2004

Department of the Treasury
Internal Revenue Service

Instructions for Schedule M-3 (Form 1120)

Net Income (Loss) Reconciliation for 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.

Schedule M-3 Part II reconciles financial statement net income (loss) for the financial statement consolidation group to income (loss) per the income statement for the U.S. consolidated tax group.

Schedule M-3, Parts III and IV reconcile financial statement net income (loss) for the U.S. consolidated tax group (per Schedule M-3, Part II, line 8) to taxable income on Form 1120, page 1, line 28.

Who Must File

Any domestic corporation or U.S. consolidated tax group (includible corporations listed on **Form 851,** Affiliations Schedule) with total assets of $10 million or more on the last day of the tax year as reported on Schedule L, line 15, column (D), must complete Schedule M-3 instead of **Schedule M-1,** Reconciliation of Income (Loss) per Books With Income per Return.

Other Form 1120 Schedules Affected by Schedule M-3 Requirements

Report on Schedules L, M-2, and Form 1120, page 1, amounts for the U.S. consolidated tax group.

Schedule L

Total assets shown on Schedule L, line 15, column (D) must equal the total consolidated assets of the U.S. consolidated tax group as of the last day of the tax year, and must be based on the same financial statements used for Schedule M-3. 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 only books and records reflect tax-basis amounts.

Schedule M-2

Schedule M-2, line 2, net income (loss) must equal the amount shown on Schedule M-3, Part II, line 8. Schedule M-2 must reflect activity only of corporations included in the U.S. consolidated tax return.

Consolidated Return (Form 1120, Page 1)

Form 1120, page 1 must report any item of income, gain, loss, deduction, or credit net of elimination entries for intercompany transactions between affiliated corporations included in the U.S. consolidated tax return (includible corporations). Corporations must not report as dividends on Form 1120, page 2, Schedule C, Dividends and Special Deductions, any amounts received from an includible corporation. Dividends received from an includible corporation must be eliminated in consolidation rather than offset by the dividends received deduction.

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. Rather, any item of income, gain, deduction, or credit of a disregarded entity must be reported as an item of its owner.

Specific Instructions for Parts I and II

Part I. Questions Regarding Corporate Financial Statements and Publicly Traded Common Stock

Line 1. Indicate Source of Net Income Shown on Part II, Line 1

Check the financial statement type listed on Part 1, line 1, that is the source of the amount on Part II, line 1. The financial statement type must be the first listed of the following types of financial statements that the corporation prepares: (a) Securities and Exchange Commission (SEC) Form 10-K financial statements; (b) other certified financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP); or (c) other financial statements (attach explanation of the accounting standards applied). If the corporation does not prepare financial statements, check line 1(d): "No income statement. Books and records used."

A corporation that does not prepare financial statements must check line 1(d), skip lines 2 through 5 of Part I, skip lines 1 through 7 of Part II, and enter net income (loss) per books and records of includible corporations on line 8 of Part II.

Part II. Reconciliation of Net Income (Loss) per Income Statement With Net Income (Loss) of Includible Corporations

For U.S. consolidated tax returns, it is not necessary for each corporation listed on Form 851 to complete Schedule M-3, Part II.

Line 1. Net Income (Loss) per Income Statement

If a corporation prepares financial statements, line 1 equals the financial statement net income (loss). The corporation must use financial statement amounts from the financial statement type checked on Schedule M-3, Part I, line 1.

Line 2. Remove Net Income (Loss) of Nonincludible Foreign Corporations

Remove the financial statement net income (loss) of each foreign entity that is included in the financial statement consolidated group and is not an includible corporation in the U.S. consolidated tax group (nonincludible foreign entity). In addition, adjust consolidation eliminations and correct for minority interest and intercompany dividends for any nonincludible foreign entity on Schedule M-3, Part II, line 5.

Attach a supporting schedule that provides the name, EIN (if applicable), and financial statement net income (loss) included on line 1 and on line 8 of each nonincludible foreign entity.

Line 3. Remove Net Income (Loss) of Nonincludible U.S. Corporations

Remove the financial statement net income (loss) of each U.S. entity that is included in the financial statement consolidated group and is not an includible corporation in the U.S. consolidated tax group (nonincludible U.S. entity). In addition, adjust consolidation eliminations and correct for minority interest and intercompany dividends for any nonincludible U.S. entity on Schedule M-3, Part II, line 5.

Attach a supporting schedule that provides the name, EIN (if applicable), and financial statement net income (loss) included on line 1 and on line 8 of each nonincludible U.S. entity.

Line 4. Include Net Income (Loss) of Other Includible Corporations

Include the financial statement net income (loss) of each corporation includible in the U.S. consolidated tax group that is not included in the financial statement consolidated group (other includible corporation).

Attach a supporting schedule that provides the name, EIN (if applicable), and financial statement net income (loss) included on line 1 and on line 8 of each other includible corporation.

Line 5. Adjust Elimination of Transactions Between Includible and Nonincludible Corporations

Include on line 5 any adjustments for minority interests, intercompany dividends, and eliminations of intercompany transactions associated with amounts removed or included on Schedule M-3, Part III, lines 2 through 4, for any nonincludible foreign entity, nonincludible U.S. entity, or other includible entity so that the adjusted consolidation entries and intercompany eliminations pertain only to the members of the U.S. consolidated tax group. Adjustments for consolidation entries are necessary on line 5 to ensure that transactions between includible corporations (corporations in the U.S. consolidated tax group) and nonincludible corporations (corporations in the financial statement consolidated group but not in the U.S. consolidated tax group) are not eliminated. Additionally, adjustments for consolidation entries are necessary on line 5 to ensure that transactions between includible corporations (corporations in the U.S. consolidated tax group) that are not in the financial statement consolidated group are eliminated.

Line 6. Adjust Net Income (Loss) to Reconcile Income Statement Year to Tax Return Year

Include on line 6 any adjustments necessary to reconcile differences between the financial statement reporting period and the corporation's tax year.

Line 7. Other Adjustments Required To Reconcile to Amount on Line 8

Include on line 7 any other adjustments to reconcile net income (loss) on Schedule M-3, Part II, line 1, with net income (loss) of includible corporations reported on Schedule M-3, Part II, line 8.

Line 8. Net Income (Loss) per Income Statement of Includible Corporations

Line 8 must reflect the consolidated income statement net income (loss) of all corporations included in the U.S. consolidated tax return.

Example 1. U.S. corporation P is publicly traded and files Form 10-K with the SEC. P owns 80% or more of the stock of U.S. corporations DS1-DS75, between 51% and 79% of the stock of U.S. corporations DS76-DS100, and 100% of the stock of foreign subsidiaries FS1-FS50. P eliminates all dividend income from DS1-DS100 and FS1-FS50 in financial statement consolidation entries. Furthermore, P eliminates the minority interest ownership of DS76-DS100 in financial statement consolidation entries. P's Form 10-K includes P, DS1-DS100 and FS1-FS50. P files a U.S. consolidated tax return with DS1-DS75.

P must check Schedule M-3, Part I, line 1(a). On Schedule M-3, Part II, line 1, P must report the consolidated net income from the SEC Form 10-K for the financial statement consolidated group of P, DS1-DS100, and FS1-FS50. P must remove the net income (loss) of FS1-FS50 on Schedule M-3, Part II, line 2. P must remove the net income (loss) before minority interests of DS76-DS100 on Schedule M-3, Part II, line 3. P must reverse on Schedule M-3, Part II, line 5, the elimination of any transactions between members of the U.S. consolidated tax group and the nonincludible corporations (DS76-DS100 and FS1-FS50), including dividends received from DS76-DS100 and the minority interest's share of the net income (loss) of DS76-DS100.

P reports on Schedule M-3, Part II, line 8, the consolidated financial statement net income (loss) attributable to P and DS1-DS75, the members of the U.S. consolidated tax group. Intercompany transactions between members of the U.S. consolidated tax group (P and

DS1-DS75) that had been eliminated in the net income amount on line 1 remain eliminated on line 8. Transactions between members of the U.S. consolidated tax group and the nonincludible corporations (DS76-DS100 and FS1-FS50) that are eliminated in the net income amount on line 1 are no longer eliminated on line 8.

Example 2. Foreign corporation F owns 100% of the stock of U.S. corporation P. P owns 100% of the stock of DS1, 60% of the stock of DS2, and 100% of the stock of FS1. Neither F nor P prepares financial statements. P files a U.S. consolidated tax return with DS1.

P must check Schedule M-3, Part I, line 1(d), skip lines 2 through 5 of Part I, skip lines 1 through 7 of Part II, and enter net income (loss) per books and records of P and DS1 on line 8 of Part II, net of eliminations for transactions between P and DS1.

Example 3. U.S. Corporation C owns 60% of the capital and profits interests in U.S. LLC N. N has net income of $100 (before minority interests) and makes no distributions during the year. C treats N as a corporation for financial statement purposes and as a partnership for U.S. Federal income tax purposes. C consolidates N in its financial statements and includes $60 of net income ($100 less the minority interest of $40) on Schedule M-3, Part II, line 1.

C must remove the $100 net income of N on Schedule M-3, Part II, line 3. C must reverse on Schedule M-3, Part II, line 5, the elimination of the $40 minority interest net income of N. The result is that C reports no income for N on Schedule M-3, Part II, line 8. C's taxable income from N must be reported by C on Schedule M-3, Part III, lines 9, 27, and 28, as applicable.

Example 4. U.S. Corporation P owns 80% of the stock of U.S. Corporation DS1. The financial statements of P do not include DS1. P files a U.S. consolidated tax return with DS1. DS1 has current year net income of $100 and pays a dividend of $50 of which $40 is paid to P. P reports the $40 dividend as part of its net income in its financial statements and on Schedule M-3, Part II, line 1. P must include the $100 net income of DS1 on Schedule M-3, Part II, line 4. P must remove on Schedule M-3, Part II, line 5, the $40 of dividend income from DS1.

Specific Instructions for Parts III and IV

For U.S. consolidated tax returns, file supporting schedules for each includible corporation. See **Consolidated returns** on page 5 of the Form 1120 instructions under **Statements.**

General Format of Parts III and IV

Columns A and D

For each line item in Schedule M-3, Parts III and IV, report in column (A) the amount of net income (loss) included in Schedule M-3, Part II, line 8, and report in column (D) the amount included in taxable income.

Columns B and C

For any item of income, gain, loss, deduction, or credit 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 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 will reverse in a future tax year (that is, have an opposite effect on taxable income in a future tax year (or years) due to the difference in timing of recognition for financial accounting and 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 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. Corporation P is a U.S. publicly traded company that files a U.S. consolidated tax return and prepares GAAP financial statements. P acquired 100% of the stock of corporation DS in 1990 in a tax-free transaction. As part of the acquisition, P acquired intellectual property (IP) and goodwill. The IP is amortizable for both financial statement purposes and Federal income tax purposes. The goodwill is only amortizable for financial statement purposes. P's annual amortization expense for the IP is $6,000 for financial statement purposes and $9,000 for Federal income tax purposes. P's annual amortization expense for the acquired goodwill is $5,000 for financial statement purposes and $0 for Federal income tax purposes. Even though the amortization attributable to the acquired goodwill may reverse in the future for Federal income tax purposes (e.g., if DS sells all of its assets), the amortization expense is a permanent difference because it is not treated as a temporary difference in P's financial statements. P must report on Schedule M-3, Part IV, line 25 (Other amortization or impairment write-offs) income statement amortization expense of $11,000 in column (A), a temporary difference of $3,000 in column (B), a permanent difference of ($5,000) in column (C), and Federal income tax amortization expense of $9,000 in column (D).

Reporting Differences in Parts III and IV

Each difference reported on Schedule M-3, Parts III and IV, 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).

Except as otherwise provided, differences for the same item must be combined or netted together. However, differences for separate items must not be combined or netted together.

Example 6. Corporation C is a calendar year taxpayer that placed in service ten depreciable fixed assets in 2000. C's total depreciation expense for its 2004 tax year for five of the assets is $50,000 for income statement purposes and $70,000 for Federal income tax purposes. C's total annual depreciation expense for its 2004 tax year for the other five assets is $40,000 for income statement purposes and $30,000 for Federal income tax purposes. The depreciation differences will reverse in future tax years and must be classified as temporary differences. C must combine all of its depreciation adjustments. Accordingly, C must report on Schedule M-3, Part IV, line 29 (Depreciation) for its 2004 tax year income statement depreciation expense of $90,000 in column (A), a temporary difference of $10,000 in column (B), and Federal income tax depreciation expense of $100,000 in column (D).

Example 7. On December 31, 2004, Corporation C, a calendar year taxpayer, established 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 a settlement C may have to pay as a result of pending litigation. The third reserve is an estimate of future warranty expenses. C treats the three reserve accounts in its financial statements as giving rise to temporary differences that will reverse in future years. The three reserves are expenses in C's 2004 financial statements but are not deductions for Federal income tax purposes in 2004. C must not combine the Schedule M-3 differences for the three reserve accounts. Accordingly, C must report the amounts attributable to the allowance for uncollectible accounts receivable on Schedule M-3, Part IV, line 30 (Bad debt expense), and must separately state and adequately disclose the amounts attributable to the reserve for pending litigation and the warranty reserve on Schedule M-3, Part IV, line 36 (Other expense/deduction items with differences).

Example 8. On January 2, 2004, Corporation C, a calendar year taxpayer, established an allowance for uncollectible accounts receivable (bad debt reserve) of $100,000. During 2004, C increased the reserve by $250,000 for additional accounts receivable that may become uncollectible. Additionally, during 2004 C decreased the reserve by $75,000 for accounts receivable that were discharged in bankruptcy during 2004. The balance in the reserve account on December 31, 2004, is $275,000. The $100,000 amount to establish the reserve account and the $250,000 to increase the reserve account are expenses on C's 2004 financial statements but are not deductible for Federal income tax purposes in 2004. However, the $75,000 decrease to the reserve is deductible for Federal income tax purposes in 2004. C treats the reserve account in its financial statements as giving rise to a temporary difference that will reverse in future tax years. C must report on Schedule M-3, Part IV, line 30 (Bad debt expense) for its 2004 tax year income statement bad debt expense of $350,000 in column (A), a temporary difference of ($275,000) in column (B), and Federal income tax bad debt expense of $75,000 in column (D).

Part III. Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return — Income (Loss) Items

Lines 1 Through 8. Additional Information for each Corporation

For any item of difference reported on lines 1 through 8, attach a supporting schedule that provides the name, EIN (if applicable), and the amount of the item of difference for each corporation.

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

Report on line 1, column (A), the income statement income (loss) from any equity method foreign corporation included in Schedule M-3, Part II, line 8. Report the dividends from any equity method foreign corporation on Schedule M-3, Part III, column (D), of lines 2 through 4, as applicable.

Line 2. Gross Foreign Dividends Not Previously Taxed

Report on line 2, column (D), the amount (before any withholding tax) of any foreign dividends included in taxable income on Form 1120, page 1, line 28. Additionally, report on line 2, column (A), the amount of dividends from any foreign corporation included on Schedule M-3, Part II, line 8. Do not report any amounts that are reported on lines 3 or 4 of Schedule M-3, Part III, or dividends that were previously taxed (see line 5).

Line 3. Subpart F, PFIC, QEF, and Similar Income Inclusions

Report on line 3, column (D), the amount included in gross income under section 551 (relating to foreign personal holding companies), section 951 (relating to Subpart F) and 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 8, 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.

Line 4. Section 78 Gross-Up

Report on line 4, column (D), the amount of any section 78 gross-up. The amount of any section 78 gross-up corresponds to the total of the amounts reported by the corporation on all **Forms 1118,** Foreign Tax Credit - Corporations and all Forms 5471.

Line 5. Gross Foreign Distributions Previously Taxed

Report on line 5 any distributions received from a foreign corporation that were included in Schedule M-3, Part II, line 8, and that were previously taxed. Report the full amount of the distributions before any withholding tax. For example, include amounts that are excluded from income under section 959 and 1293(c).

Line 6. Income (Loss) From Equity Method U.S. Corporations

Report on line 6, column (A), the income (loss) from any equity method U.S. corporation included in Schedule M-3, Part II, line 8. Report the dividends from any equity method U.S. corporation on Schedule M-3, Part III, line 7, column (D).

Line 7. U.S. Dividends Not Eliminated in Tax Consolidation

Report on line 7, column (D), the amount of any U.S. dividends included in taxable income on Form 1120, page 1, line 28 (that is, dividends received from any U.S. corporation that is not included in the U.S. consolidated tax group).

Line 8. Minority Interest for Includible Corporations

Report on line 8, column (A), the minority interest in the income statement income (loss) for any member of the U.S. consolidated tax group that is less than 100% owned.

Example 9. U.S. Corporation P owns 90% of the stock of U.S. Corporation DS1. P files a U.S. consolidated tax return with DS1. P prepares certified GAAP financial statements for the consolidated group consisting of P and DS1. P has no net income. DS1 has financial statement income (before minority interests) and taxable income of $1,000. On Schedule M-3, Part II, line 8, the U.S. consolidated group reports $900 of financial statement income ($1,000 net income less $100 minority interest). On Schedule M-3, Part III, line 8 (Minority interest for includible corporations), the U.S. consolidated tax group reports ($100) in column (A), $100 in column (C), and $0 in column (D). On Schedule M-3, Part III, line 34 (Other income (loss) items with no difference), the U.S. consolidated tax group reports $1,000 in both columns (A) and (D). As a result, financial statement net income on line 37, column (A), will total $900 and taxable income on line 37, column (D), will total $1,000.

Line 9. Income (Loss) From U.S. Partnerships and Line 10. Income (Loss) From Foreign Partnerships

For any partnership interests held by a member of the U.S. consolidated tax group (other than an interest in a disregarded entity), report on lines 9 and 10, as applicable, the sum of all items of income, gain, loss, or deduction shown on Schedule K-1, excluding net capital gains (which are reported on Schedule M-3, Part III, line 27) and net capital losses (which are reported on Schedule M-3, Part III, line 28). Attach a supporting schedule that provides the name, EIN (if applicable), and the amount from each partnership interest reported on line 9 and 10, as applicable. Report on Schedule M-3, Part III, line 10, the income (loss) from any foreign entity that is treated as a partnership for U.S. tax purposes.

Line 11. Income (Loss) From Other Flow-Through Entities

Report on line 11 the sum of all items of income, gain, loss, or deduction, excluding net capital gains (which are reported on Schedule M-3, Part III, line 27) and net capital losses (which are reported on Schedule M-3, Part III, line 28), from any flow-through entity other than a partnership or a disregarded entity. Attach a supporting schedule that provides the name, EIN (if applicable), and the amount from each flow-through entity. Examples of a flow-through entity include an entity designated as a trust, a special purpose entity, and a variable interest entity.

Line 21. Sale Versus Lease

Report on line 21 any differences (e.g., revenue, cost of goods sold, interest, and depreciation) due to characterization of a transaction as a sale for income statement purposes and as a lease for Federal income tax purposes, or vice versa.

Example 10. U.S. corporation C sells and leases property to customers. C treats each transaction as a sale for financial statement purposes. For U.S. tax purposes, C treats each transaction as a lease. The differences due to the characterization of a transaction as a sale for financial statement purposes and as a lease for U.S. tax purposes will reverse in a future tax year and must be classified as temporary differences. During 2004, C reports in its financial statements $1,000 of sales and $700 of cost of goods sold with respect to 2004 lease transactions, plus $100 of interest income on the deferred payments from prior lease transactions. For U.S. tax purposes, C reports $500 of rental income from leasing transactions and $200 of depreciation expense. C must report on Schedule M-3, Part III, line 21, for its 2004 tax year income statement net income of $400 ($1,000 - $700 + $100) in column (A), a temporary difference of ($100) in column (B), and taxable income of $300 ($500 - $200) in column (D).

Line 27. Net Capital Gain From Flow-Through Entities

Report on line 27 the net capital gains from each partnership or other flow-through entity.

Line 28. Net Capital (Loss) From Flow-Through Entities

Report on line 28 the net capital losses from each partnership or other flow-through entity.

Line 31. Disallowed Capital Loss in Excess of Capital Gains

Report as a positive amount on line 31, columns (B) and (D), the excess of the net capital losses over the net capital gains reported on Schedule D (Capital Gains and Losses) by the corporation.

Line 32. Utilization of Capital Loss Carryforward

If the corporation utilizes a capital loss carryforward on Schedule D in the current period, show the carryforward as a negative amount on line 32, columns (B) and (D).

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

Line 17. Charitable Contribution of Intangible Property

Attach a supporting schedule showing the total amounts for each column for contributions of intellectual property, stock, and other intangible property.

Line 29. Depreciation

Report on line 29 any depreciation expense that is not reported elsewhere on Schedule M-3, Part III or Part IV (e.g., on Schedule M-3, Part III, line 17, 18, or 21, or Schedule M-3, Part IV, line 33 or 34).