



SOCIETY OF ACTUARIES

Article from:

Taxing Times

December 2005 – Volume 1, No. 3

The Impact of IRS Schedule M-3 on Insurance Companies

by Amy C. Lewis and Ernest C. Ahtien

Year 2004 marked the first tax-filing year that certain corporate taxpayers were required to file the newly created IRS Schedule M-3—designed as a replacement for the Schedule M-1, which is used to reconcile a corporation's financial accounting income or loss with its taxable income or loss. The purpose of Schedule M-3 is to provide more transparency and consistency among taxpayers than Schedule M-1 in reporting differences in between financial accounting net income and taxable income. The IRS believes that Schedule M-3 will enable its agents to more effectively and efficiently identify returns and issues warranting examination.

Schedule M-3 is currently required for corporate taxpayers with assets of \$10 million or more that file Form 1120, U.S. Corporation Income Tax Return, for tax years ending on or after Dec. 31, 2004. Taxpayers who are required to file Schedule M-3 do so in lieu of Schedule M-1. In addition, the IRS plans to expand Schedule M-3 filing requirements to other taxpayers, including partnerships that file Form 1065, foreign corporations that file Form 1120-F, S corporations that file Form 1120-S, and insurance companies that file Form 1120-L and Form 1120-PC. Schedule M-3 and instructions are available on the IRS Web site at www.irs.gov.

As provided by the 2004 Schedule M-3 instructions, insurance companies are not required to file Schedule M-3 unless an insurance company is a member of a consolidated group whose parent corporation files a Form 1120 and is required to file Schedule M-3. Insurance companies who file as part of a consolidated return have the option of fully completing Schedule M-3 as if the insurance company filed an 1120, or by including the sum of all the differences between the insurance company's financial accounting net income and taxable income on a single line of the M-3, and adequately disclosing each difference in a supporting schedule. Due to the unique nature of some insurance company financial income to taxable income differences, such as differences in reserves, insurance companies may have difficulty correctly classifying certain differences on the current M-3 line items.

In June 2005, the Treasury Department and the IRS issued a draft version of the 2005 Schedule M-3 and related instructions for use by certain corporate taxpayers filing Form 1120. The 2005 Schedule M-3



instructions were not changed with regard to the requirements for insurance companies filing in a consolidated return with a parent company that files a Form 1120. When the Service finalizes and issues a Schedule M-3 for use with Forms 1120-PC and 1120-L, it is reasonable to assume that the instructions for the Form 1120 Schedule M-3 regarding this issue will also be changed.

The IRS announced in June that the planned effective date for Schedule M-3 for Forms 1065 and 1120-S was Dec. 31, 2006. However, at that time the Service planned to release Schedule M-3 for Forms 1120-PC and 1120-L in 2005, effective for tax years ending on or after Dec. 31, 2005. On Sept. 16, 2005, the Service announced that it was deferring the planned effective date for the Schedule M-3 for Forms 1120-PC and 1120-L to tax years ending on or after Dec. 31, 2006. As the purpose of Schedule M-3 is to increase transparency, insurance companies should be prepared to provide more detailed information related to the 2006 tax year on differences between financial statement income and taxable income than previously required by Schedule M-1.

To date, the IRS has not released a draft Schedule M-3 and instructions for Forms 1120-PC and 1120-L; however, the Service stated that the drafts would be released soon in the Sept. 16, 2005 press release. After the release of a draft form and instructions, the Service usually grants a 60-day comment period for public responses and questions on the drafts and then issues a revised form and instructions based on the comments. The release of the draft Schedule M-3 and related instructions will allow insurance companies to gain an understanding of the additional information that will be needed to complete the schedule for the 2006 tax year. ◀

Amy C. Lewis is manager with Ernst & Young's Lake Michigan Insurance Tax Practice in Chicago, Ill. She may be reached at Amy.Lewis@ey.com.

Ernest C. Ahtien is partner with Ernst & Young's Lake Michigan Insurance Tax Practice in Chicago, Illinois. He may be reached at ernest.achtien@ey.com.