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 and reconciles financial statement net income (loss) for the consolidated financial statement group to income (loss) per the income statement for the U.S. consolidated tax group.

Schedule M-3 Parts II and III reconcile financial statement net income (loss) for the U.S. consolidated tax group (per Schedule M-3, Part I, line 11) to taxable income on Form 1120, page 1, line 28.

Who Must File

Schedule M-3 is effective for any tax year ending on or after December 31, 2004. 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 domestic corporation (including a U.S. consolidated tax group consisting of a U.S. parent corporation and additional includible corporations listed on Form 851, Affiliations Schedule) required to file Form 1120, U.S. Corporation Income Tax Return, that reports on Schedule L of Form 1120 total consolidated 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 per Return. A U.S. corporation filing Form 1120 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 1120, page 1, item A, indicating that Schedule M-3 is attached (whether required or voluntary). A corporation filing Schedule M-3 must not file Schedule M-1.

Note. Indicate after the common parent's name on pages 2 and 3 whether the Schedule M-3 is for the parent's own activity (PAR), the consolidated tax group (CON), or consolidation eliminations (ELM). For example, common parent XYZ Corporation's name is shown on pages 2 and 3 of its own Schedule M-3 as XYZ Corporation (PAR).

If the parent corporation of a U.S. consolidated tax group files Form 1120 and files Schedule M-3, all members of the group must file Schedule M-3. However, if the parent corporation of a U.S. consolidated tax group files Form 1120 and any member of the group files Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return, or Form 1120-L, U.S. Life Insurance Company Income Tax Return, that member may either (a) fully complete Schedule M-3 as if the member filed Form 1120; or (b) complete Schedule M-3 by including the sum of all differences between the member's income statement net income (or loss) and taxable income (differences) (regardless of whether the difference would otherwise be reported elsewhere on Part II or on Part III) on Part II, line 26, Other income (loss) items with differences, and separately state and adequately disclose each difference in a supporting schedule. Any member of the U.S. consolidated tax group that files Form 1120-PC or Form 1120-L and is required to file Schedule M-3 (in accordance with the preceding sentence) may classify all differences as permanent in column (c) or identify each difference as temporary or permanent, as appropriate.

If the parent company of a U.S. consolidated tax group files Form 1120 and any member of the group files Form 1120-PC or Form 1120-L and the consolidated Schedule L reported in the return includes the assets of all of the insurance companies (as well as the non-insurance companies in the U.S. consolidated tax group), in order to determine if the group meets the $10 million threshold test for the requirement to file Schedule M-3, use the amount of total assets reported on Schedule L of the consolidated return. If the parent company of a U.S. consolidated tax group files Form 1120 and any member of the group files Form 1120-PC or Form 1120-L and the consolidated Schedule L reported in the return does not include the assets of one or more of the insurance companies in the U.S. consolidated tax group, in order to determine if the group meets the $10 million threshold test for the requirement to file Schedule M-3, use the sum of the amount of total assets reported on the consolidated Schedule L plus the amounts of all assets reported on Forms 1120-PC and 1120-L that are included in the consolidated return.

Schedule M-3 is not required for any taxpayers other than those identified in the preceding paragraphs including, for example, taxpayers required to file Form 1065, U.S. Return of Partnership Income, Form 1120S, U.S. Income Tax Return for an S Corporation, Form 1120-REIT, U.S. Income Tax Return for Real Estate Investment Trusts, Form 1120-F, U.S. Income Tax Return of a Foreign Corporation, Form 1120-H, U.S. Income Tax Return for Homeowners Associations, and Form 1120-SF, U.S. Income Tax Return for Settlement Funds. In addition, Schedule M-3 is not required for any member of a U.S. consolidated tax group if the parent corporation of the group files Form 1120-PC or Form 1120-L.

Example 1. U.S. corporation A owns U.S. subsidiary B and foreign subsidiary F. For its 2004 tax year, A prepares consolidated financial statements with B and F that report total assets of $12 million. A files a consolidated U.S. federal income tax return with B and reports total consolidated assets on Schedule L of $8 million. A's U.S. consolidated tax group is not required to file Schedule M-3 for the 2004 tax year.

If a corporation was required to file Schedule M-3 for the preceding tax year but reports on Schedule L of Form 1120 total consolidated 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.

In the case of a U.S. consolidated tax group, total assets at the end of the tax year must be determined based on the total year-end assets of all includible corporations listed on Form 851, net of eliminations for intercompany transactions and balances between the includible corporations. In addition, for purposes of determining for Schedule M-3 whether the corporation (or U.S. consolidated tax group) has total assets at the end of the current tax year of $10 million or more, the corporation's total consolidated assets must be determined on an overall accrual method of accounting unless both of the following apply: (a) the tax returns of all includible corporations in the U.S. consolidated tax group are prepared using an overall cash method of accounting, and (b) no includible corporation in the U.S. consolidated tax group prepares or is included in financial statements prepared on an accrual basis.

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 assets of the corporation (or, in the case of a U.S. consolidated tax group, the total assets of all members of the group listed on Form 851) as of the last day of the tax year, and must be the same total assets reported by the corporation (or by each member of the U.S. consolidated tax group) 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 each corporation listed on Form 851 and included in the U.S. consolidated tax return (includible corporation) net of eliminations for intercompany transactions between includible corporations. 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.

Schedule M-2

The amount shown on Schedule M-2, line 2, Net income (loss) per books, must equal the amount shown on Schedule M-3, Part I, line 11. Schedule M-2 must reflect activity only of corporations included in the U.S. consolidated tax return.

Consolidated Return (Form 1120, Page 1)

Report on Form 1120, page 1, each item of income, gain, loss, expense, or deduction net of elimination entries for intercompany transactions between includible corporations. The corporation must not report as dividends on Form 1120, Schedule C, any amounts received from an includible corporation. In general, 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. Instead, any item of income, gain, loss, deduction, or credit of a disregarded entity must be reported as an item of its owner.

Consolidated Schedule M-3 Versus Consolidating Schedules M-3

A U.S. consolidated tax group must file a consolidated Schedule M-3. Parts I, II, and III of the consolidated Schedule M-3 must reflect the activity of the entire U.S. consolidated tax group. The parent corporation also must complete Parts II and III of a separate Schedule M-3 to reflect the parent's own activity. In addition, Parts II and III of a separate Schedule M-3 must be completed by each includible corporation to reflect the activity of that includible corporation. Lastly, it generally will be necessary to complete Parts II and III of a separate Schedule M-3 for consolidation eliminations. For example, if a U.S. consolidated tax group consists of four includible corporations (the parent and three subsidiaries), the U.S. consolidated tax group must complete six Schedules M-3 as follows: (a) one consolidated Schedule M-3 with Parts I, II, and III completed to reflect the activity of the entire U.S. consolidated tax group; (b) Parts II and III of a separate Schedule M-3 for each of the four includible corporations to reflect the activity of each includible corporation; and (c) Parts II and III of a separate Schedule M-3 to eliminate intercompany transactions between includible corporations and to include limitations on deductions (e.g., charitable contribution limitations and capital loss limitations) and carryover amounts (e.g., charitable contribution carryovers and capital loss carryovers).

Note. Indicate after the common parent's name on pages 2 and 3 whether the Schedule M-3 is for the parent's own activity (PAR), the consolidated tax group (CON), or consolidation eliminations (ELM). For example, common parent XYZ Corporation's name is shown on pages 2 and 3 of its own Schedule M-3 as XYZ Corporation (PAR).

If an item attributable to an includible corporation is not shared by or allocated to the appropriate member of the group but is retained in the parent corporation's financial statements (or books and records, if applicable), then the item must be reported by the parent corporation on its separate Schedule M-3. For example, if the parent of a U.S. consolidated tax group prepares financial statements that include all members of the U.S. consolidated tax group and the parent does not allocate the group's income tax expense as reflected in the financial statements among the members of the group but retains it in the parent corporation, the parent corporation must report on its separate Schedule M-3 the U.S. consolidated tax group's income tax expense as reflected in the financial statements.

Any adjustments made at the consolidated group level that are not attributable to any specific member of the U.S. consolidated tax group (e.g., disallowance of net capital losses, contribution deduction carryovers, and limitation of contribution deductions) must not be reported on the separate consolidating parent or subsidiary Schedules M-3 but rather on the consolidated Schedule M-3 and on the consolidating Schedule M-3 for consolidation eliminations (see the second preceding paragraph).

If an includible corporation has no activity for the tax year (e.g., because the corporation is a dormant or inactive corporation), no amount for the corporation was included in Part I, line 11, and the corporation has no amounts to report on Part II and Part III of Schedule M-3 for the tax year, the parent corporation of the U.S. consolidated tax group may attach to the consolidated Schedule M-3 a statement that provides the name and EIN of the includible corporation in lieu of filing a blank Part II and Part III of Schedule M-3 for such entity.

Completion of Schedule M-3

A corporation (or any member of a U.S. consolidated tax group) required to file Schedule M-3 must complete the form in its entirety. At the time the Form 1120 is filed, all applicable questions must be answered on Part I (except that in the case of a U.S. consolidated tax group, Part I need only be completed once, on the consolidated Schedule M-3, by the parent corporation), 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 1120 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 11, use only the financial statements of the U.S. corporation filing the U.S. federal income tax return (the consolidated financial statements for the U.S. parent corporation of a U.S. consolidated tax group). If the U.S. corporation filing a U.S. federal income tax return (or the U.S. parent corporation of a U.S. consolidated tax group) is controlled by another corporation (U.S. or foreign), the U.S. corporation (or the U.S. parent corporation of a U.S. consolidated tax group) must not use the financial statements of the controlling corporation for its Schedule M-3, Part I.

If no financial statements are prepared for the U.S. corporation (or, in the case of a U.S. consolidated tax group, for the U.S. parent corporation's consolidated group) filing Form 1120, the U.S. corporation (or the U.S. parent corporation of a U.S. consolidated tax group) must enter “No” on questions 1a, 1b, and 1c, skip Part I, lines 2 through 10, and enter the net income (loss) per the books and records of the U.S. corporation (or U.S. consolidated tax group) on Part I, line 11, Net income (loss) per income statement of includible corporations.

If a non-publicly traded U.S. parent corporation of a U.S. consolidated tax group prepares financial statements and that group includes a publicly traded subsidiary that files financial statements with the Securities and Exchange Commission (SEC), the consolidated financial statements of the parent corporation are the appropriate financial statements for purposes of completing Part I. Do not use any separate company financial statements that might be prepared for publicly traded subsidiaries.

If a corporation (a) is included in the consolidated financial statements of a group (consolidated financial statement group) with a U.S. parent corporation filing a Form 1120 and Schedule M-3, (b) is not included in the Form 1120 of the parent corporation of the consolidated financial statement group, (c) does not have a separate financial statement (certified or otherwise) of its own, and (d) files its own Form 1120 (separate or consolidated), the corporation must answer questions 1a, 1b, and 1c of Part I as appropriate for its own Form 1120 and must report on Part I, line 4 or 11, as appropriate, the amount for the corporation's net income (loss) that is equal to the amount included in the income statement of the consolidated financial statement group and removed in Schedule M-3, Part I of that group's U.S. federal income tax return. However, if in the circumstances described immediately above, the corporation does have separate financial statements (certified or otherwise) of its own, independent of the amount of the corporation's net income included in its parent company's consolidated financial statements, the corporation must answer questions 1a, 1b, and 1c of Part I, as appropriate, for its own Form 1120, based on its own separate income statement, and must report on Part I, line 4, the net income amounts shown on its separate income statement.

Line 2. Questions Regarding Income Statement Period and Restatements

Enter the beginning and ending dates on line 2a for the corporation's income statement period ending with or within this tax year. Answer “Yes” on lines 2b and/or 2c if the corporation's income statement has been restated for any reason, and attach an explanation for each restatement, the original amount of each income statement item restated, and the restated amount of each income statement item restated.

Line 3. Questions Regarding Publicly Traded Voting Common Stock

The primary U.S. publicly traded voting common stock class is the most widely held or most heavily traded within the U.S. as determined by the corporation. If the corporation has more than one class of publicly traded voting common stock, attach a list of the classes of publicly traded voting common stock, the trading symbol of each class, the nine-digit CUSIP number of each class, and the name and EIN of the corporation issuing the stock.

Line 4. Worldwide Consolidated Net Income (Loss) per Income Statement

In completing Schedule M-3, the corporation must use financial statement amounts from the financial statement type checked “Yes” on Part I, line 1. If Part I, line 1a, is checked “Yes,” report on Part I, line 4, the net income amount reported in the income statement presented to the SEC on the corporation's Form 10-K (the Form 10-K for the security identified on Part I, line 3b, if applicable).

If a corporation prepares financial statements, the amount on line 4 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 4 through 8.

If the corporation does not prepare financial statements, skip lines 2a through 10 and enter the net income (loss) per the books and records of the U.S. corporation or the U.S. consolidated tax group on Part I, line 11, Net income (loss) per income statement of includible corporations.

If line 4 includes net income (loss) for a corporation that files Form 1120-PC or Form 1120-L, see the instructions for Part I, line 10, for adjustments that may be necessary to reconcile financial statement income to statutory income.

Line 5. Net Income (Loss) of Nonincludible Foreign Entities

Remove the financial statement net income (line 5a) or loss (line 5b) of each foreign entity that is included in the consolidated financial statement group and is not an includible corporation in the U.S. consolidated tax group (nonincludible foreign entity). In addition, on Part I, line 8, 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 financial statement net income (loss) included on line 4 that is removed on this line 5 for each nonincludible foreign entity.

Line 6. Net Income (Loss) of Nonincludible U.S. Entities

Remove the financial statement net income (line 6a) or loss (line 6b) of each U.S. entity that is included in the consolidated financial statement group and is not an includible corporation in the U.S. consolidated tax group (nonincludible U.S. entity). In addition, on Part I, line 8, adjust for consolidation eliminations and correct for minority interest and intercompany dividends for any nonincludible U.S. 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 (if applicable), and financial statement net income (loss) included on line 4 that is removed on this line 6 for each nonincludible U.S. entity.

Line 7. Net Income (Loss) of Other Includible Corporations

Include the financial statement net income (line 7a) or loss (line 7b) of each corporation includible in the U.S. consolidated tax group that is not included in the consolidated financial statement group (other includible corporation). In addition, on Part I, line 8, adjust for consolidation eliminations and correct for minority interest and intercompany dividends for any other includible corporation.

Attach a supporting schedule that provides the name, EIN (if applicable), and financial statement net income (loss) included on this line 7 for each other includible corporation.

Line 8. Adjustment to Eliminations of Transactions Between Includible Corporations and Nonincludible Entities

Include on line 8 any adjustments for minority interest, intercompany dividends, and eliminations of intercompany transactions associated with amounts included on Part I, line 4, amounts removed on Part I, line 5 or 6, or amounts included on Part I, line 7, so that the adjusted consolidation entries and intercompany eliminations are only those applicable to the income (loss) of includible corporations for the financial statement period. Adjustments on Part I, line 8, for consolidation entries are necessary to ensure that transactions between includible corporations and either nonincludible foreign entities or nonincludible U.S. entities are not eliminated. Additionally, adjustments on Part I, line 8, for consolidation entries are necessary to ensure that transactions between includible corporations that are in the consolidated financial statement group and other includible corporations that are not in the consolidated financial statement group are eliminated.

Line 9. Adjustment to Reconcile Income Statement Period to Tax Year

Include on line 9 any adjustments necessary to the income (loss) of includible corporations to reconcile differences between the corporation's income statement period reported on line 2a and the corporation's tax year.

Line 10. Other Adjustments Required To Reconcile to Amount on Line 11

Include on line 10 any other adjustments to reconcile net income (loss) on Part I, line 4, with net income (loss) of includible corporations reported on Part I, line 11. If the net income (loss) of an includible corporation that files Form 1120-PC or Form 1120-L is included on Part I, lines 4, 7, 8, or 9, and is computed on a basis other than statutory accounting, include on line 10 the adjustments necessary such that Part I, line 11, includes net income (loss) for such corporation on a statutory accounting basis.

Attach a supporting schedule that provides the name and EIN (if applicable) of each corporation to which the adjustment relates, the net adjustment included on line 10 for each corporation, and an explanation of each net adjustment.

Line 11. Net Income (Loss) per Income Statement of Includible Corporations

Report on line 11 the consolidated income statement net income (loss) of all corporations included in the U.S. consolidated tax return for the tax year and listed on the Form 851. If the corporation does not prepare financial statements, enter on line 11 the net income (loss) per the books and records of the U.S. consolidated tax group.

Example 2. 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 DS1-DS100 in financial statement consolidation entries. P's SEC Form 10-K includes P, DS1-DS100 and FS1-FS50 on a fully consolidated basis. P files a U.S. consolidated tax return with DS1-DS75.

P must check "Yes" on Part I, line 1a. On Part I, line 4, P must report the consolidated net income from the SEC Form 10-K for the consolidated financial statement group of P, DS1-DS100, and FS1-FS50. P must remove the net income (loss) of FS1-FS50 on Part I, lines 5a or 5b, as applicable. P must remove the net income (loss) before minority interests of DS76-DS100 on Part I, lines 6a or 6b, as applicable. P must reverse on Part I, line 8, the elimination of any transactions between the includible corporations (P and DS1-DS75) and the nonincludible entities (DS76-DS100 and FS1-FS50), including dividends received from DS76-DS100 and FS1-FS50 and the minority interest's share of the net income (loss) of DS1-DS100.

P reports on Part I, line 11, the consolidated financial statement net income (loss) attributable to the includible corporations. Intercompany transactions between the includible corporations that had been eliminated in the net income amount on line 4 remain eliminated in the net income amount on line 11. Transactions between the includible corporations and the nonincludible entities that are eliminated in the net income amount on line 4 are included in the net income amount on line 11.

Example 3. 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. F prepares certified audited financial statements. P does not prepare any financial statements. P files a U.S. consolidated tax return with DS1.

P must check "No" on Part I, lines 1a, 1b, and 1c, skip lines 2a through 10 of Part I, and enter net income (loss) per the books and records of the includible corporations (P and DS1) on Part I, line 11, net of eliminations for transactions between P and DS1.

Example 4. 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. In its financial statements, C consolidates N and includes $60 of net income ($100 less the minority interest of $40) on Part I, line 4.

C must remove the $100 net income of N on Part I, line 6a. C must reverse on Part I, line 8, the elimination of the $40 minority interest net income of N. The result is that C includes no income for N on Part I, line 11. C's taxable income from N must be reported by C on Part II, line 9, Income (loss) from U.S. partnerships.

Example 5. U.S. corporation P owns 80% of the stock of corporation DS1. DS1 is included in P's U.S. consolidated federal income tax return, even though DS1 is not included in P's consolidated financial statements. DS1 has current year net income of $100 after it pays interest of $40 to P. P has net income of $1,040 after recognition of the interest income from DS1. In its financial statements, P reports the $40 interest as part of its net income of $1,040 on Part I, line 4. P is required to include the $100 net income of DS1 on Part I, line 7, and the operations of DS1 must be included in P's return on a fully consolidated basis. P must remove on Part I, line 8, the $40 of interest income received from DS1 included by P on line 4 and the $40 of interest expense of DS1 included in line 7 for a net change of zero on line 8. On line 8, P must also remove the $20 minority interest in the net income of DS1 (DS1 net income of $100 × 20% minority interest). On Part 1, line 11, P reports $1,120, $1,040 from line 4, $100 from line 7, and ($20) from line 8. The result is that P includes on Part I, line 11, the entire net income of DS1 of $140 before minority interest and interest expense to P, less the minority interest of $20 in the net income of DS1, and the entire net income of P of $1,000 measured before recognition of the intercompany interest from DS1 and the consolidation of DS1 operations.

Specific Instructions for Parts II and III

For U.S. consolidated tax returns, file supporting schedules for each includible corporation. See *Consolidated returns* on page 4 of the Form 1120 instructions.

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 11, and report in column (d) the amount included in taxable income.

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. 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 30, is reconciled by the corporation (or, in the case of a U.S. consolidated tax group, by the group's parent corporation on Part II, line 30, of the group's consolidated Schedule M-3) in the following manner:

1. Report the amount from Part I, line 11, on Part II, line 30, column (a);
2. Leave blank Part II, lines 1 through 29, columns (a) and (d);
3. Leave blank Part III, columns (a) and (d); and
4. Report on Part II, line 30, column (d), the sum of Part II, line 30, columns (a), (b), and (c).

Note. Part II, line 30, column (d), must equal the amount on Form 1120, page 1, line 28.

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 taxable income 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 6. For the 2004, 2005, and 2006 tax years, corporation A has total consolidated 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 2005 and 2006 tax years.

For its 2004 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 2005 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 2006 tax year, A is required to complete Schedule M-3 in its entirety.

Example 7. Corporation B is a U.S. publicly traded corporation that files a U.S. consolidated tax return and prepares consolidated 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 28, Other amortization or impairment write-offs, 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 26, Amortization/impairment of goodwill, 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) (other than a transaction described in Regulations section 1.6011-(4)(b)(6) relating to significant book-tax differences), the amount must be reported in columns (a), (b), (c), and (d), as applicable, of Part II, line 12, 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 12.

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 taxable income 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) other than a transaction described in Regulations section 1.6011-(4)(b)(6) (relating to significant book-tax differences) and is therefore reported on Part II, line 12. 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, whether from unconsolidated affiliated companies, third parties, banks, or other entities, whether imputed interest or not, whether from foreign or domestic sources, whether taxable or exempt from tax and regardless of how or where the income is classified in the corporation's financial statements, must be included on Part II, line 13, column (a). Likewise, all fines and penalties 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 12, 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, 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.

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 32, 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 12, 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 25.) If an income item is described in Part II, lines 1 through 25, 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 25, report and describe the entire amount of the item on Part II, line 26, Other income (loss) items with differences.

With limited exceptions, Part III includes lines for specific items of expense or deduction (expense items). (See Part III, lines 1 through 34.) If an expense item is described on Part III, lines 1 through 34, 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 34, report and describe the entire amount of the item on Part III, line 35, Other expense/deduction items with differences.

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 26, or Part III, lines 1 through 35, report the entire amount of the item in column (a) and (d) of Part II, line 29, 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). If a specific item of income, gain, loss, expense, or deduction is described on Part II, lines 9 through 25, or Part III, lines 1 through 34, 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 8 for specific additional information required to be provided for amounts reported on Part II, lines 1 through 8.

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 and each item (and corresponding amount attributable to that item) must be separately stated and adequately disclosed on the applicable line of Schedule M-3. In addition, every item of difference must be separately stated and adequately disclosed. Differences for dissimilar items cannot be combined even if the amounts are below a certain dollar amount.

Example 8. 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 2004 tax year and is required to file Schedule M-3 for its 2005 tax year. C’s total depreciation expense for its 2005 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 2005 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 31, Depreciation, for its 2005 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 9. Corporation D is a calendar year taxpayer that was required to file Schedule M-3 for its 2004 tax year and is required to file Schedule M-3 for its 2005 tax year. On December 31, 2005, 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 a settlement D may have to pay as a result of pending litigation. 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 2005 financial statements but are not deductions for U.S. federal income tax purposes in 2005. 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 32, Bad debt expense, and must separately state and adequately disclose the amounts attributable to each of the two reserves for pending litigation and the warranty costs on a required, attached schedule that supports the amounts at Part III, line 35, Other expense/deduction items with differences.

Example 10. Corporation E is a calendar year taxpayer that was required to file Schedule M-3 for its 2004 tax year and is required to file Schedule M-3 for its 2005 tax year. On January 2, 2005, E establishes an allowance for uncollectible accounts receivable (bad debt reserve) of $100,000. During 2005, E increased the reserve by $250,000 for additional accounts receivable that may become uncollectible. Additionally, during 2005 E decreases the reserve by $75,000 for accounts receivable that were discharged in bankruptcy during 2005. The balance in the reserve account on December 31, 2005, 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 2005 financial statements but are not deductible for U.S. federal income tax purposes in 2005. However, the $75,000 decrease to the reserve is deductible for U.S. federal income tax purposes in 2005. 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 32, Bad debt expense, for its 2005 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 11. Corporation F is a calendar year taxpayer that was required to file Schedule M-3 for its 2004 tax year and is required to file Schedule M-3 for its 2005 tax year. During 2005, 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 11, 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 29, 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 11, Meals and entertainment.

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

Lines 1 Through 8. Additional Information for Each Corporation

For any item reported on Part II, lines 1, 3 through 6, or 8, 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 7, 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 11, 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 5, 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 current year taxable income on Form 1120, page 1, line 28. Report on line 2, column (a), the amount of dividends from any foreign corporation included in Part I, line 11. Do not report any amounts that are reported on Part II, lines 3 or 4, or dividends that were previously taxed (see the instructions for line 5 on this page).

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 taxable 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 taxable 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 16, Mark-to-market income (loss).

Line 4. Section 78 Gross-Up

Report on line 4, column (d), the amount of any section 78 gross-up. The section 78 gross-up amount must correspond to the total section 78 gross-up amounts reported by the corporation on all Forms 1118, Foreign Tax Credit – Corporations.

Line 5. Gross Foreign Distributions Previously Taxed

Report on line 5 any distributions received from foreign corporations that were included in Part I, line 11, and that were previously taxed. For example, include amounts that are excluded from income under sections 959 and 1293(c). Report the full amount of the distribution before any withholding tax.

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

Report on line 6, column (a), the income statement income (loss) included in Part I, line 11, 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 7, dividends received from any U.S. corporation accounted for on the equity method.

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

Report on line 7, column (a), the amount of dividends received from any U.S. corporation included in Part I, line 11. 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, taxable dividends received from any U.S. corporation that is not included in the U.S. consolidated tax group and required to be listed on Form 851).

For any dividends reported on Part II, line 7, 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 7, 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 8. Minority Interest for Includible Corporations

Report on line 8, column (a), the minority interest in the income (loss) included in the income statement income (loss) on Part I, line 11, for any member of the U.S. consolidated tax group that is less than 100% owned.

Example 12. Corporation G is a calendar year taxpayer that was required to file Schedule M-3 for its 2004 tax year and is required to file Schedule M-3 for its 2005 tax year. G owns 90% of the stock of U.S. corporation DS1. G files a U.S. consolidated tax return with DS1. G prepares certified GAAP financial statements for the consolidated financial statement group consisting of G and DS1. G has no net income of its own, and G does not report its equity interest in the income of DS1 on its separate financial statements. DS1 has financial statement net income (before minority interests) and taxable income of $1,000 ($2,500 of revenue less $1,500 cost of goods sold). On Part I, line 11, Net income (loss) per income statement of includible corporations, of the consolidated Schedule M-3, the U.S. consolidated tax group must report $900 of financial statement income ($1,000 net income less $100 minority interest). On Part II, line 8, Minority interest for includible corporations, of the consolidated Schedule M-3, the U.S. consolidated tax group reports ($100) in column (a), $100 in column (c), and $0 in column (d). On Part II, line 29, Other income (loss) and expense/deduction items with no differences, of the consolidated Schedule M-3, the U.S. consolidated tax group reports $1,000 in both columns (a) and (d). As a result, financial statement net income on Part II, line 30, column (a), will total $900, net permanent differences on Part II, line 30, column (c), will total $100, and taxable income on line 30, column (d), will total $1,000. G must prepare three consolidating Schedules M-3, each with Parts II and III, one for G, one for DS1, and one for consolidation eliminations. On the consolidating Schedule M-3 for DS1, on Part II, line 29 and line 30, G reports for DS1 $1,000 in both columns (a) and (d). On the consolidating Schedule M-3 for G, on Part II, line 30, G reports for itself zero in both columns (a) and (d). On the consolidating Schedule M-3 for consolidation eliminations, on Part II, line 8 and line 30, G reports the minority interest elimination for the U.S. consolidated tax group of ($100) in column (a), $100 in column (c), and $0 in column (d).

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

For any interest owned by the corporation or a member of the U.S. consolidated tax group 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 the following on Part II, line 9 or 10, as applicable:

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 11, Net income (loss) per income statement of includible corporations;
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 9 or 10, 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 9 or 10, as applicable.

Example 13. U.S. corporation H is a calendar year taxpayer that was required to file Schedule M-3 for its 2004 tax year and is required to file Schedule M-3 for its 2005 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 2005 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 9, $10,000 in column (a), a permanent difference of ($2,200) in column (c), and $7,800 in column (d).

Example 14. Same facts as Example 13 except that corporation H's charitable contribution deduction is wholly attributable to its partnership interest in USP and is limited to $90 pursuant to section 170(b)(2) due to other investment losses incurred by H. In its financial statements, H treated this limitation as a temporary difference. H must not report the charitable contribution limitation of $3,910 ($4,000 - $90) on Part II, line 9. H must report the limitation on Part III, line 21, Charitable contribution limitation, and report the disallowed charitable contributions of ($3,910) in columns (b) and (d).

Line 11. 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 9 or 10, as applicable) owned by a member of the U.S. consolidated tax group (other than an interest in a disregarded entity), report the following on line 11:

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 11, Net income (loss) per income statement of includible corporations;
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 11, 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 11, as applicable.

Line 12. Items Relating to Reportable Transactions

Any amounts attributable to any reportable transactions (as described in Regulations section 1.6011-4) other than transactions described in Regulations section 1.6011-4(b)(6) relating to significant book-tax differences must be included on Part II, line 12, 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 and the transaction is not described in Regulations section 1.6011-4(b)(6) relating to significant book-tax differences, the amounts attributable to that reportable transaction must be reported on Part II, line 12. In addition, all income and expense amounts attributable to a reportable transaction must be reported on Part II, line 12, 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 12 if the corporation sequentially numbers each Form 8886 and lists by identifying number on the supporting schedule for Part II, line 12, each sequentially numbered reportable transaction and the amounts required for Part II, line 12, 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 12;

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 15. Corporation J is a calendar year taxpayer that was required to file Schedule M-3 for its 2004 tax year and is required to file Schedule M-3 for its 2005 tax year. J incurred seven different abandonment losses during its 2005 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 12. The $12 million loss and the $5 million loss will be adequately disclosed if J attaches a supporting schedule for line 12 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 12, 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 12, columns (a) through (d). J must report the losses attributable to the other five abandonment losses on Part II, line 23e, Abandonment losses, regardless of whether a difference exists for any or all of those abandonment losses.

Example 16. Corporation K is a calendar year taxpayer that was required to file Schedule M-3 for its 2004 tax year and is required to file Schedule M-3 for its 2005 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 2005 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 12, 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 12 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 12, columns (a) through (d). Alternatively, the transaction will be adequately disclosed if the supporting statement for line 12 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 13. Interest Income

Report on Part II, line 13, column (a), the total amount of interest income included on Part I, line 11, and report on Part II, line 13, column (d), the total amount of interest income included on Form 1120, page 1, line 28, that is not reported elsewhere on Schedule M-3 in accordance with the next paragraph. 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 the instructions for Part II, line 18, should be made in columns (b) and (c) of this line 13.

Do not report on this line 13 amounts reported in accordance with the instructions for Part II, lines 9, 10, and 11, Income (loss) from U.S. partnerships, foreign partnerships, and other pass-through entities; Part II, line 12, Items relating to reportable transactions; and Part II, line 22, Original issue discount and other imputed interest.

Line 14. 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 12, Items relating to reportable transactions, the corporation must report on Part II, line 14, 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 31, Depreciation).

Example 17. Corporation L is a calendar year taxpayer that was required to file Schedule M-3 for its 2004 tax year and is required to file Schedule M-3 for its 2005 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, 2005, 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, 2005, L reported financial statement depreciation expense of $15,000 and depreciation for U.S. federal income tax purposes of $25,000. For L's 2005 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 14. As a result, L must report on Part II, line 14, $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 24, 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 31, Depreciation, and report $15,000 in column (a), $10,000 in column (b), and $25,000 in column (d).

Line 15. Hedging Transactions

Report on line 15, 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 taxable income 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 15. 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 15 and not on Part II, line 16, Mark-to-market income (loss).

Report any gain or loss from inventory hedging transactions on line 15 and not on Part II, line 17, Inventory valuation adjustments.

Line 16. Mark-to-Market Income (Loss)

Report on line 16 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 15, Hedging transactions, and not on line 16.

Line 17. Inventory Valuation Adjustments

Report on line 17 any amounts deducted as part of cost of goods sold during the tax year, including any amounts attributable to inventory valuation, for example, amounts attributable to cost-flow assumptions, additional costs required to be capitalized to ending inventory (including depreciation) such as section 263A costs, inventory shrinkage accruals, inventory obsolescence reserves, and lower of cost or market write-downs. Report section 481(a) adjustments related to cost of goods sold or inventory valuation on Part II, line 19, Section 481(a) adjustments, and not on this line 17.

Report any gain or loss from inventory hedging transactions on Part II, line 15, Hedging transactions, and not on this line 17.

Report mark-to-market income or (loss) associated with the inventories of dealers in securities under section 475 on Part II, line 16, Mark-to-market income (loss), and not on this line 17.

Line 18. Sale Versus Lease (for Sellers and/or Lessors)

(Also see the instructions at Part III, line 34, on page 15, 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 18, 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 tax purposes. On Part II, line 18, 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 13, Interest income, in column (a) or (d), as applicable. Depreciation expense for such transactions must be reported on Part III, line 31, Depreciation, in column (a) or (d), as applicable. Use columns (b) and (c) of Part II, lines 13 and 18, and Part III, line 31, as applicable to report the differences between column (a) and (d).

Example 18. Corporation M sells and leases property to customers. M is a calendar year taxpayer that was required to file Schedule M-3 for its 2004 tax year and is required to file Schedule M-3 for its 2005 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 2005, M reports in its financial statements $1,000 of sales and $700 of cost of goods sold with respect to 2005 lease transactions. M receives periodic payments of $500 in 2005 with respect to these 2005 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 2005 Schedule M-3, M must report on Part II, line 13, Interest income, $100 in column (a), ($100) in column (b), and zero in column (d). In addition, M must report on Part II, line 18, $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 31, Depreciation, $200 in column (b) and (d).

Line 19. Section 481(a) Adjustments

With the exception of a section 481(a) adjustment that is required to be reported on Part II, line 12, Items relating to 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 19, regardless of whether a separate line for that income or expense item exists in Part II or Part III.

Example 19. Corporation N is a calendar year taxpayer that was required to file Schedule M-3 for its 2004 tax year and is required to file Schedule M-3 for its 2005 tax year. N was depreciating certain fixed assets over an erroneous recovery period and, effective for its 2005 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 2005 tax year. In its financial statements, N treats the section 481(a) adjustment as a temporary difference. N must report on Part II, line 19, $25,000 in columns (b) and (d) for its 2005 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 31, Depreciation.

Line 20. Unearned/Deferred Revenue

With the exception of income recognized from long-term contracts that is reported on line 21, Income recognition from long-term contracts, report on line 20 any revenue amounts that are attributable to revenue that is, or was, unearned or deferred for financial statement purposes (or books and records, if applicable) or U.S. federal income tax purposes.

Line 21. Income Recognition From Long-Term Contracts

Report on line 21 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 22. Original Issue Discount and Other Imputed Interest

Report on line 22 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 23a. Income Statement Gain/Loss on Sale, Exchange, Abandonment, Worthlessness, or Other Disposition of Assets Other Than Inventory and Flow-Through Entities

Report on line 23a, 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 flow-through entity (e.g., on Schedule K-1) that are included in the net income (loss) per income statement of includible corporations reported on Part I, line 11. 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 23b through 23g, as applicable.

Line 23b. Gross Capital Gains From Schedule D, Excluding Amounts From Flow-Through Entities

Report on line 23b, gross capital gains reported on Schedule D, excluding capital gains from flow-through entities, which must be reported on Part II, lines 9, 10, or 11, as applicable.

Line 23c. Gross Capital Losses From Schedule D, Excluding Amounts From Flow-Through Entities, Abandonment Losses, and Worthless Stock Losses

Report on line 23c, gross capital losses reported on Schedule D, excluding capital losses from (a) flow-through entities, which must be reported on Part II, lines 9, 10, or 11, as applicable; (b) abandonment losses, which must be reported on Part II, line 23e; and (c) worthless stock losses, which must be reported on Part II, line 23f. Do not report on line 23c capital losses carried over from a prior tax year and utilized in the current tax year. See the instructions for Part II, line 25, regarding the reporting requirements for capital loss carryovers utilized in the current tax year.

Line 23d. Net Gain/Loss Reported on Form 4797, Line 17, Excluding Amounts From Flow-Through Entities, Abandonment Losses, and Worthless Stock Losses

Report on line 23d the net gain or loss reported on line 17 of Form 4797, Sales of Business Property, excluding amounts from (a) flow-through entities, which must be reported on Part II, lines 9, 10, or 11, as applicable; (b) abandonment losses, which must be reported on Part II, line 23e; and (c) worthless stock losses, which must be reported on Part II, line 23f.

Line 23e. Abandonment Losses

Report on line 23e any abandonment losses, regardless of whether the loss is characterized as an ordinary loss or a capital loss.

Line 23f. Worthless Stock Losses

Report on line 23f 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 23g. Other Gain/Loss on Disposition of Assets Other Than Inventory

Report on line 23g any gains or losses from the sale or exchange of property other than inventory and that are not reported on lines 23b through 23f.

Line 24. Disallowed Capital Loss in Excess of Capital Gains

Report as a positive amount on line 24, columns (b) or (c), as applicable, 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. For a U.S. consolidated tax group, the Schedule M-3 adjustment for the amount of the consolidated net capital loss that is disallowed should not be made on the separate consolidating Schedules M-3 of the includible corporations, but on the separate Schedule M-3 for consolidation eliminations as described in *Consolidated Schedule M-3 Versus Consolidating Schedules M-3*, on page 2.

Line 25. Utilization of Capital Loss Carryforward

If the corporation utilizes a capital loss carryforward on Schedule D in the current tax year, report the carryforward utilized as a negative amount on Part II, line 25, columns (b) or (c), as applicable, and column (d). For a U.S. consolidated tax group, the Schedule M-3 adjustment for the amount of the consolidated capital loss carryforward should not be made on the separate consolidating Schedules M-3 of the includible corporations, but on the separate Schedule M-3 for consolidation eliminations as described in *Consolidated Schedule M-3 Versus Consolidating Schedules M-3*, on page 2.

Line 26. Other Income (Loss) Items With Differences

Separately state and adequately disclose on Part II, line 26, all items of income (loss) with differences that are not otherwise listed on Part II, lines 1 through 25. 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 28. Total Expense/ Deduction Items

Report on Part II, line 28, columns (a) through (d), as applicable, the negative of the amounts reported on Part III, line 36, columns (a) through (d). For example, if Part III, line 36, column (a), reflects an amount of $1 million then report on Part II, line 28, column (a), ($1 million). Similarly, if Part III, line 36, column (b), reflects an amount of ($50,000), then report on Part II, line 28, column (b), $50,000.

Line 29. Other Income/Loss and Expense/Deduction 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 26, or Part III, lines 1 through 35, report the entire amount of the item in columns (a) and (d) of line 29. 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 29. 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 26, or Part III, lines 1 through 35. See Example 11 on page 7.

Line 30. Reconciliation Totals

Combine all the amounts on lines 27 through 29 and enter the totals in columns (a), (b), (c), and (d).

Note. Line 30, column (a), must equal the amount on Part I, line 11, and line 30, column (d), must equal Form 1120, page 1, line 28.

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 30, is reconciled by the corporation (or, in the case of a U.S. consolidated tax group, on the group's consolidated Schedule M-3) in the following manner:

1. Report the amount from Part I, line 11, on Part II, line 30, column (a);
2. Leave blank Part II, lines 1 through 29, columns (a) and (d);
3. Leave blank Part III, columns (a) and (d); and
4. Report on Part II, line 30, column (d), the sum of Part II, line 30, columns (a), (b), and (c).

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

A U.S. consolidated tax group must complete lines 1 through 6 in accordance with the allocation of tax expense among the members of the U.S. consolidated tax group in the financial statements (or its books and records, if applicable). If the current and deferred U.S., state, and foreign income tax expense for the U.S. consolidated tax group (income tax expense) is allocated among the members of the U.S. consolidated tax group in the group's financial statements (or its books and records, if applicable), then each member must report its allocated income tax expense on Part III, lines 1 through 6, of that member's separate Schedule M-3. However, if the income tax expense is not shared or allocated among members of the U.S. consolidated tax group but is retained in the parent corporation's financial statements (or books and records, if applicable), then amounts are reported only on Part III, lines 1 through 6, of the parent's separate Schedule M-3.

Line 7. Foreign Withholding Taxes

Report on line 7, column (a), the amount of foreign withholding taxes included in financial accounting net income on Part I, line 11. If the corporation is deducting foreign tax, use column (b) or (c), as applicable, to correct for any difference between foreign withholding tax included in financial accounting net income and the amount of foreign withholding taxes being deducted in the return. If the corporation is crediting foreign withholding taxes against the U.S. income tax liability, use column (b) or (c), as applicable, to negate the amount reported in column (a).

Line 8. Incentive Stock Options

Do not report any amount on line 8, column (a). Instead, include any amount expensed per the income statement for incentive stock options as part of the amount on Part III, line 9, column (a). Report on line 8, columns (b), (c), and (d), as applicable, any deductible amounts attributable to the disposition of shares delivered pursuant to the exercise of incentive stock options.

Line 9. Nonqualified Stock Options

Report on line 9, column (a), any amounts expensed per the income statement attributable to all stock options. Report on line 9, column (d), any deductible amounts attributable to the exercise of payments made pursuant to nonqualified stock options (i.e., stock options not qualified under section 422 or 423).

Line 10. Other Equity-Based Compensation

Report on line 10 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 (e.g., on Part III, lines 8 and 9, for incentive stock options and nonqualified stock options, respectively). Examples of amounts reportable on line 10 include payments attributable to 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 nonemployees, or as payment for property or compensation for services.

Line 11. Meals and Entertainment

Report on line 11, 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 17, Inventory valuation adjustments).

Line 12. Fines and Penalties

Report on line 12 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 12, 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. See sections 162(f) and 162(g) for additional guidance.

Line 13. Punitive Damages

Include on line 13, column (a), any amount included in net income per the income statement attributable to punitive damages, regardless of whether the amount deducted was attributable to an estimate of future anticipated payments or actual payments. Report in column (b) or (c), as applicable, the deductible or nondeductible punitive damages. Report in column (d) the amount of punitive damages deductible for U.S. federal income tax purposes.

Line 14. Parachute Payments

Report on line 14, column (a), the total expense included in financial accounting net income on Part I, line 11, that is subject to section 280G. Report in column (b) or (c), as applicable, the amount of nondeductible parachute payments pursuant to section 280G, and report in column (d) the deductible amount of compensation after any excess parachute payment limitations under section 280G. If a payment is subject to limitation under both sections 162(m) and 280G, report the total payment on this line 14.

Line 15. Compensation With Section 162(m) Limitation

Report on line 15, column (a), the total amount of non-performance-based current compensation expense for the corporate officers to whom section 162(m) applies. Report the nondeductible amount of current compensation in excess of $1 million in column (b) or (c), as applicable, and the deductible compensation in column (d). If a payment is subject to limitation under both sections 162(m) and 280G, report the total payment on Part III, line 14, Parachute payments. See Regulations section 1.162-27(g) for the interaction between sections 162(m) and 280G.

Line 16. Pension and Profit-Sharing

Report on line 16 any amounts attributable to the corporation's pension plans, profit-sharing plans, and any other retirement plans.

Line 17. Other Post-Retirement Benefits

Report on line 17 any amounts attributable to other post-retirement benefits not otherwise includible on Part III, line 16, for example, retiree health and life insurance coverage, dental coverage, etc.

Line 18. Deferred Compensation

Report on line 18, column (a), any compensation expense included in the net income amount reported in the income statement that was not reported elsewhere on Schedule M-3, column (a). Report on line 18, column (d), any compensation deductible in the current tax year that is not otherwise reportable elsewhere on Schedule M-3, including any compensation deductions deferred in a prior tax year.

Line 20. Charitable Contribution of Intangible Property

Report on line 20 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 21. Charitable Contribution Limitation

Report as a negative amount on line 21, columns (b), (c), and (d) as applicable, the excess of charitable contributions made during the tax year over the amount of the charitable contribution limitation amount. When a U.S. consolidated federal income tax return is being filed, the Schedule M-3 adjustment for the amount of contributions in excess of the limitation should not be made on the separate consolidating Schedules M-3 of the includible corporations, but on the separate consolidating Schedule M-3 for consolidation eliminations as described in *Consolidated Schedule M-3 Versus Consolidating Schedules M-3*, on page 2.

Line 22. Charitable Contribution Carryforward Used

If the corporation utilizes a contribution carryforward in the current tax year, report the carryforward utilized as a positive amount on Part III, line 22, columns (b), (c), and (d), as applicable. When a U.S. consolidated federal income tax return is being filed, the Schedule M-3 adjustment for the amount of charitable contribution carryforward used should not be made on the separate consolidating Schedules M-3 of the includible corporations, but on the separate consolidating Schedule M-3 for consolidation eliminations and adjustments as described in *Consolidated Schedule M-3 Versus Consolidating Schedules M-3*, on page 2.

Line 23. Current Year Acquisition or Reorganization Investment Banking Fees

Report on line 23 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 23 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 24. Current Year Acquisition or Reorganization Legal and Accounting Fees

Report on line 24 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 24 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 25. Current Year Acquisition/Reorganization Other Costs

Report on line 25 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 23 or 24). 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 25 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 26. Amortization/Impairment of Goodwill

Report on line 26 amortization of goodwill or amounts attributable to the impairment of goodwill.

Line 27. Amortization of Acquisition, Reorganization, and Start-Up Costs

Report on line 27 amortization of acquisition, reorganization, and start-up costs. For purposes of column (b), (c), and (d), include amounts amortizable under section 167, 195, or 248.

Line 28. Other Amortization or Impairment Write-Offs

Report on line 28 any amortization or impairment write-offs not otherwise includible on Schedule M-3.

Line 29. Section 198 Environmental Remediation Costs

Report on line 29, 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 31. Depreciation

Report on line 31 any depreciation expense that is not required to be reported elsewhere on Schedule M-3 (e.g., on Part II, lines, 9, 10, 11, or 17).

Line 32. Bad Debt Expense

Report on line 32, 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 33. Corporate Owned Life Insurance Premiums

Report on line 33 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 34. Purchase Versus Lease (for Purchasers and/or Lessees)

(Also see the instructions at Part II, line 18, on page 11, 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 34, column (a), gross rent expense for a transaction treated as a lease for income statement purposes but as a sale for tax return purposes. Report on Part III, line 34, column (d), gross rental deductions for a transaction treated as a lease for tax purposes but as a purchase for income statement purposes. Report interest expense or deduction amounts for such transactions on Part III, line 35, Other expense/deduction items with differences, in column (a) or (d), as applicable. Report depreciation expense or deductions for such transactions on Part III, line 31, Depreciation, in column (a) or (d), as applicable. Use columns (b) and (c) of Part III, lines 31, 34, and 35, as applicable, to report the differences between column (a) and (d) for such recharacterized transactions.

Example 20. U.S. corporation X acquired property with a sale price of $3,000 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 2004 tax year and is required to file Schedule M-3 for its 2005 tax year. For U.S. federal income tax purposes, because of its terms, the transaction is taxed 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 temporary. During 2005, 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 2005 Schedule M-3, X must report the following on Part III, line 34: column (a) $1,000, its financial accounting gross rental expense; column (b), ($1,000); and column (d), zero. On Part III, line 35, X reports $300 in columns (b) and (d) for the interest deduction. On Part III, line 31, X reports $1,200 in columns (b) and (d) for the depreciation deduction.

Line 35. Other Expense/Deduction Items With Differences

Report on Part III, line 35, all items of expense/deduction that are not otherwise listed on Part III, lines 1 through 34.

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 35 each reserve or contingent liability that is not reported elsewhere in Schedule M-3. Report on line 35, column (a), expenses included in net income reported on Part I, line 11, that are related to reserves and contingent liabilities. Report on line 35, 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 35 include warranty reserves, restructuring reserves, reserves for discontinued operations, reserves for legal proceedings, and reserves for acquisitions and dispositions. Only report on line 35 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 17, Inventory valuation adjustments.

The schedule of details attached to the return for line 35 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 21. Corporation P is a calendar year taxpayer that was required to file Schedule M-3 for its 2004 tax year and is required to file Schedule M-3 for its 2005 tax year. P has been sued by its customers in a class action product liability lawsuit. The trial date is in 2006. In its 2005 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 2005. 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 2005 U.S. federal income tax return on Part III, line 35, $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 35, 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.

Example 22. Same as Example 21 except that in 2006 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 2006. On its 2006 Schedule M-3, P must report on Part III, line 35, 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 35, 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.

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

Example 23. Corporation Q is a calendar year taxpayer that was required to file Schedule M-3 for its 2004 tax year and is required to file Schedule M-3 for its 2005 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, 2005, 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 35, 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 29, Other income (loss) and expense/deduction items with no differences, its prepaid advertising and report $400,000 in column (a) and (d).

Line 36. Total Expense/ Deduction Items

Report on Part II, line 28, columns (a) though (d), as applicable, the negative of the amounts reported on Part III, line 36, column (a) through (d), as applicable. For example, if Part III, line 36, column (a), reflects an amount of $1 million, then report on Part II, line 28, column (a), ($1 million). Similarly, if Part III, line 36, column (b), reflects an amount of ($50,000), then report on Part II, line 28, column (b), $50,000.