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MEMORANDUM

Re: IRS Releases Final Schedule M-3 Instructions

From: Peter H. Winslow
Samuel A. Mitchell

Date: December 7, 2004

On December 2, 2004, the IRS released the final instructions for the new Schedule M-3, Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 million or More, which will be required for tax year 2005. The new instructions have expanded from an original 5-page draft to 16 pages, containing much more specific information than previously provided.

Of interest to insurance companies, the final instructions clarify earlier guidance on the use of the schedule by consolidated groups. The instructions provide that consolidated groups that file on either Form 1120-PC or 1120-L will not have to complete the schedule for tax year 2005, for any members. Groups that file a Form 1120 but include members for which a Form 1120-PC or 1120-L is prepared must complete the schedule. However, the members that are included in the group on a Form 1120-PC or 1120-L have the option to complete the schedule in its entirety or report differences on an aggregated basis on Line 26 of Part II with a supporting schedule that separately states and adequately discloses each difference on an item-by-item basis. The instructions define "separately stated and adequately disclosed" to require aggregation of amounts regarding the "same item," but do not permit aggregation of "dissimilar items." As in earlier draft instructions, the final instructions contain examples of the separate item requirement, but none of the examples specifically defines the term "item." Thus, taxpayers are left with some uncertainty as to the level of detail required in accompanying schedules required by the schedule.

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The instructions do not reference or contain any more specific guidance on the alternative disclosure procedure in Rev. Proc. 2004-45 for book/tax differences reportable under Treas. Reg. § 1.6011-4(b)(6). The revenue procedure allows taxpayers to use the Schedule M-3 in lieu of a Form 8886 to report disclosable book/tax differences. In the insurance company context, the disclosure would be detailed on an accompanying schedule that would tie in the aggregate to Line 26 of Part II, as explained above. We recommend caution in using the alternative procedure in the insurance company context, given the lack of specific guidance on the meaning of the term “item” to be disclosed in an accompanying schedule. The consequences for failing to disclose reportable transactions under the new Jobs Act penalty and disclosure provisions are severe (\$50,000 penalty per non-listed reportable transaction, and separate SEC disclosure of the penalty). Additionally, the instructions contain no guidance on how the record-keeping requirements for transactions reportable on Form 8886 integrate with the alternative disclosure procedure using Schedule M-3.

Please call if you have questions.