

Instructions for Schedule M-3 (Form 1120)

(Rev. November 2022)

(For use with the December 2019 revision of Schedule M-3 (Form 1120))

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

Volume 2 of 3



Department of the Treasury
Internal Revenue Service

Instructions for Form 1120 Schedule M-3 (Rev. 11-2022) Catalog Number 54645N
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Normally, all intercompany dividends will have been eliminated or excluded from the financial accounting consolidated net income (loss) reported on Part I, line 4a. However, an insurance company may be required to include certain intercompany dividends on Part I, line 11, so that the amount reported on Part I, line 11, agrees with statutory accounting net income (Annual Statement). If the net income (loss) of a corporation that files Form 1120-PC or Form 1120-L is included on Part I, line 4a or line 7, and is computed on a basis other than statutory accounting, include on line 10a the adjustments necessary such that Part I, line 11, includes intercompany dividends in the net income (loss) for the corporation to the extent required by statutory accounting principles. (For insurance companies included in the consolidated U.S. income tax return, see the instructions for Part I, line 11, and Part II, line 7.)

Statutory accounting for an insurance company subsidiary acquired or merged may require the use of a financial statement period for income reported on Part I, line 11, that differs from the period reported on Part I, line 4a or line 7. Report on Part I, line 10b, adjustments to income because of such differences in accounting period.

For any adjustments reported on Part I, lines 10a, 10b, and 10c, attach a supporting statement that provides, for each corporation to which an adjustment relates, the name and EIN of the corporation; the amount of net income included in Part I before any adjustments on line 10; the amount of net income included on Part I, line 11; the amount of the net adjustment that is attributable to intercompany dividend adjustments required to be reported by statutory accounting and included on Part I, line 10a; the amount of the net adjustment attributable to other statutory accounting

requirements and included on Part I, line 10b; and the amount of the remainder of the net adjustment not required because of statutory accounting and included on Part I, line 10c. If any net adjustment is included for the corporation on Part I, line 10b or 10c, attach a supplemental supporting statement identifying the line (10b or 10c), the type, and the amount of each adjustment included in the net adjustment.

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

Report on line 11 the net income (loss) per the income statement (or books and records, if applicable) of the corporation. In the case of a U.S. consolidated tax group, report the consolidated income statement net income (loss) of all corporations listed on Form 851 and included in the consolidated U.S. income tax return for the tax year. Amounts reported in column (a) of Parts II and III (see

instructions, later) must be reported on the same accounting method used to report the amount of net income (loss) per income statement of includible corporations on Part I, line 11, which for insurance companies is statutory accounting. If an insurance company is included in a consolidated Form 1120, the amount of net income reported on Part I, line 11, will include the statutory accounting net income for the insurance corporation and the GAAP net income for the non-insurance corporations included in the U.S. consolidated tax group. (For insurance companies included in the consolidated U.S. income tax return, see the instructions for Part I, line 10, and Part II, line 7.)

Do not, in any event, report on this line 11 the net income of entities not listed on Form 851 and not included in the consolidated U.S. income tax return for the tax year. For example, it is not permissible to remove the income of nonincludible entities on lines 5

and/or 6, discussed earlier, then add back such income on lines 7 through 10, such that the amount reported on line 11 includes the net income of entities not includible in the consolidated U.S. income tax return. A principal purpose of Schedule M-3 is to report on this Part I, line 11, only the financial accounting net income of only the corporations included in the consolidated U.S. income tax return.

Whether or not the corporation prepares financial statements, Part I, line 11, must include all items that impact the net income (loss) of the corporation even if they are not recorded in the profit and loss accounts in the corporation's general ledger, including, for example, all post-closing adjusting entries (including workpaper adjustments) and dividend income or other income received from nonincludible corporations.

Example 4.

1. U.S. corporation P is publicly traded and files Form 10-K with the SEC. P owns 80% or more of the stock of 75 U.S. corporations, DS1 through DS75, between 51% and 79% of the stock of 25 U.S. corporations DS76 through DS100, and 100% of the stock of 50 foreign subsidiaries FS1 through FS50. P eliminates all dividend income from DS1 through DS100, and FS1 through FS50 in financial statement consolidation entries. Furthermore, P eliminates the minority interest ownership, if any, of DS1 through DS100 in financial statement consolidation entries. P's SEC Form 10-K includes P, DS1 through DS100, and FS1 through FS50 on a fully consolidated basis. P files a consolidated U.S. income tax return with DS1 through DS75.

P must check "Yes" on Part I, line 1a. On Part I, line 4a, P must report the consolidated net income from the SEC Form 10-K for the consolidated financial statement group of P, DS1 through DS100, and FS1 through FS50. P must remove the net income (loss) of FS1 through FS50 on Part I, line 5a or 5b, as applicable. P must remove the net income (loss) before minority interests of DS76 through DS100 on Part I, line 6a or 6b, as applicable. P must reverse on Part I, line 8:

- a. The elimination of dividends received by P and DS1 through DS75 from DS76 through DS100 and FS1 through FS50; and
- b. The recognition of minority interests' share of the net income (loss) of DS76 through DS100.

Note. The minority interests'

share, if any, of the income of DS1 through DS75 must be reported in Part II, line 8.

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

transactions was reversed on line 8.

2. Foreign corporation F owns 100% of the stock of U.S. corporation P. P owns 100% of the stock of DS1, 60% of the stock of DS2, and 100% of the stock of FS1. F prepares certified audited financial statements. P does not prepare any financial statements. P files a consolidated U.S. income tax return with DS1.
3. P must not complete Schedule M-3, Part I, with reference to the financial statements of its foreign parent F. P must check "No" on Part I, lines 1a, 1b, and 1c; skip lines 2a through 3c of Part I; and enter worldwide net income (loss) per the books and records of the includible corporations (P and DS1) on Part I, line 4a. P must enter any necessary adjustments on lines 5a through 10 in order for Part I, line 11,

to report the net income (loss) of includible corporations P and DS1, net of eliminations for transactions between P and DS1.

Example 5.

1. U.S. corporation P owns 60% of corporation DS1 which is fully consolidated in P's financial statements. P does not account for DS1 in P's separate general ledger on the equity method. DS1 has net income of \$100 (before minority interests) and pays dividends of \$50, of which P receives \$30. The dividend is eliminated in the consolidated financial statements. In its financial statements, P consolidates DS1 and includes \$60 of net income (\$100 less the minority interest of \$40) on Part I, line 4a.

P must remove the \$100 net income of DS1 on Part I, line 6a. P must reverse

on Part I, line 8, the elimination of the \$40 minority interest net income of DS1. In addition, P reverses its elimination of the \$30 intercompany dividend in its financial statements on Part I, line 8. The net result is that P includes the \$30 dividend from DS1 on Part I, line 11, and on Part II, line 7, column (a). P's dividend income included on the tax return from DS1 must be reported on Part II, line 7, column (d).

2. U.S. corporation C owns 60% of the capital and profits interests in U.S. LLC N. C does not account for N in C's separate general ledger on the equity method. N has net income of \$100 (before minority interests) and makes no distributions during the tax year. C treats N as a corporation for financial statement purposes and as a partnership for U.S. income tax

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

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

3. U.S. corporation P owns 60% of corporation DS1, which is fully consolidated in P's financial statements. P accounts for DS1 in P's separate general ledger on the equity method. DS1 has net income of \$100 (before minority interests) and pays dividends of \$50, of which P receives \$30. The dividend reduces P's

investment in DS1 for equity method reporting on P's separate general ledger where P includes its 60% equity share of DS1 income, which is \$60. In its financial statements, P eliminates the DS1 equity method income of \$60 and consolidates DS1, including \$60 of net income (\$100 less the minority interest of \$40) on Part I, line 4a.

P must remove the \$100 net income of DS1 on Part I, line 6a. P must reverse on Part I, line 8, the elimination of the \$40 minority interest net income of DS1 and the elimination of the \$60 of DS1 equity income. The net result is that P includes the \$60 of equity method income from DS1 on Part I, line 11, and on Part II, line 6, column (a). P's dividend income included on the tax return from its investment in DS1 must be reported on Part II, line 7, column (d).

4. U.S. corporation C owns 60% of the capital and profits interests in U.S. LLC N. C accounts for N in C's separate general ledger on the equity method. N has net income of \$100 (before minority interests) and makes no distributions during the tax year. C treats N as a corporation for financial statement purposes and as a partnership for U.S. income tax purposes. For equity method reporting on C's separate general ledger, C includes its 60% equity share of N income, which is \$60. In its financial statements, C eliminates the \$60 of N equity method income and consolidates N, including \$60 of net income (\$100 less the minority interest of \$40) on Part I, line 4a.

C must remove the \$100 net income of N on Part I, line 6a. C must reverse on Part I, line 8, the elimination of the

\$40 minority interest net income of N and the elimination of the \$60 of N equity method income. The result is that C includes the \$60 of equity method income for N on Part I, line 11, and on Part II, line 9, column (a). C's taxable income from N must be reported by C on Part II, line 9, column (d).

5. U.S. corporation C owns 60% of the capital and profits interests in U.S. LLC N. C accounts for N in C's separate general ledger on the equity method. N has net income of \$100 (before minority interests) and pays a \$50 cash distribution, of which C receives \$30. The distribution reduces C's investment in N for equity method reporting on C's separate general ledger. C treats N as a corporation for financial statement purposes and as a partnership for U.S. income tax

purposes. For equity method reporting on C's separate general ledger, C includes its 60% equity share of N income, which is \$60. In its financial statements, C eliminates the \$60 of N equity method income and consolidates N and includes \$60 of net income (\$100 less the minority interest of \$40) on Part I, line 4a.

C must remove the \$100 net income of N on Part I, line 6a. C must reverse on Part I, line 8, the elimination of the \$40 minority interest net income of N and the elimination of the \$60 of N equity method income. The result is that C includes the \$60 of equity method income for N on Part I, line 11, and on Part II, line 9, column (a). C's taxable income from N must be reported by C on Part II, line 9, column (d).

Example 6. U.S. corporation P owns 80% of the stock of corporation DS1. DS1 is included in P's consolidated income tax return, even though DS1 is not included in P's consolidated financial statements on either a consolidated basis or on the equity method. DS1 has current year net income of \$100 after taking into account its \$40 interest payment to P. P has net income of \$1,040 after recognition of the interest income from DS1. Because DS1 is an includible corporation, 100% of the net income of both P and DS1 must be reported on Form 1120, page 1, of the PDS consolidated U.S. income tax return, and the intercompany interest income and expense must be removed by consolidation elimination entries.

P must report its financial statement net income of \$1,040 on Part I, line 4a, and reports DS1's net income of \$100 on Part I, line 7c. Then, in order to reflect the full consolidation of the financial accounting net

income of P and DS1 on Part I, line 11, the following consolidation and elimination entries are reported on Part I, line 8: (a) offsetting entries to remove the \$40 of interest income received from DS1 included by P on line 4a, and to remove the \$40 of interest expense of DS1 included in line 7c for a net change of zero; and (b) an entry to reflect the \$20 minority interest in the net income of DS1 (DS1 net income of \$100 times 20% minority interest). The result is that Part I, line 11, reports \$1,120: \$1,040 from line 4a, \$100 from line 7c, and (\$20) from line 8. Stated another way, Part I, line 11, includes the entire \$1,000 net income of P, measured before recognition of the intercompany interest income from DS1 and the consolidation of DS1 operations, plus the entire \$140 net income of DS1, measured before interest expense to P, less the minority interest ownership of \$20 in DS1's separate net income (\$100). The consolidated U.S. income tax group is required to include on the

attached supporting statement for Part I, line 8, the details of the adjustment to the minority interest in the net income of DS1, but is not required to report the offsetting adjustment to the intercompany elimination of interest income and interest expense (though it is permitted to do so).

Line 12. Total Assets and Liabilities of Entities Included or Removed on Part I, Lines 4, 5, 6, and 7

Line 12 must be completed by all corporations that file Schedule M-3. Report on lines 12a, 12b, 12c, and 12d the total amount (not just the corporation's share) of assets and liabilities of entities included or removed on Part I, lines 4, 5, 6, and 7. All assets and liabilities reported for Schedule M-3, Part I, lines 12a, 12b, 12c, and 12d, must be entered as positive amounts.

On line 12a, enter the worldwide consolidated total assets and total liabilities of all of the

entities included in completing Part I, line 4a. On line 12b, enter the total assets and total liabilities of the entities removed in completing Part I, line 5. On line 12c, enter the total assets and total liabilities removed in completing Part I, line 6. On line 12d, enter total assets and total liabilities included in completing Part I, line 7.

Specific Instructions for Parts II and III

For consolidated U.S. income tax returns, attach supporting statements for each includible corporation. See the instructions for consolidated returns in the Instructions for Form 1120.

General Format of Parts II and III

Check the applicable box(es) at the top of pages 2 and 3 of Schedule M-3 to indicate whether the Schedule M-3 is for the:

1. Consolidated group,

2. Parent corporation,
3. Consolidated eliminations,
4. Subsidiary corporation, or
5. Mixed 1120/L/PC group.

Also check the applicable box to indicate whether the Schedule M-3 is for a sub-consolidated (6) 1120 group, or (7) 1120 eliminations. See *Consolidated Schedule M-3 Versus Consolidating Schedules M-3 for Form 1120 Groups* and *Schedule M-3 Consolidation for Mixed Groups (1120/L/PC)*, earlier.

For each line item in Parts II and III, report in column (a) the amount of net income (loss) included in Part I, line 11, and report in column (d) the amount included in taxable income on Form 1120, page 1, line 28.

For any item of income, gain, loss, expense, or deduction for which there is a difference between columns (a) and (d), the portion of the difference that is temporary must be

entered in column (b) and the portion of the difference that is permanent must be entered in column (c).

Note. A statement or explanation may be attached to any line item even if none is required.

If financial statements are prepared by the corporation in accordance with generally accepted accounting principles (GAAP), differences that are treated as temporary for GAAP must be reported in column (b) and differences that are permanent (that is, not temporary for GAAP) must be reported in column (c). Generally, pursuant to GAAP, a temporary difference affects (creates, increases, or decreases) a deferred tax asset or liability.

If the corporation does not prepare financial statements, or the financial statements are not prepared in accordance with GAAP, report in column (b) any difference that the

corporation believes will reverse in a future tax year (that is, have an opposite effect on taxable income in a future tax year (or years) due to the difference in timing of recognition for financial accounting and U.S. income tax purposes) or is the reversal of such a difference that arose in a prior tax year. Report in column (c) any difference that the corporation believes will not reverse in a future tax year (and is not the reversal of such a difference that arose in a prior tax year).

If the corporation is unable to determine whether a difference between column (a) and column (d) for an item will reverse in a future tax year or is the reversal of a difference that arose in a prior tax year, report the difference for that item in column (c).

Example 7. Corporation B is a U.S. publicly traded corporation that files a consolidated U.S. income tax return and prepares consolidated GAAP financial statements. In

prior years, B acquired intellectual property (IP) and goodwill through several corporate acquisitions. The IP is amortizable for both U.S. income tax and financial statement purposes. In the current year, B's annual amortization expense for IP is \$9,000 for U.S. income tax purposes and \$6,000 for financial statement purposes. In its financial statements, B treats the difference in IP amortization as a temporary difference. The goodwill is not amortizable for U.S. income tax purposes and is subject to impairment for financial statement purposes. In the current year, B records an impairment charge on the goodwill of \$5,000. In its financial statements, B treats the goodwill impairment as a permanent difference. B must report the amortization attributable to the IP on Part III, line 28, and report \$6,000 in column (a), a temporary difference of \$3,000 in column (b), and \$9,000 in column (d). B must report the goodwill impairment on Part III, line 26, and report \$5,000 in column (a), a permanent

difference of (\$5,000) in column (c), and \$0 in column (d).

Reporting Requirements for Parts II and III

Except for mixed group consolidation, the number of Parts II must equal the number of Parts III filed by the corporation. Mixed groups should see *Schedule M-3 Consolidation for Mixed Groups (1120/L/PC)*, earlier.

General Reporting Requirements

If an amount is attributable to a reportable transaction described in Regulations section 1.6011-4(b), the amount must be reported in columns (a), (b), (c), and (d), as applicable, of Part II, line 12, regardless of whether the amount would otherwise be reported on Part II or Part III of Schedule M-3. Thus, if a taxpayer files Form 8886, Reportable Transaction Disclosure Statement, the amounts attributable to that reportable

transaction must be entered on Part II, line 12.

A corporation is required to report in column (a) of Parts II and III the amount of any item specifically listed on Schedule M-3 that is in any manner included in the corporation's current year financial statement net income (loss) or in an income or expense account maintained in the corporation's books and records, even if there is no difference between that amount and the amount included in taxable income unless (a) otherwise provided in these instructions, or (b) the amount is attributable to a reportable transaction described in Regulations section 1.6011-4(b) and is therefore reported on Part II, line 12. For example, with the exception of interest income reflected on a Schedule K-1 received by a corporation as a result of the corporation's investment in a partnership or other pass-through entity, all interest income, included on Part I, line 11, whether from

unconsolidated affiliated companies, third parties, banks, or other entities; whether from foreign or domestic sources; whether taxable or exempt from tax; and whether classified as some other type of income for U.S. income tax purposes (such as dividends), must be included on Part II, line 13, column (a). Likewise, all fines and penalties included in Part I, line 11, paid to a government or other authority for the violation of any law for which fines or penalties are assessed must be included on Part III, line 12, column (a), regardless of the government authority that imposed the fines or penalties; regardless of whether the fines or penalties are civil or criminal; and regardless of the classification, nomenclature, or terminology attached to the fines or penalties by the imposing authority in its actions or documents.

If a corporation would be required to report in Parts II and III, column (a), the amount of

any item specifically listed on Schedule M-3 in accordance with the preceding paragraph, except that the corporation has capitalized the item of income or expense and reports the amount in its financial statement balance sheet or in asset and liability accounts maintained in the corporation's books and records, the corporation must report the proper tax treatment of the item in columns (b), (c), and (d), as applicable.

Furthermore, in applying the two preceding paragraphs, a corporation is required to report in Parts II and III, column (a), the amount of any item specifically listed on Schedule M-3 that is included in the corporation's financial statements or exists in the corporation's books and records, regardless of the nomenclature associated with that item in the financial statements or books and records. Accurate completion of Schedule M-3 requires reporting amounts according to the substantive nature of the

specific line items included in Schedule M-3 and consistent reporting of all transactions of like substantive nature that occurred during the tax year. For example, all expense amounts that are included in the financial statements or exist in the books and records that represent some form of "Bad debt expense" must be reported in Part III, line 32, column (a), regardless of whether the amounts are recorded or stated under different nomenclature in the financial statements or the books and records such as "Provision for doubtful accounts," "Expense for uncollectible notes receivable," or "Impairment of trade accounts receivable." Likewise, as stated in the preceding paragraph, all fines and penalties must be included on Part III, line 12, column (a), regardless of the terminology or nomenclature attached to them by the corporation in its books and records or financial statements.

With limited exceptions, Part II includes lines for specific items of income, gain, or loss (income items). See Part II, lines 1 through 24. If an income item is described in Part II, lines 1 through 24, report the amount of the item on the applicable line, regardless of whether there is a difference for the item. If there is a difference for the income item, or only a portion of the income item has a difference and a portion of the item does not have a difference, and the item is not described in Part II, lines 1 through 24, report and describe the entire amount of the item on Part II, line 25.

With limited exceptions, Part III includes lines for specific items of expense or deduction (expense items). See Part III, lines 1 through 37. If an expense item is described on Part III, lines 1 through 37, report the amount of the item on the applicable line, regardless of whether there is a difference for the item. If there is a difference for the expense item, or

only a portion of the expense item has a difference and a portion of the item does not have a difference and the item is not described in Part III, lines 1 through 37, report and describe the entire amount of the item on Part III, line 38.

If there is no difference between the financial accounting amount and the taxable amount of an entire item of income, loss, expense, or deduction and the item is not described or included in Part II, lines 1 through 25, or Part III, lines 1 through 38, report the entire amount of the item in columns (a) and (d) of Part II, line 28.

Special instructions for Part II, lines 25 and 28, and Part III, line 38. Whether a given income (loss) item is reported on Part II, line 25, or on Part II, line 28, or a given expense/deduction item on Part III, line 38, or on Part II, line 28, is determined separately by each member of the U.S. consolidated tax group and not at the U.S.

consolidated tax group level. For example, U.S. corporation P has two subsidiaries, A and B, that are included in P's consolidated financial statements and in P's consolidated U.S. income tax return. For financial statement purposes, P, A, and B recognize real estate tax expense when accrued. For U.S. income tax purposes, P and A recognize such expense consistent with the method used for financial statement purposes, whereas B recognizes such deduction based on a method different from that used for financial statement purposes. P and A must report this expense/deduction in columns (a) and (d) on Part II, line 28. B must report the following on Part III, line 38: in column (a), B's expense recognized in the financial statements when accrued; in column (d), B's real estate tax expense recognized for U.S. income tax purposes; and in column (b) or (c), as applicable, the difference between B's real estate tax expense in its financial

statements and its real estate tax deduction recognized for U.S. taxable income purposes.

Separately stated and adequately

disclosed. Each difference reported in Parts II and III must be separately stated and adequately disclosed. In general, a difference is adequately disclosed if the difference is labeled in a manner that clearly identifies the item or transaction from which the difference arises. See Regulations section 1.6662-4(f). If a specific item of income, gain, loss, expense, or deduction is described on Part II, lines 9 through 24, or Part III, lines 1 through 38, and the line does not indicate to “attach statement” and the specific instructions for the line do not call for an attachment of a statement, then the item is considered separately stated and adequately disclosed if the item is entered on the applicable line and the amount(s) of the item(s) is entered in the applicable columns of the applicable line. See the instructions for Part II, lines 1 through 8,

for specific additional information required to be provided for these particular lines.

Note. A statement or explanation may be attached to any line even if none is required.

Except as otherwise provided, differences for the same item must be combined or netted together and reported as one amount on the applicable line of Schedule M-3.

However, differences for separate items must not be combined or netted together. Each item (and corresponding amount attributable to that item) must be separately stated and adequately disclosed on the applicable line of Schedule M-3, or any statement required to be attached, even if the amounts are below a certain dollar amount.

Required statements for Part II, line 25, and Part III, line 38. A separate statement must be attached to Schedule M-3 (Form 1120) that includes a detailed description of

each item and adjustment entered on Part II, line 25, and Part III, line 38.

The description for each amount entered in column (a) must be readily identifiable to the name of the account in the financial statements or books and records of the taxpayer, under which the amount in column (a) was recorded in the accounting records. Also, the description for each amount entered in column (a) must include detailed information supporting each adjustment reported in columns (b) and (c), including how the adjustment is identified in the accounting records. The entire description is considered the tax description for the amount reported in column (d) for each item reported on Part II, line 25, or Part III, line 38.

Each description should adequately describe all four columns of Part II, line 25, or Part III, line 38. If additional information is required to provide an acceptable description, provide a supporting statement.

Example 8. Corporation C is a calendar year taxpayer that placed in service 10 depreciable fixed assets in a previous tax year. C files and entirely completes Schedule M-3 for its current tax year. C's total depreciation expense for its current tax year for five of the assets is \$50,000 for income statement purposes and \$70,000 for U.S. income tax purposes. C's total annual depreciation expense for its current tax year for the other five assets is \$40,000 for income statement purposes and \$30,000 for U.S. income tax purposes. In its financial statements, C treats the differences between financial statement and U.S. income tax depreciation expense as giving rise to temporary differences that will reverse in future years. C must combine all of its depreciation adjustments. Accordingly, C must report on Part III, line 31, for its current tax year income statement, depreciation expense of \$90,000 in column (a), a temporary difference of \$10,000 in column

(b), and U.S. income tax depreciation expense of \$100,000 in column (d).

Example 9. Corporation D is a calendar year taxpayer that files and entirely completes Schedule M-3 for its current tax year. On December 31, D establishes three reserve accounts in the amount of \$100,000 for each account. One reserve account is an allowance for accounts receivable that are estimated to be uncollectible. The second reserve is an estimate of coupons outstanding that may have to be paid. The third reserve is an estimate of future warranty expenses. In its financial statements, D treats the three reserve accounts as giving rise to temporary differences that will reverse in future years. The three reserves are expenses in D's current financial statements but are not deductions for U.S. income tax purposes in the current year. D must not combine the Schedule M-3 differences for the three reserve accounts. D must report the amounts

attributable to the allowance for uncollectible accounts receivable on Part III, line 32, Bad debt expense, and must separately state and adequately disclose the amounts attributable to each of the other two reserves, coupons outstanding, and warranty costs, on a required, attached statement that supports the amounts on Part III, line 38. D must also provide a description for each reserve that meets the requirements for Part III, line 38, discussed earlier under [Required statements for Part II, line 25, and Part III, line 38](#). In this example, an acceptable description would be "Coupon Issue Reserves—Rewards Expense" and "Future Warranty Expense Reserve."

Note. There is no need to add the title of the reserve account to the description if the account name for the amount in column (a) is already part of the adjustment description.

Example 10. Corporation E is a calendar year taxpayer that files and entirely

completes Schedule M-3 for its current tax year. On January 2 of the current tax year, E establishes an allowance for uncollectible accounts receivable (bad debt reserve) of \$100,000. During the current tax year, E increased the reserve by \$250,000 for additional accounts receivable that may become uncollectible. Additionally, during the current tax year, E decreases the reserve by \$75,000 for accounts receivable that were discharged in bankruptcy during the current tax year. The balance in the reserve account on December 31 of the current tax year is \$275,000. The \$100,000 amount to establish the reserve account and the \$250,000 to increase the reserve account are expenses on E's current year financial statements but are not deductible for U.S. income tax purposes in the current tax year. However, the \$75,000 decrease to the reserve is deductible for U.S. income tax purposes in the current tax year. In its financial statements, E treats the reserve account as giving rise to a temporary

difference that will reverse in future tax years. E must report on Part III, line 32, for its current tax year income statement, bad debt expense of \$350,000 in column (a), a temporary difference of (\$275,000) in column (b), and U.S. income tax bad debt expense of \$75,000 in column (d).

Example 11. Corporation F is a calendar year taxpayer that files and entirely completes Schedule M-3 for its current tax year. F incurs \$200 of meal expenses and \$100 of entertainment expenses that F deducts in computing net income per the income statement. All of the \$200 of meal expenses are subject to the 50% limitation under section 274(n). The \$100 of entertainment expenses are nondeductible under section 274(a). In its financial statements, F treats the limitation on deductions for meals and entertainment as a permanent difference. Because meals and entertainment expenses are specifically

described in Part III, line 11, F must report all of its meals and entertainment expenses on this line, regardless of whether there is a difference. Accordingly, F must report \$300 in column (a), \$200 in column (c), and \$100 in column (d). All meals and entertainment expenses, whether allowed fully or subject to limitations, must be reported on Part III, line 11. No amounts should be reported on Part II, line 28.

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

Attach supporting statements for Parts II, lines 1 through 12. For any item reported on lines 1, 3 through 6, or 8, include in the supporting statement the name of the entity for which the item is reported, the entity's EIN (if applicable), the type of entity

(corporation, partnership, etc.), and the item amounts for columns (a) through (d). See the instructions for Part II, lines 2, 7, and 9 through 12, for the specific information required for those particular lines.

Line 1. Income (Loss) From Equity Method Foreign Corporations

Report on line 1, column (a), the financial income (loss) included in Part I, line 11, for any foreign corporation accounted for on the equity method and remove such amount in column (b) or (c), as applicable. Report the amount of dividends received and other taxable amounts received from or includible with respect to foreign corporations on Part II, lines 2 through 5, as applicable.

Line 2. Gross Foreign Dividends Not Previously Taxed

Except as otherwise provided in this paragraph, report on line 2, column (d), the amount (before any withholding tax) of any

foreign dividends included in current year taxable income on Form 1120, page 1, line 28, and report on line 2, column (a), the amount of dividends from any foreign corporation included in Part I, line 11. Do not report on line 2 any amounts that must be reported on Part II, line 3 or 4, or dividends that were previously taxed and must be reported on Part II, line 5. See the instructions below for Part II, lines 3, 4, and 5.

For any dividends reported on Part II, line 2, that are received on a class of voting stock of which the corporation directly or indirectly owned 10% or more of the outstanding shares of that class at any time during the tax year, report on an attached supporting statement (1) the name of the dividend payer, (2) the payer's EIN (if applicable), (3) the class of voting stock on which the dividend was paid, (4) the percentage of the class directly or

indirectly owned, and (5) the amounts for columns (a) through (d).

Line 3. Subpart F, QEF, and Similar Income Inclusions

Report on line 3, column (d), the amount included in taxable income under section 951, relating to Subpart F; the amounts included under section 951A, relating to global intangible low-taxed income (GILTI); gains or other income inclusions resulting from elections under sections 1291(d)(2) and 1298(b)(1); and any amount included in taxable income pursuant to section 1293, relating to a qualified electing fund (QEF). The amount included under section 951 corresponds to the total of the amounts reported on Form 1120, Schedule C, lines 16a, 16b, and 16c (or the corresponding line on Form 1120-C, Schedule C, if applicable). The amount of GILTI corresponds to the amount reported on Form 1120, Schedule C, line 17 (or the corresponding line on Form

1120-C, Schedule C, if applicable). The amount of QEF income corresponds to the total of the amounts of income from a QEF reported by the corporation on all Forms 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund. See Form 8621 and the Instructions for Form 8621.

Also include on line 3 passive foreign investment company (PFIC) mark-to-market gains and losses under section 1296. Do not report such gains and losses on Part II, line 16.

Line 4. Gross-up for Foreign Taxes Deemed Paid

Report on line 4, column (d), the amount of any foreign taxes deemed paid not included in column (d) of Part II, lines 9, 10, and 11, Income (loss) from U.S. partnerships, foreign partnerships, and other pass-through entities. The foreign taxes deemed paid amount on

this line 4 must correspond to the total foreign taxes deemed paid amounts reported by the corporation on all Forms 1118, Foreign Tax Credit—Corporations, excluding the amounts reported in column (d) of Part II, lines 9, 10, and 11.

Line 5. Gross Foreign Distributions Previously Taxed

Report on line 5, column (a), any distributions received from foreign corporations that correspond to amounts included in Part I, line 11, and that were previously taxed for U.S. income tax purposes. For example, include in column (a) amounts that are excluded from taxable income under sections 959 and 1293(c). Remove such amount in column (b) or (c), as applicable. Report the full amount of the distribution before any withholding tax. Because previously taxed foreign distributions are not currently taxable, line 5, column (d), is shaded. Also, see the instructions for Part II, line 2, earlier.

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

Report on line 6, column (a), the financial income (loss) included in Part I, line 11, for any U.S. corporation accounted for on the equity method and remove such amount in column (b) or (c), as applicable. Report on Part II, line 7, dividends received from any U.S. corporation accounted for on the equity method.

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

Report on line 7, column (a), the amount of dividends included in Part I, line 11, that were received from any U.S. corporation. Report on line 7, column (d), the amount of any U.S. dividends included in taxable income on Form 1120, page 1, line 28.

Usually, the amounts included on line 7, columns (a) and (d), include only dividends received from U.S. corporations that are not

included in the U.S. consolidated tax group because intercompany dividends (dividends received from includible corporations listed on Form 851) are eliminated or excluded for financial accounting purposes and eliminated for the calculation of U.S. taxable income. In the case of an insurance company included in the consolidated U.S. income tax return required to report intercompany dividends as part of statutory accounting net income, include such intercompany dividends on Part II, line 7, column (a), and the taxable amount of those dividends on Part II, line 7, column (d). (For insurance companies included in the consolidated U.S. income tax return, see the instructions for Part I, lines 10 and 11.)

For any intercompany dividends (dividends received from includible corporations listed on Form 851) included on Part II, line 7, report on an attached supporting statement (1) the name of the dividend payer; (2) the payer's EIN; (3) the class of stock or security on

which the dividends were paid; (4) the amount of any net adjustment included on Part I, line 10a, for such dividends; and (5) the item amounts for columns (a) through (d).

For any dividends included on Part II, line 7, that are not intercompany dividends (dividends received from includible corporations listed on Form 851) that are received on classes of voting stock in which the corporation directly or indirectly owned 10% or more of the outstanding shares of that class at any time during the tax year, report on an attached supporting statement for Part II, line 7, (1) the name of the dividend payer, (2) the payer's EIN (if applicable), (3) the class of voting stock on which the dividend was paid, (4) the percentage of the class directly or indirectly owned, and (5) the item amounts for columns (a) through (d).

Line 8. Minority Interest for Includible Corporations

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

Example 12. Corporation G is a calendar year taxpayer that files and entirely completes Schedule M-3 for its current tax year. G owns 90% of the stock of U.S. corporation DS1. G files a consolidated U.S. income tax return with DS1 as the GDS1 U.S. consolidated group. G prepares certified GAAP financial statements for the consolidated financial statement group consisting of G and DS1. G has no net income of its own, and G does not report its equity interest in the income of DS1 on its separate financial statements. DS1 has financial statement net income (before minority interests) and

taxable income of \$1,000 (\$2,500 of revenue less \$1,500 cost of goods sold).

On the consolidated Schedule M-3, Part I, line 4, Worldwide consolidated net income (loss) per income statement, and on line 11, Net income (loss) per income statement of includible corporations, the U.S. consolidated tax group GDS1 must report \$900 of financial statement net income (\$1,000 net income less \$100 minority interest).

The GDS1 group must prepare one consolidated Schedule M-3, Parts II and III, and three additional Schedules M-3, Parts II and III: one for G, one for DS1, and one for consolidation eliminations.

On the Schedule M-3, Parts II and III, for DS1, \$1,000 is reported on Part II, lines 28 and 30, in both columns (a) and (d). On G's Schedule M-3, Parts II and III, zero is reported on Part II, line 30, in both columns (a) and (d). On the consolidation eliminations

Schedule M-3, Parts II and III, on Part II, lines 8 and 30, the minority interest elimination for the U.S. consolidated tax group is reported as (\$100) in column (a), \$100 in column (c), and \$0 in column (d).

On the Schedule M-3, Parts II and III, for the U.S. consolidated tax group, on Part II, line 8, Minority interest for includible corporations, (\$100) is reported in column (a), \$100 in column (c), and \$0 in column (d). On Part II, line 28, the U.S. consolidated tax group reports \$1,000 in both columns (a) and (d). As a result, financial statement net income on Part II, line 30, column (a), will total \$900; net permanent differences on Part II, line 30, column (c), will total \$100; and taxable income on line 30, column (d), will total \$1,000.

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

For any interest owned by the corporation or a member of the U.S. consolidated tax group that is treated as an investment in a partnership for U.S. income tax purposes (other than an interest in a disregarded entity), report amounts on Part II, line 9 or 10, as described below.

1. In column (a), report the sum of the corporation's distributive share of income or loss from a U.S. or foreign partnership that is included in Part I, line 11.
2. In column (b) or (c), as applicable, report the sum of all differences, if any, attributable to the corporation's distributive share of income or loss from a U.S. or foreign partnership.

3. In column (d), report the sum of all amounts of income, gain, loss, or deduction attributable to the corporation's distributive share of income or loss from a U.S. or foreign partnership (that is, the sum of all amounts reportable on the corporation's Schedule(s) K-1 received from the partnership (if applicable)), without regard to any limitations computed at the partner level (for example, limitations on utilization of charitable contributions, capital losses, and interest expense).

For each partnership reported on line 9 or 10, attach a supporting statement that provides the name and EIN (if applicable); end of year profit-sharing percentage (if applicable); end of year loss-sharing percentage (if applicable); and the amount reported in column (a), (b), (c), or (d) of line 9 or 10, as applicable.

Example 13. U.S. corporation H is a calendar year taxpayer that files and entirely completes Schedule M-3. H has an investment in a U.S. partnership, USP. H prepares financial statements in accordance with GAAP. In its financial statements, H treats the difference between financial statement net income and taxable income from its investment in USP as a permanent difference. For its current tax year, H's financial statement net income includes \$10,000 of income attributable to its share of USP's net income. H's Schedule K-1 from USP reports \$5,000 of ordinary income, \$7,000 of long-term capital gains, \$4,000 of charitable contributions, and \$200 of section 179 expense. H must report on Part II, line 9, \$10,000 in column (a), a permanent difference of (\$2,200) in column (c), and \$7,800 in column (d).

Example 14. The facts are the same as in *Example 13*, except that corporation H's

charitable contribution deduction is wholly attributable to its partnership interest in USP and is limited to \$90 pursuant to section 170(b) (2) due to other investment losses incurred by H. In its financial statements, H treated this limitation as a temporary difference. H must not report the charitable contribution limitation of \$3,910 (\$4,000–\$900) on Part II, line 9. H must report the limitation on Part III, line 21, and report the disallowed charitable contributions of (\$3,910) in columns (b) and (d).

Line 11. Income (Loss) From Other Pass-Through Entities

For any interest in a pass-through entity (other than an interest in a partnership reportable on Part II, line 9 or 10, as applicable) owned by a member of the U.S. consolidated tax group (other than an interest in a disregarded entity), report the following on line 11.

1. In column (a), report the sum of the corporation's distributive share of income or loss from the pass-through entity that is included in Part I, line 11.
2. In column (b) or (c), as applicable, report the sum of all differences, if any, attributable to the pass-through entity.
3. In column (d), report the sum of all taxable amounts of income, gain, loss, or deduction reportable on the corporation's Schedule(s) K-1 received from the pass-through entity (if applicable).

For each pass-through entity reported on line 11, attach a supporting statement that provides that entity's name and EIN (if applicable); the corporation's end of year profit-sharing percentage (if applicable; the corporation's end of year loss-sharing percentage (if applicable); and the amounts

reported by the corporation in column (a), (b), (c), or (d) of line 11, as applicable.

Line 12. Items Relating to Reportable Transactions

Any amounts attributable to any reportable transactions (as described in Regulations section 1.6011-4) must be included on Part II, line 12, regardless of whether the difference, or differences, would otherwise be reported elsewhere in Part II or Part III. Thus, if a taxpayer files Form 8886 for any reportable transaction described in Regulations section 1.6011-4, the amounts attributable to that reportable transaction must be reported on Part II, line 12. In addition, all income and expense amounts attributable to a reportable transaction must be reported on Part II, line 12, columns (a) and (d), even if there is no difference between the financial amounts and the taxable amounts.

Each difference attributable to a reportable transaction must be separately stated and adequately disclosed. A corporation will be considered to have separately stated and adequately disclosed a reportable transaction on line 12 if the corporation sequentially numbers each Form 8886 and lists by identifying number on the supporting statement for Part II, line 12, each sequentially numbered reportable transaction and the amounts required for Part II, line 12, columns (a) through (d).

In lieu of the requirements of the preceding paragraph, a corporation will be considered to have separately stated and adequately disclosed a reportable transaction if the corporation attaches a supporting statement that provides the following for each reportable transaction.

1. A description of the reportable transaction disclosed on Form 8886 for

which amounts are reported on Part II, line 12.

2. The name and tax shelter registration number, if applicable, as reported on lines 1a and 1c, respectively, of Form 8886.
3. The type of reportable transaction (that is, listed transaction, confidential transaction, transaction with contractual protection, etc.) as reported on line 2 of Form 8886.

If a transaction is a listed transaction described in Regulations section 1.6011-4(b)(2), the description must also include the description provided on line 3 of Form 8886. In addition, if the reportable transaction involves an investment in the transaction through another entity such as a partnership, the description must include the name and EIN (if applicable) of that entity as reported on line 5 of Form 8886.

Example 15. Corporation J is a calendar year taxpayer that files and entirely completes Schedule M-3 for its current tax year. J incurred seven different abandonment losses during its current tax year. One loss of \$12 million results from a reportable transaction described in Regulations section 1.6011-4(b)(5), another loss of \$5 million results from a reportable transaction described in Regulations section 1.6011-4(b)(4), and the remaining five abandonment losses are not reportable transactions. J discloses the reportable transactions giving rise to the \$12 million and \$5 million losses on separate Forms 8886 and sequentially numbers them X1 and X2, respectively. J must separately state and adequately disclose the \$12 million and \$5 million losses on Part II, line 12. The \$12 million loss and the \$5 million loss will be adequately disclosed if J attaches a supporting statement for line 12 that lists each of the sequentially numbered forms, Form 8886-X1 and Form 8886-X2, and with

respect to each reportable transaction reports the appropriate amounts required for Part II, line 12, columns (a) through (d).

Alternatively, J's disclosures will be adequate if the description provided for each loss on the supporting statement includes the names and tax shelter registration numbers, if any, disclosed on the applicable Form 8886, identifies the type of reportable transaction for the loss, and reports the appropriate amounts required for Part II, line 12, columns (a) through (d). J must report the losses attributable to the other five abandonment losses on Part II, line 23e, regardless of whether a difference exists for any or all of those abandonment losses.

Example 16. Corporation K is a calendar year taxpayer that files and entirely completes Schedule M-3 for its current tax year. K enters into a transaction with contractual protection that is a reportable transaction described in Regulations section

1.6011-4(b)(4). This reportable transaction is the only reportable transaction for K's current tax year and results in a \$7 million capital loss for both financial accounting purposes and U.S. income tax purposes. Although the transaction does not result in a difference, K is required to report on Part II, line 12, the following amounts: (\$7 million) in column (a), zero in columns (b) and (c), and (\$7 million) in column (d). The transaction will be adequately disclosed if K attaches a supporting statement for line 12 that (a) sequentially numbers the Form 8886 and refers to the sequentially numbered Form 8886-X1, and (b) reports the applicable amounts required for line 12, columns (a) through (d). Alternatively, the transaction will be adequately disclosed if the supporting statement for line 12 includes a description of the transaction; the name and tax shelter registration number, if any; and the type of reportable transaction disclosed on Form 8886.

Line 13. Interest Income

Report on Part II, line 13, column (a), the total amount of interest income included on Part I, line 11, and report on Part II, line 13, column (d), the total amount of interest income included on Form 1120, page 1, line 28, that is not required to be reported elsewhere on Schedule M-3. In column (b) or (c), as applicable, adjust for any amounts treated for U.S. income tax purposes as interest income that are treated as some other form of income for financial accounting purposes, or vice versa. For example, adjustments to interest income resulting from adjustments made in accordance with the instructions for Part II, line 18, should be made in columns (b) and (c) of this line 13.

Complete Part II of Form 8916-A. Enter the amounts from line 6, columns (a) through (d) of Form 8916-A, on Schedule M-3, Part II, line 13, columns (a) through (d), as applicable. Attach Form 8916-A.

Do not report on this line 13 or include on Form 8916-A amounts reported in accordance with the instructions for Part II, lines 9, 10, 11, 12, and 22.

Note. Any corporation that files Form 1120 (or Form 1120-C) that (a) is required to file Schedule M-3 (Form 1120) and has less than \$50 million in total assets at the end of the tax year, or (b) is not required to file Schedule M-3 and voluntarily files Schedule M-3, is not required to file Form 8916-A, but may voluntarily do so.

Line 14. Total Accrual to Cash Adjustment

This line is completed by a corporation that prepares financial statements (or books and records, if permitted) using an overall accrual method of accounting and uses an overall cash method of accounting for U.S. income tax purposes, or vice versa. With the exception of amounts required to be reported

on Part II, line 12, the corporation must report on Part II, line 14, a single amount net of all adjustments attributable solely to the use of the different overall methods of accounting (for example, adjustments related to accounts receivable, accounts payable, compensation, accrued liabilities, etc.), regardless of whether a separate line on Schedule M-3 corresponds to an item within the accrual to cash reconciliation. Differences not attributable to the use of the different overall methods of accounting must be reported on the appropriate lines of Schedule M-3 (for example, a depreciation difference must be reported on Part III, line 31).

Example 17. Corporation L is a calendar year taxpayer that files and entirely completes Schedule M-3 for its current tax year. L prepares financial statements in accordance with GAAP using an overall accrual method of accounting. L uses an overall cash method of accounting for U.S.

income tax purposes. L's financial statements for the year ending December 31 report accounts receivable of \$35,000, an allowance for bad debts of \$10,000, and accounts payable of \$17,000 related to current year acquisition and reorganization legal and accounting fees. In addition, for L's year ending December 31, L reported financial statement depreciation expense of \$15,000 and depreciation for U.S. income tax purposes of \$25,000. For L's current tax year using an overall cash method of accounting, L does not recognize the \$35,000 of revenue attributable to the accounts receivable, cannot deduct the \$10,000 allowance for bad debt, and cannot deduct the \$17,000 of accounts payable. In its financial statements, L treats both the difference in overall accounting methods used for financial statement and U.S. income tax purposes and the difference in depreciation expense as temporary differences. L must combine all adjustments attributable to the differences related to the overall accounting

methods on Part II, line 14. As a result, L must report on Part II, line 14, \$8,000 in column (a) (\$35,000 - \$10,000 \$17,000), (\$8,000) in column (b), and zero in column (d). L must not report the accrual to cash adjustment attributable to the legal and accounting fees on Part III, line 24, Current year acquisition or reorganization legal and accounting fees. Because the difference in depreciation expense does not relate to the use of the cash or accrual method of accounting, L must report the depreciation difference on Part III, line 31, Depreciation, and report \$15,000 in column (a), \$10,000 in column (b), and \$25,000 in column (d).

Line 15. Hedging Transactions

Report on line 15, column (a), the net gain or loss from hedging transactions included on Part I, line 11. Report in column (d) the amount of taxable income from hedging transactions as defined in section 1221(b)(2). Use columns (b) and (c) to report all

differences caused by treating hedging transactions differently for financial accounting purposes and for U.S. income tax purposes. For example, if a portion of a hedge is considered ineffective under GAAP but is still a valid hedge under section 1221(b)(2), the difference must be reported on line 15.

The hedge of a capital asset, which is not a valid hedge for U.S. income tax purposes but may be considered a hedge for GAAP purposes, must also be reported here.

Report hedging gains and losses computed under the mark-to-market method of accounting on line 15 and not on Part II, line 16.

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

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

Report on line 16 any amount representing the mark-to-market income or loss for any securities held by a dealer in securities, a dealer in commodities having made a valid election under section 475(e), or a trader in securities or commodities having made a valid election under section 475(f). "Securities" for these purposes are securities described in section 475(c)(2) and commodities described in section 475(e)(2). "Securities" do not include any items specifically excluded from sections 475(c)(2) and 475(e)(2), such as certain contracts to which section 1256(a) applies.

Report hedging gains and losses computed under the mark-to-market method of accounting on Part II, line 15, and not on line 16.

Traders in securities and commodities.

For a trader in securities or commodities that made a valid election under section 475(f) to use the mark-to-market method to account for securities or commodities held in connection with a trading business that files Form 4797, any Schedule M-3 entries required as a result of marking to market these securities or commodities are reported as follows: (a) mark-to-market gains and losses from Form 4797, line 10, are included on Part II, line 16, of Schedule M-3 (Form 1120); (b) any other Schedule M-3 entries required based on other results (non-mark-to-market gains and losses) included in the total reported on Form 4797, line 17, should be reported on Part II, line 23d, of Schedule M-3 (Form 1120), unless the instructions for Schedule M-3 require the amounts to be reported on another line.

Line 17. Cost of Goods Sold

Report on line 17 any amounts deducted as part of cost of goods sold during the tax year, regardless of whether the amounts would otherwise be reported elsewhere in Part II or Part III.

Examples of amounts that must be included as cost of goods sold items are amounts attributable to inventory valuation, such as amounts attributable to cost-flow assumptions, additional costs required to be capitalized (including depreciation) such as section 263A costs, inventory shrinkage accruals, inventory obsolescence reserves, and lower of cost or market (LCM) write-downs.

Complete Part I of Form 8916-A. Enter the amounts from line 8, columns (a) through (d) of Form 8916-A, on Schedule M-3, Part II, line 17, columns (a) through (d), as applicable. Attach Form 8916-A, if applicable.