



BDO Seidman, LLP
Accountants and Consultants

March 2007

Passthrough Entity Tax Bulletin

The Tax Practice at BDO Seidman is among the largest tax advisory practices in the United States.

With 34 offices and more than 300 independent alliance firm locations in the United States, BDO Seidman has the bench strength and coverage to serve you.

To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

Material discussed in this tax alert is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

New Schedule M-3 Filing Requirements for Partnerships May Apply in Unexpected Situations

Schedule M-3, which reports differences between taxable income and book income in far greater detail than Schedule M-1, has been a part of large corporation filing requirements since 2004. For years ending on or after December 31, 2006, certain partnerships will now also be required to file a version of the Schedule. Because the Schedule M-3 filing requirement of a partnership is dependent not only upon the partnership's assets and income but also on the status of its partners, even small partnerships may need to prepare the Schedule.

A partnership is required to complete Schedule M-3 in lieu of completing Schedule M-1 if:

- The total assets reported on the partnership's Schedule L at the end of the year are \$10 million or more after adding back losses and certain adjustments such as distributions that may have reduced the partnership's assets during the year.
- The partnership's total receipts for the year are \$35 million or more. Total receipts include gross sales and other income reported on page one of Form 1065, gross rentals from real estate and other property, interest, dividends, royalties, net gains from the sale of assets and any other income reported by the partnership.
- On any day of its taxable year on or after June 30, 2006, a partner which was itself required to complete a Schedule M-3 on its most recent Federal income tax return filed prior to that day (a "Reportable Entity Partner") owned or was deemed to own, directly or indirectly, a 50 percent or greater interest in the income, loss or capital of the partnership.

BDO Seidman Comment: A partner is a Reportable Entity Partner only if it was required to file a Schedule M-3 with its most recent *prior* Federal income tax return. For example, assume both a partnership and a 50 percent partner file their returns on a calendar year basis. The partner is a Reportable Entity Partner with respect to the partnership for purposes of the partnership's 2006 return only if the partner was required to file a Schedule M-3 with its return for the year ended December 31, 2005. Thus, for 2006 returns a partnership that does not have a direct or indirect 50 percent or more corporate partner will determine its Schedule M-3 filing requirement based on the asset and gross receipts thresholds above.

The Schedule M-3 instructions provide specific attribution rules for determining when a Reportable Entity Partner will be deemed to own a 50 percent or greater interest in the partnership. These rules will generally capture more entities than would many other tax ownership attribution rules:

- The parent of a consolidated group of corporations is deemed to own all corporate and partnership interests owned or deemed owned by any member of the group;
- The owner of a disregarded entity is deemed to own all corporate and partnership interests owned or deemed owned by the disregarded entity;
- The owner of 50 percent or more of a corporation by vote on *any* day of the corporation's tax year is deemed to own *all* corporate and partnership interests owned or deemed to be owned by the corporation during the year.
- The owner of 50 percent or more of partnership income, loss or capital on *any* day of the partnership tax year is deemed to own *all* corporate and partnership interests owned or deemed to be owned by the partnership during the year.
- The beneficial owner of 50 percent or more of the beneficial interest of a trust or nominee arrangement on *any* day of the trust or nominee arrangement tax year is deemed to own *all* corporate and partnership interests owned or deemed to be owned by the trust or nominee arrangement during the year

A Reportable Entity Partner with respect to any partnership must report certain information to the partnership within 30 days of first becoming a Reportable Entity Partner. Thereafter, the Reportable Entity Partner must provide an updated report to the partnership within 30 days of any change in the partnership interest it owns or is deemed to own.

If a partnership is required to file Schedule M-3, the Schedule and instructions specify the book income amounts that must be used for Part I, Lines 4-11:

- If the partnership files SEC Form 10-K it must use the book income amounts from that Form in preparing Schedule M-3
- If the partnership does not file SEC Form 10-K, it must use the book income amounts from its audited income statement, if any
- If the partnership does not file SEC Form 10-K and does not prepare an audited income statement, it must use its book income amounts from an unaudited income statement, if any
- If the partnership does not prepare any income statement, it must use the book income amounts from its books and records in preparing Schedule M-3

The total assets reported by the partnership on Form 1065, Schedule L must be consistent with the income statement used for purposes of Schedule M-3. Thus, if a partnership prepares financial statements on a GAAP basis and is required to file Schedule M-3, it must generally complete its Schedule L on a GAAP basis as well.

The instructions to Schedule M-3 provide specific rules for determining the appropriate financial statements to be used where the partnership is included in the consolidated financial statements of a group of entities or in the financial statements of more than one entity.

If a partnership is required to file Schedule M-3 it may be necessary to convert Schedule L to the method of accounting used for its financial reporting or books and records. In such a case, the beginning Schedule L balance should tie to the prior year return while the ending balance should reflect the method of accounting used to prepare the Schedule M-3.

In most cases, it will be appropriate to reflect the effect of the conversion on capital as an “Other increase” or “Other decrease” on Schedule M-2 so that the Schedule M-2 ending balance continues to agree with schedule L. The adjustment may be described as, for example, “Required tax to GAAP conversion.” This change will also be reflected in the capital accounts reported to the partners on Schedule K-1 which must tie in total to the Schedule M-2 ending balance. Therefore, it may also be appropriate to describe the adjustment in a footnote attached to Schedule K-1 such as the following:

“In prior years, the capital account shown in item N of your Schedule K-1 was determined on a Federal tax accounting basis. Beginning in 2006 the partnership is required to present item N on the basis of generally accepted accounting principles (“GAAP”) which are commonly used for financial statement reporting purposes. The conversion to GAAP presentation is reflected as a one-time adjustment to item N and is for reporting purposes only. The change has no impact on your taxable income.”

BDO Seidman Comment: The instructions to Form 1065 provide that the Schedule M-2 ending balance may reflect a different method of accounting than Schedule M-3 if a reconciling statement is attached to the return. However, those same instructions specify that line 3 of Schedule M-2 (Net Income (Loss) per Books) must be consistent with Schedule M-3. This implies that if a different method of accounting is used for Schedule M-2, the annual income difference should not be reflected on Schedule M-2 line 3 but as a separate M-2 adjustment.

If you need assistance in determining whether a partnership is required to complete a Schedule M-3 or in preparing the Schedule itself, contact any of the following individuals.

BDO Seidman Passthrough Tax Consulting Group

David Patch, NTO (301) 634-4965	Randy Frischer, New York (212) 885-8000 ext. 8445	Robert Klein, Woodbridge (732) 734-1006
Eric Kea (Co-Chairman), New York (212) 885-8000 ext. 8101	Angela Fry, Kalamazoo (269) 382-0170	Michael Kross, San Francisco (415) 490-3229
Kevin Anderson, NTO (Co-Chairman) (301) 654-4900 ext. 0222	Walter Hick, Los Angeles (714) 957-3200	Ed Moore, Atlanta (404) 979-7154
Jay Epstein, Houston (713) 986-3140	Bob Jenkins, San Francisco (415) 490-3179	Richard Noreen, Grand Rapids (616) 774-7000 ext. 3698
James Fielding, Dallas (214) 665-0631	Michael Kerekes, Los Angeles (310) 557-0300	Jay Payne, Phoenix (602) 293-2369