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A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

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DEALER TAX WATCH *OUT*

If you had called me personally to ask, "What's happening lately with IRS audits of dealers and dealerships that I need to know about?" ... Here's what I'd say:

#1. NEW SCHEDULE M-3 FOR 2004: MORE TAX RETURN DETAIL WORK & DISCLOSURE.

Will any of your clients be among the 47,000 corporate return filers that the IRS expects to complete its new Schedule M-3 this year?

If so, the special focus of this issue of the *Dealer Tax Watch* could save you some time and effort in getting up-to-speed on this brand new development.

I've read and reread everything I could get my hands on that the IRS has published concerning the new Schedule M-3. My goals were to (1) understand as much of all of this as I could, (2) distill and summarize it for you in some useful way, and (3) provide some sense of direction for coping with these new demands.

In the latter regard, I've put together a *Practice Guide* checklist on pages 24-25 suggesting some activities that you might undertake now to get ready for next year's filing season challenges.

The IRS information from various sources on Schedule M-3 is presented in a variety of formats on the succeeding pages. In many instances, it's not possible to grasp or present all of the implications and issues that you're likely to face next year. Furthermore, the information sources on which these comments are based are likely to change in some respects as the IRS completes the finalization of Schedule M-3 and the Instructions that you will be looking at next year.

Nevertheless, there is a considerable amount of work that has to be done for the first time this year to set up the appropriate information collecting and/or reporting that is now required. Rather than waiting until later and hoping that everything will be "more final" then, my intention is to give you some materials ***now,*** that you can use with a (hopefully) high level of probability that most of this will not be changed later in any significant way.

Therefore, you must understand that it will be necessary for you to carefully compare this information with the final Form (i.e., Schedule M-3) and Instructions (for Schedule M-3) when the IRS releases them later.

The thought has occurred to me that the IRS might ease up a bit and decide to postpone for at least one more year the requirement that any part of Schedule M-3 must be completed. To date, the Service has consistently said that it does not intend

see **DEALER TAX WATCH OUT**, page 28

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NEW SCHEDULE M-3 FOR 2004: MORE DETAIL WORK & DISCLOSURE FOR CORPORATE RETURNS

SCH. M-3
FORM 1120
C CORPS

BACKGROUND

Some of your clients may be among the 47,000 corporate tax return filers expected to complete new Schedule M-3 this year. If they are, you may want to start looking now at this new development and the changes it will force into your 2004 tax return preparation activities.

Right now, the new Schedule M-3 filing requirement will affect only regular corporations filing Form 1120 if they have total assets at the end of the year of $10 million or more. For as long as one can remember, Form 1120 has included Schedule M-1 on the fourth page right below the balance sheet (Schedule L). This Schedule M-1 has basically been a simple reconciliation of the taxable income reported on Page 1 of the tax return with the net income per books, as shown on the company's financial statements for the year.

Let's not get too far ahead of ourselves by assuming everyone knows what Schedule M-1 looks like or how to fill it out. You may want to review pages 26-27. This shows the current Schedule M-1 form that has been used for many years and which will continue to be used, with one minor exception, by most taxpayers filing Form 1120 if they have total assets at the end of the year of less than $10 million. This Schedule M-1 review also includes a relatively simple fact pattern with Schedule M-1 completed to show how numbers flow between "the books" and "the tax return."

"OLD" SCHEDULE M-1

A few observations about the current Schedule M-1 are in order.

The current Schedule M-1 has remained virtually unchanged for decades. Over that same period of time, large and midsize corporations have changed dramatically in the ways they are structured, in where and how they conduct their business operations, and in how they handle their corresponding financial and tax accounting.

Schedule M-1 ***does not provide a uniform reporting requirement*** for "net income per books" on Line 1 of Schedule M-1. According to the IRS, one result of this lack of uniformity in reporting requirements is that taxpayers may provide information for a *worldwide group*, for a *U.S. consolidated tax group*, or for a reporting entity that lies somewhere between these two alternatives. This is obviously directed towards parent-subsidiary groups, including especially those with international operations and international entity relationships.

Schedule M-1 ***does not provide uniform disclosure requirements for reporting differences between financial accounting net income and taxable income.*** The Financial Accounting Standards Board prescribes accounting and reporting standards which often are significantly different from the Internal Revenue Code provisions that Congress has enacted which address the U.S. Government's revenue needs or policy considerations and which are the basis for calculating taxable income on Federal income tax returns. Often, these differences are merely timing differences, hence the application of the concept of deferred taxes. In other instances, certain items of income or loss that are taken into account for one purpose may not be considered for the other; similarly, certain expenses and losses may be taken into account for one purpose, but not for the other.

This lack of uniform disclosure requirements for book-tax differences prevents efficient comparisons among taxpayers and may even prevent proper year-to-year comparisons for the same taxpayer. Accordingly, for an IRS examining agent, it is often difficult to make an assessment of the risk of noncompliance associated with a particular issue or taxpayer by looking at what is shown on Schedule M-1 of the tax return.

"TRANSPARENCY" ...WHAT IS IT? WHAT DOES IT MEAN?

The buzz word used most often by the IRS / Treasury in connection with the new Schedule M-3 is "Transparency." One view defines "transparency" in the tax system as certainty about what the tax rules are and the equal application of those rules, however complex they might be, to all taxpayers.

It may be more easy to understand the IRS / Treasury's use of the word *"transparency"* if the word *"visibility"* is substituted, since *transparency* may imply looking through something in order to see what lies beyond it (as if it weren't there, in the way). *Visibility*, on the other hand, refers to being able to see clearly what is going on—and what is the substance - of what is being looked at.

see **NEW SCHEDULE M-3**, page 4

Lifting the Veil of Obscurity

Transparency & the IRS's Great Expectations for Schedule M-3

Obscurity ...Causes Harm (by) ...	***Transparency ... Benefits (include) ...***
• Creating significant inequities, both real and perceived • Impairing government's ability to administer the tax system • Allowing opportunities for tax evasion and aggressive tax avoidance techniques • Frustrating taxpayers and tax advisors when the attempt to plan transactions and comply with the law • Resulting in unintentional misstatements of income and deductions • Creating inefficiencies that impede taxpayer decision-making and undermine economic development • Imposing significant costs on taxpayers, tax advisors and the government	• A system that is, and is perceived by taxpayers, as being more fair • Enhancement of the efficiency of administering the tax system • Decreased tax evasion • Diminished incentive to use overly aggressive tax avoidance techniques • Increased taxpayer and tax practitioner certainty in tax planning and compliance • Reduction of tax return (preparation) error rates • Greater stimulus for growth by making economic decision-making more efficient • Reduction of direct and indirect costs of complying with and administering a complex and nontransparent tax system, freeing up resources for productive activities

Source	The AICPA *Tax Policy Concept Statement: Guiding Principles for Tax Law Transparency.* Issued September 2003 by the Tax Division of the American Institute of Certified Public Accountants.

IRS' Great Expectations

IRS Commissioner Everson	• "The new Schedule will let the IRS sharpen and improve monitoring of corporate compliance. • "Our objective is to identify and resolve potential audit issues promptly. This information will help us do so. • "The new disclosures will help us target our examination efforts on high-risk areas, thereby improving and speeding the audit process."
Treasury Asst. Secy. For Tax Policy	• "The proposed Schedule M-3 will make differences between financial accounting net income and taxable income more transparent. This will help agents determine from the return whether the return should be audited and identify the differences that matter most in the audit of the return. • "We see benefits to taxpayers and the IRS from the new Schedule: a reduction in unnecessary audits and a swifter focus on those differences that are more likely to arise when taxpayers take aggressive positions or engage in aggressive transactions. • "In addition, the increased transparency will have a deterrent effect."
Acting Treasury Asst. Secy. For Tax Policy	• "The purpose of this project has been to make differences between financial accounting net income and taxable income more transparent. ...Schedule M-3 provides information that will identify taxpayers that may have engaged in aggressive transactions and therefore should be audited."
IRS LMSB Division Commissioner ***Deborah M. Nolan***	• "These changes will enable us to focus our compliance resources on returns and issues that need to be examined and avoid those that do not. • "Increasing the transparency of corporate tax returns is critical to our objectives to provide certainty to taxpayers sooner and to improve overall compliance. • "The increased transparency and uniform reporting requirements for corporate taxpayers filing Schedule M-3 will allow agents to swiftly focus on emerging issues and evolving business trends. • "This will result in a quicker and more current and efficient examination process aimed at those returns with the greatest compliance risk."
Source	*The quotes above are from IRS News Releases IR-2004-14 and IR-2004-91.*

In a recent publication concerning this tax policy concept, the AICPA explained that "transparency is an important partner with tax simplification," and that *transparency* is the basic notion that taxpayers should know, namely, (1) that a tax exists and (2) how and when the tax is imposed on them and others. According to the AICPA, transparency in tax law should be measured by how easily taxpayers can determine whether and how any particular tax provision–and the tax statute as a whole–affects their tax burden.

The AICPA *Tax Policy Concept Statement–Guiding Principles for Tax Law Transparency* issued September 2003 identifies several ways in which ***obscurity*** in the tax law may cause harm. Alternatively, ***transparency*** of the tax law should provide significant benefits. For a comparison more fully defining these terms in their taxation-related context, see page 3.

According to one SEC commentator, in financial reporting by publicly-held companies, ***transparency*** is measured by "the extent to which financial information about a company is available and understandable to investors and other market participants." So, everybody, including the financial press, is using that term for their own purposes even though there seems to be no generally accepted common understanding of what that term means.

SCHEDULE M-3 EMERGES

For those corporate tax returns that the IRS is actually auditing, often the examining agents have great difficulty in trying to find out–or figure out–what areas really warrant a closer look.

As a result of the tremendous effort the Service has expended in dealing with abusive and egregious tax shelters and a wide assortment of scams, schemes and unprofessional and unethical conduct by taxpayers and their advisors, the IRS seems to have found itself hopelessly in the hole in trying to figure out just what is going on.

The Service concluded–most reasonably–that it stands a much better chance of finding out what is really happening if it forces taxpayers to disclose more detail relating to differences in how they are treating various transactions *and items* for financial statement and for income tax purposes.

The culmination of the IRS' effort to increase the transparency of corporate tax return filings occurred earlier this year. On January 28, 2004, the Treasury Department and the IRS released a proposed draft of a new form, Schedule M-3, *Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More*, for use by certain corporate taxpayers filing Form 1120, U.S. Corporation Income Tax Return. The new Schedule M-3 would expand the current Schedule M-1, which has not been changed in format for many years.

Large and Midsize Business (LMSB) taxpayers ... C corporations with total assets of $10 million or more ... will complete the new Schedule M-3 in lieu of completing Schedule M-1 ***starting with their 2004 calendar year tax returns***. Small Business and Self-Employed (SB/SE) taxpayers will not be required to complete the new Schedule M-3; they will continue to complete Schedule M-1.

In the future, other Federal tax returns may require the completion of a Schedule that is likely to incorporate a similar Schedule M-3 reconciliation in the future. This includes taxpayers filing Form 1065, *U.S. Partnership Return of Income* and Form 1120-S, *U.S. Income Tax Return for an S Corporation*. But, for now (i.e., for 2004 tax returns), they do not.

On July 7, 2004, the Treasury Department and the IRS released a second draft, referred to as a "draft of the final version" of Schedule M-3. With this version, the IRS added a very important qualification ... A corporation required to file Schedule M-3 ***is only required to complete certain sections of Schedule M-3 in the first taxable year***.

Also, on July 7, 2004, the IRS issued Revenue Procedure 2004-45 in conjunction with the new Schedule M-3. This Revenue Procedure provides that the filing of Schedule M-3 by certain taxpayers in accordance with the Rev. Proc. will satisfy the requirements of Reg. Sec. 1.6011-4(b)(6) to disclose transactions with significant ... over $10 million ... book-tax differences.

IRS' GREAT EXPECTATIONS FOR THE NEW SCHEDULE M-3

The IRS has stated the following as "goals" associated with its new Schedule M-3. These have been echoed by many IRS representatives in slightly different prose (see also page 3).

- Increase transparency while minimizing the overall taxpayer burden.
- Reduce the time required to examine tax returns and be in a position to examine the most recent tax returns filed.
- Provide consistent reporting among taxpayers and from year-to-year for each taxpayer.
- Provide a method of presentation to obtain more useful, descriptive information at the time the Federal income tax return is filed to assist the IRS in the identification of tax returns that should or should not be selected for audit, identification of issues that should or should

not be audited, and identification of trends and areas of greater compliance risk.

- Periodically modify the form to highlight emerging issues, identify trends, and adapt to future changes encountered by large and midsize corporations.
- Facilitate tax return selection and issue identification through electronic filing.
- Facilitate the use of Limited Issue Focused Examination (LIFE) audit processes.

OVERVIEW OF SCHEDULE M-3

Some of the key observations in the *At A Glance* overview on pages 6-8 warrant further discussion and/or emphasis.

Financial statement hierarchy. The new Form asks several questions in order to identify the source of the financial statement information on which the Form 1120 corporate tax return is based. Also, taxpayers are now required to reconcile their financial accounting net income to their Federal taxable income based on the following hierarchy:

- SEC Form 10-K financial statements,
- Other certified GAAP statements (despite the imprecise accounting terminology reflected on the form, this entry refers to financial statements prepared in accordance with Generally Accepted Accounting Principles on which a Certified Public Accountant has expressed an opinion.),
- Other financial statements (with explanation of accounting method attached), and
- If the taxpayer has not prepared any financial statements ("certified" or otherwise), then the taxpayer would only report its net income as determined from its books and records.

Transactional approach requires much more detail. One aspect of the new reporting requirements that is sure to cause much digging for detail results from the "transactional approach" reflected in the way Schedule M-3 is laid out. In other words, certain amounts reported in the tax return (on or as part of a single line item) in an aggregate amount may have to be reported on several different lines in the Schedule M-3 reconciliation.

As pointed out by the Tax Executives Institute (TEI), many taxpayers are going to "be required to modify and redesign their compliance processes from gathering and analyzing book income/loss information to computing and describing book-tax differences to fit within the line item categories [of the new Schedule M-3]. For the data to be correctly mapped [to Schedule M-3], accounting and ledger systems will have to undergo a significant transformation so that the desired information is gathered into a discreet location that can then be mapped to the Schedule."

The Instructions for Schedule M-3 provide that "each difference reported [on the full-page reconciliations of income and expense line items] ***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." The Instructions add, "Except as otherwise provided, differences for the same item must be combined or netted together. However, differences for separate items must not be combined or netted together."

Consider depreciation expense as an example of the reclassification analysis complexities. Depreciation claimed in the tax return may appear only on Form 4562 and on its carryforward line on Page 1. However, the Schedule M-3 reconciliation has 5 lines on which it may be necessary to reflect depreciation amounts claimed on Page 1.

- Part II, Line 17 *Inventory valuation adjustments*
- Part II, Line 18 *Sale versus Lease*
- Part II, Line 19 *Section 481(a) adjustments*
- Part III, Line 33 *Depreciation*
- Part III, Line 38 *Section 481(a) adjustments*

Retroactive effect. TEI also observed that many taxpayers have already begun their processes for 2004 tax return reporting under the previous rules and requirements. As a result, the proposed effective date for Schedule M-3 (which requires its completion by Form 1120 filers for their calendar 2004 tax returns) has a ***clear retroactive effect.*** Completing the first and the fourth columns in the new Schedule M-3 format is likely to be very difficult in many cases because taxpayers currently categorize book income and deductions in the line item categories found on Page 1 of Form 1120 ... and these are very different from the line item categories included in the new Schedule M-3 drafts.

As noted elsewhere, for 2004, only the two middle timing difference columns (i.e. the second and third columns) are required to be completed.

EVERYTHING IS MATERIAL

Another troublesome aspect of the new reporting requirements is the reluctance of the IRS to allow any amounts or items to be unreported because of their small size.

The IRS has said that ***every item of difference must be separately stated and adequately dis-***

see **NEW SCHEDULE M-3**, page 9

At A Glance

Schedule M-3 For Corporate Returns (Forms 1120) for 2004
Far More Detail Presentation Is Now Required

What Is the Purpose of Schedule M-3?

- The purpose of this new schedule is to reconcile in greater detail a corporation's financial accounting income or loss with the taxable income or loss reported on its corporate income tax return, Form 1120. For other goals and expectations, see page 3.

Effective Date

- Sch. M-3 must be completed ***starting with taxable years ending on or after Dec. 31, 2004.***

Who Must Complete Schedule M-3?

- Any corporation or U.S. consolidated tax group required to file Form 1120 that is reporting on its Balance Sheet (*Schedule L*) total assets at the end of year ***equal to or in excess of $10 million.***
  - ♦ This is the same criterion used to determine whether a corporation is in the jurisdiction of the LMSB (Large and Mid-Size Business Division) of the IRS.
- ***Who does not have to complete Sch. M-3?***
  - ♦ Corporate tax returns showing Schedule L balance sheet total assets at the end of the year of less than $10 million are not required to complete Schedule M-3.
  - ♦ S Corporations filing Form 1120-S are not required to complete Schedule M-3 for 2004*
  - ♦ Partnerships filing Form 1065 are not required to complete Schedule M-3 for 2004*

  * IRS intends to develop comparable reporting detail for these entities in the very near future.

Timeline & Status of Schedule M-3

When Will Sch. M-3 Be Finalized?

- *January 28, 2004* ... IRS released the first version of Schedule M-3
- *March 10, 2004* ... IRS released preliminary *Instructions for Schedule M-3*
- *April 30, 2004* ... Last day for practitioner comments on Sch. M-3 and Instructions
- *July 7, 2004* ... IRS released the "draft of the final version" of Schedule M-3
  ... IRS released 23 *Frequently Asked Questions* with answers
  ... IRS released Revenue Procedure 2004-45 to streamline disclosures for some taxpayers involved with book-tax differences in excess of $10 million
- ***"Draft of Final Version" ... An Oxymoron? ...***
  - ♦ If the Sch. M-3 released July 7, 2004 is ***"final,"*** why does it say ***"Draft"***?
  - ♦ One might say that it probably says ***"Draft"*** because it's not final yet!
  - ♦ According to the IRS, this ***final*** version of Schedule M-3 was released early as a draft in order to assist corporations, practitioners, and programmers in preparing to implement Sch. M-3.
- When will Schedule M-3 be finalized?
  - ♦ The IRS has said that it does not expect any further changes to the Sch. M-3 it released on July 7, 2004.
  - ♦ The Service anticipates that the final version of Schedule M-3 to be used for filing will be available and posted on the IRS web site (www.irs.gov) in early December 2004.
- Finalization of Instructions for Sch. M-3 ...
  - ♦ The finalization of the Instructions will need to reflect various changes in Schedule format and line items between the initial version of Sch. M-3 released in January and the "draft of the final version" released in July. These changes are analyzed in some detail on pages 12-13.
  - ♦ The Service anticipates finalizing the *Instructions to Schedule M-3* in September 2004.

Key Points

- Transactional approach in format creates need for line-by-line analysis and reporting.
- Every detail must be reported - No concessions are made to size or materiality ... See page 2 of 3.

Caution

- ***As a result of the incomplete status of Schedule M-3 and the Instructions at this time ... all of the discussions of Schedule M-3 in this issue of the Dealer Tax Watch must be regarded as preliminary and subject to change, as they are based on the information the Service has released on these "preliminary" forms and instructions.***
- Note: All Line references are to the Sch. M-3 draft released July 7, 2004 - See pages 14-16.

Schedule M-3 For Corporate Returns (Forms 1120) for 2004
Far More Detail Presentation Is Now Required

For 2004, How Much of the Detail on Schedule M-3 "Must" Be Completed?

- The completion of Sch. M-3 requires a radically different approach than Schedule M-1.
  - For more on the comments submitted by the AICPA and others, see pages 10-11.
  - Many of these comments are thought-provoking and should be studied carefully as a guide to helping one actually prepare the new Sch. M-3.
- When the Service requested comments on the first version of Sch. M-3 and on the March 10 Instructions, practitioners requested some relief either in the form of a postponed effective date or some relaxation of the requirement that the entire Sch. M-3 be completed.
  - The Service would not postpone the effective date.
  - However, the IRS did grant limited relief for the corporation's transition year (i.e., the first taxable year that the corporation is required to file Sch. M-3).
- Accordingly, ***for 2004 only*** (i.e., in the first taxable year the corporation is required to file Sch. M-3), the corporation is required to complete only certain sections of Schedule M-3.
  - Page 1, Part I ***must be completed.***
  - Page 2, Part II, Columns (b) and (c) ***must be completed*** ... *temporary* and *permanent timing difference identification* related to **income (loss)** items.
  - Page 3, Part III, Columns (b) and (c) ***must be completed*** ... *temporary* and *permanent timing difference identification* related to **expense/deduction** items.
  - For 2004 only, taxpayers have the ***option*** to complete Columns (a) and (d) of Parts II and III in order to present a complete reconciliation.

The IRS Has Made No Concession to "Materiality"

- Can *de minimis* amounts be combined or netted in completing Sch. M-3?
- *No* ... There is no such thing as a *de minimis* amount ... Nothing is considered to be *immaterial.*
  - No *de minimis* exclusions based on (immaterial) dollar amounts.
  - No *de minimis* exclusions based on (immaterial) percentage of assets.
  - No *de minimis* exclusions based on (immaterial) percentage of income.
- *FAQ Question #15: Can differences below a certain dollar amount be combined together on Schedule M-3?*
  - *Answer:* No. ***Every item of difference must be separately stated and adequately disclosed*** on Sch. M-3. The final Sch. M-3 Instructions will not provide a specific dollar or ratio threshold for materiality.

For More Information on Completing Schedule M-3, See ...

- The corporation must complete Sch. M-3 in its entirety for all taxable years that the corporation is required to file Sch. M-3, other than for its first / transition / 2004 year.
- Instructions for Sch. M-3 provide some guidance on
  - Timing differences ... See page 17.
  - Income / Gain / Loss items ... See page 18.
  - Expense / Deduction items ... See page 19.
  - Foreign corporations included as either parent or subsidiaries in consolidated group.
- *Frequently Asked Questions (FAQs)* ... Provide guidance for certain situations that are more likely to be encountered ... See pages 20 to 23.
  - ***...Where corporations use permitted/optional short-cut reporting for 2004*** ... FAQ #5
  - ***...Where year-end assets exceed $10 million at the end of one year, but fall below the $10 million threshold at the end of a succeeding year*** ... FAQ #8
  - ...Where a consolidated tax return is filed ... FAQ #6
  - ...Where inventory valuation adjustments are involved ... FAQ #20
  - ...Where a portion of an item is treated the same for both book and tax purposes, and a portion of that same item gives rise to a book-tax difference ... FAQ #14
  - ...Disposition of assets other than inventory ... FAQ #21
  - ...Where the corporate partner is reporting its flow-through distributive shares of items from Partnership K-1s, etc. ... FAQ #18
  - ...Where less common forms of equity-based compensation are involved ... FAQ #23
  - ...Where cash basis reporting is used for tax purposes and accrual basis is used for financial statements ... FAQs #9 & 19
  - ...Where differences attributable to "reportable transactions" are involved ... FAQ #7

At A Glance	**Schedule M-3 For Corporate Returns (Forms 1120) for 2004** **Far More Detail Presentation Is Now Required** Page 3 of 3
Guidance for Other Special Situations	• The IRS list of *Frequently Asked Questions (FAQs)* includes guidance for other special Sch. M-3 reporting situations ... consult FAQs for detail on these. ♦ ...How each member of a U.S. consolidated tax group must complete the information regarding current and deferred U.S., state and foreign income taxes ... FAQ #22 ♦ ...Where insurance companies that file Forms 1120-PC or Forms 1120-L are involved ... FAQ #10 ♦ ...Where a U.S. consolidated tax group is controlled by a foreign corporation ... FAQ #16 ♦ ...Where certain members of a consolidated tax return filing group are publicly traded companies and other members are not ... FAQ #17
Will Schedule M-3 Be Updated Annually?	• Annual updating of this schedule seems unlikely. • The IRS has said (FAQ #13), "There is no specific timeframe for updating Schedule M-3. Schedule M-3 will be updated as necessary to ensure that Schedule M-3 obtains information on emerging issues and evolving business trends."
Will Schedule M-3 Reconciliations Be Required in Other Tax Returns?	• ***Yes***, according to the IRS. • The IRS has said that upon finalizing the Instructions to Schedule M-3 for Form 1120, Treasury and IRS will begin analyzing and developing a Schedule M-3 for ♦ Form 1065 ... *U.S. Return of Partnership Income* ♦ Form 1120-S ... *U.S. Income Tax Return For An S Corporation* ♦ Form 1120-PC ... *U.S. Property and Casualty Insurance Company Income Tax Return* ♦ Form 1120-L ... *U.S. Life Insurance Company Income Tax Return* • The Service has said that it will provide for a comment period similar to that provided for the Form 1120 Schedule M-3.
Does the Schedule M-3 Reporting Duplicate Other Tax Shelter Reporting Requirements?	• Yes, but to the extent that it does, those affected taxpayers have been afforded relief by Revenue Procedure 2004-45. • This relief relates mostly to very large taxpayers involved with $10+ million transactions creating book-tax differences who are subject to the reporting requirements of Reg. Sec. 1.6011-4. • The IRS has provided some clarification/guidance expanding on Rev. Proc. 2004-45 by the issuance of a separate set of ***Frequently Asked Questions Concerning R.P. 2004-45.*** • Note: Most Dealer PORC Form 8886 reporting issues are ***not*** affected by the issuance of Rev. Proc. 2004-45 and its elimination of overlapping reporting requirements.
Issues & Questions	• Will the tax return processing software for completing Form 1120 for 2004 be compliant with respect to the expanded Schedule M-3 requirements? • Will all of the required reporting detail be developed on time? Does the existing accounting system provide sufficient detail where Sch. M-3 requires the disclosure of information on a *transactional* basis? • How much lead time do you and/or your client need to start preparing for the Schedule M-3 additional reporting/disclosure requirements? • What should you do if currently you're not sure whether the Form 1120 will have more than $10 million in assets shown in Schedule L at the end of the year? ♦ Should you anticipate the need to complete Sch. M-3 for 2004 at this time? • Is the client aware of the additional recordkeeping burdens and additional time and fee demands imposed by the requirement to complete (even partially) Schedule M-3 for the year 2004? • See ***Practice Guide - Action Plan for Complying with New Sch. M-3*** **... pages 24-25.**

 (Continued from page 5)

closed on Schedule M-3, and it has advised that the final (Schedule M-3) Instructions will not provide a specific dollar or ratio threshold for materiality.

Therefore, there should be no *de minimis* exclusions in reporting on Schedule M-3 that are based on immateriality. This relates to immateriality that, for financial statement purposes, may be based on

- Absolute dollar amounts and/or cut-offs below a certain dollar (expenditure) level.
- Percentage or ratio of an amount under consideration to total assets.
- Percentage or ratio of an amount under consideration to either gross income or net income.

The ramifications of this are, if not mind-boggling, worthy of serious consideration before the end of the year so that taxpayers can consider the implications of coping with a seemingly unrealistic requirement.

COLLATERAL SOURCES

Comments made by the American Institute of CPAs emphasized the problems associated with the completely different transaction-by-transaction approach that provides the basic architecture for the new Schedule M-3. Comments by the American Taxation Association, in arguing for a higher total asset cut-off so that fewer taxpayers might have to file, indirectly pointed out how implausible the use of $10 million of assets–so convenient for IRS administrative purposes–may be as the line of demarcation for the filing vs. non-filing cut-off. Finally, the comments by the Tax Executive Institute emphasized many problems for worldwide consolidated filing groups. Selected comments by these organizations appear on pages 10-11.

The practitioner groups that submitted comments were clearly pressed by the very short period that they were given in which to make comments. The (preliminary) Instructions for Schedule M-3 were issued as of March 10 and April 30 was the cut-off date for practitioner comments... Not to mention the fact that this time period coincides with the busiest time of the year for many tax departments and professionals. If these organizations had been given more time to consider Schedule M-3, it is quite possible that they might have developed additional issues and/or reporting questions for the IRS to take into account.

Another basis for understanding the current draft of Schedule M-3 is by comparing the 1st draft issued January 28, 2004 (which is not reproduced here) with the 2nd draft issued July 7, 2004. An analysis of the major changes between the two versions appears on pages 12-13.

The second draft of Schedule M-3 significantly exceeds in detail the first draft. Also, it clearly reflects a number of changes (for the better, if more disclosure represents an improvement) that apparently resulted from comments made by practitioners.

ANALYZING SCHEDULE M-3

The "draft of the final" Schedule M-3 is really formidable or long enough to be called a "Form." All 3 pages of the July 7, 2004 version of Schedule M-3 appear on pages 14-16.

A careful look at each question and line item reflects the very thorough approach that the Service employed in drafting this new reconciliation Schedule. In several instances, a number of lines on the reconciliation are intended to highlight the "emerging issues" about which the IRS may be seeking to develop information for litigation purposes. As an example, note that the reconciliation for expense/deduction items contains not one, but three lines for current-year acquisition and reorganization expenses ... (1) *Investment banking fees*, (2) *Legal and accounting fees* and (3) *Other costs.*

Similarly, charitable contributions now receive attention on 4 lines, separating contributions of cash and tangible property, contributions of intangible property, contribution limitations and the use of contribution carryforwards.

Other more specific guidance for completing various line items on Schedule M-3 can be found in the following:

- ***Instructions for Sch. M-3 (Proof as of March 10, 2004).*** These Instructions contain a number of examples, including those on page 17 concerning timing differences, page 18 concerning certain income/loss items and page 19 concerning expense/deduction items.
- ***Frequently Asked Questions.*** On July 7, 2004, the IRS issued answers to 23 questions it provided concerning various aspects of Schedule M-3. Some of these questions and answers are included on pages 20-23.

CONCLUSION

Requirements for the completion of new Schedule M-3 are scheduled to take effect with 2004 tax returns for many corporations. Although the new Schedule M-3 is not yet in its final form, it is not too early to start analyzing these requirements. A *Practice Guide* checklist "Action Plan for Complying with New Schedule M-3 Reporting Requirements" for this purpose appears on pages 24-25.

We welcome your comments and suggestions for additions to it.

Selected Comments	Comments on Proposed Schedule M-3 & Instructions Interesting Information & Helpful Insights

Pleas for Relief ... Made by All ... Partially Successful

- Postpone effective date for Schedule M-3 to tax years ending on or after December 31, 2005 or (preferably) on or after December 31, 2006. (IRS said, "No.")
- For the initial compliance year, the threshold for taxpayers required to use Schedule M-3 should be increased to taxpayers with assets in excess of $250 million. (IRS said, "No.")
- Allow partial completion of Schedule M-3 for the first year.
  - ♦ This would provide taxpayers additional time to complete the necessary internal accounting system revisions ... and tax preparation software revisions ... to accurately comply with the expanded reporting requirements imposed by the addition of many new line items and the reporting of timing differences (i.e., temporary and permanent timing difference designations).
  - ♦ The IRS accepted this suggestion, but ***only*** with respect to the transition year (i.e., 2004).
  - ♦ Taxpayers are required to complete only Columns (b) and (c) of the Income (Loss) Items and Expense / Deductions Reconciliations on pages 2 and 3.
  - ♦ Taxpayers are not required to complete the first and fourth columns (Columns (a) and (d)).

Tax Executives Institute

Thorough Technical Line-by-Line Analysis of Schedule M-3

- The Tax Executives Institute (TEI) is the preeminent association of business tax executives in North America. Its more than 5,400 members represent 2,800 of the leading corporations in the United States, Canada and Europe.
- TEI's comments reflect the concerns that its membership (i.e., larger corporations and those with international entity relationships and consolidated financial statement complexities) are more likely to encounter.
  - ♦ More expeditious closure of tax return examinations, especially utilizing the relatively newer IRS *LIFE* (Limited Issue Focused Examination) approach.
  - ♦ Concerns about eliminating overlap between
    - ▪ The Form 8886 disclosure requirements for book-tax differences over $10 million and
    - ▪ The expanded disclosures required by the new Schedule M-3.
  - ♦ ***Retroactive effect.*** The substantial burdens imposed by ***immediate*** compliance requirements on taxpayers that must make substantial adjustments to their accounting and information technology systems in order to comply, particularly the need to go back to Jan. 1, 2004.
- Specific comments on the first draft (i.e., Jan. 28, 2004) of Schedule M-3 reflect concern for the need for clarification of many of line items in the book-tax reconciliations.
  - ♦ TEI's comments concerning Part I's questions on ***restatements of financial statements*** are interesting, in that they raise questions concerning under different restatement situations ...
    - ▪ Restatements due to acquisitions, dispositions and other like events
    - ▪ Restatements required due to mistake, fraud or other similar circumstances
    - ▪ Part I of Schedule M-3 asks whether there has been a restatement ***in the current year or in any of the preceding 5 years*** of the corporation's *"income statement"* (2nd draft) or *"financial statements"* (1st draft).
  - ♦ TEI makes interesting observations relative to the special issues presented by regulated industries, including insurance companies. For example, under the Internal Revenue Code, insurance companies are required to use Annual Statement statutory income as net income per books in computing taxable income. What should be reflected in the Schedule M-3 reconciliation(s)? The TEI comments amplify this considerably.
  - ♦ Practitioners with clients who have international parent or subsidiary entities, insurance companies and substantial partnership and/or other entity relationships, should read the TEI submission in its entirety so that even if the IRS does not provide guidance or clarification, the TEI's discussion of the issues requiring clarification will be helpful.

Source: Submission June 7, 2004 by Tax Executives Institute to the IRS Large and Mid-Size Business Division

Selected Comments	***Comments on Proposed Schedule M-3 & Instructions*** ***Interesting Information & Helpful Insights***
American Institute of CPAs ***Problems with the New Transaction-by-Transaction Approach***	• Schedule M-3 reflects a critical change in (Sch. M-1) reconciliation preparation methodology. • The proposed Schedule M-3 requires a ***transaction-by-transaction*** approach to accumulating and identifying book-tax differences. ♦ In addition, book income and expense must be reported (in new Sch. M-3) in categories defined by tax law. Most of these tax law categories do not exist for book purposes. ♦ The only way to determine that all book-tax differences are captured is to recode and examine every accounting transaction. ♦ To the extent that amounts are broadly combined in the financial statement presentations, the analysis required to compute the amounts that Schedule M-3 requires becomes imprecise, unless numerous sub-accounts are created for this purpose. ♦ Most corporate tax departments will be ill-prepared to make the transition to this type of methodology without significant investment in their compliance process. • This replaces the more traditional ***balance sheet account*** approach used by many taxpayers. • The Sch. M-3 transactional approach to capturing book-tax differences eliminates the checks and balances inherent in the balance sheet approach *Source: Letter dated April 30, 2004 to Ms. Susan Blake, IRS, submitted by AICPA representing Tax Accounting Technical Resource Panel, proposed Schedule M-3 Task Force*
American Taxation Association ***How Realistic or Useful Is the $10 Million Asset Cut-Off?***	• The $10 million dollar total asset cut-off is related to the IRS designation of that amount as the cut-off for large and mid-size businesses (LMSB Division). • ATA contends that, while this definition may be useful for some IRS administrative purposes, it is not necessarily appropriate for Schedule M-3 purposes ♦ It is not clear why an ***asset*** definition … rather than a ***gross income*** definition … is used. ♦ In many cases, income might be a better predictor than assets of a taxpayer's propensity to take aggressive tax positions. ♦ An income definition would also make sense in that Schedule M-3 is a reconciliation of (book-tax) income; it is not a reconciliation of the balance sheet. ♦ Published information indicates that the dollar impact of aggressive corporate tax positions lies mostly with larger corporations, and this would support the use of a total asset cut-off point of much more than $10 million. • The $10 million asset threshold, in many cases, will exclude Schedule M-3 reconciling information by many businesses. ♦ The reporting of Schedule M-3 reconciling information will not be required by many businesses that simply fall below the threshold because they have less than $10 million in total assets. ♦ ***The $10 million asset threshold does not take into account the type of business.*** A service business with only $9 million of assets could have $100 million or $200 million of gross income and, thus be a more likely candidate for aggressive tax position consideration, yet not be required to file Schedule M-3. ♦ ***$10 million asset threshold is easily avoided in many cases where real estate and/or operating facilities are not on tax return Schedule L because the taxpayer uses leased facilities.*** Many businesses (including many auto dealerships) require substantial investments in land, real estate, buildings, etc., and these assets are off-balance-sheet in the sense that the owners of the operating business also own and/or control the entities owning the real estate (but the assets and/or operations of these entities are not included in the filing of consolidated income tax returns nor in consolidated financial statements). *Source: Letter dated April 23, 2004 to Ms. Susan Blake, IRS, submitted by American Taxation Association, Corporate Tax Policy Committee*

Schedule M-3 for Corporate Form 1120 for 2004

Comparison of Sch. M-3 1st & 2nd Drafts

#1 vs. #2	*First Draft*	*Second Draft*
At a Glance	• ***Issued January 28, 2004*** ♦ "Draft as of 1-28-2004" appears on all pages • 3 Pages, divided into 4 *Parts* • Instructions for Sch. M-3 state "Proof as of March 10, 2004 (subject to change)" • IRS requested practitioners comments by April 30, 2004 on Sch. M-3 and Instructions	• ***Issued July 7, 2004*** ♦ "Draft as of July 7, 2004" appears on all pages • 3 Pages … Only 3 *Parts* ♦ Parts I & II of 1st draft combined • Described as the "draft of the final version" • *Frequently Asked Questions* (#1-23) issued July 7, 2004 by IRS to provide guidance • IRS expects to finalize Schedule M-3 in September 2004 • Permits "partial" or "short-cut" completion for first (transition) year … i.e., 2004 only.
Instructions for Sch. M-3	• Sch. M-3 Instructions designated as "Proof as of March 10, 2004" • It is anticipated that these will be updated to reflect changes in formatting and line item designation of reconciling items.	• Final instructions for Schedule M-3 will have to reflect … ♦ Reduction from 4 Parts to 3 Parts ♦ Change in column heading designations ♦ Addition, deletion and combination of some line items between 1st and 2nd drafts.
Page 1 ***Questions & Book-Tax Reconciliation***	***Part I*** • *Questions Regarding Corporate Financial Statements, etc.* … 5 lines ***Part II*** • *Reconciliation of Net Income(Loss) per Income statement with net Income (Loss) of Includible Corporations* … 8 lines	***Part I*** • *Financial Information and Net Income (Loss) Reconciliation* … 11 lines ♦ Lines 1-3 … general questions ♦ Lines 4-11 … reconciliation of book-tax ♦ Added separate lines so entity income is shown separately from entity loss
Page 2 ***Reconciliation of Income (Loss) Items***	***Part III*** • *Reconciliation … Income (Loss) Items* • 37 lines • Includes 4 (four) columns to emphasize timing difference reconciling items… ♦ (A) Income (Loss) per Income Statement ♦ (B) ***Temporary*** Difference ♦ (C) ***Permanent*** Difference ♦ (D) Income (Loss) per Tax Return • Total reconciling amounts for expense / deduction entries in Part IV are carried to bottom of Part III so that bottom line of Part III shows aggregate of all reconciliation totals and Line 37, Column (D), Part III shows taxable income (loss) as per Page 1, Line 28 of Form 1120.	***Part II*** • *Reconciliation … Income (Loss) Items* • 34 lines • Retains 4-column arrangement. • Certain column/line items are shaded to indicate that entries for those spaces are not required. • Retains same column arrangement; however, column heading references are changed from (A) - upper case to (a) - lower case, etc.. • Total reconciling amounts for expense / deduction entries in Part III are carried to bottom of Part II so that bottom line of Part II shows aggregate of all reconciliation totals and Line 34, Column (d), Part II shows taxable income (loss) as per Page 1, Line 28 of Form 1120. • ***Most significant …*** Completion of Columns (a) and (d) is designated as ***optional***.

Schedule M-3 for Corporate Form 1120 for 2004

Comparison of Sch. M-3 1st & 2nd Drafts

#1 vs. #2	First Draft	Second Draft
	Part IV	***Part III***
Page 3 Reconciliation of Expense / Deduction Items	• *Reconciliation ... Expense / Deduction Items* • 38 lines ... with totals carried to bottom of Page 2, Part III • Contains same 4-column arrangement to highlight timing difference reconciling items ♦ (A) Expense per Income Statement ♦ (B) ***Temporary*** Difference ♦ (C) ***Permanent*** Difference ♦ (D) Deduction per Tax Return • Totals from bottom of Part IV are carried to bottom of Part III (see above). * * * • Line item comments ♦ Requires nothing relating to pensions, benefits, retirement plans, etc. ♦ Line 31 reads, "Accrued non-deductible liabilities (attach schedule)"	• *Reconciliation ... Expense / Deduction Items* • 41 lines ... with totals carried to bottom of Page 2, Part II • Retains same 4-column arrangement. • Adds shading for certain column/line items • Retains transfer of totals from bottom of Page 3 to bottom of Page 2 to reflect totals of all reconciling items at the bottom of Page 2. • ***Most Significant ...*** Completion of Columns (a) and (d) is designated as ***optional***. * * * • Line item comments ♦ Added 3 new Lines (16-18) for Pension and profit sharing (16), Other post-retirement benefits (17) and Deferred compensation. ♦ Reporting for these items has been subdivided to "Expense for contingent liabilities (attach details)" ... Line 35 and "Expense for other reserves (attach details)" ... Line 36
Sec. 481(a) & Inventory Valuation Adjustments	• Income item reconciliation (Part III) ♦ Line 17 *Section 481(a) adjustments* ♦ Line 18 *Inventory valuation adjustments* • Expense / Deduction reconciliation (Part IV) ♦ Line 33 *Section 481(a) adjustments* ♦ Line 34 *Inventory valuation adjustments* • By providing separate lines, the IRS indicates that adjustments are not to be netted. ♦ Cost flow assumptions ♦ Sec. 263A uniform capitalization ♦ Shrinkage accruals ♦ Obsolescence reserve changes ♦ Lower-of-cost-or-market reserve changes ♦ Capitalizable depreciation ♦ Other inventory-related reserves treated differently for book and for tax	• Income item reconciliation (Part II) ♦ Line 19 *Section 481(a) adjustments* ♦ Line 17 *Inventory valuation adjustments* • Expense / Deduction reconciliation (Part III) ♦ Line 38 *Section 481(a) adjustments* ♦ **Deletion of separate line for** *Inventory valuation adjustments*
Regrettable Deletion	• The bottom of Part III (Page 2) contained a very useful set of columnar "explanations." • See below ...	• Regrettably, this columnar information has been deleted from the bottom of Part II (Page 2) of the July 7, 2004 version.

Net Income (loss) per income statement, Part II, Line 8	Net Temporary Differences	Net Permanent Differences	Taxable Income (Loss), (Form 1120) Page 1, line 28

SCHEDULE M-3 (Form 1120)

Department of the Treasury Internal Revenue Service

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

▶ Attach to Form 1120.
▶ See separate instructions.

OMB No. 1545-0123

2004

Name | Employer identification number

Part I Financial Information and Net Income (Loss) Reconciliation

1a Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year?

☐ **Yes.** Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.

☐ **No.** Go to line 1b.

b Did the corporation prepare a certified audited income statement for that period?

☐ **Yes.** Skip line 1c and complete lines 2a through 11 with respect to that income statement.

☐ **No.** Go to line 1c.

c Did the corporation prepare an income statement for that period?

☐ **Yes.** Complete lines 2a through 11 with respect to that income statement.

☐ **No.** Skip lines 2a through 10 and enter the corporation's net income (loss) per its books and records on line 11.

2a Enter the income statement period: Beginning ___/___/___ Ending ___/___/___

b Has the corporation's income statement been restated for the income statement period on line 2a?

☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)

☐ **No.**

c Has the corporation's income statement been restated for any of the five income statement periods preceeding the period on line 2a?

☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)

☐ **No.**

3a Is any of the corporation's voting common stock publicly traded?

☐ **Yes.**

☐ **No.** If "No," go to line 4.

b Enter the symbol of the corporation's primary U.S. publicly traded voting common stock . . . . ☐☐☐☐☐

c Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock: . . . . ☐☐☐☐☐☐☐☐☐

4	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4	
5a	Net income from nonincludible foreign entities (attach schedule)	5a	( )
b	Net loss from nonincludible foreign entities (attach schedule and enter as a positive amount) . .	5b	
6a	Net income from nonincludible U.S. entities (attach schedule)	6a	( )
b	Net loss from nonincludible U.S. entities (attach schedule and enter as a positive amount) . . .	6b	
7a	Net income of other includible entities (attach schedule)	7a	
b	Net loss of other includible entities (attach schedule and enter as a negative amount)	7b	
8	Adjustment to eliminate transactions between includible and nonincludible entities (attach schedule)	8	
9	Adjustment to reconcile income statement year to tax year of tax return (attach schedule) . . .	9	
10	Other adjustments to reconcile to amount on line 11 (attach schedule)	10	
11	**Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10	11	

For Privacy Act and Paperwork Reduction Act Notice, see the Instructions for Forms 1120 and 1120-A. Cat. No. 37961C Schedule M-3 (Form 1120) 2004

SCHEDULE M-3 (Form 1120)	Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More	OMB No. 1545-0123
Department of the Treasury Internal Revenue Service	▶ Attach to Form 1120. ▶ See separate instructions.	2004

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

	Income (Loss) Items	(a) Income (Loss) per Income Statement (optional)	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return (optional)
1	Income (loss) from equity method foreign corporations				
2	Gross foreign dividends not previously taxed				
3	Subpart F, QEF, and similar income inclusions				
4	Section 78 gross-up				
5	Gross foreign distributions previously taxed				
6	Income (loss) from equity method U.S. corporations				
7	U.S. dividends not eliminated in tax consolidation				
8	Minority interest for includible corporations				
9	Income (loss) from U.S. partnerships (attach schedule)				
10	Income (loss) from foreign partnerships (attach schedule)				
11	Income (loss) from other pass-through entities (attach schedule)				
12	Items relating to reportable transactions (attach details)				
13	Tax-exempt interest				
14	Total accrual to cash adjustment				
15	Hedging transactions				
16	Mark-to-market income (loss) other than from inventory				
17	Inventory valuation adjustments				
18	Sale versus lease				
19	Section 481(a) adjustments				
20	Unearned/deferred revenue				
21	Income recognition from long-term contracts				
22	Original issue discount and other imputed interest				
23	Income statement gain/loss on disposition of assets other than inventory				
24	Gain/loss reported on Form 4797, line 18				
25	Gross capital gain from includible corporations				
26	Gross capital loss from includible corporations				
27	Other gain/loss on disposition of assets other than inventory				
28	Disallowed capital loss in excess of capital gains				
29	Utilization of capital loss carryforward				
30	Other income (loss) items with differences (attach schedule)				
31	Other income (loss) items with no differences				
32	**Total income (loss) items.** Combine lines 1 through 31				
33	**Total expense/deduction items** (from Part III, line 41)				
34	**Reconciliation totals.** Subtract line 33 from line 32				

Note. Line 34, column (a), must equal the amount on Part I, line 11, and column (d) must equal the amount on Form 1120, page 1, line 28.

SCHEDULE M-3 (Form 1120) Department of the Treasury Internal Revenue Service	**Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More** ▶ Attach to Form 1120. ▶ See separate instructions.	OMB No. 1545-0123 **2004**

Draft as of July 7, 2004

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

	Expense/Deduction Items	(a) Expense per Income Statement (optional)	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return (optional)
1	U.S. current income tax expense				
2	U.S. deferred income tax expense				
3	State and local current income tax expense				
4	State and local deferred income tax expense				
5	Foreign current income tax expense (other than foreign withholding taxes)				
6	Foreign deferred income tax expense				
7	Foreign withholding taxes				
8	Incentive stock options				
9	Nonqualified stock options				
10	Other equity-based compensation				
11	Meals and entertainment				
12	Fines and penalties				
13	Punitive damages				
14	Excess parachute payments				
15	Excess section 162(m) compensation				
16	Pension and profit-sharing				
17	Other post-retirement benefits				
18	Deferred compensation				
19	Charitable contribution of cash and tangible property				
20	Charitable contribution of intangible property				
21	Charitable contribution limitation				
22	Charitable contribution carryforward used				
23	Current year acquisition or reorganization investment banking fees				
24	Current year acquisition or reorganization legal and accounting fees				
25	Current year acquisition/reorganization other costs				
26	Amortization/impairment of goodwill				
27	Amortization of acquisition, reorganization, and start-up costs				
28	Other amortization or impairment write-offs				
29	Abandonment losses				
30	Worthless stock deduction (attach details)				
31	Section 198 environmental remediation costs				
32	Depletion				
33	Depreciation				
34	Bad debt expense				
35	Expense for contingent liabilities (attach details)				
36	Expense for other reserves (attach details)				
37	Corporate owned life insurance premiums				
38	Section 481(a) adjustments				
39	Other expense/deduction items with differences (attach schedule)				
40	Other expense/deduction items with no differences				
41	**Total expense/deduction items.** Combine lines 1 through 40. Enter here and on Part II, line 33				

<table>
<tr><th>Timing</th><th><u>IRS GUIDANCE FOR COMPLETING SCHEDULE M-3</u>
<u>TIMING DIFFERENCES</u></th></tr>
<tr><td>Columns #1 & #4 for Income (Loss) Per Financial Statement & Per Tax Return</td><td>The Instructions for Schedule M-3 state that for each line item in Schedule M-3, report in column (A) the amount of net income (loss) included in Schedule M-3, Part II, Line 8, and report in column (D) the amount included in taxable income.
Note: On the 7/7/04 draft version of Schedule M-3, the full-page Reconciliation of Income(Loss) Items which was Part III on the 1/28/04 draft has been re-designated as Part II. Similarly, the Reconciliation of Expense/Deduction Items which was Part IV on the 1/28/04 draft has been re-designated as Part III on the 7/7/04 version. Similarly, the reference to Part II, Line 8 would be to Line 11 on the 7/7/04 draft version.</td></tr>
<tr><td>Temporary Differences & Permanent Differences

Columns #2 & #3</td><td>• For any item of income, gain, loss, deduction, or credit for which there is a difference between columns (A) and (D), the portion of the difference that is temporary must be entered in column (B) and the portion of the difference that is permanent must be entered in column (C).
• If financial statements are prepared by the corporation in accordance with GAAP (Generally Accepted Accounting Principles), differences that are treated as temporary for GAAP must be reported must be reported in column (B) and differences that are permanent (that is, not temporary for GAAP) must be reported in column (C).
• Generally, pursuant to GAAP, a temporary difference affects (creates, increases, or decreases) a deferred tax asset or liability.
• If the corporation does not prepare financial statements, or the financial statements are not prepared in accordance with GAAP, report in column (B) any difference ...
♦ That will reverse in a future tax year (that is, have an opposite effect on taxable income in a future tax year (or years) due to the difference in timing of recognition for financial accounting and Federal income tax purposes) or
♦ [That] is the reversal of such a difference that arose in a prior tax year.
• Report in column (C) any difference that will not reverse in a future tax year (and is not the reversal of such a difference that arose in a prior tax year).
• If the corporation is unable to determine whether a difference between column (A) and column (D) for an item will reverse in a future tax year or is the reversal of a difference that arose in a prior tax year, report the difference for that item in column (C).</td></tr>
<tr><td>Reporting Timing Differences

Example #5</td><td>• Corporation P is a U.S. publicly traded company that files a U.S. consolidated tax return and prepares GAAP financial statements. P acquired 100% of the stock of corporation DS/domestic subsidiary in 1990 in a tax-free transaction.
• As part of the acquisition, P acquired intellectual property (IP) and goodwill. The IP is amortizable for both financial statement purposes and for Federal income tax purposes. The goodwill is only amortizable for financial statement purposes.
• P's annual amortization expense for the IP is $6,000 for financial statement purposes and $9,000 for Federal income tax purposes. P's annual amortization expense for the acquired goodwill is $5,000 for financial statement purposes and $0 for Federal income tax purposes.
• Even though the amortization attributable to the acquired goodwill may reverse in the future for Federal income tax purposes (e.g., if DS sells all of its assets), the amortization expense is a permanent difference because it is not treated as a temporary difference in P's financial statements.
• P must report on Schedule M-3 on the line for "Other amortization or impairment write-offs"
♦ Income statement amortization expense of $11,000 in column (A),
♦ A temporary difference of $3,000 in column (B),
♦ A permanent difference of ($5,000) in column (C), and
♦ Federal income tax amortization expense of $9,000 in column (D).
• Note: This would be reported on Line 26, Part III of the 7/7/04 draft version of Sch. M-3.
• Goodwill is no longer deductible on the books - but that does not change the illustrative points that the example is trying to make.</td></tr>
<tr><td>Source</td><td>• Instructions for Schedule M-3 (Form 1120) - "Proof as of March 10, 2004 - Subject to Change"</td></tr>
</table>

Income Items	***IRS GUIDANCE FOR COMPLETING SCHEDULE M-3 INCOME - LOSS ITEMS***
Reporting Differences in The Sch. M-3 Reconciliations	• Each difference reported in the Schedule M-3 reconciliations 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 Reg. Sec. 1.6662-4(f). • Except as otherwise provided, differences for the same item must be combined or netted together. However, differences for separate items must not be combined or netted together.
Minority Interest for Includible Corporations ***Example #9***	• Report on Line 8, column (A), the minority interest in the income statement income (loss) for any member of the U.S. consolidated tax group that is less than 100% owned. (The Line 8 on the Jan. 28, 2004 version of Sch. M-3 remains as Line 8 on the July 7, 2004 version.) • ***Facts.*** U.S. Corporation P owns 90% of the stock of U.S. Corporation DS1. P files a U.S. consolidated tax return with DS1. P prepares certified GAAP financial statements for the consolidated group consisting of P and DS1. P has no net income. DS1 has financial statement income (before minority interests) and taxable income of $1,000. • On Schedule M-3, Part II, Line 8 (Part I, Line 11 on the 7/7/04 draft version), the U.S. consolidated group reports $900 of financial statement income ($1,000 net income less $100 minority interest). • On Schedule M-3, Part III, Line 8 (Part II, Line 8 on the 7/7/04 draft version) *Minority Interest for includible corporations*, the U.S. consolidated tax group reports ($100 in column (A), $100 in column (C), and $0 in column (D)). • On Schedule M-3, Part III, Line 34 (Part II, Line 31 on the 7/7/04 draft version) *Other income (loss) items with no difference*, the U.S. consolidated tax group reports $1,000 in both columns (A) and (D). • As a result, financial statement net income on Part III, Line 37, column (A) (Part II, Line 34 on the 7/7/04 draft version) will total $900 and taxable income on Line 37, column (D), will total $1,000.
Sale Versus Lease ***Example #10***	• Report on Line 21 any differences (e.g., revenue, cost of goods sold, interest and depreciation) due to characterization of a transaction as a sale for income statement purposes and as a lease for Federal Income tax purposes, or vice versa. • Note: Part III, Line 21 on the Jan. 28, 2004 version of Sch. M-3 changes to Part II, Line 18 on the July 7, 2004 version. • ***Facts.*** U.S. corporation C sells and leases property to customers. C treats each transaction as a sale for financial statement purposes. For U.S. tax purposes, C treats each transaction as a lease. ***The differences due to the characterization of a transaction as a sale for financial statement purposes and as a lease for U.S. tax purposes will reverse in a future tax year and must be classified as temporary differences.*** • During 2004, ***in its financial statements,*** C reports $1,000 of sales and $700 of cost of goods sold with respect to 2004 lease transactions, plus $100 of interest income on the deferred payments from prior lease transactions. • For U.S. tax purposes, C reports $500 of rental income from leasing transactions and $200 of depreciation expense. • On the line for *"Sale versus lease,"* C must report for its 2004 tax year ♦ Income statement net income of $400 ($1,000- $700 + $100) in column (A), ♦ A temporary difference of ($100) in column (B), and ♦ Taxable income of $300 ($500 - $200) in column (D).
Source	• *Instructions for Schedule M-3 (Form 1120)* - "Proof as of March 10, 2004 - Subject to Change" • Note: On the 7/7/04 draft version of Schedule M-3, the full-page *Reconciliation of Income(Loss) Items* which was Part III on the 1/28/04 draft has been re-designated as Part II. Similarly, the *Reconciliation of Expense/Deduction Items* which was Part IV on the 1/28/04 draft has been re-designated as Part III on the 7/7/04 version.

Deductions	IRS GUIDANCE FOR COMPLETING SCHEDULE M-3 EXPENSE & DEDUCTION ITEMS
Depreciation ***Example #6***	• ***Facts.*** Corporation C is a calendar year taxpayer that placed in service ten depreciable fixed assets in 2000. C's total depreciation expense for its 2004 tax year for five of the assets is $50,000 for income statement purposes and $70,000 for Federal income tax purposes. C's total annual depreciation expense for its 2004 tax year for the other five assets is $40,000 for income statement purposes and $30,000 for Federal income tax purposes. • ***The depreciation differences will reverse in future tax years and must be classified as temporary differences. ... C must combine all of its depreciation adjustments.*** • Accordingly, C must report on Schedule M-3, Part IV, Line 29 (Part III, Line 33 on the 7/7/2004 draft version) *Depreciation* for its 2004 tax year ♦ Income statement depreciation expense of $90,000 in column (A), ♦ Temporary difference of $10,000 in column (B), and ♦ Federal income tax depreciation expense of $100,000 in column (D).
Changes in General Reserve Balances ***Example #7***	• ***Facts.*** On December 31, 2004, Corporation C, a calendar year taxpayer, established three reserve accounts in the amount of $100,000 for each account. ♦ One reserve account is an allowance for accounts receivable that are estimated to be uncollectible. ♦ The second reserve is an estimate of a settlement that C may have to pay as a result of pending litigation. ♦ The third reserve is an estimate of future warranty expenses. • C treats the three reserve accounts in its financial statements as giving rise to temporary differences that will reverse in future years. The three reserves are expenses in C's 2004 financial statements, but they are not deductions for Federal income tax purposes in 2004. • ***C must not combine the Schedule M-3 differences for the three reserve accounts.*** • Accordingly, C must separately report ♦ The amounts attributable to the allowance for uncollectible accounts receivable on the Schedule M-3 line for *Bad debt expense*, Part IV, Line 30 (Part III, Line 34 on the 7/7/04 draft version), and ♦ Must separately state and adequately disclose the amounts attributable to the reserve for pending litigation and the warranty reserve on the Schedule M-3 line for *Other expense/ deduction items with differences*, Part IV, Line 36 of the 1/28/2004 draft. • Note: On the 7/7/2004 draft version, Part III has included two additional lines - #35 & #36 - on which these reserve balance changes might be reported, or else they might be reported on Line 39. A single line (Line #31: *Accrued non-deductible liabilities*) provided for all reserves on the Jan. 28, 2004 version, and it has been expanded to 2 Lines on the July 7, 2004 version (Lines #35: *Expense for contingent liabilities* and Line #36: *Expense for other reserves*). In all cases, the attachment of a detailed schedule is required.
Accounts Receivable ... Reserve for Bad Debts ***Example #8***	• ***Facts.*** On January 2, 2004, Corporation C, a calendar year taxpayer, established an allowance for uncollectible accounts receivable (bad debt reserve) of $100,000. During 2004, C increased the reserve by $250,000 for additional accounts receivable that may become uncollectible. Additionally, during 2004 C decreased the reserve by $75,000 for accounts receivable that were discharged in bankruptcy during 2004. The balance in the reserve account on December 31,2004, is $275,000. • The $100,000 amount to establish the reserve account and the $250,000 to increase the reserve account are expenses on C's 2004 financial statements, but these amounts are not deductible for Federal income tax purposes in 2004. However, the $75,000 decrease to the reserve is deductible for Federal income tax purposes in 2004. • C treats the reserve account in its financial statements as giving rise to a temporary difference that will reverse in future tax years. • C must report on the Schedule M-3 line for *Bad debt expense*, Part IV, Line 30 (Part III, Line 34 on the 7/7/2004 draft version) its 2004 tax year ♦ Income statement bad debt expense of $350,000 in column (A), ♦ Temporary difference of ($275,000) in column (B), and ♦ Federal income tax bad debt expense of $75,000 in column (D).
Source	• See *Source & Notes* on page 18.

NEW SCHEDULE M-3 FOR CORPORATE RETURNS

*More Detailed Questions & Clarification**

Question	*IRS Answer, Clarification, Discussion*

Where corporations use the permitted, optional short-cut reporting for 2004 ...

Question	IRS Answer, Clarification, Discussion
• ***Question:*** If a corporation chooses not to complete Columns A and D of Parts II and III in the corporation's transition year, how is Part II, Line 34, reconciled for the U.S. consolidated tax group in the transition year? (FAQ #5)	• ***Answer:*** Part II, Line 34, for the U.S. consolidated tax group is reconciled in the following manner in the transition year: ♦ the amount reported on Part I, Line 11, must be reported in Part II, Line 34, Column A, ♦ Part II, Lines 1 through 33, Columns A and D, must be left blank, ♦ Part III, Columns A and D, must be left blank, and ♦ Part II, Line 34, Column D, must equal the sum of Part II, Line 34, Columns A, B, and C.

Where a consolidated tax return is filed ...

Question	IRS Answer, Clarification, Discussion
• ***Question:*** Is each member of a U.S. consolidated tax group required to file its own Schedule M-3? (FAQ #6) • ***Example:*** If a U.S. consolidated tax group consists of a parent and three subsidiaries, it is anticipated that six Schedule M-3s must be completed and attached to the tax return of the group as follows: ♦ Parts I, II, and III of a Schedule M-3 by the parent reflecting Part I information for the entire consolidated group and its own activity in Parts II and III, ♦ Parts II and III of Schedule M-3 by each of the three subsidiaries reflecting their respective activity, ♦ Parts II and III of a consolidating Schedule M-3 to account for items such as differences between financial statement net income and taxable income related to intercompany transactions and adjustments made at the consolidated group level that are not attributable to any specific member of the U.S. consolidated tax group (e.g., disallowance of net capital losses, contribution deduction carryovers, and limitation of contribution deductions), and ♦ One consolidated Sch. M-3 with Parts I, II, and III resulting from consolidating those Sch. M-3s described above.	• ***Answer:*** Part I of Schedule M-3 must be completed once to report the consolidated information and activity for the entire U.S. consolidated tax group. However, Parts II and III of Schedule M-3 must be completed separately by each member of the U.S. consolidated tax group to reflect each member's own activity. • The parent company must complete all parts of Schedule M-3 by including: ♦ The consolidated information for the U.S. consolidated tax group in Part I, and ♦ Its own separate (i.e., non-consolidated) company information in Parts II and III. • Each subsidiary corporation in the U.S. consolidated tax group must complete Parts II and III on its own separate Schedule M-3 to reflect its own activity. • Additionally, Parts II and III must be completed on a consolidating Schedule M-3 in order to consolidate all the Schedule M-3 information of the entire U.S. consolidated tax group.

Where inventory valuation adjustments are involved ...

Question	IRS Answer, Clarification, Discussion
• ***Question:*** What must be included on Part II, Line 17, Inventory valuation adjustments? (FAQ #20)	• ***Answer:*** Any amounts related to inventory valuation must be included on Part II, Line 17. This includes ♦ Cost-flow assumptions, ♦ Additional costs required to be capitalized to ending inventory (including depreciation), ♦ Inventory shrinkage accruals, ♦ Inventory obsolescence reserves, and ♦ lower-of-cost-or-market write-downs. • Section 481(a) adjustments related to inventory valuation are to be excluded from Line 17, and instead, they are to be reported on Part II, Line 19, *Section 481(a) adjustments.*

Question	*IRS Answer, Clarification, Discussion*
Where a portion of an item is treated the same for both book and tax purposes, and a portion of that same item gives rise to a book-tax difference (such as Sec. 274) ...	
• ***Question:*** If a portion of an item of income, gain, loss, expense, or deduction is treated the same for income statement and federal income tax purposes and a portion of the item gives rise to a difference, does the corporation report all amounts attributable to the item on one line of Parts II or III, as applicable, or is the portion of the item without a difference reported on Part II, Line 31, Other income (loss) items with no differences or Part III, Line 40, Other expense/deduction items with no differences, as applicable, and the portion of the item with a difference reported on the applicable line of Parts II or III? (FAQ #14)	• ***Answer:*** All amounts attributable to the item must be reported on the applicable line of Parts II or III and not segregated between that line and Part II, Line 31, or Part III, Line 40, as applicable. • For example, if a corporation incurs $200 of meals and entertainment expenses that were deducted in computing net income per the income statement, and $50 of the $200 is subject to the 50% limitation under Section 274(n), ... ♦ ***Do it this way.*** The corporation must report all of its meals and entertainment expenses on Part III, Line 11, *Meals and entertainment.* ♦ Specifically, the corporation reports $200 in Column A, $25 in Column B and/or C, as applicable, and $175 in Column D. ♦ ***Don't do it this way.*** The corporation should not report the $150 of meals and entertainment expenses that were deducted in computing net income per the income statement and are fully deductible for U.S. Federal income tax purposes on Part III, Line 40, *Other expense/deduction items* with no differences, and the $50 subject to the limitation under Section 274(n) on Part III, Line 11, *Meals and entertainment.*
Disposition of assets other than inventory ...	
• ***Question:*** What must be included on Part II, Line 23, *Income statement gain/loss on disposition of assets other than inventory*? (FAQ #21)	• ***Answer:*** Taxpayers must include on Part II, Line 23 all gains and losses on the disposition of assets other than inventory that are included in the net income (loss) per income statement of includible corporations reported on Part I, Line 11, even if there are no differences between the gain or loss included in net income (or loss) per the income statement and taxable income. • Thus, unless otherwise required to be reported on a separate line of Part II, such gains and losses must be reported on Part II, Line 23, Column A, and reversed in Part II, Line 23, Columns B and/or C, as applicable. • The corresponding gains and losses for U.S. Federal income tax purposes are reported on Part II, Lines 24-27, as applicable, unless required to be reported elsewhere on Part II.

Question	*IRS Answer, Clarification, Discussion*
Where the corporation is reporting flow-through distributive shares of items from Partnership K-1s, etc. ...	
• ***Question:*** How must a corporation report on Schedule M-3 the corporation's distributive share of income or loss from a partnership, trust, or other flow-through entity that is reported on Schedule K-1? (FAQ #18) *Answer Continued ...* ♦ Report the sum of all net capital gains reported for all Schedule K-1s received on Part II, Line 25, *Gross capital gain from includible corporations*, and the sum of all net capital losses reported on all Schedule K-1s received on Part II, Line 26, *Gross capital loss from includible corporations*.	• ***Answer:*** The corporation must report the corporation's distributive share of income or loss from a partnership, trust, or other flow-through entity that is reported on Schedule K-1 in the following manner, even if the amount does not result in a difference between the net income (or loss) per the income statement and taxable income: ♦ Separately report for each Schedule K-1 received the sum of all amounts included in Part I, Line 11, Net income (loss) per income statement of includible corporations, in Column A, Part II, Line 9, *Income (loss) from U.S. partnerships*, Part II, Line 10, *Income (loss) from foreign partnerships*, or Part II, Line 11, *Income (loss) from other pass-through entities*, as applicable. ♦ With the exception of capital gains and losses, separately report in Column B and/or Column C for each Schedule K-1 received each separately stated item on Schedule K- 1 for which a separate line is provided on Schedule M-3, Part II, Line 1 through 29, or Part III, Line 1 through 38 (e.g., Part II, Line 13, *Tax-exempt interest*, and Part III, Line 19, *Charitable contribution of cash and tangible property*). Otherwise, report the amount in Column B and/or Column C of Part II, Line 9, 10, or 11, as applicable. *(See left column for continuation of answer ...)*
Where less common forms of equity-based compensation are involved ...	
• ***Question:*** What must be included on Part III, Line 10, *Other equity-based compensation*? (FAQ #23)	• ***Answer:*** Any amounts for equity-based compensation involving incentive and nonqualified stock option compensation should be reported on Part III, Lines 8 and 9, respectively. • All other amounts must be included on Part III, Line 10. These amounts would include ♦ Compensation attributable to employee stock purchase plans (ESPPs), ♦ Phantom stock options, ♦ Phantom stock units, ♦ Stock warrants, ♦ Stock appreciation rights, and ♦ Restricted stock.
Where year-end assets exceed $10 million at the end of one year, but fall below the $10 million threshold at the end of a succeeding year ...	
• ***Question:*** If a corporation was required to complete Schedule M-3 in the preceding taxable year and the corporation reports on Schedule L of Form 1120 total assets at the end of the current taxable year of less than $10 million, is the corporation required to file Schedule M-3 for the current taxable year? (FAQ #8)	• ***Answer:*** No. • The corporation may either ♦ Continue to complete Schedule M-3, or ♦ File Schedule M-1. • However, if the corporation chooses to file Schedule M-1 and, in a subsequent taxable year, the corporation is required to complete Sch. M-3, the corporation will be required to complete Sch. M-3 in its entirety in that subsequent taxable year (including Columns A and D of Parts II and III). • Note: The Service is currently evaluating whether a corporation should be required to continue to file Schedule M-3 once it has filed Schedule M-3 for the first time.

NEW SCHEDULE M-3 FOR CORPORATE RETURNS

*More Detailed Questions & Clarification**

Question	*IRS Answer, Clarification, Discussion*
Where cash basis reporting is used for tax purposes and accrual basis is used for financial statements ...	
• ***Question:*** If a corporation prepares financial statements on an accrual basis and the corporation uses an overall cash method of accounting for federal income tax purposes, must the corporation's total assets at the end of the corporation's taxable year be determined ***on an accrual basis*** or on a cash basis for purposes of determining whether the corporation has total assets at the end of the current taxable year of $10 million or more? (FAQs #9) • ***Related Question:*** Who must complete Part II, Line 14, *Total accrual to cash adjustment*, and what must be included on this line? (FAQ #19)	• ***Answer:*** In this situation, the corporation's total assets must be determined ***on an accrual basis*** (i.e., the same basis as the corporation's financial statements), for purposes of determining whether the corporation has total assets at the end of the current taxable year of $10 million or more. • ***Answer:*** Part II, Line 14, *Total accrual to cash adjustment* is completed only by a corporation with financial statements (or books and records, if permitted) prepared using an accrual method of accounting that uses an overall cash method of accounting for federal income tax purposes (or vice-versa). ♦ The corporation must report on Line 14 a single amount net of all adjustments attributable to the use of the different overall methods of accounting (e.g., adjustments related to accounts receivable, accounts payable, compensation, and accrued liabilities). ♦ Differences not attributable to the use of the different overall (cash and accrual basis) methods of accounting must be reported on the appropriate line of Schedule M- 3 (e.g., depreciation).
Where differences attributable to "reportable transactions" are involved ...	
• ***Question:*** Are differences between financial statement net income and taxable income attributable to any reportable transaction (as described in Reg. Sec. 1.6011-4(b)) required to be separately disclosed on Sch. M-3? (FAQ #7)	• ***Answer:*** Yes. • ***Each difference*** attributable to any reportable transaction (other than a transaction described in Reg. Sec. 1.6011-4(b)(6); see also Rev. Proc. 2004-45) ***must be separately stated and adequately disclosed*** on Part II, Line 12, *Items relating to reportable transactions*, ***regardless of whether the difference would otherwise be reported elsewhere on Part II or on Part III.*** • ***Multiple items of difference.*** If a reportable transaction gives rise to two or more items of difference, each difference must be separately stated and adequately disclosed on a supporting schedule. • ***Cross-Referenced to Form 8886.*** Additionally, the description of each difference must reference the specific, identified reportable transaction disclosed by the taxpayer on Form 8886, *Reportable Transaction Disclosure Statement.*

Source: Department of Treasury - Office of Public Affairs, *Schedule M-3: Frequently Asked Questions*, dated July 7, 2004.
* Note: Not all 23 FAQs appearing on Treasury Release are included above.

PRACTICE GUIDE

New Schedule M-3 Reporting Requirements For Corporate Tax Returns (Forms 1120) For 2004

Action Plan	To Do	Done	Comments
1. ***Determine whether client is required to complete Schedule M-3 for 2004.*** • If Schedule L total assets at the end of 2004 exceed $10 million, Schedule M-3 is required. • ***Review last year's return Balance Sheet (Form 1120, Schedule L).*** ♦ Are total assets in excess of $10 million as of Dec. 31, 2003? ▪ If "No," are any liabilities on the Dec. 31, 2003 balance sheet inappropriately netted against asset balances? ▪ If the are, would total assets as of that date, if correctly presented, exceed $10 million? ▪ If "No," are total assets as of Dec. 31, 2004 expected to be in excess of $10 million?			
2. ***Assess how problematic completion of Schedule M-3 is likely to be.*** • ***Review new Schedule M-3 and M-3 Instructions.*** ♦ Become familiar with all reporting requirements and line items. ♦ Schedule a staff meeting to discuss changes, if necessary. • ***Review last year's Schedule M-1 Reconciling Items.*** ♦ Review all Schedule M-1 items in 2003 return. ♦ If these or similar items are expected to recur as book-tax differences in 2004, will there be any problems in completing Schedule M-3 (either on a short-cut basis, or in its entirety - all four columns) to reflect these items? ♦ Are there any "new" book-tax differences anticipated to be reported in Schedule M-1 / M-3 this year? ♦ If there are, will there be any problems in completing Schedule M-3 (either on a short-cut basis, or in its entirety - all four columns) to reflect these items?			
3. ***Review last year's files.*** Review all audit and/or tax return workpapers and adjusting entries for 2003 • Identify all entries and amounts that were ignored or waived as being ***immaterial*** (or for similar reasons). ♦ These entries/waived adjustments should be flagged for 2004 reporting (should they recur) in order to be Sch. M-3 reporting compliant. ♦ Query ... If these immaterial amounts/transactions do not relate to items that create a book-tax difference, can they still be ignored? • Schedule M-3 provides no leeway for "immaterial" amounts. ♦ All amounts and all items are required to be disclosed in Schedule M-3. ♦ There are no *de minimis* exceptions for reporting dollar amounts or transactions. ♦ The Service has said, "***Every item of difference must be separately stated and adequately disclosed*** on Schedule M-3. The final Sch. M-3 Instructions will not provide a specific dollar or ratio threshold for materiality."			
4. *Continued on next page ...*			

ADDITIONAL COMMENTS & FOLLOW-UP NEEDED

____

Major problem areas are anticipated to be: __________________________

____

____

____

PRACTICE GUIDE

New Schedule M-3 Reporting Requirements For Corporate Tax Returns (Forms 1120) For 2004

Action Plan	To Do	Done	Comments
4. ***Assess adequacy of information collection and summarization.*** • Determine whether the current accounting system, general ledger and/or supporting ledgers and schedules will provide appropriate detail to comply with line-by-line *transactional reporting* required by Schedule M-3. • Schedule M-3 must be completed (at least partially) for 2004 returns. Therefore, all of the information required by Sch. M-3 must be accumulated from January 1, 2004 forward (i.e., retroactive back to Jan. 1, 2004). ♦ If the present accounting system and/or supporting schedules will not yield that information at year-end, collection of that information on a year-to-date basis immediately will avoid requiring that effort during the "busy season." • For example, depreciation claimed in the tax return may appear only on Form 4562 and on its carryforward line on Page 1. In contrast, the new Sch. M-3 reconciliation has 5 lines on which it may be necessary to split out different depreciation amounts claimed.			
5. ***Schedule a client meeting to discuss / explain ...*** • New Schedule M-3 reporting requirements. • Additional recordkeeping that may be required. • How much of the additional compliance detail collection work can be done by client (controller staff, internal auditors, etc.) • Anticipated additional time and fees resulting from requirement to complete (even partially) Schedule M-3 for 2004.			
6. ***Contact tax return software provider for Form 1120 corporate tax preparation. Software needs to be Sch. M-3 compliant.*** • Will software for 2004 corporate returns be Schedule M-3 compliant? • By what date will compliant software be available? • How will you determine that software will satisfy new reporting? • Will you have adequate time to test compliance of software on a trial basis?			
7. ***Suggestions for managing your tax practice.*** • ***In the pre-year-end activity (between now and December 31),*** assign Schedule M-3 assessment coordinating responsibilities to one person (or a team) ... ♦ To identify anticipated reporting problem areas, etc. ♦ To evaluate steps necessary to comply with (or to approximate as closely as possible) requirements for completing Schedule M-3. ♦ To see how corporate returns filed in various states will be affected ... ▪ Will the new Schedule M-3 be adopted/accepted by the states with whom corporate income tax returns are filed? ▪ If not, what further modifications will be necessary? ♦ To recommend Firm policy on handling and/or disclosure of certain items. ♦ To draft letter or memo to clients on new Schedule M-3 requirements. • ***During the Form 1120 filing season (after January 1, 2005),*** consider a single person (or team) to review all Schedule M-3s filed for 2004. ♦ Logically, this could be a further activity of the individual(s) responsible for coordinating pre-year-end Schedule M-3 activities. (See above.) ♦ This will provide for centralization and consistency within the Firm for the actual reporting / compliance aspects of the new Schedule M-3. ♦ Realistically, you may want to assess the likelihood that full compliance with Schedule M-3 Instructions may not be possible ... ▪ To what extent might it be necessary to net transactions or to report net losses, even though M-3 does not "permit" netting? ▪ To what extent the Sch. M-3 prohibition against using any *de minimis* amounts may not be complied with. ▪ Other matters where a "Firm Policy" needs to be developed w/r/t Sch. M-3.			

RECONCILING TAXABLE INCOME TO NET INCOME PER BOOKS "OLD" SCHEDULE M-1 FOR USE BY SMALLER FORM 1120 CORPORATION FILERS

The completion of Schedule M-1 will continue to be required by all corporations filing Form 1120 whose total assets at the end of the year are less than $10 million. The only exception is that Schedule M-1 is not required to be completed if the corporation's total receipts for the tax year and its total assets at the end of the tax year are both less than $250,000.

Schedule M-1 appears below. In addition, if you want to test your mettle, you can complete Schedule M-1 in connection with the relatively simple fact pattern described below and on the facing page.

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income per Return** (see page 20 of instructions)

1	Net income (loss) per books		7	Income recorded on books this year not included on this return (itemize): Tax-exempt interest $	
2	Federal income tax per books			....	
3	Excess of capital losses over capital gains			....	
4	Income subject to tax not recorded on books this year (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
	....		a	Depreciation . . . . $...........	
5	Expenses recorded on books this year not deducted on this return (itemize):		b	Charitable contributions $...........	
a	Depreciation . . . . $...............			....	
b	Charitable contributions $...............			....	
c	Travel and entertainment $...............		9	Add lines 7 and 8	
	....				
6	Add lines 1 through 5		10	Income (line 28, page 1)—line 6 less line 9	

The following profit and loss account appeared in the books of Tentex for the calendar year.

Account		Debit	Credit
Gross sales			$3,250,000
Sales returns and allowances		$50,000	
Cost of goods sold		1,920,000	
Dividends received			10,000
Interest income:			
On state bonds	$5,000		
Taxable	5,500		
	------		10,500
Proceeds from life insurance			9,500
Premiums on life insurance		9,500	
Compensation of officers		170,000	
Salaries and wages--indirect		450,000	
Repairs		14,000	
Bad debts		3,750	
Rental expense		110,000	
Taxes		43,750	
Interest expense:			
On loan to buy tax-exempt bonds	$850		
Other	27,200		
	------	28,050	
Contributions		40,500	
Depreciation--indirect		18,380	
Advertising		51,420	
Profit-sharing plan		32,650	
Other expenses of operations		58,000	
Loss on securities		3,600	
Federal income tax accrued		82,812	
Net income per books after tax		193,588	
		----------	----------
Total		**$3,280,000**	**$3,280,000**
		=========	=========

RECONCILING TAXABLE INCOME TO NET INCOME PER BOOKS
"OLD" SCHEDULE M-1
FOR USE BY SMALLER FORM 1120 CORPORATION FILERS

Tentex analyzed its retained earnings, and the following appeared in this account on its books.

Item	Debit	Credit
Balance, January 1		$238,000
Net profit (before federal income tax)		276,400
Reserve for contingencies	$10,000	
Income tax accrued for the year	82,812	
Dividends paid during the year	65,000	
Refund of 2000 income tax		18,000
Balance, December 31	374,588	
Total	**$532,400**	**$532,400**

Schedule M-1--Reconciliation of Income (Loss) per Books With Income per Return. Schedule M-1 starts with the net income (loss) per books, after reduction for federal income tax accrued, as shown in the corporation's profit and loss account. It provides for necessary adjustments to reconcile this amount with the taxable income shown on line 28, page 1.

Line 1. $193,588 is the net income per books. It appears in the profit and loss account as net income per books after tax.

Line 2. $82,812 is the federal income tax accrued for the tax year.

Line 3. $3,600 is the excess of capital losses over capital gains. The net loss is from the sale of securities.

Line 4. This would show all income subject to tax but not recorded on the books for this year. This can happen if the corporation valued assets on its books at an amount greater than that used for tax purposes. When it has a sale of these assets, the gain included in taxable income is greater than that recorded on the books. It shows the difference here.

Line 5. Tentex shows expenses recorded on its books that it does not deduct. The $7,827 listed on line 5b is for contributions over the 10% limit. Tentex itemizes the remaining nondeductible expenses on a statement (not illustrated) attached to the return. These include the following expenses.

1.	Premiums paid on term life insurance on corporate officers	$9,500
2.	Interest paid to purchase tax-exempt securities	850
3.	Reduction of salaries by work opportunity credit	12,000
4.	**Total**	**$22,350**

Line 6. Enter the total of lines 1 through 5.

Line 7. This is income recorded on the corporation's books during the year that is not taxable and is not included on the return. This total, $14,500, includes insurance proceeds of $9,500 and tax-exempt interest on state bonds of $5,000.

Line 8. This includes all deductions claimed for tax purposes but not recorded in the corporation's books. Tentex enters $1,620 on line 8a. This is the difference between the depreciation claimed on the tax return and the depreciation shown on the corporation's books. If the corporation had other deductions to itemize on this line but not enough space, it would attach an itemized statement to the return.

Line 9. Enter $16,120, the total of lines 7 and 8.

Line 10. The difference between lines 6 and 9 must agree with line 28, page 1.

(Continued from page 1)

to postpone its planned initial implementation for the year 2004.

However, it is possible (one might argue) that over the next few months if more objections, concerns and possible problems are raised, it may become evident even to the IRS that it is just expecting too much too soon. If that were to happen, it still is very likely that you will have to go through all of these exercises in greater reporting detail next year.

Underlying sources for these discussions of Schedule M-3 include the first and second drafts of Schedule M-3 (issued January 28, 2004 and July 7, 2004, respectively), draft Instructions for Schedule M-3 (issued as of March 10, 2004), assorted and sundry IRS Announcements, Notices and clarifications in the form of *Frequently Asked Questions* (FAQs) related thereto. In addition, I studied the comments submitted to the IRS on these documents and a few other sources that I thought might shed further light or be helpful.

I don't want to be an alarmist ... the sky definitely is not falling. But, be forewarned: You may be in for some unpleasant surprises and tough detail work if you've got to grapple with the new Schedule M-3 anytime soon.

My suggestion is: Don't put all of this off until next February when it's time to plug some figures into your tax return software. By then, it may be too late!

#2. SOME CHANGES BY THE PENSION FUNDING EQUITY ACT OF 2004 COULD AFFECT YOUR DEALERS' PORCs. The subject of PORCs still appears to be mighty important to the IRS. Due to the total focus in this issue of the *DTW* on the new Schedule M-3 reporting requirements, we plan to include in the next (September 2004) issue of the *Dealer Tax Watch* a mid-year update on PORCs.

This coverage will include a discussion of the important changes affecting non-life insurance companies that were included in the Pension Funding Act of 2004, signed by the President on April 10. These changes in the Law apply to tax years ending after December 31, 2003, so, for all intents and purposes they are effective immediately for calendar year taxpayers.

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