Schedule M-3 Book to Tax Adjustments: Overcoming the Toughest Challenges in Reporting Income and Expense Differences

WEDNESDAY, AUGUST 10, 2016, 1:00-2:50 pm Eastern

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• Double-click on the PDF and a separate page will open.

• Print the slides by clicking on the printer icon.
Schedule M-3 Book to Tax Adjustments

Aug. 10, 2016

Professor Cherie Hennig, Ph.D., Associate Professor of Accounting
University of North Carolina at Wilmington, Wilmington, N.C.
cheriehennig@msn.com
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## Today’s Program

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IDENTIFYING ENTITIES REQUIRED TO COMPLETE SCHEDULE M-3
Identifying Entities Required To Complete Schedule M-3: Corporations

• All corporations with **$50 million** or more in assets must complete all parts of Schedule M-3 (I, II, III).
  – Regular Corporations, Form 1120
  – Cooperatives, Form 1120C
  – Life insurance companies, Form 1120-L
  – Property and casualty insurance companies, Form 1120-PC
  – Foreign corporations, Form 1120-F
  – S corporations, Form 1120S

• Any corporation with **$10 million** or more but less than **$50 million** in assets is only required to complete Part I.
  – May file Schedule M-1 in lieu of Parts II and III.
Identifying Entities Required To Complete Schedule M-3: Partnerships

- With $35 million or more in total receipts
  - Sum of gross receipts or sales, ordinary income from other partnerships, net farm profit, net gain from sale of business property, other income, gross rental income, net long-term/short-term capital gain, Sect. 1231 gain

- With $10 million or more of assets on Schedule L on last day of tax year, or with “adjusted total assets” on last day of year, which is the greater of:
  - Total assets at the end of the tax year before capital distributions, losses and adjustments that reduce total capital; or
  - Combined total liabilities on all schedules K-1
  - May affect real estate partnerships with deficits in capital accounts.

- Same $50 million total asset rule as for corporations for parts II & III.
Identifying Entities Required To Complete Schedule M-3: Partnership Example

- P, a U.S. partnership, files a Form 1065 for the tax year ending Dec. 31, 2016.
- P reports total assets on Schedule L of $8 million. During 2016, P made distributions of $4 million reported on Schedule M-2.
- P has total assets on Schedule L of $8 million and liabilities of $12 million, resulting in a deficit in the capital accounts of $4 million.
- P is required to complete a Schedule M-3, Part I in both cases, because its adjusted total assets are $12 million.
- Note: May elect to complete Schedule M-1 in lieu of Parts II and III of Schedule M-3.
Identifying Entities Required To Complete Schedule M-3: Partnerships, Reportable Entity Partner

REP is defined as:

1. Owns, or is deemed to own under the Schedule M-3 instructions, an interest of 50% or more in the partnership’s capital, profit or loss, on any day during the tax year of the partnership after June 30, 2006; and

2. Was required to complete a Schedule M-3 on its most recently filed income tax return or return of income filed prior to that date.

   - This excludes individuals who are partners, since they are not Schedule M-3 filers.

   - Detailed rules are set out in the instructions to Schedule M-3 (Form 1065) concerning attribution rules for determining 50% ownership rules.
Identifying Entities Required To Complete Schedule M-3: Partnerships, REP Example
ACCURATELY COMPLETING SCHEDULE M-3, PART I: AN OVERVIEW
Tips For Accurately Completing Schedule M-3, Part I

- Financial statement hierarchy: If no Form 10-K is filed, and the taxpayer has two or more non-tax basis certified income statements, the priority is:
  - U.S. GAAP
  - International Financial Reporting Standards (IFRS)
  - Any other international accounting standards (IAS)
  - Statutory accounting for insurance companies
  - Other regulatory accrual accounting
  - Any other accrual accounting standard
  - Any fair market value standard
  - Any cash basis standard
M-3 Part I, lines 1-3, Form 1120

1a Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year?
   □ Yes. Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
   □ No. Go to line 1b. See instructions if multiple non-tax-basis income statements are prepared.

b Did the corporation prepare a certified audited non-tax-basis income statement for that period?
   □ Yes. Skip line 1c and complete lines 2a through 11 with respect to that income statement.
   □ No. Go to line 1c.

c Did the corporation prepare a non-tax-basis income statement for that period?
   □ Yes. Complete lines 2a through 11 with respect to that income statement.
   □ No. Skip lines 2a through 3c and enter the corporation’s net income (loss) per its books and records on line 4a.

2a Enter the income statement period:  Beginning MM/DD/YYYY Ending MM/DD/YYYY

b Has the corporation’s income statement been restated for the income statement period on line 2a?
   □ Yes. (If “Yes,” attach an explanation and the amount of each item restated.)
   □ No.

c Has the corporation’s income statement been restated for any of the five income statement periods immediately preceding the period on line 2a?
   □ Yes. (If “Yes,” attach an explanation and the amount of each item restated.)
   □ No.

3a Is any of the corporation’s voting common stock publicly traded?
   □ Yes.
   □ No. If “No,” go to line 4a.

b Enter the symbol of the corporation’s primary U.S. publicly traded voting common stock

   □□□□□□□□

c Enter the nine-digit CUSIP number of the corporation’s primary publicly traded voting common stock

   □□□□□□□□
M-3, Part I, lines 1-3, Form 1120-S

1a Did the corporation prepare a certified audited non-tax-basis income statement for the period ending with or within this tax year? (See instructions if multiple non-tax-basis income statements are prepared.)
   □ Yes. Skip line 1b and complete lines 2 through 11 with respect to that income statement.
   □ No. Go to line 1b.

b Did the corporation prepare a non-tax-basis income statement for that period?
   □ Yes. Complete lines 2 through 11 with respect to that income statement.
   □ No. Skip lines 2 through 3b and enter the corporation’s net income (loss) per its books and records on line 4a.

2 Enter the income statement period: Beginning __________/________/_________ Ending __________/________/_________

3a Has the corporation’s income statement been restated for the income statement period on line 2?
   □ Yes. (If “Yes,” attach an explanation and the amount of each item restated.)
   □ No.

b Has the corporation’s income statement been restated for any of the five income statement periods immediately preceding the period on line 2?
   □ Yes. (If “Yes,” attach an explanation and the amount of each item restated.)
   □ No.
This Schedule M-3 is being filed because (check all that apply):

- **A** □ The amount of the partnership’s total assets at the end of the tax year is equal to $10 million or more.
- **B** □ The amount of the partnership’s adjusted total assets for the tax year is equal to $10 million or more. If box B is checked, enter the amount of adjusted total assets for the tax year __________.
- **C** □ The amount of total receipts for the tax year is equal to $35 million or more. If box C is checked, enter the total receipts for the tax year __________.
- **D** □ An entity that is a reportable entity partner with respect to the partnership owns or is deemed to own an interest of 50 percent or more in the partnership’s capital, profit, or loss, on any day during the tax year of the partnership.

<table>
<thead>
<tr>
<th>Name of Reportable Entity Partner</th>
<th>Identifying Number</th>
<th>Maximum Percentage Owned or Deemed Owned</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>E □ Voluntary Filer.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
**Part I**  
Financial Information and Net Income (Loss) Reconciliation

1a Did the partnership file SEC Form 10-K for its income statement period ending with or within this tax year?
   - Yes. Skip lines 1b and 1c and complete lines 2 through 11 with respect to that SEC Form 10-K.
   - No. Go to line 1b. See instructions if multiple non-tax-basis income statements are prepared.

b Did the partnership prepare a certified audited non-tax-basis income statement for that period?
   - Yes. Skip line 1c and complete lines 2 through 11 with respect to that income statement.
   - No. Go to line 1c.

c Did the partnership prepare a non-tax-basis income statement for that period?
   - Yes. Complete lines 2 through 11 with respect to that income statement.
   - No. Skip lines 2 through 3b and enter the partnership’s net income (loss) per its books and records on line 4a.

2 Enter the income statement period: Beginning __________/_________/_________ Ending __________/_________/_________

3a Has the partnership’s income statement been restated for the income statement period on line 2?
   - Yes. (If “Yes,” attach a statement and the amount of each item restated.)
   - No.

b Has the partnership’s income statement been restated for any of the five income statement periods immediately preceding the period on line 2?
   - Yes. (If “Yes,” attach a statement and the amount of each item restated.)
   - No.
<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>4a</td>
<td>Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1</td>
</tr>
</tbody>
</table>
| 4b   | Indicate accounting standard used for line 4a (see instructions):  
|      | (1) ☐ GAAP    (2) ☐ IFRS    (3) ☐ Statutory   (4) ☐ Tax-basis  (5) ☐ Other (specify) |
| 5a   | Net income from nonincludible foreign entities (attach statement) |
| 5b   | Net loss from nonincludible foreign entities (attach statement and enter as a positive amount) |
| 6a   | Net income from nonincludible U.S. entities (attach statement) |
| 6b   | Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount) |
| 7a   | Net income (loss) of other includible foreign disregarded entities (attach statement) |
| 7b   | Net income (loss) of other includible U.S. disregarded entities (attach statement) |
| 7c   | Net income (loss) of other includible entities (attach statement) |
| 8    | Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach statement) |
| 9    | Adjustment to reconcile income statement period to tax year (attach statement) |
| 10a  | Intercompany dividend adjustments to reconcile to line 11 (attach statement) |
| 10b  | Other statutory accounting adjustments to reconcile to line 11 (attach statement) |
| 10c  | Other adjustments to reconcile to amount on line 11 (attach statement) |
| 11   | Net income (loss) per income statement of includible corporations. Combine lines 4 through 10.  
**Note.** Part I, line 11, must equal Part II, line 30, column (a) or Schedule M-1, line 1 (see instructions). |
M-3 Part I, Lines 4-11

- Line 4 is used to reconcile worldwide consolidated income (loss) to net income (loss) statement of includible entities.
- Line 11 may not include income of entities not included in the income tax return.
- Includible/excludible entities are reported on lines 5-6.
- Includible/excludible disregarded entities are reported on line 7.
- Adjustments related to eliminations of transactions between includible and non-includible entities are reported on line 8.
- Adjustments to reconcile the income statement period to the tax year are reported on line 9.
- Report on line 10, other adjustments to reconcile to amount on line 11.
- **Note:** For corporations not electing to file a consolidated return, S Corporations, and Partnerships, Line 4 will most likely equal Line 11.
Schedule M-2 Reconciliation With Line 11

- For corporations, Schedule M-3, Part I, Line 11 must equal the amount shown on Schedule M-2, line 2 (net Income (loss) per books)
- The instructions explain that the beginning and ending retained earnings accounts reported on Schedule M-2, lines 1 and 8, must also agree with Schedule L, Line 25 (unappropriated retained earnings).
- NO “plug” figure in M-2 is used to make ending retained earnings balance.
- For partnerships, reconcile with line 3 of M-2.
- For 1120-S, no reconciliation with M-2, which is an analysis of AAA and OAA.
Schedule M-3, Part I, Line 12

• Report the TOTAL amounts, not just the parent’s share of assets and liabilities of entities included/removed

  – Line 12(a): Worldwide consolidated assets/liabilities of entities included on line 4
  – Line 12(b): Entities assets/liabilities removed on line 5
  – Line 12(c): Entities assets/liabilities removed on line 6
  – Line 12(d): Assets/liabilities of entities included on line 7

• Note: There is no requirement that the sum of the (a)-(b)-(c)+(d) amounts equal schedule L asset/liability totals
ACCURATELY COMPLETING SCHEDULE M-3, PARTS II AND III: AN OVERVIEW
Tips For Accurately Completing Schedule M-3, Parts II And III: An Overview

- Report in Parts II and III any item listed in Schedule M-3 that is included in the financial statements or books and records.
  - Must report even if no book-tax difference
  - Mapping and classification issues
  - Do not use “Other” when a specific line exists
  - Nomenclature: For any specified line, report any item or transaction of like substantive nature. The nomenclature used in the financial statements is irrelevant.
  - When there is a difference for only a portion of an item, you should report the entire amount on applicable line.

- Disregarded entity — treat as items of owner: Do not file separate Schedule M-3
Permanent Vs. Temporary Differences

• Taxpayers report “temporary” differences in Parts II and III, Column (b); and “permanent” differences in Parts II and III, Column (c).
• If taxpayer uses GAAP:
  – Treat any item as temporary that GAAP treats as temporary
  – Treat other items as permanent
• If taxpayer does not use GAAP or prepare financial statements:
  – Temporary – if it will reverse in future year or it is a reversal from a prior year
  – Permanent – if it will not reverse in a future year and it is not a reversal from a prior year
• Treat as permanent if unable to determine
  – May want to attach an explanation
Completing Columns (b) and (c)

- If GAAP financial statements are prepared, any differences that are treated as temporary for GAAP purposes are reported in Column b, and any other differences are reported in Column c as permanent differences.

- If financial statements are not prepared or do not follow GAAP, use professional judgment to determine the temporary or permanent categorization of the reconciling item.
  - The instructions to Schedule M-3 indicate that a difference should be reported as temporary if the company believes that the amount will reverse in a future year or years due to the difference in timing of recognition for financial accounting and federal tax purposes, or is the reversal of a difference that arose in a prior year.
Reporting Book/Tax Differences: Example

• Apple Corporation, a calendar-year, accrual-basis corporation, received $360,000 on Sept. 1, 20016 as a prepayment for two years of rent on a vacant warehouse owned by the company.

• Apple reports the rental income as it is earned for financial accounting purposes, but reports the amount as income in the year received for tax purposes.

• The 2016 difference between $6,000 book rental income ($36,000 x 4/24) and $36,000 taxable rental income, or $30,000, is a temporary difference reported in Column b, since it will reverse in the future.

• In 2017 and 2018, the book-tax differences of $18,000 ($18,000 - $0) and $12,000 ($12,000 - $0) are temporary differences reported in Column b (reversals of differences that arose in 2016).
Separately Stated And Adequately Disclosed

- The instructions specifically require that each difference reported in parts II and III be *separately stated and adequately disclosed*.
  
  - An item is considered separately stated and adequately disclosed if the item is reported on the applicable line, and the amount(s) of the item(s) are reported in the applicable columns of the applicable line.
  
  - In some cases, the specific line item specifically requests that the taxpayer “attach schedule” or “attach details” or require more detailed information.
  
  - In some cases, neither the specific line item nor the Instructions for that line item require supporting schedules or details.

Important to read the instructions!
Separately Stated And Adequately Disclosed (Cont.)

• The instructions provide acceptable examples as:
  – “Foreign currency translation adjustment”
  – “Gains and losses on available-for-sale securities”
• It is likely that many general ledger account titles would not meet the “separately stated and adequately disclose” requirement.
  – “Other income” does not clearly identify the item or transaction from which the amount arose.
  – “Prepaid expenses” does not clearly identify the prepaid items.
  – Items such as prepaid insurance, prepaid advertising and prepaid postage must be separately stated and adequately disclosed.
Items Having No Book/Tax Differences

• The Instructions to Schedule M-3 specifically state that a corporation must include in column (a) of Part II any item specifically listed on Schedule M-3 that is included in any manner in the corporation’s current year net income figure used on Schedule M-3, even if there is no book/tax difference for the item.

• Two exceptions to this requirement are:
  1. Any amount otherwise required to be reported on Line 12 as a reportable transaction under Reg. §1.6011-4(b), or
  2. The item is subject to different treatment under the Instructions.
ACCURATELY COMPLETING SCHEDULE M-3, PART II DIFFERENCES FOR INCOME ITEMS
Tips For Accurately Completing M-3, Part II

- 6, income from a subsidiary, equity method vs. dividend method
- 9, income from a partnership
- 13, interest income (Form 8916-A)
- 17, cost of goods sold (Form 8916-A)
- 23-24, gain/loss on dispositions of assets
- 25, other income (loss) items with differences
Line 6: Income (Loss) From Equity Method

- Under the equity method of accounting for investments in common stock:
  - If a domestic corporation owns between 20 and 50% of another corporation, domestic or foreign, the corporation must include its percentage interest in the net income of that entity as part of the corporation’s financial accounting net income.
  - If the ownership interest is less than 20%, then the investing corporation will include only the dividends received from such entity in its book income.

- Since the equity method of accounting does not have a counterpart in the tax law, Line 6 of Part II is used to adjust for any equity-method income included in financial accounting net income but not included in taxable income.
  - The adjustment is temporary, since future dividends reported on Line 7 represent a reversal of the recognition of financial accounting income under the equity method.
Line 9: Partnership Income

- Net partnership income (loss) is shown in the aggregate on Line 9. The specific items of income/expense from the partnership are not shown separately.

- Example:
  - Branson Corp. has a 30% interest in the BCD partnership.
  - During the current year, BCD earned $3,000 of tax-exempt interest income, of which $900 ($3,000 x .30) was allocated to Branson Corp.
  - The adjustment for this tax-exempt interest is made on Line 9 of Schedule M-3, income (loss) from U.S. partnerships, not on Line 13, interest income.
Line 16: Interest Income (Form 8916-A, Part II)

- Separately state the following types of interest income on the following lines on Part II, Form 8916-A:
  1. Tax-exempt interest income
  2. Interest income from hybrid securities
  3. Sale/lease interest income
  4. Inter-company interest income - from outside tax affiliated group
  5. Inter-company interest income - from tax affiliated group
  6. Other interest income

- Column a includes the total amount of interest income included in Part I, Line 11 total income for all includable entities.

- Column d reports the total interest income included in taxable income, Line 28 of Form 1120, for all includable entities.

- Columns b and c are used to adjust for any tax-exempt interest received, as well as any interest income that is treated as some other form of income in the financial statements, or vice versa.
Interest Income Example

- Dextrose Corp. reported interest income of $450,000, including $90,000 interest on city of Dayton bonds.
- The $90,000 is reported on Line 1 of Part II, Form 8916-A, and a negative adjustment of $90,000 is made in Column c (permanent difference).
- The remaining $360,000 is reported on Line 5 of Form 8916-A.
- Line 6(a) will show $450,000 and Line 6(d) will show $360,000.
Interest Income Example (Cont.)

- U.S. Corp. invests in securities that have a stated yield. Due to certain features of the securities, the income from the investment is reported in the GAAP financial statements as interest income. U.S. Corp. reports the income as dividend income for tax purposes.

- Line 2, Column (a) of Part II, Form 8916-A, interest income from hybrid securities, would reflect the GAAP interest amount.
  - The amount to be characterized as dividend income for tax purposes should be eliminated via columns (b) or (c).
  - Dividend income would be reported on Line 7 of Part II in columns (b) or (c) as appropriate.
  - Column (d) would reflect the total dividend income for tax purposes.
Line 17, Cost Of Goods Sold  
(Form 8916-A, Part I)

• Cost of goods sold is entered as a NEGATIVE number on Line 17.
  – Form 8916-A detail is entered as a POSITIVE NUMBER in Column a, even if no Schedule M-3 adjustment is necessary.
• Inventory valuation methods creating book-tax differences are adjusted in Column b.
• Example:
  – If the lower-of-cost-or-market method is used for valuing inventory for both financial accounting and tax purposes, Reg. §1.471-2 requires an item-by-item valuation, while GAAP allows for valuation on an item-by-item, group-by-group, or even total market and total cost basis.
  – The resulting book-tax difference is reported on Line 5, Part I, Form 8916-A.
Form 8916-A, Part I, Cost Of Goods Sold

Include all amounts deducted as part of cost of goods sold during the tax year, regardless of whether the amounts would otherwise be reported elsewhere in parts II or III.

Do NOT include fines and penalties, or damage awards.

When included in COSG, report the following on Line 2 of the 8916-A:

a. Stock option expense
b. Other equity based compensation
c. Meals and entertainment
d. Parachute payments
e. Compensation with Sect. 162(m) limitation
f. Pension and profit sharing
g. Other post retirement benefits
h. Deferred compensation
i. Sect. 198 environmental remediation costs
j. Amortization
k. Depletion
l. Depreciation
m. Corporate-owned life insurance premiums
Lines 23-24: Reporting Gains And Losses

• These lines are used to report various gains and losses from sales or exchanges of property, as well as abandonment losses and worthless stock losses, and capital loss carryovers.

• Line 23 actually is composed of seven lines.
  – Line (Line 23a) reports total financial statement gains or losses.
  – Lines 23b through 23g provide details for the corresponding gains and losses reported for federal income tax purposes.
  – Reversals are reported in columns b or c as applicable.
Lines 23a And 23b

- Line 23a: Columns b and c of Line 23a are used to reverse any amounts reported in Column a.
  - Column d is shaded, since the gains and losses for tax purposes are reported on lines 23b through 25.
  - Column a of lines 23b through 23g are also shaded, since only taxable gains and losses are reported on these lines.

- Line 23b: Reports the gross capital gains reported by the corporation on Schedule D of Form 1120, with the exception of capital gains from flow-through entities.
  - The figure reported is gross gains, the total of only those transactions with either short-term or long-term capital gains.
Line 23c

- Line 23c: Gross capital losses reported on Schedule D, Form 1120 are included.
  - Pass-through losses, abandonment losses and worthless stock losses are not reported on this line.
  - Do not include any capital loss carryovers from a prior tax year.
  - These losses are reported on Line 24.
Line 23d

- Line 23d: Include ordinary income reported on Form 4797 from:
  - Gain or loss on the sale of property used in a trade or business and held for one year or less (Form 4797, Line 10)
  - Net loss from gains and losses on the sales or exchanges of Sect. 1231 properties used in the trade or business or for the production of income and held longer than one year (Form 4797, Line 11)
  - Recapture of current-year gain §1231 gain under the recapture rules for net §1231 losses in the preceding five years (Form 4797, Line 12)
  - Recaptured §1231 gain under the various depreciation recapture rules of §1245 and §1250 (Form 4797, Line 13)
  - Recapture from casualty or theft gains (Form 4797, Line 15)
  - Recaptured §1231 gain under the related-party rules applicable to like-kind exchanges (Form 4797, Line 16)
Line 23e

- Line 23e: Since an abandonment loss does not qualify as a sale or exchange, the loss will generally be an ordinary loss.
  - Reg. §1.167(a)-8 describes specific requirements for recognizing a loss from the abandonment of depreciable property.
  - Reg. §1.165-2 describes the requirements for non-depreciable property abandonment losses.
Line 23f

- Line 23f: Report any worthless stock loss, regardless of its tax characterization as either ordinary loss or capital loss.
  - A separate schedule must be attached that discloses each transaction giving rise to such loss.
- If the stock is held as an investment, the loss is generally capital loss.
- Stock held by a securities dealer as inventory generates ordinary loss.
- A domestic corporation can claim an ordinary loss for any stock in an affiliated corporation (e.g., 80% controlled) that becomes worthless during the tax year.
  - A worthless stock loss would be recognized in the same year for both book and tax purposes, although a capital loss may be subject to the capital loss limitation.
Line 23g

- Line 23g: Report any remaining gain or loss on assets other than inventory not reported on lines 23b through 23f.
- Only a few transactions fit in this category, since the other lines cover most dispositions of capital assets and business properties, including depreciation recapture.
  - One possible transaction reported on this line is a sale of a “corn products”-type property that is taxed as ordinary income due to its integral relationship to the day to day operations of the business. (*Corn Products Refining Company v. Commissioner*, 350 U.S. 46 (1955))
Line 24

- All gains and losses incurred by a corporation typically are deducted in determining financial accounting income.
- A corporate taxpayer may not deduct a net capital loss, since capital losses are limited to net capital gains.
- A disallowed capital loss is included in Column d of Line 24.
- For consolidated returns, the adjustment is made on the consolidated eliminations Schedule M-3, not the individual schedule of the member. Capital losses not deductible because of the §1211 limitation may be carried back three years and forward five years as a short-term loss, and can offset capital gains in those years.
- Capital loss carryovers utilized in the current year are reported on Line 24 in Column d.
Reporting Gains And Losses: Example

- Tandy Corp. reported the following gains and losses on its financial statements:
  - Gain on sale of investment securities held 6 years $330,000
  - Gain on sale of equipment 340,000
  - Loss on abandonment of warehouse (260,000)
  - Loss on worthless stock (2% interest in company) (180,000)
  - Loss on sale of land held as an investment (70,000)
  - Net gain reported for financial accounting purposes $160,000

- For tax purposes, the gain on the sale of equipment was $500,000, $420,000 of which is ordinary income.
- Tandy has a $30,000 capital loss carryover from the previous tax year.
Example: Tandy Reports Following On Pt. I

<table>
<thead>
<tr>
<th>Line #</th>
<th>a</th>
<th>b</th>
<th>c</th>
<th>d</th>
</tr>
</thead>
<tbody>
<tr>
<td>23a</td>
<td>$160,000</td>
<td>$(160,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23b</td>
<td></td>
<td>$410,000</td>
<td></td>
<td>$410,000</td>
</tr>
<tr>
<td>23c</td>
<td></td>
<td>$(70,000)</td>
<td></td>
<td>$(70,000)</td>
</tr>
<tr>
<td>23d</td>
<td></td>
<td>$420,000</td>
<td></td>
<td>$420,000</td>
</tr>
<tr>
<td>23e</td>
<td></td>
<td>$(260,000)</td>
<td></td>
<td>$(260,000)</td>
</tr>
<tr>
<td>23f</td>
<td></td>
<td>$(180,000)</td>
<td></td>
<td>$(180,000)</td>
</tr>
<tr>
<td>23g</td>
<td></td>
<td>$-</td>
<td></td>
<td>$-</td>
</tr>
<tr>
<td>24</td>
<td></td>
<td>$(30,000)</td>
<td></td>
<td>$(30,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$160,000</td>
<td>$130,000</td>
<td></td>
<td>$290,000</td>
</tr>
</tbody>
</table>

Line 23b  =  $330,000 + $80,000
Line 25, Other Income (Loss) Items With Differences

- Minimize use of Line 25; make sure there is no other line the item should be reported on.
- The supporting schedule for this line must include a description of the type of income (loss) and the:
  - (a) Book Income amount,
  - (b) The temporary difference amount,
  - (c) The permanent difference amount, and
  - (d) The taxable Income amount.
- Examples of permissible descriptions:
  - Comprehensive Income (SFAS No. 130)
  - Foreign currency translation adjustments
  - Gains and losses on available-for-sale securities
  - Life insurance proceeds; increase in CSV
Example: Part II, lines 7-17

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>U.S. dividends not eliminated in tax consolidation</td>
<td>5,792.</td>
</tr>
<tr>
<td>8</td>
<td>Minority interest for includible corporations</td>
<td>5,792.</td>
</tr>
<tr>
<td>9</td>
<td>Income (loss) from U.S. partnerships</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Income (loss) from foreign partnerships</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Income (loss) from other pass-through entities</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Items relating to reportable transactions</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Interest income (see instructions)</td>
<td>4,410.</td>
</tr>
<tr>
<td>14</td>
<td>Total accrual to cash adjustment</td>
<td>-1,050.</td>
</tr>
<tr>
<td>15</td>
<td>Hedging transactions</td>
<td>3,360.</td>
</tr>
<tr>
<td>16</td>
<td>Mark-to-market income (loss)</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Cost of goods sold (see instructions)</td>
<td>-2,437,485.</td>
</tr>
</tbody>
</table>
Example: Part II, lines 23-24

<table>
<thead>
<tr>
<th></th>
<th>a Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities</th>
<th>9,000.</th>
<th>-9,000.</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>b Gross capital gains from Schedule D, excluding amounts from pass-through entities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>c Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses</td>
<td></td>
<td>-5,500.</td>
<td>-5,500.</td>
</tr>
<tr>
<td></td>
<td>d Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses</td>
<td></td>
<td>18,500.</td>
<td>18,500.</td>
</tr>
<tr>
<td></td>
<td>e Abandonment losses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>f Worthless stock losses (attach statement)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>g Other gain/loss on disposition of assets other than inventory</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>24 Capital loss limitation and carryforward used</td>
<td></td>
<td>5,500.</td>
<td>5,500.</td>
</tr>
</tbody>
</table>
### Example: Part II, lines 25-30

<table>
<thead>
<tr>
<th></th>
<th>Other income (loss) items with differences (attach statement)</th>
<th></th>
<th>Total income (loss) items. Combine lines 1 through 25</th>
<th></th>
<th>Total expense/deduction items (from Part III, line 38)</th>
<th></th>
<th>Other items with no differences</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>25</td>
<td>In. 25. Stmt.</td>
<td>76,008</td>
<td>-2,342,275.</td>
<td>9,500</td>
<td>-77,058.</td>
<td>-2,409,833</td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>26</td>
<td></td>
<td></td>
<td>3,046,473.</td>
<td></td>
<td>332,809.</td>
<td>2,496</td>
<td>61,691.</td>
<td>392,004</td>
</tr>
<tr>
<td>27</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>28</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>a Mixed groups, see instructions. All others,</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>combine lines 26 through 28</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>b PC insurance subgroup reconciliation totals.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>c Life insurance subgroup reconciliation totals.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>Reconciliation totals. Combine lines 29a through 29c.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Note.</strong></td>
<td>Line 30, column (a) must equal the amount on Part I, line 11, and column (d) must equal Form 1120, page 1, line 28.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
ACCURATELY COMPLETING SCHEDULE M-3, PART III DIFFERENCES FOR EXPENSE ITEMS
Schedule M-3, Part III: Overview

• Lines 1 through 36 disclose specific expenses that are deducted on the Form 1120. The various lines are grouped into logical categories, which do not necessarily correspond to the lines on the Form 1120.

• This requires some effort to identify deductions that must be disclosed separately on the M-3, but are netted with other deductions on the Form 1120.
  • For example, Part III requires certain forms of employee compensation to be separately stated, while the Form 1120 only requires compensation paid to officers to be separately stated.

• Line 37 is used to disclose other expenses that have either a temporary or a permanent difference.
  • Note: All other expenses that are not disclosed separately on Part III because there is no temporary or permanent difference are included on Line 28 on Part II, other items with no differences.
Tips For Accurately Completing Part III Of Schedule M-3

- Line 11, meal and entertainment expenses
- Line 12, fines and penalties
- Lines 19-21, charitable contribution deduction
- Line 31, depreciation deduction
- Line 32, bad debt expense
- Line 37, other expense (deduction) items with differences
Line 11: Meals And Entertainment

- Meals and entertainment expenses are fully deductible for financial accounting purposes, but are subject to a 50% disallowance rule (§274(n)) for tax purposes, creating a permanent difference that is reported in Column (c).
- Other non-deductible items creating permanent differences:
  - Gifts ($25 limit per donee per year (§274(b)(1)))
  - Entertainment facilities (non-deductible (§274(g)))
  - Expenses for cruise ship conventions (limited (§274(h)(2)))
  - Event ticket prices (limited to face value (§274(l)(1)))
  - Skybox costs (limited to cost of non-skybox tickets (§274(l)(2)))
  - Luxury water travel (limited to twice the daily government per diem rate (§274(m)(1)))
- The financial categorization is irrelevant; these expenditures must be reported on Line 11.
K Corp. deducted $423,000 on its financial statements including:

- $120,000 for business meals
- $40,000 for 400 gifts to customers valued at $100 each
- $250,000 for Super Bowl tickets with a face value of $200,000, distributed to customers.

K’s tax deduction is $283,000 ($423,000 book deduction - $60,000 disallowance under the 50% rule for meals - $30,000 disallowed gift expenses exceeding $25 per gift - $50,000 excess paid for tickets).

A permanent difference of $140,000 ($423,000 - $283,000) is reported in Column (c).
A corporation incurs $200 of meals and entertainment expenses that were deducted in computing net income per the income statement, and $50 of the $200 is subject to the 50% limitation under §274(n).

- The corporation must report all of its meals and entertainment expenses on Part III, Line 11, meals and entertainment.

- The corporation reports $200 in Column (a), $25 in columns (b) and/or (c), as applicable, and $175 in Column (d).

- The corporation should not report the $150 of meals and entertainment expenses that are fully deductible for U.S. federal income tax purposes on Part II, Line 29, other income (loss) and expense/deduction items with no differences; and the $50 subject to the limitation under §274(n) on Part III, Line 11, meals and entertainment.
Line 12: Fines And Penalties

- For financial accounting purposes, these expenditures are normally deductible (e.g., the amount is incurred, the fact of the liability is fixed, the amount is reasonably estimable, etc.).
- §162(f) specifically denies a tax deduction for fines, penalties, bribes, kickbacks and any other payments violating public policy.
- This creates a permanent book-tax difference reported in Column (c).
- The financial categorization is irrelevant; if the expenditure is a fine or penalty, it must be reported on Line 12.
Townes Corp. incurred $45,000 of speeding fines related to its fleet of delivery trucks during the current year.

- This amount was deducted as delivery expense in the financial statements.
- This amount is reported in Column (a) of Line 12 and is also reported as a negative permanent adjustment in Column (c).
- Its financial categorization is irrelevant.
Charitable Contribution Of Cash And Tangible Property

- The book and tax amounts for contributions of tangible property may differ in a year, for a variety of reasons.
- For book purposes, a contribution deduction of a non-monetary asset is equal to the fair market value of the asset. Gain or loss on the contribution (when compared to the book value of the non-monetary asset) is also recognized.
- For tax purposes, corporations deduct the fair market value of the asset, provided the asset qualifies as a capital or §1231 asset.
- Exceptions are made for certain ordinary income properties as defined in Sect. 1221, such as inventories, and for depreciation-recapture properties.
- Half the appreciation in value may be deductible for contributions of inventories for certain limited uses (§170(e)).
• Zeus Corp. deducted contributions of cash and property totaling $222,000 for financial accounting purposes.

• Some of the property contributions included depreciation-recapture properties and inventories, which reduce the tax deduction for the year to $178,000.

• Zeus reports a permanent difference of ($44,000) in Column (c).
Charitable contributions of intangible property include:

- Intellectual property, patents, copyrights and trademarks
- Securities, including stocks and their derivatives, stock options and bonds
- Conservation easements
- Railroad rights of way
- Mineral rights

The requirement to separately report these items is related to §170(e)(1)(b), which limits the deduction for contributions of intellectual properties to:

- The taxpayer’s basis or the fair market value of the property, plus
- A certain percentage of the income generated by the intellectual property in later years.

Previously, the fair market value of the intellectual property was deductible, even if the valuation was suspect.
• G Corp. contributes a patent to State University with an adjusted basis of $560,000 and a FMV of $900,000.

• G deducts $900,000 on its financial statements in year 1.

• G’s allowable deduction for tax purposes under §170(m)(2) is $1,360,000 ($560,000 in year 1, $280,000 in year 2 and $520,000 in year 3).
  • Year 1: A charitable contribution of $900,000 is reported in Column (a), a ($340,000) negative temporary adjustment in Column (b), and a tax deduction of $560,000 in Column (d).
  • Year 2: A $280,000 positive temporary adjustment is reported in Column (b), and a tax deduction of $280,000 in Column (d).
  • Year 3: A $60,000 positive temporary adjustment is reported in Column (b), a $460,000 positive permanent adjustment in Column (c), and a tax deduction of $520,000 in Column (d).
Line 21: Charitable Contribution Limitation/Carryforward

• A deduction for charitable contributions is limited to 10% of taxable income before considering the contribution and any special deductions such as a net operating loss or capital loss carryback (but not carryforward), and any dividends-received deduction (§170(b)(2)).

• Contributions not deducted in the current year may be carried over for a maximum of five years (§170(d)(2)).
• Matthews Corp. has taxable income before charitable contributions of $500,000 in both year 1 and year 2, and made charitable contributions of $64,000 in year 1 and $32,000 in year 2.

• In year 1, Matthews will show a negative temporary adjustment in column (b) for the $14,000 of contributions not deductible for tax purposes (i.e., those contributions exceeding 10% of the $500,000 taxable income).

• In year 2, Matthews will show a positive temporary adjustment of $14,000 in column (b) for the reversal of this previously non-deducted amount, as the carryover is fully deductible in Year 2 since the $46,000 sum of the current-year deduction and the carryover amount is less than 10% of the taxable income for that year.
• Depreciation often creates book-tax differences, since tax depreciation computations generally ignore salvage value, use depreciation conventions not used for book purposes (such as the mid-quarter convention for personalty), use different recovery periods and recovery rates (MACRS), and may include immediate expensing deductions for certain personalty under §179.

• Differing book/tax depreciation methods means differing book/tax gains or losses when depreciable assets are sold or exchanged prior to the end of their depreciable lives.
**Line 31 Example**

- Banyon Corp., a calendar-year corporation, placed in service the following assets on 1/1 of the current year:
  
<table>
<thead>
<tr>
<th>Asset</th>
<th>Cost</th>
<th>Useful Life</th>
<th>MACRS Life</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delivery Vans</td>
<td>$60,000</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>Warehouse</td>
<td>$1,000,000</td>
<td>40</td>
<td>39</td>
</tr>
<tr>
<td>Machinery</td>
<td>$400,000</td>
<td>10</td>
<td>7</td>
</tr>
</tbody>
</table>

- Straight-line depreciation is used for financial accounting.
- MACRS depreciation is used for tax.
- The cost recovery deductions are as follows:
  
<table>
<thead>
<tr>
<th>Asset</th>
<th>Books</th>
<th>Tax</th>
<th>(Depreciation Rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delivery Vans</td>
<td>$10,000</td>
<td>$12,000</td>
<td>(20.00%)</td>
</tr>
<tr>
<td>Warehouse</td>
<td>$25,000</td>
<td>$24,610</td>
<td>(2.461%)</td>
</tr>
<tr>
<td>Machinery</td>
<td>$40,000</td>
<td>$57,160</td>
<td>(14.29%)</td>
</tr>
</tbody>
</table>

  $75,000          $93,770

- Report $75,000 in (a), $93,770 in (d) and a temporary difference of $18,770 in (b).
The deduction for bad debts expense is another cost recovery item that frequently creates book-tax differences.

For financial accounting purposes, the *allowance method* is required.

For tax purposes, the *direct write-off method*, in which bad debt expense is recognized only when the specific account proves uncollectible, is used.

When these two methods differ, a temporary book-tax difference is recorded.
Line 32 Example

- Trainer Corp. estimates the addition to its bad debt allowance to be $380,000, an expense based on 2% of its $19,000,000 sales revenue for the year.
- For tax purposes, Trainer deducts $322,000 under the direct write-off method.
- The ($58,000) book-tax difference is a temporary difference in Column (b).
- If Trainer later determines that the reserve is no longer warranted:
  - For financial statement purposes, it closes the reserve by recording miscellaneous income.
  - For tax purposes, a book-tax difference is reported on Line 32.
Line 37: Other Expense/Deduction Items With Differences

- Likely items to be reported on this line include:
  - Amortization of prepaid expenses, such as prepaid subscriptions, license fees and prepaid insurance
  - Expenses related to reserves and contingent liabilities, including warranty reserves, restructuring reserves, reserves for discontinued operations and reserves for acquisitions and dispositions
  - Note: Report reserves for litigation on Line 13, bad debt reserves on Line 32, reserves for inventory obsolescence on Form 8916-A, Part I
  - Accrued expenses for financial accounting that do not meet the economic performance requirement for tax deductibility
- All entries on this line require a separate attached schedule providing the details for each item listed, in order to meet the separately stated and adequately disclosed requirement.
I. Presentation of guaranteed payments “clarified” and examples are now provided in Schedule M-3 Instructions, page 15.

II. The treatment of guaranteed payments deducted on other lines, such as rental activity or portfolio activity guaranteed payment expense, is not discussed.
Guaranteed Payments Example

- PS has gross income from operations of $300,000. Partner GP, a 1/3 partner, received a guaranteed payment of $100,000 that is not capitalized.
- Ordinary business income of $200,000 is reported on Line 22, page 1 of Form 1065.
- $300,000 is reported on lines 1 and 2, page 5 of Form 1065 (analysis of income).
- The $100 permanent difference in Column (c) is presented as a negative amount.
- It relates to the income item shown on Line 4 of Schedule K.

<table>
<thead>
<tr>
<th>M-3</th>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
<th>(d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Part II, line 26</td>
<td>200,000</td>
<td></td>
<td>100,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Part III, line 9</td>
<td>100,000</td>
<td></td>
<td>-100,000</td>
<td>0</td>
</tr>
</tbody>
</table>
### Example: Part III

<table>
<thead>
<tr>
<th>Expense/Deduction Items</th>
<th>(a) Expense per Income Statement</th>
<th>(b) Temporary Difference</th>
<th>(c) Permanent Difference</th>
<th>(d) Deduction per Tax Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 U.S. current income tax expense</td>
<td>131,615</td>
<td></td>
<td>-131,615</td>
<td></td>
</tr>
<tr>
<td>2 U.S. deferred income tax expense</td>
<td>1,784</td>
<td></td>
<td>-1,784</td>
<td></td>
</tr>
<tr>
<td>11 Meals and entertainment</td>
<td>4,200</td>
<td></td>
<td>-2,100</td>
<td>2,100</td>
</tr>
<tr>
<td>19 Charitable contribution of cash and tangible property</td>
<td>47,300</td>
<td></td>
<td></td>
<td>47,300</td>
</tr>
<tr>
<td>20 Charitable contribution of intangible property</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21 Charitable contribution limitation/carryforward</td>
<td></td>
<td>-3,744</td>
<td></td>
<td>-3,744</td>
</tr>
<tr>
<td>31 Depreciation</td>
<td>71,720</td>
<td>23,940</td>
<td></td>
<td>95,660</td>
</tr>
<tr>
<td>32 Bad debt expense</td>
<td>111,520</td>
<td>-8,200</td>
<td></td>
<td>103,320</td>
</tr>
<tr>
<td>33 Corporate owned life insurance premiums</td>
<td>3,250</td>
<td></td>
<td>-3,250</td>
<td>0</td>
</tr>
</tbody>
</table>

**38 Total expense/deduction items.** Combine lines 1 through 37. Enter here and on Part II, line 27, reporting positive amounts as negative and negative amounts as positive.

|  | 371,389 | 11,996 | -138,749 | 244,636 |
### Example: Part II, Lines 27-30

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Line 26</th>
<th>Line 27</th>
<th>Line 28</th>
<th>Line 29</th>
<th>Line 30</th>
</tr>
</thead>
<tbody>
<tr>
<td>27</td>
<td>Total expense/deduction items (from Part III, line 38)</td>
<td>-371,389.</td>
<td>-11,996.</td>
<td>138,749.</td>
<td>-244,636.</td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>Other items with no differences</td>
<td>3,046,473.</td>
<td></td>
<td></td>
<td></td>
<td>3,046,473.</td>
</tr>
<tr>
<td>29</td>
<td>Mixed groups, see instructions. All others, combine lines 26 through 28</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>b</strong> PC insurance subgroup reconciliation totals</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>c</strong> Life insurance subgroup reconciliation totals</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>Reconciliation totals. Combine lines 29a through 29c</td>
<td>332,809.</td>
<td>-2,496.</td>
<td>61,691.</td>
<td>392,004.</td>
<td></td>
</tr>
</tbody>
</table>
ACCURATELY COMPLETING SCHEDULE UTP FOR UNCERTAIN TAX POSITIONS
Reporting Uncertain Tax Positions

- Schedule UTP is used to report uncertain tax positions affecting the federal income tax liability:
  - Income recognized for financial income but not recognized on the tax return
  - Deductions taken on the tax return but not deducted for financial income
  - Information regarding a tax credit that could be reduced or disallowed upon audit
Reporting Uncertain Tax Positions (Cont.)

• Report when:
  • A tax position is taken on U.S. federal income tax return for the current or prior tax year, AND
  • Either corporation or related party has recorded a reserve with respect to that tax position for federal income tax in audited financial statements, OR a reserve for that tax position was not recorded because the corporation expects to litigate the position.
Financial Statement Disclosure of an Uncertain Tax Position

- ASC740-10-50 uses a two-step process:
  - Recognition based on “more likely than not” standard
  - Measurement based on weighted average of probability of success.
- Footnote disclosure of uncertain tax positions required

- Applicable to:
  - Deferred Tax Assets
  - Deferred Tax Liabilities
  - Effective Tax Rate Reconciliation

- Not limited to federal income tax positions
  - Applies to state, local, and international taxes.
    - Frequently involves Nexus Issues.
Why is Schedule UTP Required?

• Ann. 2010-9, Ann. 2010-75: Annual disclosure of uncertain tax positions will improve tax compliance and administration

• On 9/7/2010, the IRS issued proposed Reg. 1.6012-2 giving it the regulatory underpinning to require certain corporations to attach the Schedule UTP to their tax returns

• Additional information available at:

• Starting with the 2014 tax year, Schedule UTP is required of all corporate Schedule M-3, Part I filers that issue GAAP financial statements.
  • Pass-through entities are currently exempt.
### UTP Disclosures

<table>
<thead>
<tr>
<th>Likelihood of success and disclosure</th>
<th>Position (other than reportable transactions)</th>
<th>Form 8275</th>
<th>Form UTP</th>
</tr>
</thead>
<tbody>
<tr>
<td>0% to 20%</td>
<td>Frivolous Position: “Patently improper”--position should never be taken on a return.</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>20% to 33%</td>
<td>Reasonable Basis: No taxpayer penalty if position adequately disclosed on the return</td>
<td>YES¹</td>
<td>YES</td>
</tr>
<tr>
<td>33% to 40%</td>
<td>Realistic Possibility: No tax preparer penalty if adequately disclosed on the return</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td>40% to 50%</td>
<td>Substantial Authority. No Sec. 6662 penalty.</td>
<td>NO</td>
<td></td>
</tr>
<tr>
<td>50% to 99%</td>
<td>More likely than not: &gt;50% chance of success</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>100%</td>
<td>Certain.</td>
<td>NO</td>
<td>NO</td>
</tr>
</tbody>
</table>

¹If UTP filed, form 8275 not required
### Schedule UTP Filers (2012)

<table>
<thead>
<tr>
<th>Asset Size</th>
<th># of Returns</th>
<th># with UTP</th>
<th>Year UTP Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000,000 - $50,000,000</td>
<td>23,800</td>
<td>n/a</td>
<td>2014</td>
</tr>
<tr>
<td>$50,000,000 - $100,000,000</td>
<td>6,100</td>
<td>214</td>
<td>2012</td>
</tr>
<tr>
<td>More than $100,000,000</td>
<td>12,400</td>
<td>2,018</td>
<td>2010</td>
</tr>
<tr>
<td>Total</td>
<td>42,300</td>
<td>2,232</td>
<td></td>
</tr>
</tbody>
</table>
## Schedule UTP Filers (2011)

<table>
<thead>
<tr>
<th>Assets</th>
<th>Total</th>
<th>With UTP</th>
<th>NO UTP</th>
<th>% with UTP</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;$100,000,000</td>
<td>26%</td>
<td>10%</td>
<td>17%</td>
<td>36%</td>
</tr>
<tr>
<td>SEC filer</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Audited</td>
<td>45%</td>
<td>4%</td>
<td>40%</td>
<td>10%</td>
</tr>
<tr>
<td>Unaudited</td>
<td>29%</td>
<td>3%</td>
<td>26%</td>
<td>9%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>17%</td>
<td>83%</td>
<td>17%</td>
</tr>
</tbody>
</table>
UTP Filing Results (2011)

- Of the 2,144 Schedule UTPs filed,
  - 4,766 UTP disclosures (2.2 average)
  - 50% of returns had only 1 UTP
  - Top 3 IRC Code Sections
    - 41—Research tax credits
    - 482—Transfer pricing (21%)
    - 162—Trade and business expenses
  - 40% were prepared by Big Four accounting firms.
  - 3% had inadequate explanations
Schedule UTP, Part I Disclosures

- The IRC section(s) relating to the tax position
- Whether the position is permanent (P) or temporary (T)
- The EIN of the pass-through entity, if any, to which the tax position relates (indicate F for foreign partnership)
  - Example: The tax position involves the corporate partner’s distributive share of a partnership item
- Major tax position: Check box if the relative size of the tax position is >=10% of the sum of all the tax positions listed
  - Do not check if corporation expects to litigate the position
- Rank tax positions from largest (1) to smallest
  - Use the letter T for transfer pricing positions and G for all other tax positions
Schedule UTP, Part III Disclosures

• Include a concise description of each uncertain tax position, including a description of the relevant facts and information that will apprise the IRS of the identity of the tax position and the nature of the issue
  • Not required: The rationale for the position, an assessment of the hazards of a tax position or an analysis of the support for or against the tax position

• In most cases, the description should not exceed a few sentences.
  • Stating that the description is “available upon request” is not an adequate description.
<table>
<thead>
<tr>
<th>Insufficient Description</th>
<th>Sufficient Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>This is a research credit issue.</td>
<td>The taxpayer incurred support department costs that were allocated to various research projects based upon a methodology the taxpayer considers reasonable. The issue is whether the taxpayer’s method of allocating these costs is acceptable by the IRS.</td>
</tr>
<tr>
<td>This is a transfer pricing issue.</td>
<td>The taxpayer allocated management service costs between its domestic subsidiaries and a foreign subsidiary located in Country X using a methodology the taxpayer considers reasonable. The issue is whether the taxpayer’s method of allocating these costs is acceptable by the IRS.</td>
</tr>
</tbody>
</table>
When to make UTP Accrual: Example

• Cat Company purchased and placed in service on January 1 of the current year a building which cost $1,000,000.
• Applicable and marginal tax rate of 34%.
• Annual straight line financial depreciation expense is $50,000.
• Results of component depreciation analysis are used to compute the year 1 depreciation expense on the building and its component parts.
## When to make an Accrual: Alternate Scenarios

<table>
<thead>
<tr>
<th></th>
<th>Financial Depreciation Expense</th>
<th>Tax Depreciation Expense</th>
<th>Deferred Tax Liability</th>
<th>Probability of success</th>
<th>UTP Accrual</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>$50,000</td>
<td>$50,000</td>
<td>$-</td>
<td>100%</td>
<td>$-</td>
</tr>
<tr>
<td>b</td>
<td>$50,000</td>
<td>$100,000</td>
<td>$17,000</td>
<td>95%</td>
<td>$-</td>
</tr>
<tr>
<td>c</td>
<td>$50,000</td>
<td>$150,000</td>
<td>$34,000</td>
<td>60%</td>
<td>$13,600</td>
</tr>
<tr>
<td>d</td>
<td>$50,000</td>
<td>$200,000</td>
<td>$51,000</td>
<td>40%</td>
<td>$51,000</td>
</tr>
</tbody>
</table>
When to make UTP Accrual

• a. (100% success) no accrual for a deferred tax liability since book and tax depreciation are the same and there is no accrual for an uncertain tax position.

• b. (95% success) accrual for a deferred tax liability of $17,000 [($100,000 - $50,000) x 34%] on the difference between the book and tax depreciation using an applicable tax rate.

  — **Materiality.** Management decided against an accrual for an uncertain tax position, since the 5% risk requires an accrual for an uncertain tax position of only $850 ($17,000 x 5%) which not material in relation to its tax accruals for the year.
When to make UTP Accrual

• c. (60% success) Management determined that it is “more likely than not” the tax depreciation deduction would be sustained upon audit and makes an accrual for the 40% deemed to be an uncertain tax position.
  — This position must be disclosed on Schedule UTP.

• d. (40% success) the tax depreciation deduction does not meet the “more likely than not” threshold so an UTP accrual for 100% of the deferred tax liability is made.
  — This position must be disclosed on Schedule UTP.
UTP Example: Contingent Liability

- $100,000 accrual for a contingent liability from potential environmental contamination
  - No payment will be made until all legal appeals have been exhausted, which management expects to occur within three to five years.
  - No deduction can be taken on this year’s tax return, because the “economic performance” test has not been met.
  - A portion of the payment may be a non-deductible capital expenditure.
- Deferred tax asset, net of UTP: $17,500  [$100,000 x 35% - (1-.5)]
- No UTP disclosure, since position not yet taken on the tax return
An R&E tax credit of $35,000 reduced both financial tax expense and federal tax payable.

- Management believes it is “more likely than not” that the full credit can be claimed; however, the IRS could deny part of the credit due to inadequate contemporaneous documentation.

- This is a “permanent difference.”

- Accrual for UTP: $3,500 [$35,000 x .10]

- UTP disclosure required
Future Changes?
AICPA Recommendations

• Recommended Schedule M-3 changes:
  • Increase $10 million threshold
  • Eliminate columns (a) and (d), or make page 1 of 1120 optional for M-3 filers
  • Eliminate separate M-3s for members of consolidated group
  • Eliminate Form 8916-A
  • Eliminate reportable entity partnership requirement
• Alternatively, eliminate M-3 and expand M-1 to show temporary and permanent differences separately
  • http://www.aicpa.org/interestareas/tax/resources/taxmethodsperiods/advocacy/downloadeddocuments/aicpa_08.01.2011_sch_m3_comments.pdf
Current Tax Forms

- Draft forms available at:

- Final forms available at: