



presents

Mastering the Revised Federal Schedule M-3 Identifying and Reporting Data for Full Compliance

A Live 100-Minute Audio Conference with Interactive Q&A

Today's panel features:

John P. Bennecke, Managing Director, **True Partners Consulting**, Chicago

Tim Ross, Partner and Firmwide Leader for Large and Midsized, **Clifton Gunderson**, Indianapolis

Wednesday, July 22, 2009

The conference begins at:

1 pm Eastern

12 pm Central

11 am Mountain

10 am Pacific

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*Mastering The Revised Federal Schedule
M-3 Teleconference*

July 22, 2009

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Schedule M-3: A Historical Perspective

Schedule M-3

A Historical Perspective

- Back in 2004, the Treasury Department and IRS released IR 2004-14, seeking comments on the proposed Form 1120, Schedule M-3
- The Schedule M-3 was developed in order to provide for increased transparency in corporate tax returns filed, and to allow for consistency in tax reporting among corporations
- Draft form and instructions were released on March 11, 2004, to be effective for years ending Dec. 31, 2004, for taxpayers with total assets in excess of \$10 million
- Schedule M-3 was first required to be filed by qualifying C corporations, with the reporting requirement expanded to S corporations and partnerships in subsequent years



Schedule M-3

A Historical Perspective

- Reportable transactions: Schedule M-3 provides an alternative disclosure procedure for obligations covered under Treasury Reg. 1.6011-4, for items with significant book tax differences (See Rev. Proc. 2004-45)

The requirement of Schedule M-3 sets the stage for the era of increased transparency in tax reporting, and provides a more direct tie into the financial reporting requirements of corporations, S corporations and partnerships. Schedule M-3 has been revised several times since its inception in 2004, and has strived to increase the level of reporting required and to allow for increased consistency among taxpayers and their respective entities



Role Of M-3 In The Environment Of Transparency



Role Of Schedule M-3 And The Environment Of Transparency

Tax reporting/compliance

- Increased reporting requirements in the era of Schedule M-3
- Direct tie into financial reporting world
- More-focused IRS exams
- Facilitates more focused issue identification: Limited issue focused exams (LIFEs)
- Standardization of tax reporting
- E-filing: Leads the way for standardization in an e-filing environment



Role Of Schedule M-3 And The Environment Of Transparency (Cont.)

Financial reporting

- Schedule M-3 provides a direct correlation and tie-in to the financial statements of the reporting entity
 - SEC filings
 - Audited financials
 - Unaudited financials/compilations
 - Requires a reconciliation between financial statements and tax returns
 - Schedule M-3 requires reporting consistent with the concepts of FAS 109, Accounting for Income Taxes. (Part III lines 1 – 6)
- FIN 48 (Disclosure of Uncertain Tax Positions)
 - Public company
 - Private company (effective for years ending on or after Dec. 31, 2009)



2008 Updates: An Overview Of Schedule M3 By Entity Type



2008 Updates – What's New Overview Of Sch. M-3 (By Entity Type)

- Form 1120: Net income (loss) reconciliation for corporations with total assets of \$10 million or more
- Form 1120S: Net income (loss) reconciliation for corporations with total assets of \$10 million or more
- Form 1065: Net income (loss) reconciliation for certain partnerships



2008 Form 1120

- **Overview of Schedule M-3**

- Who must complete
 - Any domestic corporation or consolidated group filing Form 1120 whose total assets equal to or exceed \$10 million dollars or
 - Any U.S. corporation filing Form 1120 may voluntarily complete Schedule M-3 instead of Schedule M-1
 - A corporation completing Schedule M-3, whether required or voluntary, must check Item A, box 4 on page 1 of Form 1120 indicating Schedule M-3 is attached
- Part I
 - Reconcile worldwide financial statement income/(loss) for a consolidated group or separate corporation reported on line 4a to net income/(loss) of the corporation for U.S. taxable income purposes, as reported on line 11
- Parts II and III
 - Reconcile the corporation's U.S. income/(loss) per the financial statements reported on Part I, line 11 to U.S. taxable income/(loss) reported on Form 1120, page 1, line 28

What's New for 2008

- Form 1120, Schedule K
- New Schedule B for Schedule M-3 filers
- Changes made to Schedule M-3



2008 Form 1120 (Cont.)

- Form 1120, Schedule K – Other information
 - Additional information is reported for direct and indirect ownerships
 - Questions 4 and 5
 - Request direct ownership of 20% or more
 - In the past, corporations were only required to disclose direct or indirect ownership of their voting stock of 50% or more



2008 Form 1120 (Cont.)

- Schedule M-3, Schedule B
 - Required for all Schedule M-3 filers
 - Additional information related to the reconciliation of worldwide income/(loss) per the financial statements to net income/(loss) required to U.S. income tax reporting
 - To support reconciliation of Part 1, lines 4a through line 11
 - The questions relate to:
 - Partnership allocations that are disproportionate to a corporation's ownership percentage
 - Related party transactions defined in §267(b)
 - Cost-sharing arrangement with a related foreign party which the corporation has not filed Form 5471
 - Accounting method changes for GAAP (SFAS 154) and tax purposes
 - VEBA trusts that were used to hold funds for employee benefits
 - Allocation of mixed-service costs that do not conform to the Federal Energy Regulatory Commission's method



2008 Form 1120 (Cont.)

- Schedule M-3
 - Part I, line 4b (new): Which of the following accounting standards is used to compute worldwide net income/(loss) for financial reporting purposes
 - GAAP
 - IFRS
 - Statutory
 - Tax basis
 - Other (specify)



2008 Form 1120 (Cont.)

- Schedule M-3 (Cont.)
 - Part I, line 7
 - There are three sub-categories for a foreign disregarded entity that is not included in worldwide net income/(loss) per the financial statements (Part I, line 4a), but is included in the calculation of U.S. book income/(loss) (Part I, line 11)
 - Foreign disregarded entities
 - U.S. disregarded entities
 - Other includible entities



2008 Form 1120 (Cont.)

- Schedule M-3 (Cont.)
 - Part I, line 11 includes a note for 2008 that net income/(loss) should equal the amounts on Part II, line 30 of column (a) and Schedule M-2, line 2
 - Part I, line 12 (new)
 - Report the total assets and liabilities of all the entities included or removed (Part I, lines 4 through 7) in the reconciliation of net income/(loss)



2008 Form 1120S

Overview of Schedule M-3

- Who must complete
 - Any corporation required to file Form 1120S whose total assets are equal to or exceed \$10 million or
 - Any corporation filing Form 1120S can voluntarily complete Schedule M-3 instead of Schedule M-1
 - Whether required or voluntary, if Schedule M-3 is completed the corporation must check the box on page 1 of Form 1120S, item C, indicating Schedule M-3 is attached
- Part I
 - Reconcile worldwide financial statement income/(loss) for a consolidated group or separate corporation reported on line 4a to net income/(loss) of the corporation for U.S. taxable income purposes, as reported on line 11.
- Parts II and III
 - Reconcile the corporation's U.S. income/(loss) per the financial statements reported on Part I, line 11 to U.S. taxable income/(loss) reported on Form 1120, page 1, line 28

What's new for the 2008 tax year

- Changes made to Schedule M-3



2008 Form 1120S (Cont.)

- Schedule M-3
 - Part I, line 4b (new): Which accounting standards is used to compute worldwide net income/(loss) for financial reporting purposes
 - GAAP
 - IFRS
 - Tax basis
 - Other (specify)

* Similar change as Form 1120 but excludes statutory option



2008 Form 1120S (Cont.)

- Schedule M-3 (Cont.)
 - Part I, line 7 (similar to Form 1120)
 - Lists the three sub-categories for a foreign disregarded entity not included in worldwide net income/(loss) per the financial statements (Part I, line 4a) but is included in the calculation of U.S. book income/(loss) (Part I, line 11)
 - Foreign disregarded entities
 - U.S. disregarded entities
 - Other includible entities



2008 Form 1120S (Cont.)

- Schedule M-3 (Cont.)
 - Part I, line 11 includes a note for 2008 that net income/(loss) must equal the amounts on Part II, line 26 of column (a)
 - Part I, line 12 (new)
 - Report total assets and liabilities of all entities included or removed (Part I, lines 4 through 7) in the reconciliation of net income/(loss) reported on Part I, line 11



2008 Form 1065

Overview of Schedule M-3

- Purpose of Schedule M-3
 - To show transparency between net income/(loss) on the financial statements and net income/(loss) of partnership found on page 5 of Form 1065
- Who must complete
 - An entity required to file Form 1065 whose total assets or adjusted total assets are equal to or exceed \$10 million
 - The partnership's total assets at the end of the tax year must be determined on an overall accrual method unless both of the following apply:
 - The tax return is prepared using the cash method and
 - The entity does not prepare financial statements using, and is not included in financial statements prepared on, an accrual basis
 - An entity filing Form 1065 can voluntarily complete Schedule M-3 instead of Schedule M-1
 - The entity's total receipts is equal to or greater than \$35 million or
 - An entity that is a reportable entity partner within the partnership owns or is deemed to own, directly or indirectly, 50% or more in the partnership's capital, profit or loss
 - Whether required or voluntary, if Schedule M-3 is completed the partnership must check the box on page 1, Line J of Form 1065, indicating Schedule M-3 is attached

What's new for the 2008 tax year

- Form 1065
- New Schedule C
- Changes to Schedule M-3



2008 Form 1065 (Cont.)

- What's new for the 2008 tax year
 - Page 1, line G, box 6 is a new checkbox for partnerships to file an initial and final return under the technical terminations rules
 - Revised Schedule B
 - Constructive ownership of the partnership
 - Line 3a and 3b – detail of partners, under section 267(c), who own directly or indirectly 50% or more of the partnerships capital, profit or loss
 - Line 4a – detail required if the partnership owns directly 20% or 50% or more, directly or indirectly, the voting stock of a foreign or domestic corporation
 - Line 4b – detail required if the partnership owns directly 20% or 50% or more, directly or indirectly, in capital, profit or loss of a foreign or domestic partnership
 - Line 6d states the partnership is not filing or is not required to file Schedule M-3
 - Line 8 relates to the cancellation, forgiveness or modification of debt which in turn the partnership will recognize income which is separately stated on Schedule K
 - Line 12c relates to a basis reduction under §734(b) or 743(b) due to a substantial built-in loss. If the answer is “Yes” a statement is required to be attached showing the computation and allocation of the basis adjustment
 - Line 13 asks whether the partnership, during the current or prior year, distributed property received in a LKE or contributed LKE property to another entity (including a disregarded entity)
 - Line 14 asks about the distribution to a partner a tenancy-in-common or other undivided interest in partnership property
 - Line 15 asks for the number of Form 8858 required to be filed by the partnership



2008 Form 1065 (Cont.)

- New Schedule C
 - Required for all Schedule M-3 filers
 - This schedule provides additional information regarding financial transactions by the partnership of which the taxpayer is a member. The transactions included are:
 - Transfers governed under Reg. 1.707-8 that require disclosure
 - Disproportionate allocations of income/(loss) from the partnership's investments
 - The acquisition, sale, exchange or transfer of any interest in an intangible asset from/to a related party as defined under §267(b) and 707(b)(1); and
 - Changes in accounting principles for financial accounting reporting and U.S. income tax purposes



2008 Form 1065 (Cont.)

- Schedule M-3
 - Part I, line 4b (new): Which of the following accounting standards is used to compute worldwide net income/(loss) for financial reporting purposes
 - GAAP
 - IFRS
 - 704(b)
 - Tax basis
 - Other (specify)



2008 Form 1065 (Cont.)

- Schedule M-3 (Cont.)
 - Part I, line 11 includes a note for 2008 that net income/(loss) should equal the amounts on Part II, line 26 of column (a)
 - Part I, line 12 (new)
 - Report the total assets and liabilities of all the entities included or removed (Part I, lines 4 through 7) in the reconciliation of net income/(loss)



2008 Form 8916-A

- Overview of Form 8916-A
 - Purpose of this form is to provide a detailed schedule of the amounts reported on the applicable Schedule M-3 for cost of goods sold, interest income and interest expense.
- Who must complete
 - If an entity completes Schedule M-3 for Forms 1120, 1065, 1065-B, 1120-L, 1120-PC and 1120S
 - Form 8916-A must be completed for:
 - Each separate entity required to file Schedule M-3
 - For consolidated tax return filers:
 - Consolidated entity
 - Eliminations company
 - Parent entity
 - Each subsidiary



2008 Form 8916-A (Cont.)

- Overview of Form 8916-A (Cont.)
 - Part I. Cost of goods sold
 - Line 1, Amounts attributable to cost flow assumptions
 - An example is the differences between LIFO reserves for book and tax purposes
 - Line 2 has an extensive list of adjustments
 - Stock option expense
 - Meals and entertainment
 - §162(m) compensation limitation
 - Amortization
 - Depreciation
 - Line 6, Other items with differences
 - A schedule must be attached for any adjustments not listed on lines 1 through 5. An example is the break-out of accrued vacation affecting both cost of labor and SG&A expenses



2008 Form 8916-A (Cont.)

- Overview of Form 8916-A (Cont.)
 - Part II. Interest income
 - Line 1: Report §103, state and local tax-exempt interest income
 - Line 2: Report interest income from a hybrid and related party debt
 - Line 3: Report interest income from periodic payments from transactions characterized as a lease for book purposes, in column (a), and as a sale for tax purposes, in column (d)
 - Line 4a: Report intercompany interest income from an entity included on Schedule M-3, Part I, line 4 but not included on Schedule M-3, Part I, line 11
 - Line 4b: Report total intercompany interest income from an entity within the affiliated group
 - Line 5: Report interest income not required to be reported on lines 1 through 4b
 - Line 6: Total interest income must reconcile to Schedule M-3, Part II, either line 11 or line 13 (depending which tax form is completed)



2008 Form 8916-A (Cont.)

- **Overview of Form 8916-A (Cont.)**
 - Part III. Interest expense
 - Line 1: Column (a) is the total interest expense from hybrid securities characterized as debt for financial purposes and column (d) as equity for tax purposes
 - Report interest expense from a debt that is both hybrid and related party debt on line 1 and not on line 3a or 3b
 - Line 2: Report in column (a) interest expense from periodic payments from transactions characterized as a lease for financial purposes and as a purchase for tax. Report in column (d) total interest expense from periodic payments from transactions characterized as a purchase for financial purposes and as a lease for tax.
 - Line 3a: Report total intercompany interest expense included on Schedule M-3, Part I, line 4 but not included on Schedule M-3, Part I, line 11
 - Line 3b: Report total intercompany interest expense to an entity within the affiliated group
 - Line 4: Report total interest expense not required to be reported on lines 1 through 3b
 - Line 5 must reconcile to Schedule M-3, Part III where interest expense is being reported



Tax Advice Notice

We are required by regulation to inform you that any tax advice contained in this communication (or in any attachment) is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of:

- (i) avoiding U.S. federal, state, or local tax penalties or
- (ii) promoting, marketing, or recommending to another party any transaction or matter addressed in this communication (or any attachment).

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Mastering The Revised Schedule M-3 Teleconference

July 22, 2009

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New Forms, Schedules, Issues For Form 1120-F Filers

Form 1120-F

- Form 1120-F must be filed by a foreign corporation that:
 - Was engaged in a trade or business in the U.S.;
 - Had income that was effectively connected with the conduct of a U.S. trade or business under Sect. 864; or
 - Had U.S.-source income (FDAP) that was not effectively connected with the conduct of a U.S. trade or business under Sect. 881, even if that income was tax-exempt, based on an income tax treaty between the U.S. and the foreign country or based on a Code section
 - “FDAP” refers to the gross amount of U.S. non-business income (or investment-type income) that is “fixed or determinable, annual, or periodic” and is subject to withholding of tax at a rate of 30% or lower under treaty

Form 1120-F, Schedule H

- Deductions allocated to effectively connected income under regulations Sect. 1.861-8
 - Calculates direct and indirect allocation and apportionment of deductions to income effectively connected with the conduct of a U.S. trade or business
 - Effectively connected income (ECI)
 - Discloses the underlying methods and records used to do so
 - Total deductions allocated and apportioned to ECI are reported on line 21 of Schedule H and are also entered on section II, line 26 (calculation of ECI) of Form 1120-F

Form 1120-F, Schedule I

- Interest expense allocation under regulations Sect. 1.882-5
 - Calculates interest expense allocable to ECI and the total interest expense deduction allowed
 - Total interest expense deduction as calculated is reported on line 25 of Schedule I and is also entered on section II, line 18 (calculation of ECI) of Form 1120-F

Form 1120-F, Schedule P

- List of foreign partner interests in partnerships
 - Discloses the foreign corporation's ownership in U.S. partnerships and foreign partnerships with ECI
 - Reconciles income and expenses to Schedule K-1 of Form 1065
 - Calculates the foreign corporation's outside basis in each partnership allocable to ECI

Schedules M-1 And M-2

- Schedules M-1 and M-2 were moved from page 6 of 1120-F and are now a separate form
- Schedule M-1 is only filed by those companies with less than \$10 million in total assets
- Schedule M-2 is filed by all 1120-F filers

Form 1120-F And Schedule M-3

- Any foreign corporation required to file 1120-F that has total assets of greater than \$10 million must complete and file Schedule M-3
 - Assets measured at the end of the corporation's tax year
 - Total assets as reported on Schedule L, line 17
 - Schedule M-3 is filed in lieu of Schedule M-1

Requirements For More Information From Foreign Companies

- Environment is such that the IRS will continue to expand reporting requirements for foreign business entities
- Ownership and related party disclosures
- Arm's length transactions
- Transfer pricing in general
- Use of “Tier One” issue nomenclature
 - Foreign tax credit generators

Form 8916-A

- Interest income and expense
 - Requires more detail for differences between book and tax interest
 - Part II – Interest income
 - Part II – Interest expense

M-3 And Partnership Issues

Who Must File?

- Total assets of \$10 Million or more as of the end of the tax year, as reported on Schedule L
- Adjusted total assets equal to or in excess of \$10 Million or more as of the end of the tax year
- Gross receipts of \$35 million or more for the tax year
- The partnership has a reportable entity partner that must also file schedule M-3

Schedule L Issues

- Schedule L must be prepared on a non-tax basis (ex:GAAP) if non-tax financial statements were prepared for any purpose during the tax year
- If not, then Schedule L must be prepared using the partnership's books and records
- Total assets used for Schedule L must be the same total assets reported in the financial statements used to prepare Schedule M-3

Adjusted Total Assets

- Defined as:
 - Total assets as reported on line 14 of Schedule L, plus
 - Any distributions for the year on lines 6a or 6b of Schedule M-2, plus
 - Any adjustments to capital reported on lines 4 or 7 of Schedule M-2
- In theory, this is to prevent partnerships from purposely avoiding the \$10 million threshold

Guaranteed Payments

- Schedule M-3, part III, line 9
- Requires separate disclosure of guaranteed payments
 - Payments treated as expense
 - Payments capitalized by the partnership
 - Payments received (income) by the partnership as a partner in another partnership

Reportable Entity Partners

- Reportable entity partner (REP) is a partner who:
 - Owns or is deemed to own 50% or greater interest in income, loss, or capital; and
 - Was required to file Schedule M-3
- Reports made by the REPs must be retained by both the REP and the partnership

Reportable Entity Partners (Cont.)

- Report must be made to the partnership within 30 days of first becoming a REP
- Because of the indirect ownership rules, Schedule L reporting and the adjusted total asset rule, partnerships with low activity or assets may be required to file Schedule M-3

Other Issues

- Be sure to file Form 8916-A
- Form 1065, Schedule C
 - New for tax year 2008, requiring further disclosures
 - E.g.: Did the partnership make any change in accounting method for financial statement purposes?
 - The questions are tailored to glean information on asset transfer, financial accounting method changes, cost sharing arrangements, and other similar issues

What Can We Expect Going Forward?

What Can We Expect?

- Schedule M-3 is a window into the Service's concerns
- Expect the "Schedule M-3" concept to continue to be expanded
- Note that Schedule C is now going outside of book to tax reconciliation, and requiring information as to specific transactions
- One concern: The number of changes being made each year may affect tax compliance software updates

What Can We Expect (Cont.)

- Read “Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance” (Treasury Report)
- The IRs will continue to “tweak” the Schedule M-3
 - Trends and issues identified during examinations
 - Disclosures that will further decrease examination time required
 - Changes in tax law
 - Changes in business practices

Form 1120, Schedule M-3:

<http://www.irs.gov/pub/irs-pdf/f1120sm3.pdf>

Instructions:

<http://www.irs.gov/pub/irs-pdf/i1120sm3.pdf>

Form 1065, Schedule M-3:

<http://www.irs.gov/pub/irs-pdf/f1065sm3.pdf>

Instructions:

<http://www.irs.gov/pub/irs-pdf/i1065sm3.pdf>

Form 1120-S, Schedule M-3:

<http://www.irs.gov/pub/irs-pdf/f1120ss3.pdf>

Instructions:

<http://www.irs.gov/pub/irs-pdf/i1120ss3.pdf>

Form 1120-F, Schedule M-3:

<http://www.irs.gov/pub/irs-pdf/f1120fm3.pdf>

Instructions:

<http://www.irs.gov/pub/irs-pdf/i1120fm3.pdf>