment of interest. In its financial statements, X treats the difference between the financial accounting and U.S. federal tax treatment of this transaction as a temporary difference. During 2007, X reports in its financial statements \$1,000 of gross rental expense that, for federal income tax purposes, is recharacterized as a \$700 payment of principal and a \$300 payment of interest, accompanied by a depreciation deduction of \$1,200 (based on

other facts). On its 2007 Schedule M-3, X must report the following on Part III, line 28: column (a) \$1,000, its financial accounting gross rental expense; column (b), (\$1,000); and column (d), zero. On Part III, line 26, X reports zero in column (a) and \$300 in columns (b) and (d) for the interest deduction. On Part III, line 24, X reports zero in column (a) and \$1,200 in columns (b) and (d) for the depreciation deduction.

### **Line 29. Other Expense/ Deduction Items With Differences**

Report on Part III, line 29, all items of expense/deduction that are not otherwise listed on Part III, lines 1 through 28.

**Comprehensive income.** If any “comprehensive income” as defined by SFAS No. 130 is reported on this line, describe the item(s) in detail as, for example, “Foreign currency translation adjustments” and “Gains and losses on available-for-sale securities.”

### **Reserves and contingent liabilities.**

Report on line 29 amounts related to the change in each reserve or contingent liability that is not required to be reported elsewhere on Schedule M-3. For example: (1) amounts relating to changes in reserves for litigation must be reported on Part III, line 13, Judgments, Damages, Awards, and Similar Costs; and (2) amounts relating to changes in reserves for uncollectible accounts receivable must be reported on Part III, line 32, Bad Debt Expense. (See Examples 9, 21, and 22.)

Report on Part III, line 35, the amortization of various items of prepaid expense, such as prepaid subscriptions and license fees, prepaid insurance, etc.

Report on line 29, column (a), expenses included in net income reported on Part I, line 10, that are related to reserves and contingent liabilities. Report on line 29, column (d), amounts related to liabilities for reserves and contingent liabilities that are deductible in the current tax year for U.S. federal income tax purposes. Examples of items that must be reported on line 29 include warranty reserves, restructuring reserves, reserves for discontinued operations, and reserves for acquisitions and dispositions. Only report on line 29 items that are not required to be reported elsewhere on Schedule M-3, Parts II and III. For example, the expense for a reserve for inventory obsolescence must be reported on Part II, line 15.

The schedule of details attached to the return for line 29 must separately state and adequately disclose the nature and amount of the expense related to each reserve and/or contingent liability. The appropriate level of disclosure depends upon each taxpayer’s operational activity and the nature of its accounting records. For example, if a corporation’s net income amount reported in the income statement includes anticipated expenses for a discontinued operation as a single amount, and its general ledger or other books, records, and workpapers provide details for the anticipated expenses under more explanatory and defined categories such as employee termination costs, lease cancellation costs, loss on sale of equipment, etc., a supporting schedule that lists those categories of expenses and their details will satisfy the requirement to separately state and adequately disclose. In order to separately state and adequately disclose the employee termination costs, it is not required that an anticipated termination cost amount be listed for each employee, or that each asset (or category of asset) be listed along with the anticipated loss on disposition.



**Example 19.**

**A.** Corporation P is a calendar year taxpayer that was required to file Schedule M-3 for its 2006 tax year and is required to file Schedule M-3 for its 2007 tax year. P has been sued by its customers in a class action product liability lawsuit. The trial date is in 2008. In its 2007 financial statements, P establishes a reserve of \$1 million for its potential liability related to the class action lawsuit and reports corresponding expenses in the amounts of \$400,000 for estimated product replacement and \$600,000 for estimated personal damages. For U.S. federal income tax purposes, the \$1 million is not deductible in 2007. In its financial statements, P treats the difference between the financial statement treatment and the U.S. federal income tax treatment of the reserve for the lawsuit as a temporary difference. P must report in its 2007 U.S. federal income tax return on Part III, line 29, \$1 million in column (a), (\$1 million) in column (b), and zero in column (d). If P attaches a supporting schedule to Part III, line 29, explaining that the \$1 million of difference is attributable to estimated product replacement cost in the amount of \$400,000 and estimated personal damages in the amount of \$600,000, that level of detail will be sufficient to separately state and adequately disclose the \$1 million adjustment.

**B.** Same as Example 19A except that in 2008 P pays \$1 million to settle the lawsuit with the settlement documents stipulating that the product replacement amount is \$450,000 and the damage amount is \$550,000. Both the \$450,000 and \$550,000 settlement amounts are deductible for U.S. federal income tax purposes in 2008. On its 2008 Schedule M-3, P must report on Part III, line 29, zero in column (a), \$1 million in column (b), and \$1 million in column (d). If P attaches a supporting schedule to Part III, line 29, explaining that the \$1 million of difference is attributable to actual product replacement cost in the amount of \$450,000 and actual personal damages in the amount of \$550,000, that level of detail will be sufficient to separately state and adequately disclose the \$1 million deduction.

**Example 20.** Corporation Q is a calendar year taxpayer that was required to file Schedule M-3 for its 2006 tax year and is required to file Schedule M-3 for its 2007 tax year. On July 1 of each year, Q has a fixed liability for its annual insurance premiums that provides a 12-month coverage period beginning July 1 through June 30. In addition, Q historically prepays 12 months of advertising expense on July 1. On July 1, 2007, Q prepays its insurance premium of \$500,000 and advertising expenses of \$800,000. For financial statement purposes, Q capitalizes and amortizes the prepaid insurance and advertising over 12 months. For U.S. federal income tax purposes, Q deducts the insurance premium when paid and amortizes the advertising over the 12-month period. In its financial statements, Q treats the differences attributable to the financial statement treatment and U.S. federal income tax treatment of the prepaid insurance and advertising as temporary differences. Q must separately state and adequately disclose on Part III, line 31, its prepaid insurance premium and report \$250,000 in column (a) ( $\$500,000/12$  months X 6 months), \$250,000 in column (b), and \$500,000 in column (d). Q must also separately state and adequately disclose on Part II, line 25, Other income (loss) and expense/ deduction items with no differences, its prepaid advertising and report \$400,000 in column (a) and (d).

**Line 30. Total Expense/ Deduction Items**

Report on Part II, line 24, columns (a) through (d), as applicable, the negative of the

amounts reported on Part III, line 30, column (a) through (d), as applicable. For example, if Part III, line 30, column (a), reflects an amount of \$1 million, then report on Part II, line 24, column (a), (\$1 million). Similarly, if Part III, line 30, column (b), reflects an amount of (\$50,000), then report on Part II, line 24, column (b), \$50,000.

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