

Washington Tax Report

On July 7, 2004, the Treasury Department and the Internal Revenue Service released a draft of the final version of the new Schedule M-3, Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More. Any corporation (or U.S. consolidated tax group) required to file Form 1120, U.S. Corporation Income Tax Return, that reports on Schedule L of Form 1120 total assets at the end of the corporation's (or U.S. consolidated tax group's) taxable year that equal or exceed \$10 million is required to include Schedule M-3 with its return. A U.S. consolidated tax group is required to file a Schedule M-3 for each member of the consolidated group and a separate consolidated Schedule M-3. Schedule M-3 is effective for taxable years ending on or after December 31, 2004. It will be apparent after reading this *Washington Tax Report* that the inclusion, where required, of Schedule M-3, or multiple Schedules M-3 in the case of a consolidated group, will add considerable complexity to the preparation of U.S. corporate income tax returns.

The initial draft Schedule M-3 was unveiled January 28, 2004, and the IRS accepted comments through April 30, 2004. The draft Schedule M-3 instructions were issued March 11, 2004, and have yet to be finalized. The Service anticipates that the

instructions to Schedule M-3 will be finalized in September 2004.

Acting Treasury Assistant Secretary for Tax Policy Greg Jenner stated, "The purpose of this project has been to make differences between financial accounting net income

and taxable income more transparent. Schedule M-3 accomplishes this. Schedule M-3 provides information that will identify taxpayers that may have engaged in aggressive transactions and therefore should be audited."

The draft of the final version of the Schedule M-3 consists of three parts. Part I, Financial Information and Net Income (Loss) Reconciliation, looks first to obtain information about the taxpayer's financial income statement and then to reconcile worldwide net income (loss) per income statement with the net income (loss) per income statement of includible corporations (either a single corporation or corporations that are included in a U.S. consolidated tax group). This will allow the IRS to see both foreign and domestic nonincludible entities as well as any adjustments that have been made between the includible and nonincludible entities.

Schedule M-3, Part II, Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Income (Loss) Items, reports differences between the net income (loss) per the financial income state-

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ment and taxable income per the tax return with respect to items usually considered to be income or (loss) items.

Schedule M-3, Part III, Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Expense/Deduction Items, reports differences between the net income (loss) per the financial income statement and taxable income per the tax return with respect to items usually considered to be expense/deduction items.

Part II and III require the taxpayer to identify the portion of each difference that is a permanent difference and the portion that is a temporary difference. The specific differences listed in Part II and III are comprised of: 1) low risk differences that are reported for greater transparency; 2) high risk differences that may require attention; and 3) other areas of special concern such as emerging issues. IRS Commissioner Mark W. Everson said, “The new disclosures will help us target our examination efforts on high-risk areas, thereby improving and speeding the audit process.”

In addition to releasing the draft of the final version of the Schedule M-3, the Treasury Department and the Internal Revenue Service issued Revenue Procedure 2004-45. According to the Service, Rev. Proc. 2004-45 is meant to eliminate the overlap between the disclosure requirements for reportable transactions with a significant book-tax difference and the new Schedule M-3.

Reg. §1.6011-4(b)(6) defines a transaction with a significant book-

tax difference as a transaction where the amount for tax purposes of any item or items of income, gain, expense, or loss from the transaction differs by more than \$10 million on a gross basis from the amount of the item or items for book purposes in any taxable year. The disclosure requirements for reportable transactions with a significant book-tax difference apply to taxpayers that are either: 1) reporting companies under the Securities and Exchange Act of 1934; or 2) business entities that have \$250 million or more in gross assets for book purposes at the end of any financial accounting period that ends with or within the entity's taxable year in which the transaction occurs.

Rev. Proc. 2004-45 provides that a corporation required to file Schedule M-3 for a taxable year ending on or after December 31, 2004 that completes and files Schedule M-3 with the corporation's timely filed original tax return (including extensions) is deemed to satisfy the disclosure requirements for transactions with a significant book-tax difference. Furthermore, under the alternative disclosure procedures, a taxpayer that is required to disclose

reportable transactions with a significant book-tax difference, but is not required to file Schedule M-3 (e.g., a partnership or S corporation having \$250 million or more in gross assets, a company reporting under the Securities and Exchange Act of 1934 with total assets reported on Schedule L of less than \$10 million) is deemed to satisfy the disclosure requirements if the taxpayer discloses on a Schedule M-3 each item of income, gain, loss, deduction or credit for which the difference between the amount included in the taxpayer's financial statement net income (loss) for the taxable year and the amount included in taxable income for the taxable year is greater than \$10 million. This alternative disclosure procedure is available for taxable years ending before December 31, 2004.

Deborah M. Nolan, IRS Large and Mid-Size Business Division Commissioner, stated, “The alternative reporting under the revenue procedure will provide taxpayers flexibility in deciding how to disclose significant book-tax differences and will encourage taxpayers to adopt the standard format of the new Schedule M-3 earlier.” ■

Related Links:

Final Draft Schedule M-3: http://www.irs.gov/pub/irs-utl/draftm-3_-_070704.pdf

Draft Schedule M-3 Instructions:

http://www.irs.gov/pub/irs-utl/draft_m-3_instructions_-_3.11.2004.pdf

Schedule M-3 Frequently Asked Questions:

http://www.irs.gov/pub/irs-utl/m-3_faq.pdf

Rev. Proc. 2004-45: <http://www.irs.gov/pub/irs-drop/rp-04-45.pdf>

Rev Proc. 2004-45 Frequently Asked Questions:

<http://www.irs.gov/businesses/corporations/article/0,,id=119992,00.html>