General Description of Schedule M-3:
Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More

Background

- 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 and conduct business, and in their corresponding financial and tax accounting.
- Schedule M-1 (and the related instructions) do not provide a uniform reporting requirement for "net income per books" on line 1 of Schedule M-1. As a result, taxpayers may provide information for (i) the worldwide group, (ii) the U.S. consolidated tax group, or (iii) something in between.
- Similarly, Schedule M-1 (and the related instructions) do not provide uniform disclosure requirements for reporting differences between financial accounting net income and taxable income. The lack of requirements prevent efficient comparisons among taxpayers and from year to year for the same taxpayer, thus making assessment of the risk of noncompliance associated with an issue or a taxpayer more difficult.

Goals of Schedule M-3

- Increase transparency while minimizing 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) audits through greater transparency.

Highlights of Schedule M-3

Who is affected?

- Only Large and Midsize Business (LMSB) corporate taxpayers reporting gross assets of $10 million or more on Schedule L (balance sheet) on Form 1120 at the end of the taxable year would be required to complete and file Schedule M-3 instead of Schedule M-1.
- All other taxpayers would continue to complete and file Schedule M-1. No changes are proposed for Schedule M-1 at this time.
- It is expected that a form similar to Schedule M-3 will be designed for Form 1065 Partnership Income Tax Returns, Form 1120S Small Business Corporation Income Tax Returns, and perhaps other federal income tax returns that warrant enhanced transparency.

Specifics of Schedule M-3

Part I – Question regarding corporate financial statements and publicly traded common stock

Part 1 asks questions to identify the source of the financial statement information. Taxpayers would be required to reconcile financial accounting net income to taxable income based on the following hierarchy:

- SEC Form 10-K financial statements;
- Other certified GAAP statements;
- Other financial statements (with explanation of accounting method attached); and
- If no financial statements are prepared by the taxpayer (certified or otherwise), then the taxpayer would report income from its books and records on the last line (Line 8) of Part II and skip the other lines.

Part II – Reconciliation of net income (loss) per income statement with net income (loss) of includible corporations

Part II is a consolidated schedule that reconciles the taxpayer's worldwide net income (loss) per the income statement (as determined in Part I (for example, the income statement per the financial statements if one is prepared by the taxpayer)) to the net income (loss) of the corporations included in the U.S. tax return (the U.S. consolidated tax group).

- (Line 1) Start with net income (or loss) per the income statement.

- (Line 2) Remove net income (or loss) of foreign corporations that are included in Line 1, but not in the U.S. consolidated tax group.

- (Line 3) Remove net income (or loss) of U.S. corporations that are included in Line 1, but not in the U.S. consolidated tax group (for example, 51% to 79%-owned U.S. subsidiaries).

- (Line 4) Include net income (or loss) of corporations that are consolidated for federal income tax purposes, but are not included on Line 1.

- (Line 5) Adjust (remove or include) eliminations of intercompany transactions that relate to non-includible entities removed in lines 2 and 3 or included in line 4, leaving only intercompany eliminations that relate to includible entities. Generally, for those corporations removed on Lines 2 and 3, Line 5 will add back dividends received by the U.S. consolidated tax group and adjust for minority interests included on Lines 2 or 3.

- (Line 6) Include adjustments for differences between the taxpayer's income statement year and tax return year.

- (Line 7) Include any other necessary adjustments and attach a detailed schedule of those adjustments.

- (Line 8) Line 8 is the net income (or loss) per the income statement of the consolidated tax group. Taxpayers that did not prepare financial statements would enter net income (or loss) per books and records for the U.S. consolidated tax group.

The instructions to Part II would clarify that any amounts reported on Lines 2-7 must be separately stated and adequately disclosed and the combining, or netting, of amounts is not permitted.

<u>Part III and IV– Reconciliation of net income (loss) per income statement of includible corporations with taxable income per return.</u>

Part III and IV are consolidating schedules that reconcile the net income (or loss) per the income statement of the U.S. consolidated tax group in Part II Line 8 to the taxable income of the U.S. consolidated tax group on Form 1120, Page 1, Line 28.

- Part III breaks out differences (between the net income (or loss) per the income statement and taxable income) in items usually considered to be income (or loss) items.

- Part IV breaks out differences (between the net income (or loss) per the income statement and taxable income) in items usually considered to be expense/deduction items.

- Any income (or loss) items in Part III, or any expense/deduction items in Part IV, that do not result in a difference between net income (or loss) per the income statement and taxable income are reported on a single line in each respective part.

- Part III and IV require the taxpayer to identify the portion of each difference that is a permanent difference and the portion that is a temporary difference. Generally, items of difference that will reverse (that is, have an opposite effect on taxable income in later years due to the difference in timing of recognition for accounting and federal income tax purposes) or that are a reversal of prior differences are temporary differences, and items that will never reverse are permanent differences.

- The specific differences listed in Part III and IV reflect:
  - low risk differences that are separated out for greater transparency,
  - high risk differences that may require attention, and
  - other areas of special concern such as emerging issues.

- The instructions to Part III and Part IV will clarify that any difference reported must be separately stated and adequately disclosed.

- Part III and IV each conclude with a summation of each of the columns. The total of each column in Part IV is reported on a separate line at the bottom of Part III.
  - The first column of Part III is the net income per the income statement and must equal the amount shown at Part II Line 8.
  - The second column is the total of all temporary differences.
  - The third column is the total of all permanent differences.
  - The fourth column is taxable income and must equal the amount shown at Form 1120, Page 1, Line 28.

Schedule L

- No changes are proposed to the format of Schedule L (the balance sheet) of Form 1120 at this time.
- The Form 1120 instructions would clarify that:
  - The balance sheet amounts on Schedule L reflect full consolidation accounting for all entities that are included in the tax return (with full elimination of intercompany transactions between all includible entries), and not some form of combination accounting.
  - The balance sheet amounts on Schedule L should correspond to the taxpayer's financial statement amounts, if financial statements are prepared (in the case of a U.S. consolidated tax group, if financial statements are prepared for the U.S. parent).
  - The balance sheet amounts on Schedule L should not be tax-basis balance sheet amounts, unless the taxpayer only keeps tax-basis books and records and reconciles to taxable income from net income per books and records rather than from some financial statement net income amount.