



SOCIETY OF ACTUARIES

Article from:

# Taxing Times

September 2006 – Volume 2, No. 2

# The IRS Schedule M-3 for Insurance Companies

by Amy C. Lewis

Insurance companies will be required to file the Internal Revenue Service (IRS) Schedule M-3 for tax years ending on or after Dec. 31, 2006. Schedule M-3 was designed by the IRS 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 and to enable the IRS to more effectively and efficiently identify returns and issues warranting examination.

2004 marked the first tax filing year that certain corporate taxpayers were required to file the newly-created Schedule M-3. As provided by the 2004 Schedule M-3 instructions, insurance companies were not required to file Schedule M-3, unless an insurance company was a member of a consolidated group whose parent corporation filed a Form 1120 and was required to file Schedule M-3. Insurance companies who filed as part of a consolidated return had the option of fully completing Schedule M-3 as if the insurance company filed a Form 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.

On Dec. 13, 2005, the IRS released the first drafts of the 2006 Schedules M-3 and related instructions for corporations that file Forms 1120-PC and 1120-L, along with draft Schedules M-3 for partnerships and S-corporations. The original draft schedules and instructions for the Schedules M-3 for Form 1120-PC and 1120-L filers were based on the draft 2005 Schedule M-3 for Form 1120 filers and instructions released for comment by Treasury and the IRS on June 23, 2005.

After receiving comments on the first drafts, the IRS released revised draft Schedules M-3 and instructions for Forms 1120-PC and 1120-L in April 2006. In addition to the revised draft M-3s, the IRS also released a draft of a new Form 8916, "Reconciliation of Schedule M-3 Taxable Income with Tax Return Taxable Income for Mixed Groups," which is designed to provide a means for consolidating and reconciling taxable income for corporations that include both an insurance company and a non-insurance company, or two different types of insurance companies, such as life insurance and property and casualty insurance. The IRS

announced it was seeking comments regarding the revised draft M-3s, Form 8916, and related instructions through June 1, 2006. It is likely that the IRS will issue revised forms and instructions based on the comments received.

Once the IRS finalizes the new insurance Schedules M-3, the following corporations will be required to use Schedule M-3 for Forms 1120-PC or 1120-L in lieu of the previous Schedule M-1 or Schedule M-3 for Form 1120, beginning with tax years ending on or after Dec. 31, 2006:

- An insurance corporation filing a separate return with total assets of \$10 million or more;
- A consolidated return group with an insurance parent corporation, with total consolidated assets of \$10 million or more;
- Insurance subsidiaries that have been required to partially complete Schedule M-3 (Form 1120) because they are included in a Form 1120 consolidated return that is required to file Schedule M-3.

During the first year that taxpayers will be required to file these new insurance Schedules M-3, the reporting of detail for columns (a) and (d) of Parts II and III will be optional, as was the case with Schedule M-3 for first year Form 1120 filers. However, this will only apply to the

first two groups of corporations above; insurance subsidiaries included in a consolidated Form 1120 will be required to complete all columns of Parts II and III, as they were required to file Schedule M-3 in years prior to Dec. 31, 2006. The instructions also have been modified to clearly indicate that Schedule M-3 is required to be filed if the threshold amount is met, whether or not a consolidated return is filed.

Part I is the same for all three Schedules M-3. Several new lines were added in Parts II and III of each insurance Schedule M-3 to reflect insurance-specific income and expense items, such as premium income, tax reserves, policy acquisition costs, and the special loss discount account. Additionally, some lines were eliminated because they either do not apply to insurance corporations or are considered low risk items as to insurance corporations. Those items that the IRS considers to be of lower compliance risk are to be reported in sufficient detail in the supporting schedules for the "other" with differences lines.

While the Schedules M-3 are designed to present a more detailed reconciliation than the previous Schedule M-1, there may actually be less disclosure for some differences reported in columns (b) and (c) of Parts II and III than previously reported on Schedule M-1. For example, if an insurance corporation on its 2005 return reports three separately described adjustments associated with interest income on its Schedule M-1, to report those same adjustments on Schedule M-3 with a 2006 return, the amounts would be combined together and reported as a lump sum in columns (b) and/or (c) of Part II, line 13, with no detail or supporting schedule required. This result is true for many of the named lines on Schedule M-3; however, there are several lines that still require supporting schedules. The instructions provide that for these lines, such as for Part II, line 25, "Other income (loss) items with differences," each difference must be "separately stated and adequately disclosed." It is important to remember that for any line that does not require detail with the return, supporting information must still be available in the corporation's records so as to respond to examination or inquiry by the IRS.

The draft Schedules M-3 and Form 8916 deal with several previously unaddressed issues for corporate taxpayers who file a consolidated tax return that includes a combination of Forms 1120, 1120-PC, and/or 1120-L. Page 1 of the revised draft Schedule M-3 for Forms 1120, 1120-PC and 1120-L has a checkbox to indicate if a corporation is filing as part of a mixed group. Checkboxes have also been added at the top of pages 2 and 3 of the Schedule M-3s to indicate when

an M-3 is for a group sub-consolidation or elimination, as a separate group sub-consolidation is required for all Forms 1120, 1120-PC, 1120-L, within the mixed group.

The new Form 8916, allows a mixed group a means for consolidating and reconciling taxable income. The Form is designed to reconcile consolidated taxable income from the Schedule M-3 to taxable income reported on the consolidated tax return. Amounts to be reported on Form 8916 include such items as net operating loss deduction, dividends received deduction, special life deductions, and life/non-life loss limitations. Currently, the draft form and instructions require that any amounts reported as other adjustments require supporting schedule and short explanation of the amounts to be attached.

Even though insurance corporations will receive the benefit of knowledge learned from the experiences of C corporations in implementing Schedule M-3, they will still be faced with potentially significant upfront costs for implementation. Since the IRS is not requiring any new Schedules M-3 for years ended Dec. 31, 2005, giving all other LMSB taxpayers at least an additional year to prepare, it is unlikely the IRS will entertain deferral of the effective date for insurance corporations. Companies should plan for the additional amount of work and resources in connection with next year's implementation of new Schedules M-3.

Additionally, it seems likely that some changes will be made to Page 1 of Form 1120-L to allow for a subtotal of income before special deductions. In this way, the Schedule M-3 reconciliation total for Form 1120-L would be comparable to the reconciliation totals for Forms 1120-PC and 1120, which would aid in the preparation of a consolidated M-3 and reconciliation of taxable income for mixed filing groups.

The draft Schedules M-3, Form 8916 and instructions can be found in the business section of [www.irs.gov](http://www.irs.gov), on the Corporations page. The Web site also offers interested taxpayers a subscription to the Schedule M-3 e-mail news service so they can automatically receive future information about Schedule M-3. ◀

---

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](mailto:Amy.Lewis@ey.com).