2011 Instructions for Schedule M-3 (Form 1120S)

Department of the Treasury
Internal Revenue Service

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

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

What's New

- An attachment to support the information reported on Part III, line 29, Research and development costs, is no longer required.
- Instructions for Part I, line 12, clarify that assets and liabilities must be reported on lines 12a-12d as positive amounts.
- Instructions have been added to clarify reporting by traders in securities or commodities that have made a valid election under section 475(f) to use the mark-to-market method to account for securities or commodities. See *Traders in securities and commodities* under the instructions for Part II, line 14, for more information.
- The IRS has created a page on IRS.gov for information about Schedule M-3 (Form 1120S) and its instructions at *www.irs.gov/form1120s*. Information about any future developments affecting Schedule M-3 (such as legislation enacted after we released it) will be posted on that page.

Purpose of Schedule

Schedule M-3, Part I, asks certain questions about the corporation's financial statements and reconciles financial statement worldwide net income (loss) for the corporation (or consolidated financial statement group, if applicable), as reported on Part I, line 4a, to income (loss) per the income statement of the corporation for U.S. income tax purposes, as reported on Part I, line 11.

Schedule M-3 Parts II and III reconcile financial statement net income (loss) for the U.S. tax return (per Schedule M-3, Part I, line 11) to total income (loss) on Form 1120S, Schedule K, line 18.

Where To File

If the corporation is required to file (or voluntarily files) Schedule M-3 (Form 1120S), the corporation **must** file Form 1120S and all attachments and schedules, including Schedule M-3 (Form 1120S), with the Department of the Treasury, Internal Revenue Service Center, Ogden, UT 84201-0013.

Who Must File

Any corporation required to file Form 1120S, U.S. Income Tax Return for an S Corporation, that reports on Schedule L of Form 1120S total assets at the end of the corporation's tax year that equal or exceed $10 million must complete and file Schedule M-3 instead of Schedule M-1, Reconciliation of Income (Loss) per Books With Income (Loss) per Return. A U.S. corporation filing Form 1120S that is not required to file Schedule M-3 may voluntarily file Schedule M-3 instead of Schedule M-1. A corporation filing Schedule M-3 must check the box on Form 1120S, item C, indicating that Schedule M-3 is attached (whether required or voluntary). A corporation filing Schedule M-3 must not file Schedule M-1.

Example 1.

1. U.S. corporation A owns U.S. subsidiary B and foreign subsidiary F. For its 2011 tax year, A prepares consolidated financial statements with B and F that report total assets of $12 million. A files a U.S. income tax return with B (a corporation that has made a qualified subchapter S subsidiary election) and reports total assets on Schedule L of $8 million. A's U.S. tax group is not required to file Schedule M-3 for the 2011 tax year.

2. U.S. corporation C owns U.S. subsidiary D. For its 2011 tax year, C prepares consolidated financial statements with D, but C and D file separate U.S. income tax returns. The consolidated accrual basis financial statements for C and D report total assets at the end of the tax year of $12 million after intercompany eliminations. C reports separate company total year-end assets on its Schedule L of $7 million. D reports separate company total year-end assets on its Schedule L of $6 million. Neither C nor D is required to file Schedule M-3 for the 2011 tax year.

Other Issues Affecting Schedule M-3 Filing Requirements

If a corporation was required to file Schedule M-3 for the preceding tax year, but reports on Schedule L of Form 1120S total assets at the end of the current tax year of less than $10 million, the corporation is not required to file Schedule M-3 for the current tax year. The corporation may either (a) file Schedule M-3, or (b) file Schedule M-1, for the current tax year. However, if the corporation chooses to file Schedule M-1 for the current tax year, and for a subsequent tax year the corporation is required to file Schedule M-3, the corporation must complete Schedule M-3 in its entirety (Part I and all columns in Parts II and III) for that subsequent tax year.

For purposes of determining whether the corporation has total assets at the end of the current tax year of $10 million or more, the corporation's total assets must be determined on an overall accrual method of accounting unless both of the following apply: (a) the tax return of the corporation is prepared using an overall cash method of accounting, and (b) no includible entity in the U.S. tax return prepares or is included in financial statements prepared on an accrual basis.

Note. See the instructions for Part I, line 1, for a discussion of non-tax-basis income statements and related non-tax-basis balance sheets to be used in the preparation of Schedule M-3 and of Form 1120S, Schedule L.

Schedule L

If a non-tax-basis income statement and related non-tax-basis balance sheet is prepared for any purpose for a period ending with or within the tax year, Schedule L must be prepared showing non-tax-basis amounts. See the instructions for Part I, line 1, for a discussion of non-tax-basis income statements and related non-tax-basis balance sheets prepared for any purpose and the impact on the selection of the income statement used for Schedule M-3 and the related non-tax-basis balance sheet amounts that must be used for Schedule L.

Total assets shown on Schedule L, line 15, column (d), must equal the total assets of the corporation as of the last day of the tax year, and must be the same total assets reported by the corporation in the non-tax-basis financial statements, if any, used for Schedule M-3. If the corporation does not prepare non-tax-basis financial statements, Schedule L must be based on the corporation's books and records. The Schedule L balance sheet can show tax-basis balance sheet amounts if the corporation is allowed to use books and records for Schedule M-3 and the corporation's books and records reflect only tax-basis amounts.

Generally, total assets at the beginning of the year (Schedule L, line 15, column (b)) must equal total assets at the close of the prior year (Schedule L, line 15, column (d)). For each Schedule L balance sheet item reported for which there is a difference between the current opening balance sheet amount and the prior closing balance sheet amount, attach a schedule that reports the balance sheet item, the prior closing amount, the current opening amount, and a short explanation of the difference. In particular, indicate if the differences occurred because of acquisitions or mergers.

For purposes of measuring total assets at the end of the year, the corporation's assets may not be netted or reduced by the corporation's liabilities. In addition, total assets may not be reported as a negative amount. If Schedule L is prepared on a non-tax-basis method, an investment in a partnership may be shown as appropriate under the corporation's non-tax-basis method of accounting, including, if required by the corporation's reporting methodology, the equity method of accounting for investments. If Schedule L is prepared on a tax-basis method, an investment by the corporation in a partnership must be shown as an asset and measured by the corporation's adjusted basis in its partnership interest. Any liabilities contributing to such adjusted basis must be shown on Schedule L as corporate liabilities. In any event, any investments or other assets reported on Schedule L can never be reported as negative amounts.

Entity Considerations for Schedule M-3

For purposes of Schedule M-3, references to the classification of an entity (for example, as a corporation, a partnership, or a trust) are references to the treatment of the entity for U.S. income tax purposes. An entity that generally is disregarded as separate from its owner for U.S. income tax purposes (disregarded entity) must not be separately reported on Schedule M-3 except, if required, on Part I, line 7a, 7b, or line 7c. On Schedule M-3, Parts II and III, any item of income, gain, loss, deduction, or credit of a disregarded entity must be reported as an item of its owner. In particular, the income or loss of a disregarded entity must not be reported on Part II, lines 7, 8, or 9 as from a separate partnership or other pass-through. The financial statement income or loss of a disregarded entity other than a qualified subchapter S subsidiary (QSub) is included on Part I, line 7b, if and only if its financial statement income or loss is included on Part I, line 11, but not on Part I, line 4a. The financial statement income or loss of a QSub is included on Part I, line 7c, if and only if its financial statement income or loss is included on Part I, line 11, but not on Part I, line 4a.

Qualified Subchapter S Subsidiaries (QSubs). Because a QSub is a disregarded entity, for purposes of Schedule M-3, Schedule L, and the tax return in general, the subsidiary is deemed to have liquidated into the parent S corporation. As such, all QSubs are treated as divisions of the S corporation parent and they must not be separately reported on Schedule M-3 except, if required, on Part I, line 7c.

Reportable Entity Partner Reporting Responsibilities

A reportable entity partner with respect to a partnership filing Form 1065 is an entity that (1) owns or is deemed under these instructions to own, directly or indirectly, a 50 percent or greater interest in the income, loss, or capital of the partnership on any day of the tax year and (2) was required to complete Schedule M-3 on its most recently filed U.S. income tax return or return of income filed prior to that day.

For the purposes of these instructions:

1. The parent corporation of a consolidated tax group is deemed to own all corporate and partnership interests owned or deemed to be owned under these instructions by any member of the tax consolidated group;
2. The owner of a disregarded entity is deemed to own all corporate and partnership interests owned or deemed to be owned under these instructions by the disregarded entity;
3. The owner of 50 percent or more of a corporation by vote on any day of the corporation tax year is deemed to own all corporate and partnership interests owned or deemed to be owned under these instructions by the corporation during the corporation tax year;
4. The owner of 50 percent or more of partnership income, loss, or capital on any day of the partnership tax year is deemed to own all corporate and partnership interests owned or deemed to be owned under these instructions by the partnership during the partnership tax year; and
5. The beneficial owner of 50 percent or more of the beneficial interest of a trust or nominee arrangement on any day of the trust or nominee arrangement tax year is deemed to own all corporate and partnership interests owned or deemed to be owned under these instructions by the trust or nominee arrangement.

A reportable entity partner with respect to a partnership (as defined above) must report the following to the partnership within 30 days of first becoming a reportable entity partner and, after first reporting to the partnership under these instructions, thereafter within 30 days of the date of any change in the interest it owns or is deemed to own, directly or indirectly, under these instructions, in the partnership.

1. Name.
2. Mailing address.
3. Taxpayer identification number (TIN or EIN), if applicable.
4. Entity or organization type.
5. State or country in which it is organized.
6. Date on which it first became a reportable entity partner.
7. Date with respect to which it is reporting a change in its ownership interest in the partnership, if applicable.
8. The interest in the partnership it owns or is deemed to own in the partnership, directly or indirectly (as defined under these instructions) as of the date with respect to which it is reporting.
9. Any change in that interest as of the date with respect to which it is reporting.

The reportable entity partner must retain copies of required reports it makes to partnerships under these instructions. Each partnership must retain copies of the required reports it receives under these instructions from reportable entity partners.

Example 2. A, a limited liability company (LLC) filing a Form 1065 for 2011, is owned 50 percent by U.S. corporation Z which files Form 1120S. A owns 50 percent of each of B, C, D, and E, each also an LLC filing a Form 1065 for calendar year 2011. Z was first required to complete Schedule M-3 (Form 1120S) for its corporate tax year ended December 31, 2010, and filed its Form 1120S with Schedule M-3 for 2010 on September 15, 2011. As of September 16, 2011, Z was a reportable entity partner with respect to A and, through A, with respect to B, C, D, and E. On October 5, 2011, Z reports to A, B, C, D, and E, as it is required to do within 30 days of September 16, that Z is a reportable entity partner directly owning (with respect to A) or deemed to own indirectly (with respect to B, C, D, and E) a 50 percent interest. Therefore, because Z was a reportable entity partner for 2011, each of A, B, C, D, and E is required to complete Schedule M-3 (Form 1065) for 2011, regardless of whether they would otherwise be required to complete Schedule M-3 for that year.

Completion of Schedule M-3

A corporation required to file Schedule M-3 must complete the form in its entirety. At the time the Form 1120S is filed, all applicable questions must be answered on Part I, all columns must be completed on Parts II and III, and all numerical data required by Schedule M-3 must be provided. Any schedule required to support a line item on Schedule M-3 must be attached at the time Schedule M-3 is filed and must provide the information required for that line item.

Specific Instructions for Part I

Part I. Financial Information and Net Income (Loss) Reconciliation

When To Complete Part I

Part I must be completed for any tax year for which the corporation files Schedule M-3.

Line 1. Questions Regarding the Type of Income Statement Prepared

For Part I, lines 1 through 12, use only the financial statements of the U.S. corporation filing the U.S. income tax return.

Non-Tax-Basis Financial Statements and Tax-Basis Financial Statements

A tax-basis income statement is allowed for Schedule M-3 and a tax-basis balance sheet for Schedule L only if no non-tax-basis income statement and no non-tax-basis balance sheet was prepared for any purpose and the books and records of the corporation reflect only tax-basis amounts. The corporation is deemed to have non-tax-basis income statements and the related non-tax-basis balance sheets for the current tax year for purposes of Schedule M-3 and Schedule L if such non-tax-basis financial statements were prepared for and presented to management, creditors, shareholders, government regulators, or any other third parties for a period ending with or within the tax year.

If a non-tax-basis income statement is prepared that is a certified non-tax-basis income statement for the period ending with or within the tax year, the corporation must check “Yes” for Part I, line 1a, and use that income statement for Schedule M-3. If no certified non-tax-basis income statement is prepared but an unaudited non-tax-basis income statement is prepared for the period ending with or within the tax year, the corporation must check “Yes” for Part I, line 1b, and use that income statement for Schedule M-3.

Order of priority in accounting standards. If two or more non-tax-basis income statements are both certified non-tax-basis income statements for the period, the income statement prepared according to the following order of priority in accounting standards shall be used.

1. U.S. Generally Accepted Accounting Principles (GAAP).
2. International Financial Reporting Standards (IFRS).
3. Any other International Accounting Standards (IAS).
4. Other regulatory accrual accounting.
5. Any other accrual accounting standard.
6. Any fair market value standard.
7. Any cash basis standard.

If no non-tax-basis income statement is certified and two or more non-tax-basis income statements are prepared, the income statement prepared according to the first listed of the accounting standards listed above shall be used.

If no non-tax-basis financial statements are prepared for a U.S. corporation filing Schedule M-3 (Form 1120S), the U.S. corporation must check “No” on questions 1a and 1b, skip Part I, lines 2, 3a, and 3b, and enter the net income (loss) per the books and records of the U.S. corporation on Part I, line 4a.

Lines 2 and 3. Questions Regarding Income Statement Period and Restatements

Enter the beginning and ending dates on line 2 for the corporation’s annual income statement period ending with or within the current tax year.

The questions on Part I, lines 3a and 3b, regarding income statement restatements refer to the worldwide consolidated income statement issued by the corporation filing the U.S. income tax return and used to prepare Schedule M-3. Answer “Yes” on lines 3a and/or 3b if the corporation’s annual income statement has been restated for any reason. Attach a short explanation of the reasons for the restatement in net income for each annual income statement period that is restated, including the original amount and restated amount of each annual statement period’s net income.

Line 4. Worldwide Consolidated Net Income (Loss) per Income Statement

Report on Part I, line 4a, the worldwide consolidated net income (loss) per the income statement (or books and records, if applicable) of the corporation.

In completing Schedule M-3, the corporation must use financial statement amounts from the financial statement type checked “Yes” on Part I, line 1, or from its books and records if Part I, line 1b, is checked “No.”

If a corporation prepares non-tax-basis financial statements, the amount on line 4a must equal the financial statement net income (loss) for the income statement period ending with or within the tax year as indicated on Part I, line 2.

If the corporation prepares non-tax-basis financial statements and the income statement period differs from the corporation’s tax year, the income statement period indicated on Part I, line 2, applies for purposes of Part I, lines 4 through 8.

If the corporation does not prepare non-tax-basis financial statements and has checked “No” on Part I, line 1b, enter the net income (loss) per the books and records of the U.S. corporation on Part I, line 4a.

Indicate on Part I, line 4b, which of the following accounting standards were used for line 4a.

1. U.S. Generally Accepted Accounting Principles (GAAP).
2. International Financial Reporting Standards (IFRS).
3. Tax basis.
4. Other (Specify).

Report on Part I, lines 5a through 10, as instructed below, all adjustment amounts required to adjust worldwide net income (loss) reported on this Part I, line 4a (whether from financial statements or books and records), to net income (loss) of the corporation that must be reported on Part I, line 11. Report on line 12a the worldwide consolidated total assets and total liabilities amounts for the corporation using the same financial statements (or book and records) used for the worldwide consolidated income (loss) amount reported on line 4a.

Line 5. Net Income (Loss) of Nonincludible Foreign Entities

Remove the financial net income (line 5a) or loss (line 5b) of each foreign entity that is included on line 4a and is not an includible entity in the U.S. tax return (nonincludible foreign entity). In addition, on Part I, line 8, adjust for consolidation eliminations and correct for minority interest and intercompany dividends between any nonincludible foreign entity and the entity filing Form 1120S. Do not remove in Part I the financial net income (loss) of any nonincludible foreign entity accounted for on line 4a using the equity method.

Attach a supporting schedule that provides the name, EIN (if applicable), and net income (loss) included on line 4a that is removed on this line 5 for each separate nonincludible foreign entity. Also state the total assets and total liabilities for each such separate nonincludible foreign entity and include those assets and liabilities amounts in the total assets and total liabilities reported on Part I line 12b. The amounts of income (loss) detailed on the supporting schedule should be reported for each separate nonincludible foreign entity without regard to the effect of consolidation or elimination entries. If there are consolidation or elimination entries relating to nonincludible foreign entities whose income (loss) is reported on the attached schedule that are not reportable on Part I, line 8, the net amounts of all such consolidation and elimination entries must be reported on a separate line on the attached schedule, so that the separate financial accounting income (loss) of each nonincludible foreign entity remains separately stated.

For example, if the net income (after consolidation and elimination entries) of a nonincludible foreign sub-consolidated group is being reported on line 5a, the attached supporting schedule should report the income (loss) of each separate nonincludible foreign legal entity from each such entity's own financial accounting net income statement or books and records, and any consolidation or elimination entries (for intercompany dividends, minority interests, etc.) not reportable on Part I, line 8, should be reported on the attached supporting schedule as a net amount on a line separate and apart from lines that report each nonincludible foreign entity's separate net income (loss).

Line 6. Net Income (Loss) of Nonincludible U.S. Entities

Remove the financial net income (line 6a) or loss (line 6b) of each U.S. entity that is included on line 4a and is not an includible entity in the U.S. tax return (nonincludible U.S. entity). In addition, on Part I, line 8, adjust for consolidation eliminations and correct for minority interest and intercompany dividends between any nonincludible U.S. entity and any includible entity. Do not remove in Part I the financial net income (loss) of any nonincludible U.S. entity accounted for on line 4a using the equity method.

Attach a supporting schedule that provides the name, EIN, and net income (loss) included on line 4a that is removed on this line 6 for each separate nonincludible U.S. entity. Also state the total assets and total liabilities for each such separate nonincludible U.S. entity and include those assets and liabilities amounts in the total assets and total liabilities reported on Part I line 12c. The amounts of income (loss) detailed on the supporting schedule should be reported for each separate nonincludible U.S. entity without regard to the effect of consolidation or elimination entries. If there are consolidation or elimination entries relating to nonincludible U.S. entities whose income (loss) is reported on the attached schedule that are not reportable on Part I, line 8, the net amounts of all such consolidation and elimination entries must be reported on a separate line on the attached schedule, so that the separate financial accounting income (loss) of each nonincludible U.S. entity remains separately stated. For example, if the net income (after consolidation and elimination entries) of a nonincludible U.S. sub-consolidated group is being reported on line 6a, the attached supporting schedule should report the income (loss) of each separate nonincludible U.S. legal entity from each such entity's own financial accounting net income statement or books and records, and any consolidation or elimination entries (for intercompany dividends, minority interests, etc.) not reportable on Part I, line 8, should be reported on the attached supporting schedule as a net amount on a line separate and apart from lines that report each nonincludible U.S. entity's separate net income (loss).

Lines 7a, 7b, and 7c. Net Income (Loss) of other Foreign Disregarded Entities, Net Income (Loss) of Other Disregarded Entities (Except Qualified Subchapter S Subsidiaries), and Net Income (Loss) of Other Qualified Subchapter S Subsidiaries (QSubs)

Include on line 7a the financial income of any foreign disregarded entity that is not included on Part 1 line 4a, but is included in Part I, line 11 (other foreign disregarded entities). Include on line 7b or 7c the financial net income or (loss) of each disregarded entity in the U.S. tax return that is not included in the consolidated financial group and therefore not included in the income reported on Part I, line 4a. Include on line 7b the financial income of any U.S. disregarded entity that is not a qualified subchapter S subsidiary (QSub) or a foreign disregarded entity and that is not included in the income reported on Part I, line 4a, but is included in Part I, line 11 (other disregarded entities). Include on line 7c the financial income of any QSub that is not included in the income reported on line 4a, but is included on line 11 (other QSub). In addition, on Part I, line 8, adjust for consolidation eliminations and correct for minority interest and intercompany dividends for any other disregarded entity or other QSub.

Attach a supporting schedule that provides the name, EIN, and net income (loss) per the financial statement or books and records on this line 7 for each separate other disregarded entity or other QSub. Also state the total assets and total liabilities for each such separate included entity and include those assets and liabilities amounts in the total assets and total liabilities reported on Part I line 12d. The amounts of income (loss) detailed on the supporting schedule should be reported for each separate other disregarded entity or other QSub without regard to the effect of consolidation or elimination entries solely between or among the entities listed. If there are consolidation or elimination entries relating to such other disregarded entities or other QSub whose income (loss) is reported on the attached schedule that are not reportable on Part I, line 8, the net amounts of all such consolidation and elimination entries must be reported on a separate line on the attached schedule, so that the separate financial accounting income (loss) of each other disregarded entity or other QSub remains separately stated. For example, if the net income (after consolidation and elimination entries) of a sub-consolidated group of other disregarded entities is being reported on line 7b, the attached supporting schedule should report the income (loss) of each separate other disregarded entity from each entity's own financial accounting net income statement or books and records, and any consolidation or elimination entries (for intercompany dividends, minority interests, etc.) not reportable on Part I, line 8, should be reported on the attached supporting schedule as a net amount on a line separate and apart from lines that report each other disregarded entity's separate net income (loss).

Line 8. Adjustment to Eliminations of Transactions Between Includible Entities and Nonincludible Entities

Adjustments on Part I, line 8, to reverse certain financial accounting consolidation or elimination entries are necessary to ensure that transactions between includible entities and nonincludible U.S. or foreign entities are not eliminated, in order to report the correct total amount on Part I, line 11. Also, additional consolidation entries and elimination entries may be necessary on Part I, line 8, related to transactions between includible entities that are in the consolidated financial group and other disregarded entities and QSubs that are not in the consolidated financial group but that are reported on Part I, line 7a, 7b, or 7c, in order to report the correct total amount on Part I, line 11.

Include on Part I, line 8, the total of the following: (a) amounts of any adjustments to consolidation entries and elimination entries that are contained in the amount reported on Part I, line 4a, required as a result of removing amounts on Part I, line 5 or 6; and (b) amounts of any additional consolidation entries and elimination entries that are required as a result of including amounts on Part I, line 7a, 7b, or 7c. This is necessary in order that the consolidation entries and intercompany elimination entries included in the amount reported on Part I, line 11, are only those applicable to the financial net income (loss) of includible entities for the financial statement period. For example, adjustments must be reported on line 8 to remove minority interest and to reverse the elimination of intercompany dividends included on Part I, line 4a, that relate to the net income of entities removed on Part I, line 5 or 6, because the income to which the consolidation or elimination entries relate has been removed. Also, for example, consolidation or elimination entries must be reported on line 8 to eliminate any intercompany dividends between entities whose income is included on Part I, line 7a, 7b, or 7c, and other entities included in the U.S. income tax return. See Examples 3A, 3B, and 4 in the instructions for line 11.

If a corporate owner of an interest in another entity: (a) accounts for the interest in entity in the owner corporation's separate general ledger on the equity method, and (b) fully consolidates entity in the owner corporation's consolidated financial statements, but entity is not includible in the owner corporation's U.S. income tax return, then, as part of reversing all consolidation and elimination entries for the nonincludible entity, the corporate owner must reverse on Schedule M-3, Part I, line 8, the elimination of the equity income inclusion from entity. If the owner corporation does not account for entity on the equity method on its own general ledger, it will not have eliminated the equity income for consolidated financial statement purposes, and therefore will have no elimination of equity income to reverse.

The attached supporting schedule for Part I, line 8, must identify the type (for example, minority interest, intercompany dividends, etc.) and amount of consolidation or elimination entries reported, as well as the names of the entities to which they pertain. It is not necessary, but it is permitted, to report intercompany eliminations that net to zero on Part I, line 8, such as intercompany interest income and expense.

Line 9. Adjustment To Reconcile Income Statement Period to Tax Year

Include on line 9 any adjustments necessary to the income (loss) of includible entities to reconcile differences between the corporation's income statement period reported on line 2 and the corporation's tax year. Attach a schedule describing the adjustment.

Line 10. Other Adjustments To Reconcile to Amount on Line 11

Include on line 10 any other adjustments to reconcile net income (loss) on Part I, line 4a, through Part I, line 9, with net income (loss) on Part I, line 11.

For any adjustments reported on Part I, line 10, attach a supporting schedule with an explanation of each net adjustment included on line 10.

Line 11. Net Income (Loss) per Income Statement of the Corporation

Report on line 11 the net income (loss) per the income statement (or books and records, if applicable) of the corporation. Amounts reported in column (a) of Parts II and III (see instructions below) must be reported on the same accounting method used to report the amount of net income (loss) per income statement of the corporation on Part I, line 11.

Do not, in any event, report on this line 11 the net income of entities not included in the 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, above, then to add back such income on lines 7 through 10, such that the amount reported at line 11 includes the net income of entities not includible in the 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 entities included in the 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 entities. If the corporation prepares unconsolidated financial statements using the same accounting method used to determine worldwide consolidated net income (loss) for Part I line 4a, and if it uses the equity method for investments, the amount reported on Part I line 11, will equal the amount of the unconsolidated net income (loss) reported on the unconsolidated financial statements. See Examples 3B.3 and 3B.4.

Example 3A. U.S. corporation P files a Form 1120S U.S. tax return and prepares certified audited income statements for GAAP. P owns 100% of the stock of U.S. corporations DS1 through DS75, between 51% and 99% of the stock of U.S. corporations DS76 through DS100, and 100% of the stock of foreign entities 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 DS76 through DS100 in financial statement consolidation entries.

P must check "Yes" on Part I, line 1a. On Part I, line 4a, P must report the consolidated net income 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, lines 5a or 5b, as applicable, and remove on Part I, lines 6a or 6b, as applicable, any net income (loss) from DS1 through DS75 where a QSub election has not been made by P. P must remove the net income (loss) before minority interests of DS76 through DS100 on Part I, lines 6a or 6b, as applicable. P must reverse on Part I, line 8, the elimination of any transactions between the includible entity (P and any QSubs) and the nonincludible entities (DS1 through DS75 with no QSub election, DS76 through DS100 and FS1 through FS50), including dividends received from non-QSub DS1 through DS75, DS76 through DS100, and FS1 through FS50 and the minority interest's share of the net income (loss) of DS76 through DS100.

P reports on Part I, line 11, the consolidated financial statement net income (loss) attributable to the corporation and QSubs. Intercompany transactions between the corporation and the QSubs 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 corporation 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 were reversed on line 8.

Example 3B.

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 at Part I, line 11, and on Part II, line 6, column (a). P's taxable dividend income from DS1 must be reported on Part II, line 6, 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 7, column (a). C's taxable income from N must be reported by C on Part II, line 7, 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 at Part I, line 11, and on Part II, line 5, column (a). P's taxable dividend income from its investment in DS1 must be reported on Part II, line 6, 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 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 7, column (a). C's taxable income from N must be reported by C on Part II, line 7, column (d).

Example 4. U.S. corporation P owns 100% of the stock of QSub corporation DS1. DS1 is included in P's federal 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 a QSub, 100% of the net income of both P and DS1 must be reported on Form 1120S of P's 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 at Part I, line 11, the following consolidation and elimination entries are reported on Part I, line 8: 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. The result is that Part I, line 11, reports $1,140: $1,040 from line 4a, and $100 from line 7c. 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. P's U.S. income tax group is not required to include on the attached supporting schedule for Part I, line 8, 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. Assets and liabilities reported on lines 12a through 12d must be reported as positive amounts.

On line 12a, enter the worldwide consolidated total assets and total liabilities of all of the entities included in computing 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

General Format of Parts II and III

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 total income (loss) on Form 1120S, Schedule K, line 18.

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

When To Complete Columns (a) and (d)

A corporation is not required to complete columns (a) and (d) of Parts II and III for the first tax year the corporation is required to file Schedule M-3. However, the corporation must complete columns (a) and (d) for all tax years subsequent to the first tax year the corporation is required to file Schedule M-3.

If, for any tax year (or tax years) prior to the first tax year a corporation is required to file Schedule M-3, a corporation voluntarily files Schedule M-3 instead of Schedule M-1, then in those voluntary filing years the corporation is not required to complete columns (a) and (d) of Parts II and III. In addition, in the first tax year the corporation is required to file Schedule M-3, the corporation is not required to complete columns (a) and (d) of Parts II and III.

If a corporation chooses not to complete columns (a) and (d) of Parts II and III in the first tax year the corporation is required to file Schedule M-3 (or in any year in which the corporation voluntarily files Schedule M-3), then Part II, line 26, is reconciled by the corporation in the following manner:

1. Report the amount from Part I, line 11, on Part II, line 26, column (a);
2. Leave blank Part II, lines 1 through 25, columns (a) and (d);
3. Leave blank Part III, columns (a) and (d); and
4. Report on Part II, line 26, column (d), the sum of Part II, line 26, columns (a), (b), and (c).

Note. Part II, line 26, column (d), must equal the amount on Form 1120S, Schedule K, line 18.

When To Complete Columns (b) and (c)

Columns (b) and (c) of Parts II and III must be completed for any tax year for which the corporation files Schedule M-3.

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).

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 total income (loss) 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 5. For the 2010, 2011, and 2012 tax years, corporation A has total assets on the last day of the tax year as reported on Schedule L, line 15, column (d), of $8 million, $11 million, and $12 million, respectively. A is required to file Schedule M-3 for its 2011 and 2012 tax years.

For A's 2011 tax year, the first tax year that A is required to file Schedule M-3, A is only required to complete Part I and columns (b) and (c) of Parts II and III.

For A's 2012 tax year, A is required to complete Schedule M-3 in its entirety.

Example 6. Corporation B is a U.S. corporation that files a U.S. tax return and prepares GAAP financial statements. In prior years, B acquired intellectual property (IP) and goodwill. 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 21, 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 19, 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

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 10, regardless of whether the amount would otherwise be reported on Part II or Part III of Schedule M-3. Thus, if a taxpayer is required to file Form 8886, Reportable Transaction Disclosure Statement, the amounts attributable to that reportable transaction must be reported on Part II, line 10.

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 total income (loss) 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 10. 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 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 11, 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 9, column (a), regardless of the government authority that imposed the fines or penalties, regardless of whether the fines or penalties are civil or criminal, 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 column (a) of Parts II and III 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 column (a) of Parts II and III 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 on Part III, line 25, in 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 9, 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 21.) If an income item is described in Part II, lines 1 through 21, 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 21, report and describe the entire amount of the item on Part II, line 22.

With limited exceptions, Part III includes lines for specific items of expense or deduction (expense items). (See Part III, lines 1 through 28.) If an expense item is described on Part III, lines 1 through 28, 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 28, report and describe the entire amount of the item on Part III, line 31.

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 21, or Part III, lines 1 through 28, report the entire amount of the item in columns (a) and (d) of Part II, line 25.

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. For further guidance about adequate disclosure, see Regulations section 1.6662-4(f). If a specific item of income, gain, loss, expense, or deduction is described on Part II, lines 7 through 21, or Part III, lines 1 through 28, and the line does not indicate to "attach schedule" or "attach details," and the specific instructions for the line do not call for an attachment of a schedule or statement, then the 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. See the instructions for Part II, lines 1 through 6, for specific additional information required to be provided for these particular lines.

Note. A schedule 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 schedule required to be attached, even if the amounts are below a certain dollar amount.

Required schedules for Part II, line 22, and Part III, line 31. A separate schedule must be attached to Schedule M-3 (Form 1120S) that includes a detailed description of each item and adjustment entered on Part II, line 22, and Part III, line 31.

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 22, or Part III, line 31.

Each description should adequately describe all four columns of Part II, line 22, or Part III, line 31. If additional information is required to provide an acceptable description, provide a supporting attachment.

Example 7. Corporation C is a calendar year taxpayer that placed in service ten depreciable fixed assets in 2005. C was required to file Schedule M-3 for its 2010 tax year and is required to file Schedule M-3 for its 2011 tax year. C's total depreciation expense for its 2011 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 2011 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 24, for its 2011 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 8. Corporation D is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax year and is required to file Schedule M-3 for its 2011 tax year. On December 31, 2011, 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 2011 financial statements but are not deductions for U.S. income tax purposes in 2011. 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 25, 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 schedule that supports the amounts at Part III, line 31.

D must also provide a description for each reserve that meets the requirements for Part III, line 31, discussed earlier under *Required schedules for Part II, line 22, and Part III, line 31.* 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 9. Corporation E is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax year and is required to file Schedule M-3 for its 2011 tax year. On January 2, 2011, E establishes an allowance for uncollectible accounts receivable (bad debt reserve) of $100,000. During 2011, E increased the reserve by $250,000 for additional accounts receivable that may become uncollectible. Additionally, during 2011 E decreases the reserve by $75,000 for accounts receivable that were discharged in bankruptcy during 2011. The balance in the reserve account on December 31, 2011, 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 2011 financial statements but are not deductible for U.S. income tax purposes in 2011. However, the $75,000 decrease to the reserve is deductible for U.S. income tax purposes in 2011. 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 25, for its 2011 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 10. Corporation F is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax year and is required to file Schedule M-3 for its 2011 tax year. During 2011, F incurs $200 of meals and entertainment expenses that F deducts in computing net income per the income statement. $50 of the $200 is subject to the 50% limitation under section 274(n). 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 8, F must report all of its meals and entertainment expenses on this line, regardless of whether there is a difference. Accordingly, F must report $200 in column (a), $25 in column (c), and $175 in column (d). F must not report the $150 of meals and entertainment expenses that are deducted in F's financial statement net income and are fully deductible for U.S. income tax purposes on Part II, line 25, Other items with no differences, and the $50 subject to the limitation under section 274(n) on Part III, line 8.

Part II. Reconciliation of Net Income (Loss) per Income Statement of the Corporation With Total Income (Loss) per Return

For any item reported on Part II, lines 1, and 3 through 5, attach a supporting schedule that provides 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 and 6, 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 or includible from foreign corporations on Part II, lines 2 through 4, 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 total income (loss) on Form 1120S, Schedule K, line 18, 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 dividends that were previously taxed and must be reported on Part II, line 4. (See the instructions below for Part II, lines 3 and 4.) Report withholding taxes on Part III, line 31, Other expense/deduction items with differences, or Part II, line 25, Other items with no difference, as applicable.

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 schedule (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 income under section 951 (relating to Subpart F), gains or other income inclusions resulting from elections under sections 1291(d)(2) and 1298(b)(1), and any amount included in income pursuant to section 1293 (relating to qualified electing funds). The amount of Subpart F income corresponds to the total of the amounts reported by the corporation on line 6, Schedule I, of all Forms 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations. The amount of qualified electing fund income corresponds to the total of the amounts reported by the corporation on line 3(a), Part II, of all Forms 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.

Also include on line 3 PFIC mark-to-market gains and losses under section 1296. Do not report such gains and losses on Part II, line 14.

Line 4. Gross Foreign Distributions Previously Taxed

Report on line 4, column (a), any distributions received from foreign corporations that were 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 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. Report withholding taxes on Part III, line 31, Other expense/deduction items with differences, or Part II, line 25, Other items with no differences, as applicable. Since previously taxed foreign distributions are not currently taxable, line 4, column (d) is shaded.

(Also, see instructions above for Part II, line 2.)

Line 5. Income (Loss) From Equity Method U.S. Corporations

Report on line 5, 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 6, dividends received from any U.S. corporation accounted for on the equity method.

Line 6. U.S. Dividends Not Eliminated in Tax Consolidation

Report on line 6, column (a), the amount of dividends included in Part I, line 11, that were received from any U.S. corporation. Report on line 6, column (d), the amount of any U.S. dividends included in total income (loss) on Form 1120S, Schedule K, line 18 (that is, taxable dividends received from any U.S. corporation that is not a QSub).

For any dividends included on Part II, line 6, 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 schedule for Part II, line 6, (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 7. Income (Loss) From U.S. Partnerships and Line 8. Income (Loss) From Foreign Partnerships

For any interest owned by the corporation 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 7 or 8, as described below.

1. In column (a), 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, 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), 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 each partnership reported on line 7 or 8, attach a supporting schedule that provides the name, 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 lines 7 or 8, as applicable.

Example 11. U.S. corporation H is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax year and is required to file Schedule M-3 for its 2011 tax year. 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 2011 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 7, $10,000 in column (a), a permanent difference of ($2,200) in column (c), and $7,800 in column (d).

Line 9. 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 7 or 8, as applicable) owned by the corporation (other than an interest in a disregarded entity), report the following on line 9:

1. In column (a), 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, the sum of all differences, if any, attributable to the pass-through entity; and
3. In column (d), the sum of all taxable amounts of income, gain, loss, or deduction reportable on the corporation's Schedules K-1 received from the pass-through entity (if applicable).

For each pass-through entity reported on line 9, attach a supporting schedule that provides that entity's name, 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 9, as applicable.

Line 10. Items Relating to Reportable Transactions

Any amounts attributable to any reportable transactions (as described in Regulations section 1.6011-4(b)) must be included on Part II, line 10, regardless of whether the difference, or differences, would otherwise be reported elsewhere in Part II or Part III. Thus, if a taxpayer is required to file Form 8886 for any reportable transaction described in Regulations section 1.6011-4(b), the amounts attributable to that reportable transaction must be reported on Part II, line 10. In addition, all income and expense amounts attributable to a reportable transaction must be reported on Part II, line 10, 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 10 if the corporation sequentially numbers each Form 8886 and lists by identifying number on the supporting schedule for Part II, line 10, each sequentially numbered reportable transaction and the amounts required for Part II, line 10, 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 schedule 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 10;
2. The name and reportable transaction or tax shelter registration number, if applicable, as reported on lines 1a and 1c, respectively, of Form 8886; and
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 also must 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 12. Corporation J is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax year and is required to file Schedule M-3 for its 2011 tax year. J incurred seven different abandonment losses during its 2011 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 10. The $12 million loss and the $5 million loss will be adequately disclosed if J attaches a supporting schedule for line 10 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 10, columns (a) through (d). Alternatively, J's disclosures will be adequate if the description provided for each loss on the supporting schedule includes the names and reportable transaction or 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 10, columns (a) through (d). J must report the losses attributable to the other five abandonment losses on Part II, line 21e, regardless of whether a difference exists for any or all of those abandonment losses.

Example 13. Corporation K is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax year and is required to file Schedule M-3 for its 2011 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 2011 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 10, 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 schedule for line 10 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 10, columns (a) through (d). Alternatively, the transaction will be adequately disclosed if the supporting statement for line 10 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 11. Interest Income

Report on Part II, line 11, column (a), the total amount of interest income included on Part I, line 11, and report on Part II, line 11, column (d), the total amount of interest income included on Form 1120S, Schedule K, line 18, that is not required to be reported elsewhere on Schedule M-3. In columns (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 16, should be made in columns (b) and (c) of this line 11.

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 11, columns (a) through (d), as applicable. Attach Form 8916-A.

Do not report on this line 11 or include on Form 8916-A amounts reported in accordance with instructions for Part II, lines 7, 8, 9, 10, and 20.

Line 12. 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 10, the corporation must report on Part II, line 12, 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 24).

Example 14. Corporation L is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax year and is required to file Schedule M-3 for its 2011 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, 2011, 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, 2011, L reported financial statement depreciation expense of $15,000 and depreciation for U.S. income tax purposes of $25,000. For L's 2011 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 12. As a result, L must report on Part II, line 12, $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 17, Current year acquisition and reorganization of 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 24, Depreciation, and report $15,000 in column (a), $10,000 in column (b), and $25,000 in column (d).

Line 13. Hedging Transactions

Report on line 13, column (a), the net gain or loss from hedging transactions included on Part I, line 11. Report in column (d) the amount of income (loss) 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 still is a valid hedge under section 1221(b)(2), the difference must be reported on line 13. 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 13 and not on Part II, line 14.

Report any gain or loss from inventory hedging transactions on line 13 and not on Part II, line 15.

Line 14. Mark-to-Market Income (Loss)

Report on line 14 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" are 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 13, Hedging transactions, and not on line 14.

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 14, of Schedule M-3 (Form 1120S); (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 21d, of Schedule M-3 (Form 1120S), unless the instructions for Schedule M-3 require the amounts to be reported on another line.

Line 15. Cost of Goods Sold

Report on line 15 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 15, columns (a) through (d), as applicable. Attach Form 8916-A.

Note. The entries in columns (a) and (d) of Schedule M-3, line 15, are negative amounts.

Do not report the following on line 15 or on Form 8916-A.

- Amounts reportable on Part II, line 10.
- Any gain or loss from inventory hedging transactions reportable on Part II, line 13.
- Amounts reportable on Part II, line 16.
- Amounts reportable on Part II, line 19.
- Mark-to-market income or (loss) associated with the inventories of dealers in securities under section 475 reportable on Part II, line 14.
- Section 481(a) adjustments related to cost of goods sold or inventory valuation reportable on Part II, line 17.
- Fines and penalties reportable on Part III, line 9.
- Judgments, damages, awards, and similar costs, reportable on Part III, line 10.
- Amounts included on Part III, line 28.

Example 15. Corporation C is a calendar year taxpayer that placed in service ten depreciable fixed assets in 2005. C was required to file Schedule M-3 for its 2010 tax year and is required to file Schedule M-3 for its 2011 tax year. C's total depreciation expense for its 2011 tax year for five of the assets is $50,000 for financial accounting purposes and $70,000 for U.S. income tax purposes. C's total annual depreciation expense for its 2011 tax year for the other five assets is $40,000 for financial accounting purposes and $30,000 for U.S. income tax purposes. In addition, C incurs $200 of meals and entertainment expenses that C deducts in computing net income for financial accounting purposes. All $200 of the meals and entertainment expenses is subject to the 50% limitation under section 274(n). In its financial statements, C treats the $50,000 depreciation and $100 of the meals and entertainment as other costs in computing cost of goods sold. C must include on Form 8916-A and on Schedule M-3, Part II, line 15, in column (a), the $50,000 of depreciation and $100 of meals and entertainment. C must also include a temporary difference of $20,000 in column (b), a permanent difference of ($50) in column (c), and $70,050 in column (d) ($70,000 depreciation and $50 meals and entertainment expenses). In addition, C must report on Part III, line 24, for its 2011 tax year income statement, depreciation expense of $40,000 in column (a), a temporary difference of ($10,000) in column (b), and $30,000 in column (d); and on Part III, line 8, meals and entertainment expense of $100 in column (a), a permanent difference of ($50) in column (c), and $50 in column (d). All other cost of goods sold items would be added to the amounts included on Part II, line 15, detailed in this example and reported on Form 8916-A and on Part II, line 15, in the appropriate columns.

Line 16. Sale Versus Lease (for Sellers and/or Lessors)

Also see the instructions at Part III, line 28, Purchase Versus Lease (for Purchasers and/or Lessees).

Asset transfer transactions with periodic payments characterized for financial accounting purposes as either a sale or a lease may, under some circumstances, be characterized as the opposite for tax purposes. If the transaction is treated as a lease, the seller/lessor reports the periodic payments as gross rental income and also reports depreciation expense or deduction. If the transaction is treated as a sale, the seller/lessor reports gross profit (sale price less cost of goods sold) from the sale of assets and reports the periodic payments as payments of principal and interest income.

On Part II, line 16, column (a), report the gross profit or gross rental income for financial accounting purposes for all sale or lease transactions that must be given the opposite characterization for U.S. income tax purposes. On Part II, line 16, column (d), report the gross profit or gross rental income for federal income tax purposes. Interest income amounts for such transactions must be reported on Part II, line 11, in column (a) or (d), as applicable. Depreciation expense for such transactions must be reported on Part III, line 24, in column (a) or (d), as applicable. Use columns (b) and (c) of Part II, lines 11 and 16, and Part III, line 24, as applicable to report the differences between column (a) and (d).

Example 16. Corporation M sells and leases property to customers. M is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax year and is required to file Schedule M-3 for its 2011 tax year. For financial accounting purposes, M accounts for each transaction as a sale. For U.S. income tax purposes, each of M's transactions must be treated as a lease. In its financial statements, M treats the difference in the financial accounting and the U.S. income tax treatment of these transactions as temporary. During 2011, M reports in its financial statements $1,000 of sales and $700 of cost of goods sold with respect to 2011 lease transactions. M receives periodic payments of $500 in 2011 with respect to these 2011 transactions and similar transactions from prior years and treats $400 as principal and $100 as interest income. For financial accounting purposes, M reports gross profit of $300 ($1,000 − $700) and interest income of $100 from these transactions. For U.S. income tax purposes, M reports $500 of gross rental income (the periodic payments) and (based on other facts) $200 of depreciation deduction on the property. On its 2011 Schedule M-3, M must report on Part II, line 11, $100 in column (a), ($100) in column (b), and zero in column (d). In addition, M must report on Part II, line 16, $300 of gross profit in column (a), $200 in column (b), and $500 of gross rental income in column (d). Lastly, M must report on Part III, line 24, $200 in column (b) and (d).

Line 17. Section 481(a) Adjustments

With the exception of a section 481(a) adjustment that is required to be reported on Part II, line 10, for reportable transactions, any difference between an income or expense item attributable to an authorized (or unauthorized) change in method of accounting made for U.S. income tax purposes that results in a section 481(a) adjustment must be reported on Part II, line 17, regardless of whether a separate line for that income or expense item exists in Part II or Part III.

Example 17. Corporation N is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax year and is required to file Schedule M-3 for its 2011 tax year. N was depreciating certain fixed assets over an erroneous recovery period and, effective for its 2011 tax year, N receives IRS consent to change its method of accounting for the depreciable fixed assets and begins using the proper recovery period. The change in method of accounting results in a positive section 481(a) adjustment of $100,000 that is required to be spread over four tax years, beginning with the 2011 tax year. In its financial statements, N treats the section 481(a) adjustment as a temporary difference. N must report on Part II, line 17, $25,000 in columns (b) and (d) for its 2011 tax year and each of the subsequent three tax years (unless N is otherwise required to recognize the remainder of the 481(a) adjustment earlier). N must not report the section 481(a) adjustment on Part III, line 24.

Line 18. Unearned/Deferred Revenue

Report on line 18, column (a), amounts of revenues included in Part I, line 11, that were deferred from a prior financial accounting year. Report on line 18, column (d), amounts of revenues recognizable for U.S. income tax purposes in the current tax year that are recognized for financial accounting purposes in a different year. Also report on line 18, column (d), any amount of revenues reported on line 18, column (a), that are recognizable for U.S. income tax purposes in the current tax year. Use columns (b) and (c) of line 18, as applicable, to report the differences between column (a) and (d).

Line 18 must not be used to report income recognized from long-term contracts. Instead, use line 19.

Line 19. Income Recognition From Long-Term Contracts

Report on line 19 the amount of net income or loss for financial statement purposes (or books and records, if applicable) or U.S. income tax purposes for any contract accounted for under a long-term contract method of accounting.

Line 20. Original Issue Discount and Other Imputed Interest

Report on line 20 any amounts of original issue discount (OID) and other imputed interest. The term “original issue discount and other imputed interest” includes, but is not limited to:

1. The excess of a debt instrument’s stated redemption price at maturity over its issue price, as determined under section 1273;
2. Amounts that are imputed interest on a deferred sales contract under section 483;
3. Amounts treated as interest or OID under the stripped bond rules under section 1286; and
4. Amounts treated as OID under the below-market interest rate rules under section 7872.

Line 21a. Income Statement Gain/Loss on Sale, Exchange, Abandonment, Worthlessness, or Other Disposition of Assets Other Than Inventory and Pass-Through Entities

Report on line 21a, column (a), all gains and losses on the disposition of assets except for (a) gains and losses on the disposition of inventory, and (b) gains and losses allocated to the corporation from a pass-through entity (for example, on Schedule K-1) that are included in the net income (loss) of the corporation reported on Part I, line 11. Reverse the amount reported in column (a) in column (b) or (c), as applicable. The corresponding gains and losses for U.S. income tax purposes are reported on Part II, lines 21b through 21g, as applicable.

Line 21b. Gross Capital Gains From Schedule D, Excluding Amounts From Pass-Through Entities

Report on line 21b gross capital gains reported on Schedule D (Form 1120S), Capital Gains and Losses and Built-in Gains, excluding capital gains from pass-through entities, which must be reported on Part II, lines 7, 8, or 9, as applicable.

Line 21c. Gross Capital Losses From Schedule D, Excluding Amounts From Pass-Through Entities, Abandonment Losses, and Worthless Stock Losses

Report on line 21c gross capital losses reported on Schedule D (Form 1120S), excluding capital losses from (a) pass-through entities, which must be reported on Part II, lines 7, 8, or 9, as applicable; (b) abandonment losses, which must be reported on Part II, line 21e; and (c) worthless stock losses, which must be reported on Part II, line 21f.

Line 21d. Net Gain/Loss Reported on Form 4797, Line 17, Excluding Amounts From Pass-Through Entities, Abandonment Losses, and Worthless Stock Losses

Report on line 21d the net gain or loss reported on line 17 of Form 4797, Sales of Business Property, excluding amounts from (a) pass-through entities, which must be reported on Part II, lines 7, 8, or 9, as applicable; (b) abandonment losses, which must be reported on Part II, line 21e; and (c) worthless stock losses, which must be reported on Part II, line 21f. The amount reported on line 21d is the amount that would have been carried to line 17 of Form 4797 in the case of a corporation that is not an S corporation.

Note. Traders in securities or commodities that have made a valid election under section 475(f) to use the mark-to-market method to account for securities or commodities, see the instructions for Part II, line 14, earlier.

Line 21e. Abandonment Losses

Report on line 21e any abandonment losses, regardless of whether the loss is characterized as an ordinary loss or a capital loss.

Line 21f. Worthless Stock Losses

Report on line 21f any worthless stock loss, regardless of whether the loss is characterized as an ordinary loss or a capital loss. Attach a schedule that separately states and adequately discloses each transaction that gives rise to a worthless stock loss and the amount of each loss.

Line 21g. Other Gain/Loss on Disposition of Assets Other Than Inventory

Report on line 21g any gains or losses from the sale or exchange of property other than inventory that are not reported on lines 21b through 21f.

Line 22. Other Income (Loss) Items With Differences

Separately state and adequately disclose on Part II, line 22, all items of income (loss) with differences that are not otherwise listed on Part II, lines 1 through 21. Attach a schedule that itemizes the type of income (loss) and the amount of each item and provides a description that states the income (loss) name for book purposes for the amount recorded in column (a) and describes the adjustment being recorded in column (b) or (c). The entire description completes the tax description for the amount included in column (d) for each item separately stated on this line.

The attached schedule should have five columns. The first column has the description for the next four columns. The second column is column (a) income (loss) per income statement, third column is column (b) temporary difference, the fourth column is column (c) permanent difference, and the fifth column is column (d) income (loss) per tax return. Every item listed on the attached schedule for line 22 must always have columns (a) + (b) + (c) = (d). Each item with amounts in columns (a), (b), (c), and (d) will be totaled and included as one line on line 22.

If any "comprehensive income" as defined by Statement of Financial Accounting Standards (SFAS) No. 130 is reported on this line, describe the item(s) in detail. Examples of sufficiently detailed descriptions include "Foreign currency translation adjustments—comprehensive income" and "Gains and losses on available-for-sale securities—comprehensive income."

Line 23. Total Income (Loss) Items

Combine lines 1 through 22 and enter the total on line 23.

Note. Line 15, Cost of goods sold, columns (a) and (d), are negative amounts which will affect the totals entered on line 23.

Line 24. Total Expense/ Deduction Items

Report on Part II, line 24, columns (a) through (d), as applicable, the negative of the amounts reported on Part III, line 32, columns (a) through (d). For example, if Part III, line 32, column (a), reflects an amount of $1 million, then report on Part II, line 24, column (a), ($1 million). Similarly, if Part III, line 32, column (b), reflects an amount of ($50,000), then report on Part II, line 24, column (b), $50,000.

Line 25. Other Items With No Differences

If there is no difference between the financial accounting amount and the taxable amount of an entire item of income, gain, loss, expense, or deduction and the item is not described or included in Part II, lines 1 through 22, or Part III, lines 1 through 31, report the entire amount of the item in columns (a) and (d) of line 25. If a portion of an item of income, loss, expense, or deduction has a difference and a portion of the item does not have a difference, do not report any portion of the item on line 25. Instead, report the entire amount of the item (that is, both the portion with a difference and the portion without a difference) on the applicable line of Part II, lines 1 through 22, or Part III, lines 1 through 31. See *Example 10*, earlier.

Line 26. Reconciliation Totals

If a corporation chooses not to complete columns (a) and (d) of Parts II and III in the first tax year the corporation is required to file Schedule M-3 (or for any year in which the corporation voluntarily files Schedule M-3), Part II, line 26, is reconciled by the corporation in the following manner:

1. Report the amount from Part I, line 11, on Part II, line 26, column (a);
2. Leave blank Part II, lines 1 through 25, columns (a) and (d);
3. Leave blank Part III, columns (a) and (d); and
4. Report on Part II, line 26, column (d), the sum of Part II, line 26, columns (a), (b), and (c).

Part III. Reconciliation of Net Income (Loss) per Income Statement of the Corporation With Total Income (Loss) per Return—Expense/ Deduction Items

Note. Expense amounts that reduce financial accounting income must be reported on Part III, column (a), as positive amounts. Deduction amounts that reduce taxable income must be reported on Part III, column (d), as positive amounts. Amounts reported on Part II, line 24, must be the negative of the amounts reported on Part III, line 32.

Lines 1 Through 6. Income Tax Expense

If the corporation does not distinguish between current and deferred income tax expense in its financial statements (or its books and records, if applicable), report income tax expense as current income tax expense using lines 1, 3, and 5, as applicable.

Line 7. Equity-Based Compensation

Report on line 7 any amounts for equity-based compensation or consideration that are reflected as expense for financial accounting purposes (column (a)) or deducted in the U.S. income tax return (column (d)) other than amounts reportable elsewhere on Schedule M-3, Parts II and III. Examples of amounts reportable on line 7 include payments attributable to stock options (including incentive stock options and nonqualified stock options), employee stock purchase plans (ESPPs), phantom stock options, phantom stock units, stock warrants, stock appreciation rights, and restricted stock, regardless of whether such payments are made to employees or non-employees, or as payment for property or compensation for services.

Line 8. Meals and Entertainment

Report on line 8, column (a), any amounts paid or accrued by the corporation during the tax year for meals, beverages, and entertainment that are accounted for in financial accounting income, regardless of the classification, nomenclature, or terminology used for such amounts, and regardless of how or where such amounts are classified in the corporation's financial income statement or the income and expense accounts maintained in the corporation's books and records. Report only amounts not otherwise reportable elsewhere on Schedule M-3, Parts II and III (for example, Part II, line 15).

Line 9. Fines and Penalties

Report on line 9 any fines or similar penalties paid to a government or other authority for the violation of any law for which fines or penalties are assessed. All fines and penalties expensed in financial accounting income (paid or accrued) must be included on this line 9, column (a), regardless of the government or other authority that imposed the fines or penalties, regardless of whether the fines and penalties are civil or criminal, regardless of the classification, nomenclature, or terminology used for the fines or penalties by the imposing authority in its actions or documents, and regardless of how or where the fines or penalties are classified in the corporation's financial income statement or the income and expense accounts maintained in the corporation's books and records. Also report on line 9, column (a), the reversal of any overaccrual of any amount described in this paragraph. See section 162(f) for additional guidance.

Report on line 9, column (d), any such amounts as described in the preceding paragraph that are includible in taxable income, regardless of the financial accounting period in which such amounts were or are included in financial accounting net income. Complete columns (b) and (c) as appropriate.

Do not report on this Part III, line 9, amounts required to be reported in accordance with instructions for Part III, line 10.

Do not report on this Part III, line 9, amounts recovered from insurers or any other indemnitors for any fines and penalties described above.

Line 10. Judgments, Damages, Awards, and Similar Costs

Report on line 10, column (a), the amount of any estimated or actual judgments, damages, awards, settlements, and similar costs, however named or classified, included in financial accounting income, regardless of whether the amount deducted was attributable to an estimate of future anticipated payments or actual payments. Also report on line 10, column (a), the reversal of any overaccrual of any amount described in this paragraph.

Report on line 10, column (d), any such amounts as are described in the preceding paragraph that are includible in taxable income, regardless of the financial accounting period in which such amounts were or are included in financial accounting net income. Complete columns (b) and (c) as appropriate.

Do not report on this Part III, line 10, amounts required to be reported in accordance with instructions for Part III, line 9.

Do not report on this Part III, line 10, amounts recovered from insurers or any other indemnitors for any judgments, damages, awards, or similar costs described above.

Line 11. Pension and Profit-Sharing

Report on line 11 any amounts attributable to the corporation's pension plans, profit-sharing plans, and any other retirement plans.

Line 12. Other Post-Retirement Benefits

Report on line 12 any amounts attributable to other post-retirement benefits not otherwise includible on Part III, line 11 (for example, retiree health and life insurance coverage, dental coverage, etc.).

Line 13. Deferred Compensation

Report on line 13, column (a), any compensation expense included in the net income (loss) amount reported in Part I, line 11, that is not deductible for U.S. income tax purposes in the current tax year and that was not reported elsewhere on Schedule M-3, column (a). Report on line 13, column (d), any compensation deductible in the current tax year that was not included in the net income (loss) amount reported in Part I, line 11, for the current tax year and that is not reportable elsewhere on Schedule M-3. For example, report originations and reversals of deferred compensation subject to section 409A on line 13.

Line 15. Charitable Contribution of Intangible Property

Report on line 15 any charitable contribution of intangible property, for example, contributions of:

- Intellectual property, patents (including any amounts of additional contributions allowable by virtue of income earned by donees subsequent to the year of donation), copyrights, trademarks;
- Securities (including stocks and their derivatives, stock options, and bonds);
- Conservation easements (including scenic easements or air rights);
- Railroad rights of way;
- Mineral rights; and
- Other intangible property.

Line 16. Current Year Acquisition or Reorganization Investment Banking Fees

Report on line 16 any investment banking fees paid or incurred in connection with a taxable or tax-free acquisition of property (for example, stock or assets) or a tax-free reorganization. Report on this line any investment banking fees incurred at any stage of the acquisition or reorganization process including, for example, fees paid or incurred to evaluate whether to investigate an acquisition, fees to conduct an actual investigation, and fees to consummate the acquisition. Also include on this line 16 investment banking fees incurred in connection with the liquidation of a subsidiary, a spin-off of a subsidiary, or an initial public stock offering.

Line 17. Current Year Acquisition or Reorganization Legal and Accounting Fees

Report on line 17 any legal and accounting fees paid or incurred in connection with a taxable or tax-free acquisition of property (for example, stock or assets) or tax-free reorganization. Report on this line any legal and accounting fees incurred at any stage of the acquisition or reorganization process including, for example, fees paid or incurred to evaluate whether to investigate an acquisition, fees to conduct an actual investigation, and fees to consummate the acquisition. Also include on this line legal and accounting fees incurred in connection with the liquidation of a subsidiary, a spin-off of a subsidiary, or an initial public stock offering.

Line 18. Current Year Acquisition/Reorganization Other Costs

Report on line 18 any other fees paid or incurred in connection with a taxable or tax-free acquisition of property (for example, stock or assets) or a tax-free reorganization not otherwise reportable on Schedule M-3 (for example, Part III, line 16 or 17). Report on this line any fees paid or incurred at any stage of the acquisition or reorganization process including, for example, fees paid or incurred to evaluate whether to investigate an acquisition, fees to conduct an actual investigation, and fees to consummate the acquisition. Also include on this line other acquisition/reorganization costs incurred in connection with the liquidation of a subsidiary, a spin-off of a subsidiary, or an initial public stock offering.

Line 19. Amortization/ Impairment of Goodwill

Report on line 19 amortization of goodwill or amounts attributable to the impairment of goodwill.

Line 20. Amortization of Acquisition, Reorganization, and Start-Up Costs

Report on line 20 amortization of acquisition, reorganization, and start-up costs. For purposes of columns (b), (c), and (d), include amounts amortizable under section 167, 195, or 248.

Line 21. Other Amortization or Impairment Write-Offs

Report on line 21 any amortization or impairment write-offs not otherwise includible on Schedule M-3.

Line 22. Section 198 Environmental Remediation Costs

Report on line 22, column (a), any amounts attributable to environmental remediation costs included on Part I, line 11. Report in columns (b), (c), and (d), as applicable, any deductible amounts attributable to environmental remediation costs described in section 198 that are paid or incurred during the current tax year.

Line 23a. Depletion—Oil & Gas

Report on line 23a, column (a), any oil and gas depletion included on Part I, line 11.

Line 23b. Depletion—Other than Oil & Gas

Report on line 23b any depletion expense/deduction other than oil and gas that is not required to be reported elsewhere on Schedule M-3 (for example, on Part II, line 7, 8, 9, or 15).

Line 24. Depreciation

Report on line 24 any depreciation expense that is not required to be reported elsewhere on Schedule M-3 (for example, on Part II, line 7, 8, 9, or 15).

Line 25. Bad Debt Expense

Report on line 25, column (a), any amounts attributable to an allowance for uncollectible accounts receivable or actual write-offs of accounts receivable included on Part I, line 11. Report in column (d) the amount of bad debt expense deductible for federal income tax purposes under section 166.

Line 26. Interest Expense

Report on Part III, line 26, column (a), the total amount of interest expense included on Part I, line 11, and report on Part III, line 26, column (d), the total amount of interest deduction included on Form 1120S, Schedule K, line 18, that is not required to be reported elsewhere on Schedule M-3. In columns (b) or (c), as applicable, include any adjustments for any amounts treated for U.S. income tax purposes as interest deduction that are treated as some other form of expense for financial accounting purposes, or vice versa. For example, adjustments to interest expense/deduction resulting from adjustments made in accordance with the instructions for Part III, line 28, Purchase versus lease (for purchasers and/or lessees), should be made in columns (b) and (c), as applicable, of this line 26.

Complete Part III of Form 8916-A. Enter the amounts from line 5, columns (a) through (d) of Form 8916-A, on Schedule M-3, Part III, line 26, columns (a) through (d), as applicable. Attach Form 8916-A.

Do not report on this Form 8916-A and line 26 amounts reported in accordance with the instructions for Part II, lines 7, 8, 9, and 10.

Line 27. Corporate Owned Life Insurance Premiums

Report on line 27 all amounts of insurance premiums attributable to any life insurance policy if the corporation is directly or indirectly a beneficiary under the policy or if the policy has a cash value. Report in column (d) the amount of the premiums that are deductible for federal income tax purposes.

Line 28. Purchase Versus Lease (for Purchasers and/or Lessees)

Note. Also see the instructions for sellers and/or lessors in the instructions for Part II, line 16.

Asset transfer transactions with periodic payments characterized for financial accounting purposes as either a purchase or a lease may, under some circumstances, be characterized as the opposite for tax purposes.

If a transaction is treated as a lease, the purchaser/lessee reports the periodic payments as gross rental expense. If the transaction is treated as a purchase, the purchaser/lessee reports the periodic payments as payments of principal and interest and also reports depreciation expense or deduction with respect to the purchased asset.

Report in column (a) gross rent expense for a transaction treated as a lease for financial accounting purposes but as a sale for U.S. income tax purposes. Report in column (d), gross rental deductions for a transaction treated as a lease for U.S. income tax purposes but as a purchase for financial accounting purposes. Report interest expense for such transactions on Part III, line 26, in column (a) or (d), as applicable. Report depreciation expense or deductions for such transactions on Part III, line 24, in column (a) or (d), as applicable. Use columns (b) and (c) of Part III, lines 24, 26, and 28, as applicable, to report the differences between column (a) and (d) for such recharacterized transactions.

Example 18. U.S. corporation X acquired property in a transaction that, for financial accounting purposes, X treats as a lease. X is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax year and is required to file Schedule M-3 for its 2011 tax year. Because of its terms, the transaction is treated for U.S. income tax purposes as a purchase and X must treat the periodic payments it makes partially as payment of principal and partially as payment of interest. In its financial statements, X treats the difference between the financial accounting and U.S. income tax treatment of this transaction as a temporary difference. During 2011, X reports in its financial statements $1,000 of gross rental expense that, for U.S. income tax purposes, is recharacterized as a $700 payment of principal and a $300 payment of interest, accompanied by a depreciation deduction of $1,200 (based on other facts). On its 2011 Schedule M-3, X must report the following on Part III, line 28: column (a), $1,000, its financial accounting gross rental expense; column (b), ($1,000); and column (d), zero. On Part III, line 26, X reports zero in column (a) and $300 in columns (b) and (d) for the interest deduction. On Part III, line 24, X reports zero in column (a) and $1,200 in columns (b) and (d) for the depreciation deduction.

Line 29. Research and Development Costs

Report in column (a) the amount of expenses included in net income reported on Part I, line 11, that are related to research and development expense. Report in column (d) the amount of deductions included in Form 1120S, line 21, and/or separately reported on Form 1120S, Schedule K, that are recognized and reported as Section 174 research and experimental expenditures consistent with the corporation's adopted method of accounting for such expenditures. In column (c), as applicable, include any adjustments for any amounts treated for U.S. income tax purposes as research or experimental expenditures that are treated as some other form of expense for financial accounting purposes, or vice versa. Report any difference in timing recognition in column (b). For example, if the taxpayer's financial accounting method does not specify otherwise, column (b) adjustments include adjustments for timing differences between financial and tax accounting for: (1) deferral and amortization of research expenditures, (2) reduction of section 174 expenditures under section 280C or section 482, (3) costs attributable to obtaining a patent, (4) research in social sciences, and (5) cost elements for property of a character subject to depreciation.

Section 174 provides two methods for the treatment of research and experimental expenditures paid or incurred by a taxpayer in connection with the taxpayer's trade or business. These expenditures may be treated as expenses not chargeable to a capital account and deducted in the year in which they are paid or incurred, or they may be deferred and amortized.

Example 19. Corporation X is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax return and is required to file Schedule M-3 for its 2011 tax year. During 2011, X incurred $100,000 of research and development costs that X recognized as an expense in its financial statements. Also, X incurred $20,000 in attorney fees in obtaining a patent application that X capitalized and amortized in its financial statements. X recognized a $2,000 amortization deduction. In compliance with its adopted method of accounting under section 174, X deducts research and experimental expenditures for U.S. income tax purposes. Accordingly, X must report $100,000 in column (a), $20,000 in column (b), and $120,000 in column (d). X must also report $2,000 in column (a), ($2,000) in column (b), and $0 in column (d) on Part III, line 21, Other amortization or impairment write-offs.

Example 20. Assume the same facts as Example 19 except Corporation X elected to capitalize and amortize its research and expenditures over 60 months with respect to all its research programs for U.S. tax purposes. X first realized benefits from such expenditures on August 1. Accordingly, X must report $100,000 in column (a), a temporary difference of ($90,000) ($20,000 less ($120,000/60 months X 55 months)) in column (b), and $10,000 in column (d).

Example 21. Corporation X is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax return and is required to file Schedule M-3 for its 2011 tax year. X adopted the current expense method for research and experimental expenditures for U.S. income tax purposes. During 2011, X incurred $50,000 of research and development costs that X recognized as an expense in its financial statements. Also, X undertook to develop a new machine for its business. X expended $30,000 on the project of which $10,000 represents actual costs of material, labor, and component cost to construct the machine, and $20,000 represents research costs not attributable to the machine itself. X capitalized all costs of $30,000 related to the machine and recognized $6,000 of depreciation expense in its financial statements. X's depreciation expense on the $10,000 of costs related to the machine itself was $2,000 for U.S. income tax purposes. Accordingly, X must report $50,000 in column (a), $20,000 (research costs which are not attributable to the machine itself) in column (b), and $70,000 in column (d). X must also report $6,000 in column (a), ($4,000) in column (b), and $2,000 in column (d) on Part III, line 24, Depreciation.

Example 22. Corporation X is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax return and is required to file Schedule M-3 for its 2011 tax year. During 2011, X incurred $10,000 of research and development costs related to social sciences that it recognized as an expense in its financial statements. X adopted the current expense method to research and experimental expenditures for U.S. income tax purposes. Because such costs are not allowable costs under section 174, X must report $10,000 in column (a), permanent difference ($10,000) in column (c), and $0 in column (d). If such costs are otherwise deductible for U.S. income tax purposes, X must report this item of expense on Part III, line 31, Other expense/deduction items with differences.

Example 23. Corporation X is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax return and is required to file Schedule M-3 for its 2011 tax year. During 2011, X paid $75,000 to acquire or in-license intangible assets under a collaborative arrangement with another company that X recognized as a research and development expense in its financial statements. X adopted the current expense method for research and experimental expenditures for U.S. income tax purposes. Because payments made to acquire rights to a product or technology are excluded costs from the definition of research and experimental expenditures, X must report $75,000 in column (a), ($75,000) in column (c), and $0 in column (d). X must report any amortization otherwise allowable related to the payments on Part III, line 21, Other amortization or impairment write-offs.

Example 24. Corporation X is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax return and is required to file Schedule M-3 for its 2011 tax year. X adopted the current expense method for research and experimental expenditures for U.S. income tax purposes. During 2011, X incurred $100,000 of research and development costs that X recognized as an expense for both financial accounting and U.S. income tax purposes. A portion of the expenses were credit eligible expenses, and X claimed a research credit of $1,000. X did not make the reduced credit election under section 280C. Accordingly, since X's financial accounting method does not specify otherwise, X must report $100,000 in column (a), ($1,000) (reduction of research and experimental expenditures to the extent of the credit amount) in column (b), and $99,000 in column (d).

Line 30. Section 118 Exclusion

Report on line 30 any inducements received in the current year and treated as contributions to the capital of a corporation by a non-shareholder. Report in column (a) any income amount as a negative number and any expense amount as a positive number.

Corporations must identify on an accompanying schedule referencing line 30 the fair market value of land or other property (including cash) provided to the corporation by any non-shareholder, including a governmental unit or civic group, as an inducement, or for any other purpose. Include inducements for the corporation to locate its business in a particular state, municipality, community, or locality for the purpose of enabling the corporation to expand its existing operating facilities, including corporate headquarters, distribution center(s), or factory(ies) ("inducements").

On the accompanying schedule also identify any inducements that include refundable or transferable tax credits, including transferable credits that were sold.

The schedule must separately state, adequately disclose, and identify all of the dollar amounts summarized by this line. An accompanying schedule is required even if there are no dollar amounts reported on line 30.

Line 31. Other Expense/ Deduction Items With Differences

Separately state and adequately disclose on Part III, line 31, all items of expense/deduction that are not otherwise listed on Part III, lines 1 through 30.

Attach a schedule that describes and itemizes the type of expense/deduction and the amount of each item, and provides a description that states the expense/deduction name for book purposes for the amount recorded in column (a) and describes the adjustment being recorded in column (b) or (c). The entire description completes the tax description for the amount included in column (d) for each item separately stated on this line.

The schedule of details attached to the Schedule M-3 for line 31 must separately state and adequately disclose the nature and amount of the expense related to each reserve and/or contingent liability. The appropriate level of disclosure depends upon each taxpayer's operational activity and the nature of its accounting records. For example, if a corporation's net income amount reported in the income statement includes anticipated expenses for a discontinued operation as a single amount, and its general ledger or other books, records, and work papers provide details for the anticipated expenses under more explanatory and defined categories such as employee termination costs, lease cancellation costs, loss on sale of equipment, etc., a supporting schedule that lists those categories of expenses and their details will satisfy the requirement to separately state and adequately disclose. In order to separately state and adequately disclose the employee termination costs, it is not required that an anticipated termination cost amount be listed for each employee, or that each asset (or category of asset) be listed along with the anticipated loss on disposition.

The attached schedule should have five columns. The first column has the description for the next four columns. The second column is column (a) expense per income statement, the third column is column (b) temporary difference, the fourth column is column (c) permanent difference, and the fifth column is column (d) deduction per tax return. Every item listed on the attached schedule for line 31 must always have columns (a) + (b) + (c) = (d). Each item with amounts in columns (a), (b), (c), and (d) will be totaled and included as one line on line 31.

Comprehensive income. If any "comprehensive income" as defined by SFAS No. 130 is reported on this line, describe the item(s) in detail as, for example, "Foreign currency translation adjustments—comprehensive income" and "Gains and losses on available-for-sale securities—comprehensive income."

Reserves and contingent liabilities. Report on line 31 amounts related to the change in each reserve or contingent liability that is not required to be reported elsewhere on Schedule M-3. For example: (1) amounts relating to changes in reserves for litigation must be reported on Part III, line 10, Judgments, damages, awards, and similar costs; and (2) amounts relating to changes in reserves for uncollectible accounts receivable must be reported on Part III, line 25, Bad debt expense. See *Example 8, Example 9,* and *Example 25.*

Report on line 31, the amortization of various items of prepaid expense, such as prepaid subscriptions and license fees, prepaid insurance, etc.

Report on line 31, column (a), expenses included in net income reported on Part I, line 11, that are related to reserves and contingent liabilities. Report on line 31, column (d), amounts related to liabilities for reserves and contingent liabilities that are deductible in the current tax year for U.S. income tax purposes. Examples of reserves that are allowed for book purposes, but not for tax purposes, include warranty reserves, restructuring reserves, reserves for discontinued operations, and reserves for acquisitions and dispositions. Only report on line 31 items that are not required to be reported elsewhere on Schedule M-3, Parts II and III.

Example 25. Corporation Q is a calendar year taxpayer that was required to file Schedule M-3 for its 2010 tax year and is required to file Schedule M-3 for its 2011 tax year. On July 1 of each year, Q has a fixed liability for its annual insurance premiums on its home office building that provides a 12-month coverage period beginning July 1 through June 30. In addition, Q historically prepays 12 months of advertising expense on July 1. On July 1, 2011, Q prepays its insurance premium of $500,000 and advertising expenses of $800,000. For financial accounting purposes, Q capitalizes and amortizes the prepaid insurance and advertising over 12 months. For U.S. income tax purposes, Q deducts the insurance premium when paid and amortizes the advertising over the 12-month period. In its financial statements, Q treats the differences attributable to the financial statement treatment and U.S. income tax treatment of the prepaid insurance and advertising as temporary differences.

Q also has a legal expense reserve where $300,000 was expensed for financial accounting purposes and a ($100,000) temporary difference was calculated to arrive at the income tax deduction of $200,000. The schedule attached to Q's return for Part III, line 31, must be separately stated and adequately disclosed as follows:

Description	Column (a) Expense per Income Statement	Column (b) Temporary Difference	Column (c) Permanent Difference	Column (d) Deduction per Tax Return
Prepaid insurance premium expensed not capitalized	$250,000	$250,000	-0-	$500,000
Legal expense reserve	$300,000	($100,000)	-0-	$200,000
Total line 31	$550,000	$150,000	-0-	$700,000

Line 32. Total Expense/ Deduction Items

Report on Part II, line 24, columns (a) though (d), as applicable, the negative of the amounts reported on Part III, line 32, columns (a) through (d), as applicable. Report positive amounts as negative and negative amounts as positive. For example, if Part III, line 32, column (a), reflects an amount of $1 million, then report on Part II, line 24, column (a), ($1 million). Similarly, if Part III, line 32, column (b), reflects an amount of ($50,000), then report on Part II, line 24, column (b), $50,000.