

**2007**

**DRAFT**

# Instructions for Schedule M-3 (Form 1120-F)

## **Net Income (Loss) Reconciliation for Foreign Corporations with Reportable Assets of \$10 Million or More**

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

### **General Instructions**

#### **Purpose of Schedule**

Schedule M-3, Part I, determines, on an unconsolidated basis, the net income (loss) of the nonconsolidated foreign corporation that is filing Form 1120-F, U.S. Income Tax Return of a Foreign Corporation, Schedule M-3 Parts II and III reconcile this financial result with the corporation's effectively connected taxable income on Form 1120-F, page 3, line 29.

For purposes of this reconciliation, Part I, line 1, provides rules for determining the income statement(s) the taxpayer must use in reporting the net income (loss) to be reported on Part I, line 4. Part I, lines 5 through 10 then provide adjustments to include or exclude financial results to reconcile the income statement results reportable on Part I, line 4, to the foreign corporation's adjusted financial net income (loss) reportable on Part I, line 11.

For foreign corporations other than foreign banks, Part I, line 11, includes the worldwide net income (loss) of the nonconsolidated foreign corporation, adjusted for the results of excludible entities and includible disregarded entities. For foreign banks, Part I, line 11, is limited to the income (loss) derived from the same set(s) of books that are reported on Form 1120-F, Schedule L (Balance Sheet per books). Foreign banks are foreign corporations described in Regulations section 1.882-5T(c)(4).

#### **Who Must File**

Schedule M-3 is effective for taxable years ending on or after December 31, 2007. For purposes of determining whether a corporation with a 52-53-week tax year must file Schedule M-3, such corporation's tax year is deemed to end or close on the last day of the calendar month nearest to the last day of the 52-53-week tax year. (For further guidance

on 52-53-week tax years, see Regulations section 1.441-2(c)(1).)

Any foreign corporation required to file Form 1120-F, that reports on Schedule L, line 17 of Form 1120-F, total assets at the end of the corporation's tax year that equal or exceed \$10 million, must complete and file Schedule M-3 in lieu of Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return.

A foreign corporation filing Form 1120-F that is not required to file Schedule M-3 may voluntarily file Schedule M-3. A foreign corporation filing Schedule M-3 must check the box on Form 1120-F, page 1, indicating that Schedule M-3 is attached. A corporation filing Schedule M-3 must not also file Schedule M-1. For the first year that a corporation files Schedule M-3, it may exclude reporting in columns (a) and (e) of Parts II and III.

In determining its reportable assets for purposes of Schedule M-3, the corporation must use an overall accrual method of accounting unless both of the following apply: (a) the tax return is prepared using an overall cash method of accounting, and (b) the corporation does not prepare or is not included in income statements prepared on an accrual basis. For purposes of measuring total assets at the end of the year, assets may not be netted or offset against liabilities.

### **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, line 17, of Form 1120-F 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 (including all of Parts II and III) for that subsequent tax year.

### **Other Form 1120-F Schedules Affected by Schedule M-3 Requirements**

#### **Schedule L**

Generally, the assets and liabilities required to be reported on Schedule L are the total assets and liabilities reflected on the set(s) of books of the foreign corporation that include assets that give rise to U.S. effectively connected income and U.S. booked liabilities (as defined in Regulation sections 1.882-5(d)(2) and 1.882-5T(d)(2)(ii)(A), and (iii)). The total assets and liabilities include the interbranch assets and liabilities and the noneffectively connected assets reflected on such books. Such books will reflect the assets of the foreign corporation located in the United States and all other of its assets

used in its trade or business within the United States (other than its assets giving rise to effectively connected income under sections 864(c)(6) or (7)). A foreign corporation may instead elect to report its worldwide assets/liabilities on Schedule L under Regulation section 1.6012-2(g)(1)(ii). If a foreign corporation (including a foreign bank) elects worldwide reporting on Schedule L, the same set(s) of books must be used to report the adjusted worldwide net income (loss) results in Part I, line 11.

If the foreign corporation has more than one set of books and records relating to assets located in the United States or used in a trade or business conducted in the United States, it must report the combined amounts shown on all such books and records on Schedule L, as adjusted to eliminate transactions recorded between the reportable books. However, amounts recorded between the set(s) of books and other divisions of the foreign corporation or includible entities reportable on Schedule M-3, Part I, line 5, are not eliminated (except for certain transactions with disregarded entities that are also reportable on Schedule L), unless the taxpayer elects worldwide reporting under Regulation section 1.6012-2(g)(1)(ii).

***Adaptation of Form 1120F, Schedule L for treaty-based reporting.*** The set(s) of books reported on Form 1120F, Schedule L for treaty-based reporting purposes will generally be the same set(s) of books reported on Schedule L for effectively connected income reporting purposes. However, certain books that give rise to effectively connected income might not necessarily give rise to treaty-based reporting. For example, the assets on a set of books could still be attributed to a U.S. office for effectively connected income reporting purposes even when transferred away from the U.S. permanent establishment for treaty reporting purposes. See Regulation section 1.864-4(c)(5)(iii). Additionally, a set of books having no effectively connected income or U.S. booked liabilities under Regulation section 1.882-5(d)(2) might still constitute a set of books of the U.S. permanent establishment because the items recorded thereon are primarily attributable to the U.S. permanent establishment under the application by analogy of the OECD Transfer Pricing Guidelines as authorized by the relevant treaty. In such cases, the set(s) of books that must be reported on Form 1120F, Schedule L are those of the U.S. permanent establishment as determined under OECD Transfer Pricing Guidelines.

## **Schedule M-2**

If the foreign corporation answered “Yes” to Part I, line 1 of Schedule M-3, the amount shown on Schedule M-2, line 2, Net income (loss) per books, must equal the amount shown on Schedule M-3, Part I, line 11. If the foreign corporation answered “No” to part I, line 1, the amount shown on Schedule M-2, line 2, Net income (loss) per books, will not necessarily equal the amount shown on Schedule M-3, Part I, line 11, because in that case the Schedule M-2 must use the Net income (loss) from the set(s) of books reported on Schedule L.

## **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 to the classification of the entity for U.S. federal income tax purposes.

For a foreign corporation other than a bank, an entity that generally is disregarded as separate from the foreign corporation filing Form 1120-F for federal income tax purposes (“disregarded entity”) is reported on Schedule M-3, Part I, Line 4, if the foreign corporation’s applicable income statement includes the net income of such disregarded entity. Otherwise, the results of the disregarded entity are separately reported on Part I, line 5. On Parts II and III, any item of income, gain, loss or deduction of a disregarded entity must be reported as an item of the foreign corporation, and is not reported on Part II, lines 9, 10, or 11, as from a partnership or pass-through entity.

*Foreign bank DE books on line 5.* For foreign banks, the net income(loss) of certain disregarded entities are not consolidated with other U.S.-based sets of books reported on line 4. The set(s) of books with respect to disregarded entities are included on Part I, line 5, if the set(s) of books of such disregarded entities give rise to U.S. booked liabilities under Regulation section 1.882-5(d)(2)(iii). Transactions between the set(s) of books reported on line 4 and line 5 are eliminated on line 8. However, a U.S. LLC that is a disregarded entity whose set(s) of books do not give rise to U.S. booked liabilities under Regulation section 1.882-5(d)(2)(iii) are not included in line 4 or line 5. Transactions between such disregarded entities and set(s) of books reported on line 4 are not eliminated.

### **Reportable Entity Partner Reporting Responsibilities**

For the purposes of Schedule M-3 instructions, a reportable entity partner with respect to a partnership filing Form 1065 is an entity that (1) owns or is deemed to own, directly or indirectly, under these instructions a 50 percent or greater interest in the income, loss or capital of the partnership on any day of the tax year on or after June 30, 2006, and (2) was required to complete Schedule M-3 on its most recently filed US federal income tax return or return of income filed prior to that day. A corporation filing a Form 1120-F income tax return required to complete Schedule M-3 is subject to the reportable entity partner reporting responsibilities with respect to partnership interests it owns or is deemed to own, directly or indirectly, on or after January 1, 2008.

For the purposes of Schedule M-3 instructions, (1) 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; (2) 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; (3) 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 (4) 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) its name, (2) its mailing address, (3) its taxpayer identification number (TIN or EIN) if applicable, (4) its entity or organization type, (5) the state or country in which it is organized, (6) the date on which it first became a reportable entity partner (7) the 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, and (9) any change in that interest as of the date with respect to which it is reporting.

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

**Example 1.** A, an LLC filing a Form 1065 for 2008, is owned 50 percent by Z a foreign corporation engaged in trade or business within the United States. A owns 50 percent of each of B, C, D, and E, each also an LLC filing a Form 1065 for calendar year 2008. Z was first required to complete Form 1120-F Schedule M-3 for its corporate tax year ended December 31, 2007, and filed its Form 1120-F with Schedule M-3 for 2007 on September 15, 2008. As of September 16, 2008, Z was a reportable entity partner with respect to A and, through A, with respect to B, C, D, and E. On October 5, 2008, 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 2008, each of A, B, C, D, and E is required to complete Form 1065 Schedule M-3 for 2008, regardless of whether they would otherwise be required to complete Schedule M-3 for that year. Z must retain a copy of each of the required reports it makes to A, B, C, D, and E under these instructions, including the reports it makes October 5, 2008.

### **Completion of Schedule M-3**

A corporation required to file Schedule M-3 must complete Parts I, II and III of the Schedule in its entirety and attach the Schedule to Form 1120F. At the time the Schedule M-3 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. All additional schedules specifically referenced in these instructions must be completed and attached to the Schedule M-3 when filed.

### **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 foreign corporation files Schedule M-3.

### **Question A. Treaty Position Taken on Form 1120-F, page 3, for Taxable Income**

If a foreign corporation is resident in a country having a treaty with the United States that expressly permits determining the attribution of profits to a permanent establishment under OECD Transfer Pricing Guidelines principles (e.g. U.S. – United Kingdom or U.S. – Japan Income Tax Treaties), answer “Yes” if the corporation reports income under the treaty method in lieu of the effectively connected income rules under sections 864 and 882. For reporting under this method in Parts II and III, see instructions for the reporting of income in columns (a) through (e) on Parts II and III at page XX.

**Questions B through D.** For Schedule M-3, Part I, Questions B through D, use only the income statements of the foreign corporation filing Form 1120F. If the foreign corporation prepares its own income statements but is controlled by another corporation (U.S. or foreign) that prepares income statements that include the foreign corporation, the foreign corporation must use for its Schedule M-3, Part I, its own income statements and not the income statements of the controlling corporation. These income statements are used for completing line 4. The foreign corporation’s own “nonconsolidated” income statements may include consolidation of nonincludible entities that the foreign corporation owns. The net income on such statement, including the net income of the “nonincludible” subsidiary entities is reportable on line 4. The adjustment to remove the net income of such nonincludible entities is reportable on line 7 (see below).

**Example 2.** FC1 is a foreign corporation other than a bank, resident in Country X, and engaged in a trade or business in the United States. F is required to file Form 1120F. FC1 reports on Schedule L more than \$10 million in assets and therefore, is required to file Schedule M-3. FC1 is owned 100 percent by FC, its non-banking parent corporation also resident in Country X. FC is not engaged in trade or business in the United States. FC1’s net income (loss) results are included in a certified audited consolidated income statement of FC. FC1 also has a nonconsolidated income statement that is not certified. In answering questions B through D, FC1 may not use FC’s consolidated income statement. It must use its own nonconsolidated, worldwide income statement which is a statement described in Question C.

**Example 3.** Same facts as Example 2, except FC1 is a disregarded entity. Under U.S. tax principles, FC is the taxpayer treated as directly engaged in trade or business within the United States and is required to file Form 1120F and Schedule M-3. FC’s consolidated certified audited income statement, described in Question B, is the applicable statement to be used.

### **Line 1. Foreign Banks Described in Treas. Reg. 1.882-5T(c)(4)**

If a foreign corporation is a foreign bank described in Regulation section 1.882-5T(c)(4), answer “Yes” to Part I, line 1. Special rules pertain to the corporation for Part I, lines 4 through 11. For Schedule M-3 purposes, a foreign bank is defined based on section 581 principles with respect to the conduct of its banking activities on a worldwide level, without regard to whether it conducts a banking trade or business within the United States. These requirements include having a substantial part of its worldwide business consist of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks. In addition, the foreign corporation must be subject to bank regulatory supervision in its country of incorporation.

### **Line 2. Questions Regarding Income Statement Period and Restatements**

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

Part I, lines 2b and 2c, regarding restatements of income statements refer to the income statement issued by the corporation filing the U.S. federal income tax return. Answer “Yes” on lines 2b and/or 2c if the corporation’s annual income statement has been restated for any reason. Attach a short explanation of the reason for the restatement for each applicable period, including the original amount and restated amount of each annual statement period’s net income.

### **Line 3. Question Regarding Publicly Traded Stock**

If the foreign corporation’s stock is traded on any exchange, domestic or foreign, please report the name of the exchange(s) on the line provided. If additional room is needed, attach a schedule.

### **Line 4. Net income (loss) from the income statement identified in Part I, line 1.**

Part I, line 4, reports the net income (loss) from the applicable income statement identified in Part I, line 1.

**Foreign Banks.** If the foreign bank has nonconsolidated, worldwide income statements, requested in Questions B or C, the foreign bank should check “Yes” to these Questions B or C. However, do not report these results on Part I, line 4. If the foreign bank has certified audited income statements for the set(s) of books from which the balance sheet reported on Form 1120F, Schedule L is derived as described in Question D, the net income (loss) from such statements is used to report on line 4, except that any disregarded entities whose results are reportable on Schedule L are excluded from Line 4. Disregarded entities includible in Schedule L are separately reported on Part I, line 5.

If the foreign bank does not have the certified audited income statements described in Question D, the bank should use any other income statement derived from the set(s) of books from which the balance sheet reported on Form 1120F, Schedule L is derived. For this purpose, the term “any other income statement” includes unaudited income statements prepared by the corporation under the method of accounting generally used by the corporation. If no such statements are available, trial balances prepared from general ledgers or similar other records should be used.

***Foreign Corporations other than banks.*** If the foreign corporation is not a bank, Part I, questions B, C, and D, provide a hierarchy of applicable income statements for reporting on Part I, line 4. If the corporation has the nonconsolidated, worldwide, certified audited income statement described in Question B, report the net income (loss) from such statements on Line 4. If the corporation does not have an income statement of that type but does have the nonconsolidated, worldwide unaudited income statement described in question C, report the net income (loss) from such statements on Line 4. These unaudited income statements should first include those prepared by the corporation under the method of accounting generally used by the corporation. If no such unaudited statements are available, other income statements may be used, including trial balances prepared from the corporation’s worldwide books and records.

If the foreign corporation has neither of these income statements, then the net income (loss) derived from the set(s) of books described in Question D is used to report net income (loss) on line 4, excluding disregarded entities. All disregarded entities are reported on Part I, line 5. For non-banks, the set(s) of books described in Question D are those that give rise to U.S. booked liabilities under Regulation sections 1.882-5(d)(2) and 1.882-5T(d)(2)(ii) and not under Regulation section 1.882-5T(d)(2)(iii).

***All Foreign Corporations.*** The amount on line 4 must equal the income statement net income (loss) for the income statement period ending with or within the tax year as indicated on line 2a.

If the income statement period differs from the corporation’s tax year, the income statement period indicated on line 2a applies for purposes of Part I, lines 4 through 8.

***Reporting with Schedule L set(s) of books*** – Question D filers. All foreign banks and any other foreign corporation that reports on Part I, line 4, the financial results from the set(s) of books used in preparing Form 1120-F, Schedule L, excluding disregarded entities, must attach a schedule that identifies each book (e.g. New York Branch, International Banking Facility, Cayman Branch) and its net income (loss) that is included on Part I, line 4. Transactions recorded between these books must be eliminated and shown in the aggregate as a separate line item on this schedule. Do not include eliminations for transactions with disregarded entities reported on line 5. Report on line 8, the eliminations for transactions between set(s) of books reported on line 4 and disregarded entities reported on line 5.



**Line 5. Net Income (Loss) from Includible Disregarded Entities (“includible entities”)**

Include the net income (loss) of any disregarded entity that is not included in the income reported on Part I, line 4, but should be included in Part I, line 11. The financial results of disregarded foreign entities are reported on lines 5a (income) and 5b (loss); disregarded U.S. entities are reported on lines 5c (income) and 5d (loss). The applicable financial statement of the disregarded entity to use is determined first under Question B if available, then under Question C. However a foreign bank should only use the set(s) of books from the disregarded entity that give rise to U.S. booked liabilities under Regulation section 1.882-5T(d)(2)(iii) and are reportable on Schedule L.

**Foreign Banks.** A foreign bank should include on line 5 each disregarded entity that meets the following two conditions (1) the entity is either itself engaged in trade or business within the United States and has generated income effectively connected with it or, it is not engaged itself in a trade or business within the United States but has income effectively connected with another trade or business within the United States of the foreign bank; and (2) the net income (loss) of the entity would be includible on Part I, line 4, if the assets and liabilities of such entity were held directly by the foreign bank rather than by the disregarded entity. This determination should be made separately for each disregarded entity.

If the income of the includible entity is effectively connected with a trade or business within the United States but would not have been includible on Part I, line 4, if it were held directly by the foreign corporation rather than by the includible entity, then any effectively connected income of the includible entity is reported on Part II, line 23, instead of Part I, line 5. Income of this latter type will be income that is treated as effectively connected income under section 864(c)(6) or (7), or it will be effectively connected income from the set(s) of books of the disregarded entity that does not give rise to U.S. booked liabilities as defined in Regulation section 1.882-5T(d)(2)(iii).

**Foreign Corporations other than a bank.** If the foreign corporation is not a bank, include on line 5, all disregarded entities not included on Part I, line 4. When a foreign corporation reports income (loss) from an income statement identified in Question B or C, net income (loss) of a disregarded entity may or may not be included in line 4, depending on the foreign corporation’s accounting principles. However, inclusion of disregarded entities will be necessary on line 5 when a taxpayer has reported on Part I, line 4, amounts from income statements described in Question D or similar unaudited statements.

Adjustments for intercompany transactions between the foreign corporation and includible disregarded entities may be required. See instructions for Part I, line 8, below.

Attach a supporting schedule for each separate line 5a through 5d that provides the name, EIN (if applicable), and net income (loss) per the income statement for each includible disregarded entity.

### **Line 6. Net Income (Loss) from Includible Foreign Locations**

Line 6 does not apply to foreign banks or to foreign corporations other than banks that report nonconsolidated, worldwide income (loss) on Part I, line 4. For all other corporations, report the net income (loss) of any foreign locations that are not included in the income reported on Part I, line 4.

Attach a supporting schedule that provides by country, the name and net income (loss) per the income statement on Part I, line 6, of all foreign locations. Foreign corporations other than banks that have effectively connected income with respect to transactions entered into as a global dealer in securities must report separately in this supporting schedule the net income (loss) for each set(s) of books for which the effectively connected dealer income is recorded within each separate country. All foreign corporations must report their effectively connected global dealing income in Part II, line 16.

### **Line 7. Net Income (Loss) of Nonincludible Entities**

This line does not apply to foreign banks or to foreign corporations other than banks who report on Part I, line 4, income (loss) from income statements described in Question D or similar unaudited statements. For any other corporations, remove the net income (line 7a) or loss (line 7b) of any other entity whose income (loss) is reported on Part I, line 4, but should be excluded from Part I, line 11. Examples of such entities are the foreign corporation's parent corporation, subsidiaries (other than disregarded entities) and partnerships that are combined with the corporation in the income statement described in Questions B or C. Do not remove in Part I the financial statement net income (loss) of any nonincludible entity accounted for in the income statements on the equity method. These entities are adjusted on Part II, lines 8 through 11.

In addition, on Part I, line 8, adjustments for intercompany transactions between the foreign corporation and nonincludible entities may be required. See instructions for line 8, below.

Attach a supporting schedule that provides the name, EIN (if applicable), and net income (loss) per the income statement or books and records included on line 4 that is removed on this line 7 for each separate nonincludible entity.

### **Line 8. Adjustments to Intercompany Transactions**

Include on Part I, line 8: (i) adjustments to consolidation entries and elimination entries that are contained in the amount reported on Part I, line 4, required as a result of adding

amounts on Part I, line 5 and 6; and (ii) amounts of any additional consolidation entries and elimination entries that are required as a result of removing amounts on Part I, line 7.

**Foreign Banks.** For foreign banks, adjustments are necessary to ensure consistency with the financial results of the set(s) of books reported on Form 1120-F, Schedule L. Adjustments on line 8 are for transactions between the foreign bank and each disregarded entity reported on Part I, line 5. For example, adjustments must be reported on line 8 to eliminate any intercompany dividends received by the foreign corporation from any disregarded entity whose results are included on Part I, line 5. However, if a disregarded entity is not reportable on Part I, line 5 (e.g. because it does not give rise to U.S. booked liabilities under Regulation section 1.882-5T(d)(2)(iii)), the dividend received by the foreign bank is not eliminated on Part I, line 8. Instead, the dividend is eliminated as an interbranch transaction in Part II, line 3, column (c).

**Foreign Corporations other than a bank.** For foreign corporations other than a bank, adjustments are necessary in order that the consolidation entries and intercompany eliminations entries included in the amount reported on Part I, line 11, are only those applicable to worldwide income of the nonconsolidated foreign corporation. Adjustments on line 8 may be with respect to transactions between the foreign corporation and either a disregarded entity reported on Part I, line 5, or a nonincludible entity reported on Part I, line 7. Adjustments for transactions with nonincludible entities are required only when the foreign corporation reports worldwide income on Part I, line 4, from an income statement described in Part I, Questions B through C. 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 4, that relate to the net income of entities removed on Part I, line 7, because the income to which the consolidation or elimination entries relate has been removed. In addition, consolidation or elimination entries must be reported on line 8 to eliminate any intercompany dividends received by the foreign corporation from any disregarded entity whose results are included on Part I, line 5.

**Special treatment of equity method inclusions for a foreign corporation other than a bank.** If a foreign corporation other than a bank reports worldwide income on Part I, line 4, and is an owner of an interest in another entity that (1) is accounted for in the foreign corporation's separate general ledger on the equity method, and (2) is fully consolidated in the foreign corporation's worldwide income statements thus eliminating the equity inclusion, and if that entity is also reported on Part I, line 7, as a nonincludible entity then, an adjustment on Part I, line 8, must be made. The foreign corporation must restore on Schedule M-3, Part I, line 8, the equity income inclusion from that entity. If the foreign corporation does not account for the entity on the equity method on its own general ledger, it will not have eliminated the equity income for nonconsolidated, worldwide income 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 (e.g., 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, to report intercompany eliminations that net to zero on Part I, line 8, such as intercompany interest income and expense. For instance, if the foreign corporation reports interest income on Part I, line 4, from transactions with a disregarded entity included on Part I, line 5, it is not necessary (but allowable) to report the offsetting gross interest income and gross interest expense on Part I, line 8.

**Example 4** F is a foreign corporation other than a bank and has a fiscal financial and tax year-end. F files Form 1120-F because it engaged in a trade or business within the United States and is required to file Schedule M-3. F owns two U.S. subsidiaries, S1 and S2, and has made a check the box election for S1 to be treated as a disregarded entity. Both S1 and S2 have the same fiscal year-end as F. In addition, F's home country accounting rules require the inclusion of S2's income and expenses in F's nonconsolidated, worldwide, certified audited income statements. However, S1's income and expenses are not included in F's nonconsolidated, worldwide, certified audited income statements.

On Schedule M-3, F must check "Yes" to Question B. F must report its net income (loss) from its nonconsolidated, worldwide, certified audited income statements on Part I, line 4. On Part I, line 5, F must include the net income (line 5c) or loss (line 5d) generated by S1, the disregarded US entity. Because S2 is included in the nonconsolidated, worldwide, certified audited income statements it is not reported on Part I, line 5, since it is already included on Part I, line 4.

Any adjustments necessary to remove intercompany transactions between F and S1 must be reported on Part I, line 8.

#### **.Line 9. Adjustment to Reconcile Income Statement Period to Tax Year**

Include on line 9 any adjustments necessary to reconcile differences between the income statement period reported on line 2a and the corporation's tax year. Attach a supporting schedule identifying the type of transaction and amount of each adjustment.

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

Include on line 10 any other adjustments, not reportable on lines 5 through 9, to reconcile net income (loss) on Part I, line 4, with net income (loss) on Part I, line 11.

For any adjustments reported on Part I, line 10, attach a supporting schedule that provides, for each entity to which an adjustment relates: the name and EIN (if applicable) of the entity, the nature of the adjustment, the amount of net income (loss) included in Part I before any adjustments on line 10, and the amount of net income

(loss) included on Part I, line 11.

### **Line 11. The Adjusted Net Financial Income (Loss) of the Nonconsolidated Foreign Corporation**

The sum of lines 4 through 10 constitutes the adjusted nonconsolidated net income (loss) of the foreign corporation that is to be reconciled in Parts II and III with the foreign corporation's effectively connected income reported on Form 1120F, page 3, line 29.

In all cases, Part I, line 11, includes the net income of only entities whose income is included, in whole or part, on the U.S. federal income tax return for the tax year. It is not permissible to remove the net income of non-includible entities reportable on line 7, above and then add back such income on lines 8 through 10, such that the amount reported on line 11, includes the net income of entities not includible in the U.S. federal income tax return.

#### ***Example 5. Foreign Corporations Other than a Bank***

FC is a foreign corporation other than a bank engaged in trade or business within the United States and required to file Form 1120F and Schedule M-3. FC does not have income statements that report its nonconsolidated, worldwide income, but FC does have unaudited income statements for the set(s) of books it reports on Schedule L with respect to its trade or business within the United States. FC reports net income on these statements of \$50,000. Included in these results are foreign disregarded entity FDE1 with net income of \$20,000 and foreign disregarded entity FDE2 with net loss of (\$5,000). FDE1 and FDE2 do not have effectively connected income that give rise to U.S. booked liabilities. In addition, FC has foreign locations that are not included in such income statements. These locations do not have effectively connected income on set(s) of books that give rise to U.S. booked liabilities. The net income of such foreign locations is \$25,000.

FC must answer "No" to questions B through D on Part I. FC must report on Part I, line 4, \$35,000 (Total income reported of \$50,000 excluding the results of FDE1 and FDE2). On Part I, line 5a, FC will include the \$20,000 of net income of FDE1 and will include on Part I, line 5b, the (\$5,000) net loss of FDE2. The net income of \$25,000 from foreign locations must be included on Part I, line 6.

#### ***Example 6. Foreign Corporations Other than a Bank***

FC is a foreign corporation other than a bank engaged in trade or business within the United States and required to file Form 1120F and Schedule M-3. FC owns NI, a C-corporation. FC has certified audited income statements that report its nonconsolidated, worldwide income. FC reports net income on these statements of \$120,000. Included in

these results are foreign disregarded entity FDE1 with net income of \$30,000, foreign disregarded entity FDE2 with net loss of (\$5,000), and NI's net income of \$40,000. FDE1 and FDE2 both have effectively connected income that give rise to U.S. liabilities. \$5,000 of interest income received by FC from NI is eliminated in the preparation of these statements.

FC must answer "Yes" to Question B. FC must report on Part I, line 4, \$120,000. The results of FDE1 and FDE2 are not reported on Part I, line 5, since their results are already included on Part I, line 4. NI's income of \$40,000 is included on Part I, line 7, because NI is a nonincludible entity. The \$5,000 of interest income is reported on Part I, line 8. Assuming no other adjustments are required on Part I, lines 9 and 10, the total income reported on Part I, line 4, is \$85,000 ( $\$120,000 - \$40,000 + \$5,000$ )

### ***Example 7. Foreign Bank***

FC is a foreign corporation that is a bank engaged in trade or business within the United States and required to file Form 1120F and Schedule M-3. FC has certified audited income statements that report its nonconsolidated, worldwide net income and unaudited income statements for the set(s) of books it reports on Schedule L for its trade or business within the United States. FC reports net income on the set(s) of books of its trade or business within the United States of \$50,000, which includes the results of U.S. disregarded entity USDE1 with net income of \$15,000 and U.S. disregarded entity USDE2 with a net loss of (\$5,000).

Although FC must answer "Yes" to Question B, FC must not report on Part I, line 4, the results of these nonconsolidated, worldwide, certified audited income statements. FC must also answer "No" to Question D. FC must report on Part I, line 4, the amount from the unaudited income statements for the set(s) of books it reports on Schedule L of \$40,000 (Total income reported of \$50,000, excluding the results of UDE1 and UDE2 which also give rise to effectively connected income and are set(s) of books included in Form 1120F, Schedule L). On Part I, line 5c, FC will include the \$15,000 of net income of UDE1 and will include on Part I, line 5d, the (\$5,000) net loss of UDE2. Assuming no other adjustments are required on Part I, lines 8 through 10, the net income reported on Part I, line 4, is \$50,000, and the net income reported on line 11 is \$50,000.

### **General Instructions for Parts II and III**

Indicate the name of the foreign corporation and the Employee Identification Number at the top of each page, as they appear on the first page of the Form 1120-F.

**Columns (a) and (e).** For each line item in Parts II and III, report in column (a) the amount included in the net income (loss) reported on Part I, line 11. For each line item, report in column (e) the amount included in net effectively connected taxable income (loss) on Form 1120-F, page 3, line 29.

### ***Columns (b), (c), and (d)***

The temporary and permanent differences reportable in columns (b) and (c) are determined first under U.S. tax principles before any residual amounts are determined and reported as permanent differences as allocations to noneffectively connected income in column (d).

Column (d) is used to report income and deductions that are allocated to noneffectively connected income with respect to third-party amounts that are not already included in permanent differences in column (c). In Part II, lines 1 through 22, allocate specific categories of income to noneffectively connected income. Part III, column (d) is used only to allocate deductions to noneffectively connected income of all foreign corporations that report Schedule M-3.

Income and expense items may have both temporary differences reportable in column (b) and permanent differences for allocations to noneffectively connected income in column (d). Similarly, items that give rise to permanent differences under U.S. tax principles that are reportable in column (c) may also have permanent differences for allocations to noneffectively connected income that are reportable in column (d). Interbranch amounts of a foreign bank included in column (a) are also reported in column (c) unless such items are treated under U.S. tax principles as third party amounts sourced and allocated within or without the United States (e.g. certain global dealing income that is split-sourced under Prop. Regs. section 1.863-3(h)) or such treatment is otherwise provided under an Advance Pricing Agreement or Mutual Agreement Procedure pursuant to an income tax treaty.

***Example 8.*** FC is a foreign bank that is required to File Form 1120F and Schedule M-3. FC included on Part I, line 11, \$100 of interest income of which \$60 is effectively connected tax-exempt interest income and \$40 is noneffectively connected tax-exempt interest income. In addition, FC included on Part I, line 11, \$300 of fee and commission income that was recognized for U.S. tax purposes in a prior year. FC also included \$400 of meals and entertainment expenses of which \$200 is deductible under section 274. FC determines that 60% of its deductions under U.S. tax principles are allocable to noneffectively connected income.

FCs reports on Part II, line 4a, column (a), the \$100 of tax-exempt interest income. FC reports (\$100) of permanent book tax difference on line 4a, column (c) to eliminate the tax-exempt interest income. No amount is reportable on line 4a, column (d) since all of the income is a permanent difference under U.S. tax principles without regard to its allocation between effectively and noneffectively connected income. FC also includes on Part II, line 7, column (a), the \$300 of fee and commission income. Since this amount was already recognized in a prior year for U.S. tax purposes, FC reports on line 7, column (b), a temporary difference of (\$300). On Part III, line 10, column (a), FC includes the \$400 of meals and entertainment expenses. FC first computes its limitation under section 274 before determining the amount allocable to noneffectively connected income. Therefore, FC reports in on Part III, line 10, column (c), a permanent difference of (\$200). FC then determines the 60 percent of the remaining \$200 of meals and

entertainment expense that is allocable to noneffectively connected income and reports this (\$120) on Part III, line 10, column (d).

**Example 9.** The facts are the same as in Example 8, except the \$100 of tax-exempt interest is not included on Part I, Line 11, and is therefore excluded from Part II, Line 4, column (a). Because the \$100 of tax-exempt interest income is partially nontaxable effectively connected income, it has significance in determining the allocation of expenses under indirect methods, and is therefore required to be reported on Part II, line 4. The full \$100 of tax-exempt interest is reported in column (c) as a positive number and reversed in column (d) as a negative number. None of the \$100 is reportable in column (e).

### **Treatment of items under an Eligible Treaty-Based Return Position to Attribute Business Profits to a U.S. Permanent Establishment**

If a foreign corporation elects to use an eligible treaty (e.g. Article 7 and accompanying Exchange of Notes of U.S. – United Kingdom; and U.S. – Japan Income Tax treaties) that provides a permissible method other than the rules of section 864(c) and 882 to determine its profits attributable to a U.S. permanent establishment, answer “Yes” to Question A on Part I of Schedule M-3. If an eligible treaty is elected the foreign corporation must report on Form 1120F, Section II, its business profits attributable to its U.S. permanent establishment under such income tax treaty that applies the OECD Transfer Pricing Guidelines in lieu of the effectively connected income rules of sections 864 and 882. When business profits under an eligible treaty is reported on Form 1120F, Section II in lieu of the effectively connected income rules of the Code, the treatment of items in columns (c) and (d) must be adapted to apply the concepts of the applicable treaty.

**Foreign Bank treaty-based reporting.** If the foreign corporation is a foreign bank, interbranch income and expense and noneffectively connected income are not treated as permanent differences to the extent such items are attributable to the US permanent establishment and are also included in net income (loss) reported on Part I, line 11. For any item reported on Part I, line 11 that is attributable to the foreign corporation’s U.S. tax return, such amounts may have temporary differences under U.S. tax principles (e.g., depreciation deductions includible in column (a) may have temporary book tax differences reportable in column (b). For amounts reported in Part II, column (a), do not report as permanent differences, interbranch interest or other interbranch income in column (c) or noneffectively connected income including foreign related party interest, dividends or royalties that are not ECI under §864(c)(4)(D) in column (d)) to the extent such amounts are attributable to the U.S. permanent establishment under the OECD Transfer Pricing Guidelines, applied by analogy. If any amounts are not reported in Part II, column (a) as part of the set(s) of books that constitute the books of the U.S.



permanent establishment, but are attributable to the U.S. permanent establishment under application of the OECD Transfer Pricing Guidelines, such amounts *are* included as permanent differences in columns (b) and (d). Report in column (e) all amounts that are attributable to the permanent establishment.

***Treaty-based reporting for foreign corporations other than banks.*** Foreign corporations other than banks must include interbranch income and expense as book tax differences to the extent such items are not included in worldwide income reported on Part I, line 11, and such items are attributable to the U.S. permanent establishment. Interbranch income should have been eliminated in arriving at the adjusted nonconsolidated income reportable on Part I, line 11. To the extent such interbranch amounts are attributable to a U.S. permanent establishment under Article 7 of an applicable income tax treaty, the amounts are also includible as a book tax difference if they are reported in business profits under an eligible treaty-based tax return position. Such amounts are reported as permanent differences in column (c) and included in column (e). Third-party amounts included in worldwide income that are not attributable to the U.S. permanent establishment should be reported in the following manner:

*Column b)-Temporary differences* are determined under U.S. principles and reported in column (b)

*Column (d) – Permanent differences* for amounts not attributable to a U.S. permanent establishment are reported as a negative number in column (d).

*Column (e) – Report the income or deduction* includible in business profits attributable to the U.S. permanent establishment in column (e).

***Example 10.*** FC is a foreign bank that has three sets of books that give rise to U.S. book liabilities under Regulation section 1.882-5(d)(2)(iii) and that are reportable on Form 1120F, Schedule L. Two of the books are maintained in the United States by its U.S. branch. The third book is a portfolio of effectively connected loans that are recorded, managed and funded in FC's home office in Country X. The three books are consolidated for Form 1120F, Schedule L reporting purposes. FC files its Form 1120F, and Schedule M-3 under an eligible treaty to report its business profits attributable to its U.S. permanent establishment in lieu of reporting its net effectively connected income under sections 864 and 882. The two books maintained in the United States are primarily attributable to FC's U.S. permanent establishment. The third set of books that would constitute a set of books for Regulation section 1.882-5(d)(2)(iii) purposes is not attributable to FC's permanent establishment in the year FC files its Form 1120F under the treaty-based method. On the two books that are attributable to FC's U.S. permanent establishment FC records net book income of \$400 comprised of \$500 of interbranch interest income, \$200 of noneffectively connected interest income and \$1,200 of what would be effectively connected income under Code-based principles. FC has \$1,000 third party interest expense and \$400 of interbranch expense on its books that are priced at arm's length with its home office and that are attributable to its U.S. permanent

establishment. FC has other expenses of \$325. FC also has \$100 of income attributable to its U.S. permanent establishment that is recorded in its home office on set(s) of books that are predominantly not attributable to FC's U.S. permanent establishment. FC determines that \$75 of its book interest expense must be disallowed after equity capital is allocated to the U.S. permanent establishment under the OECD Transfer Pricing Guideline principles applicable to Article 7 of the treaty.

FC reports \$350 of treaty-based profits attributable to its U.S. permanent establishment as follows:

On Part II, line 4a, column (a), \$1,900 of interest income is reported for the total interest income of the set(s) of books attributable to the U.S. permanent establishment. In column (c), \$100 is reported as a permanent difference for the income not included on the set(s) of books reported on Form 1120F, Schedule L. In column (e), the total interest of \$2,000 is reported as income attributable to the U.S. permanent establishment.

On Part III, line 26(a), the U.S. permanent establishment's book interest expense of \$1,400 is reported in column (a). The total book amount is reversed on line 26(a) in either column (b), (c) and (d). In columns (b) and/or (c), \$1,325 is reported as a negative number for the amount of expense that is not reclassified as capital. In column (d), \$75 is reported as a negative number for the amount of interest expense that is allocated to capital of the U.S. permanent establishment. The tax amount of interest expense is reported on Part III, line 26(b). In columns (b) and/or (c) \$1,325 is reported as interest expense. On line 26(b), in column (e), the interest expense attributable to the U.S. permanent establishment is reported as \$1,325.

On Part III, the \$325 of book expenses attributable to the U.S. permanent establishment are recorded in columns (a) and (e) in their respective categories. No adjustments are made in this example in columns (b) for temporary differences or to business profits that are not attributable to the U.S. permanent establishment in column (d). No additional expenses are attributable to the U.S. permanent establishment from the home office which would be reportable in column (c).

### **When To Complete Columns (a) and (e)**

A foreign corporation is not required to complete columns (a) and (e) of Parts II and III for the first tax year the foreign corporation is required to file Schedule M-3. For all subsequent years the foreign corporation is required to file Schedule M-3, the corporation must complete Schedule M-3 in its entirety. Accordingly, the corporation must complete columns (a) and (e) of Parts II and III 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 foreign corporation is required to file Schedule M-3, a foreign corporation voluntarily files Schedule M-3 in lieu of Schedule M-1, then in those voluntary filing years the corporation is not required to complete columns (a) and (e) of Parts II and III. In addition, in the first tax year the

foreign corporation is required to file Schedule M-3, the corporation is not required to complete columns (a) and (e) of Parts II and III.

If a foreign corporation chooses not to complete columns (a) and (e) of Parts II and III in the first tax year the foreign 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 28, is reconciled by the corporation in the following manner:

1. Report the amount from Part I, line 11, on Part II, line 28, column (a);
2. Leave blank Part II, lines 1 through 27, columns (a) and (e);
3. Leave blank Part III, columns (a) and (e);
4. Report on Part II, line 28, columns (b) through (d), the total of Part II, lines 1 through 27, columns (b) through (d) respectively, and
5. Report on Part II, line 28, column (e), the sum of Part II, line 28, columns (a), (b), (c) and (d). Note. Part II, line 28, column (e), must equal the amount on Form 1120-F, page 3, line 29.

#### **When To Complete Columns (b), (c) and (d)**

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

If the income statements of the foreign corporation are prepared in accordance with U.S. generally accepted accounting principles (US GAAP), differences that are treated as temporary for US GAAP must be reported in column (b) and differences that are permanent (that is, not temporary for US GAAP) must be reported in column (c) or column (d). Generally, pursuant to US GAAP, a temporary difference affects (creates, increases, or decreases) a deferred tax asset or liability.

If the foreign corporation does not prepare income statements, or the income statements are not prepared in accordance with US GAAP but instead are prepared using a foreign 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 taxable income in a future tax year or years due to the difference in timing of recognition for financial accounting and U.S. federal income tax purposes) or is the reversal of such a difference that arose in a prior tax year. This determination is made based on the facts available at the time the foreign corporation files its U.S. tax return. Report in columns (c) and (d) 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 foreign corporation is unable to determine whether a difference between column (a) and column (e) 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 11.** For the 2007, 2008, and 2009 tax years, foreign corporation A has total

assets on the last day of the tax year as reported on Schedule L, line 17, column (d), of \$8 million, \$11 million, and \$12 million, respectively. A is required to file Schedule M-3 for its 2008 and 2009 tax years.

For its 2007 tax year, A voluntarily files Schedule M-3 in lieu of Schedule M-1 and does not complete columns (a) and (e) of Parts II and III.

For A's 2008 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), (c) and (d) of Parts II and III.

For A's 2009 tax year, A is required to complete Schedule M-3 in its entirety.

In addition, for A's 2008, A may voluntarily complete Schedule M-3 in its entirety.

### **Schedule M-3 Reporting Requirements for §1.6011-4(b) Reportable Transactions**

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), (d) and (e), as applicable, of Part II, line 12, Items relating to reportable transactions, regardless of whether the amount would otherwise be reported on Part II or Part III of Schedule M-3. Thus, if a taxpayer files Form 8886, Reportable Transaction Disclosure Statement, the amounts attributable to that reportable transaction must be reported on Part II, line 12.

A corporation is required to report in column (a) of Parts II and III the amount of every item specifically listed on Schedule M-3 that is in any manner included in the foreign corporation's current year income 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 taxable income unless 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 12.

For example, with the exception of interest income reflected on a Schedule K-1 received by a foreign corporation as a result of the corporation's investment in a partnership or other pass-through entity, and interest equivalents, all interest income included on Part I, Line 11, whether from unconsolidated 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. federal income tax purposes (such as dividends), must be included on Part II, line 4a, column (a). For the exceptions, look for the specific line in Part II.

Similarly, 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 11, column (a), regardless of the 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.

Assume that a foreign corporation would be required to report in column (a) of Parts II and III the amount of an item specifically listed on Schedule M-3 in accordance with the preceding paragraphs, except for the fact that the corporation has capitalized the item of income or expense and reports the amount in its income statement balance sheet or in asset and liability accounts maintained in the corporation's books and records instead of in its income statement. In that case, the foreign corporation must report the proper tax treatment of the item in columns (b), (c), (d), and (e), as applicable.

Furthermore, in applying the preceding paragraphs, a foreign 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 Part I, line 11, regardless of the nomenclature associated with that item in the income 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 income statements or exist in the books and records that represent some form of "Bad debt expense," must be reported on Part III, line 24, in column (a), regardless of whether the amounts are recorded or stated under different nomenclature in the income statements or the books and records such as: "Provision for doubtful accounts"; "Allowance for uncollectible notes receivable"; or "Impairment of trade accounts receivable." Likewise, as stated above, all fines and penalties must be included on Part III, line 11, column (a), regardless of the terminology or nomenclature attached to them by the corporation in its books and records or income statements. Similarly, if the fine and penalty, for example, is included in another item, the amount of the fine or penalty should be segregated and included on Part III, line 11.

With limited exceptions, Part II includes lines for specific items of income, gain, or loss ("income items"). (See specific instructions for Part II, lines 1 through 23.) If an income item is described in Part II, lines 1 through 23, 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 23, report and describe the entire amount of the item on Part II, line 24.

With limited exceptions, Part III includes lines for specific items of expense, allocation, or deduction ("expense items"). (See specific instructions for Part III, lines 1 through 31.) If an expense item is described on Part III, lines 1 through 31, 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 31, report and describe the entire amount of the item on Part III, line 32.

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 24, or Part III, lines 1 through 32, report the entire amount of the item in columns (a) and (e) of Part II, line 27.

**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), Rev. Proc. 2004-45, 2004-31 I.R.B. 140 and Rev. Proc. 2005-75, 2005-50 I.R.B. 1137. If a specific item of income, gain, loss, expense, allocation or deduction is described on Part II, lines 1 through 24, or Part III, lines 1 through 32, 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.

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.

**Example 12.** Foreign corporation FC has been filing a Form 1120-F from its 2000 tax year through the present. The income statement year is identical to the tax year. FC placed in service ten depreciable, fixed, U.S. assets during its 2000 tax year. FC was required to file Schedule M-3 for its 2007 tax year and is required to file Schedule M-3 for its 2008 tax year. FC’s total depreciation expense for its 2008 tax year for five of the assets is \$50,000 for income statement purposes and \$70,000 for U.S. federal income tax purposes. FC’s total annual depreciation expense for its 2008 tax year for the other five assets is \$40,000 for income statement purposes and \$30,000 for U.S. federal income tax purposes. In its income statements, FC treats the differences between income statement and U.S. federal income tax depreciation expense as giving rise to temporary differences that will reverse in future years. FC must combine all of its depreciation adjustments.

Accordingly, FC must report on Part III, line 23, for its 2008 tax year income statement depreciation expense of \$90,000 in column (a), a temporary difference of \$10,000 in column (b), and U.S. federal income tax depreciation expense of \$100,000 in column (e).

**Example 13.** Foreign Corporation D was required to file Schedule M-3 for its 2007 tax year and is required to file Schedule M-3 for its 2008 tax year. The income statement year is identical to the tax year. On the last day of its 2008 tax year, D establishes two 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 future warranty expenses. Both reserves are only for income that is effectively connected. In its income statements, D treats the two reserve accounts as giving rise to temporary differences that will reverse in future years. The two reserves are expenses for D's 2008 income statements but are not deductions for U.S. federal income tax purposes in 2008. D must not combine the Schedule M-3 differences for the two reserve accounts. D must report the amounts attributable to the allowance for uncollectible accounts receivable on Part III, line 24, Bad debt expense, and must separately state and adequately disclose the amounts attributable to the other reserve, for warranty costs, on a required, attached schedule that supports the amounts on Part III, line 32.

**Example 14.** Corporation E was required to file Schedule M-3 for its 2007 tax year and is required to file Schedule M-3 for its 2008 tax year. The income statement year is identical to the tax year. At the beginning of the 2008 tax year, E establishes an allowance for uncollectible accounts receivable (bad debt reserve) of \$100,000 all of which is related to assets that give rise to effectively connected income. During 2008, E increased the reserve by \$250,000 for additional accounts receivable that may become uncollectible of which \$150,000 is related to assets that give rise to effectively connected income. Additionally, during 2008, E decreases the reserve by \$75,000 for accounts receivable that were discharged in bankruptcy during 2008, of which \$50,000 is related to assets that give rise to effectively connected income. The balance in the reserve account on the last day of the 2008 tax year, is \$275,000, of which \$200,000 relates to assets that give rise to effectively connected income. The \$100,000 amount to establish the reserve account and the \$250,000 to increase the reserve account are expenses on E's 2008 income statements but are not deductible for U.S. federal income tax purposes in 2008. However, of the \$75,000 decrease to the reserve only \$50,000, which is attributable to assets that give rise to effectively connected income, is deductible for U.S. federal income tax purposes in 2008.

In its income 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 24, Bad debt expense, for its 2008 tax year income statement bad debt expense of \$350,000 in column (a). The temporary difference of (\$275,000) is determined under US tax principles and reported in column (b) without regard to its effectively or noneffectively connected character. The amounts allocable to noneffectively connected income are then determined and reported in column (d), FC must report the \$(25,000) allocable to

noneffectively connected income in column (d) and U.S. federal income tax bad debt expense of \$50,000 in column (e).

## **Part II. Reconciliation of Net Income (Loss) per Income Statement of Nonconsolidated Foreign Corporations With Taxable Income per Return**

**Foreign corporations report, on lines 1 through 25 in column (a), the gross income amounts included in the financial net income (loss) reported on Part I, line 11. (see instructions for Part I, line 11 for differences between foreign banks and foreign corporations other than a bank.)**

### **Line 1. Gross Receipts or Sales**

Enter total gross receipts or sales net of returns and allowances. In column (e), enter the amount from Form 1120F, Section II, line 1c. Do not report gross receipts resulting from reportable transactions (line 12), sale of securities that are marked to market (line 14), currency gains and losses from other section 988 transactions (line 15), or receipts or sales of securities from global securities dealings (line 16).

### **Line 2. Cost of Goods Sold**

Report on line 2 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. However, do not report the items mentioned in the next paragraph on this line 2. Examples of amounts that must be included on line 2 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. Attach a schedule separately stating each item included on this line and the amount for each column.

Do not report the following on this line 2:

- Amounts reportable on Part II, line 12;
- Any gain or loss from inventory hedging transactions reportable on Part II, line 13;
- Mark-to-market income or (loss) under section 475 reportable on Part II, line 14;
- Global dealing income reportable on Part II, line 16;
- Section 481(a) adjustments related to cost of goods sold or inventory valuation reportable on Part II, line 18;



- Original issue discount, imputed interest, and phantom income reportable on Part II, line 20;
- Fines and penalties reportable on Part III, line 11; and
- Judgments, damages, awards and similar costs, reportable on Part III, line 12.

### **Line 3a through 3b. Dividends**

Report on the lines 3a through 3b, column (a), the amount of dividends included in Part I, line 11 from foreign and U.S. entities. Report on lines 3a through 3b, column (e), the amount of any dividends included in taxable income on Form 1120-F, page 3, line 4. Do not include on lines 3a through 3b dividends from global securities dealing which are reportable on Part II, line 16c, or dividends reported elsewhere (e.g., line 12 for reportable transactions).

### **Line 3c. Substitute Dividend Payments Received**

Report on line 3c, the gross substitute dividend payments received with respect to securities loans under section 1058 or substantially similar transactions, or from sale repurchase transactions, as described in Regulations sections 1.861-3(a)(6), 1.864-5(b)(2)(ii) and 1.881-2(b)(2). Do not net substitute dividend payments received against any substitute dividend payments made by the foreign corporation to another securities lender. Foreign banks must report in column (c) all U.S. source substitute dividend payments received as beneficial owner whether or not such payments are included in Part I, line 11, and whether or not such payments received are effectively connected income. For example, substitute dividends received by a foreign bank that are all recorded on set(s) of books that are not reported on Form 1120F, Schedule L, should report the payments received as a positive number in column (c) and reverse the amounts as a negative number in column (d) as allocable to noneffectively connected income. No amount would be reported in columns (a) and (e). Foreign source substitute dividend payments that are effectively connected with the foreign corporation's trade or business within the United States are reportable in column (e). Do not report on line 3c, substitute dividend payments received in custody for another owner of the substitute payment.

Note: U.S. source substitute dividend payments are characterized as dividends only to the extent they are noneffectively connected with the foreign corporation's trade or business within the United States. U.S. source substitute dividends not reported to the foreign corporation on Form 1042-S are also reportable on Form 1120F, Section I.

**Example 15.** FC, a foreign bank resident in Country X, is engaged in a banking trade or business within the United States through a U.S. permanent establishment. FC has an income tax treaty with the United States that imposes 15% tax on gross portfolio

dividends received by the corporation that are not attributable to a U.S. permanent establishment. FC records securities lending transactions with respect to U.S. and foreign stocks on its home office set(s) of books. These set(s) of books do not give rise to U.S. booked liabilities under Regulations section 1.882-5(d)(2)(iii) and are not reportable on Form 1120F, Schedule L. FC receives \$200 of substitute dividends from transactions described in section 1058, all of which are noneffectively connected with FC's trade or business within the United States and are not attributable to FC's U.S. permanent establishment. Under Regulations sections 1.861-3(a)(6) and 1.881-2(b)(2), the substitute dividends are characterized as U.S. source dividends. Under FC's treaty with the United States, the dividends are subject to 15% gross basis tax.

The substitute payments are not reportable on Part I, line 11, or Part II, line 3c, column (a). FC must report \$200 of dividends on line 3c in, column (c) as a positive number. On line 3d, column (d), the \$200 is reported as a negative number, and zero is reported in column (e). On Form 1120F, Section I, FC must report the substitute dividends received that are not reported by the withholding agent on Form 1042-S.

#### **Line 4a. Interest Income excluding interest equivalents**

Report on Part II, line 4a, column (a), the total amount of interest income included in Part I, line 11, and report on Part II, line 4a, column (e), the total amount of interest income included on Form 1120-F, page 3, line 5, that is not required to be reported elsewhere in Part II. In columns (b) or (c), as applicable, adjust for amounts treated for U.S. federal income tax purposes as interest income that are treated as some other form of income in the income statements, or vice versa. All interbranch interest income included on Part I, line 11, that is excluded from taxable income is reported as a permanent difference in column (c). Foreign corporations other than banks, see the instructions for Part I, line 8, regarding eliminations of interbranch transactions.

Do not report on this line 4a, in any column, amounts reported in accordance with instructions for Part II, lines 4b, 4c, 9, 10, 11, 12, 13, 16a, 20 and 23.

**Example 16.** FC is a foreign bank that is required to file Form 1120F and Schedule M-3. FC included on Part I, line 11, the following interest income items: \$600 of interbranch interest income, \$100 of Tax Exempt interest, \$60 of which is effectively connected, \$300 of interest with respect to securities described in Regulations section 1.864-4(c)(5)(ii)(b)(3) ("10% rule securities"), \$150 of which is allocable to noneffectively connected income under the rule of that paragraph, and \$1,000 of other effectively connected interest income.

FCs reports on Part II, line 4a, column (a) all \$2,000 of this interest income. FC reports (\$700) as a permanent difference on line 4a, column (c), to eliminate all \$100 of the tax-exempt interest income (including the noneffectively connected portion) and the entire interbranch interest income. FC must also report (\$150) of noneffectively connected interest income from its "10% rule securities" in column (d). FC reports \$1,150 of

effectively connected interest income in column (e).

#### **Line 4b. Substitute Interest Payments Received**

Report on line 4b, the gross substitute interest payments received with respect to securities loans under section 1058, sale repurchase transactions, or similar transactions, as described in Regulations sections 1.861-2(a)(7), 1.864-5(b)(2)(ii) and 1.881-2(a)(2). Do not net substitute interest payments received against substitute interest payments made by the foreign corporations with respect to any section 1058, sale repurchase transactions included payments made with respect to “matched book” transactions, or any similar transaction.

Foreign banks must report all U.S. source substitute interest payments received as beneficial owner, whether or not such payments are included in Part I, line 11, and Part II, line 4b, column (a). All substitute interest received by a foreign bank that is recorded on set(s) of books that are not reported on Form 1120F, Schedule L, are reportable as a positive number in column (c) and such amounts are reversed and reportable as a negative number in column (d), as allocable to noneffectively connected income.

Do not report on line 4b substitute interest payments received in custody for another owner of the substitute payment.

Report all substitute interest payments received on line 4b whether or not such amounts are characterized as interest or other income under the Code. Note: U.S. source substitute interest payments received are characterized as “other income” to the extent such amounts are effectively connected with the foreign corporation’s trade or business within the United States. *See* Rev. Rul. 80-135, 1980-12 C.B. 18.

**Example 17.** FC, a foreign bank receives \$1,000 of gross U.S. source substitute interest payments with respect to sale repurchase agreements. FC also has gross U.S. source substitute interest with respect to securities loans of municipal bonds in transactions described in section 1058. All of the substitute interest received is included on Part I, line 11, and on FC’s set(s) of books reported on Form 1120F, Schedule L.

FC must report all \$1,200 of the substitute interest in column (e) as effectively connected income. The \$200 U.S. source substitute interest received from the municipal bond securities loans is not tax-exempt municipal bond interest income and is not reportable in column (c) as a tax-exempt permanent difference.

#### **Line 4c. Interest equivalents other than substitute interest reported in line 4b**

Report on line 4c all other interest equivalent income other than substitute interest reportable on line 4b. Other interest equivalents consist of fees and commission income

with respect to certain financial transactions that do not give rise to interest under section 163 (financial guarantee fees, acceptance , confirmation and standby letter of credit fees). Do not report periodic income with respect to notional principal contracts on Part II, line 4c. Such amounts are reportable on other lines, such as that for hedging transactions (line 13).

Do not report on this line 4c, amounts reported in accordance with instructions for Part II, lines 4a, 4c, 9, 10, 11, 12, 13, 16a, 20 and 23.

**Line 5. Gross rental income.**

Report on line 5, gross rental income that is treated as rental income for both the taxpayer's financial reporting purposes and for U.S. federal income tax purposes. Gross rents that are recorded as a sale for a financial purpose and as rental income for federal tax purposes or vice-versa, are reportable on Part II, Line 17, instead of line 5.

**Line 7. Fee and Commission Income**

Report on line 7, column (a), any amounts included on Part I, line 11, as gross fee and commission income. Such income generally includes income with respect to services performed (e.g. fees for brokerage service transactions and negotiation letters of credit). Do not include amounts reportable on Part II, line 4c.

**Line 8. Income (Loss) From Equity Method Corporations**

Report on line 8, column (a), the income statement income (loss) included in Part I, line 11, for any corporation accounted for on the equity method and remove such amount in column (b) or (c), as applicable. Include on Part II, line 3, column (e), dividends received from any corporation accounted for on the equity method to the extent the dividends constitute effectively connected income

**Line 9. Income (Loss) From U.S. Partnerships and  
Line 10. Income (Loss) From Foreign Partnerships**

**Note:** The income (loss) reported in column (e) must reconcile with the effectively connected taxable income reportable to the foreign corporation on Form K-1 and by the foreign corporation on Form 1120-F, Schedule P.

Except as provided below for certain foreign partnership interests, report amounts on Part II, line 9 or 10, as described below:

1. Report in column (a), the sum of the corporation's distributive shares of all items of income, gain, deduction and loss from a U.S. or foreign partnership that are included in Part I, line 11;

2. Report in column (b) or (c), as applicable, except for amounts described for column (e) below, 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. Report in column (d), the total amount of non-effectively connected income that relates to the distributive share of income or loss from a U.S. or foreign partnership;
4. Report in column (e), except for amounts described in item 5, below, the sum of all amounts attributable to the corporation's distributive shares of income or loss from a U.S. or foreign partnership (i.e., the sum of all amounts reportable on the corporation's Schedule(s) K-1 received from the partnership (if applicable)), that is included in taxable income.

Do not report on Part II, line 9 or 10, as applicable, any portion of a corporation's deduction under section 199 (income attributable to domestic production activities) attributable to a partnership interest of the corporation. A corporation must report this deduction only on Part III, Line 17.

***Exclusion of Certain Foreign partnership interests from Line 10.***

Foreign corporations other than banks that have foreign partnership interests with no effectively connected income for the year need not separately report those interests on this line. If, however, the foreign corporation reports a partnership interest on the equity method in the income statement used for Part 1, line 4, it may report such amounts in column (a) of this line. The corporation should report effectively connected amounts in column (e) consistent with the reporting equity method amounts in column (a). For example, if the foreign corporation does not report the partnership interest on Part II, line 10, column (a), it should not report any amounts in column (e) for the partnership interest. It would instead report the income and other items from the partnership interest for column (e) purposes based on the reporting for each line included in the income statement. However, if a foreign corporation allocates interest expense under the separate currency pools method in Regulations section 1.882-5(e) or allocates excess interest expense under Regulations section 1.882-5(d), and interest expense included in the foreign corporation's distributive share of a foreign partnership is included in such allocation, see instructions to Part III, line 26a, below for the required reporting.

***Example 18.*** FC is a calendar year taxpayer that was required to file Schedule M-3 for its 2007 tax year and is required to file Schedule M-3 for its 2008 tax year. FC is a partner in a U.S. partnership USP. FC prepares income statements in accordance with home country GAAP. In its income statements, FC treats the difference between income statement net income and taxable income from its investment in USP as a permanent difference. For its 2008 tax year, FC's income statement includes \$10,000 of income attributable to its share of USP's net income. FC'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. It has been determined that all of these amounts are effectively connected to FC's trade or business within the United States. H must report on Part II, line 9, \$10,000 in column (a), a (\$200) temporary difference in column (b) for the section 179 deduction that is effectively connected with FC's trade or business, a permanent difference of (\$2,000) in column (c), and \$7,800 in column (e). The (\$2,000) permanent difference reported in column (c) is determined as the aggregate difference between columns (a) and column (e) after effectively connected temporary differences in column (b).

**Example 19.** Same facts as Example 18 except that corporation H's charitable contribution deduction is wholly attributable to its partnership interest in USP and is limited to \$90 pursuant to section 170(b)(2) due to other investment losses incurred by H. In its income statements, H treated this limitation as a temporary difference. H must not report the charitable contribution limitation of \$3,910 (\$4,000 - \$90) on Part II, line 9. H must report the limitation on Part III, line 16, and report the disallowed charitable contributions of (\$3,910) in columns (b) and (e).

### **Line 11. 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 9 or 10, as applicable) owned by the corporation report the following on line 11:

1. Report 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. Report in column (b) or (c), as applicable, the sum of all differences, if any, attributable to the pass-through entity;
3. Report in column (d), the total amount of noneffectively connected income related to the distributive share of income or loss from the pass-through entity;
4. Report in column (e), 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).

Do not report on Part II, line 11, any portion of a corporation's deduction under section 199 (income attributable to domestic production activities) even if some or all of the corporation's deduction under section 199 is attributable to an interest in a pass-through entity held by the corporation. A corporation must report its deduction under section 199 only on Part III, Line 19.

For each pass-through entity reported on line 11, 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), (d), or (e) of line 11, as applicable.

### **Line 12. Items Relating to Reportable Transactions**

Any amounts attributable to any reportable transactions (as described in Regulations section 1.6011-4) must be included on Part II, line 12, regardless of whether the difference, or differences, would otherwise be reported elsewhere in Part II or Part III. Thus, if a taxpayer files Form 8886 for any reportable transaction described in Regulations section 1.6011-4, the amounts attributable to that reportable transaction must be reported on Part II, line 12. In addition, all income and expense amounts attributable to a reportable transaction must be reported on Part II, line 12, columns (a) and (e) even if there is no difference between the income statement 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 12 if the corporation sequentially numbers each Form 8886 and lists by identifying number on the supporting schedule for Part II, line 12, each sequentially numbered reportable transaction and the amounts required for Part II, line 12, columns (a) through (e).

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 12;
2. The name and tax shelter registration number, if applicable, as reported on lines 1a and 1b, respectively, of Form 8886; and
3. The type of reportable transaction (i.e., 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 20.** Corporation J is a calendar year taxpayer that was required to file Schedule M-3 for its 2007 tax year and is required to file Schedule M-3 for its 2008 tax year. J incurred seven different abandonment losses during its 2008 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 12. The \$12 million loss and the \$5 million loss will be adequately disclosed if J attaches a supporting schedule for line 12 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 12, columns (a) through (e). Alternatively, J's disclosures will be adequate if the description provided for each loss on the supporting schedule includes the names and 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 12, columns (a) through (e). 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 21.** Corporation K is a calendar year taxpayer that was required to file Schedule M-3 for its 2007 tax year and is required to file Schedule M-3 for its 2008 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 2008 tax year and results in a \$7 million capital loss for both income statement purposes and U.S. federal income tax purposes. It was determined that the entire amount is attributable to effectively connected income. Although the transaction does not result in a difference, K is required to report on Part II, line 12, the following amounts: (\$7 million) in column (a), zero in columns (b) and (c), and (\$7 million) in column (e). The transaction will be adequately disclosed if K attaches a supporting schedule for line 12 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 12, columns (a) through (e). Alternatively, the transaction will be adequately disclosed if the supporting statement for line 12 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 13. Hedging Transactions**

Report on line 13, column (a), the net gain or loss from hedging transactions included in net income per the income statement other than:

- hedging transactions entered into by a global dealing operation. (See line 16 instructions);
- qualified integrated foreign currency hedging transactions under Regulations section 1.988-5 (report these transactions on either Part II, line 4, or in Part III, line 26(a), column (a) as applicable);



- hedging transactions entered into by a commodities dealer that makes a mark-to-market election under section 475(e) (See instructions to line 14(b)); and
- hedging transactions entered into by a securities or commodities trader that makes a mark-to-market election under section 475(f) (See instructions to line 14(c)).

Do not report the income from the hedged item(s) on line 13. For hedging transactions reportable on line 13, report in column (e) the amount of taxable income 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. federal 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. federal income tax purposes but is considered a hedge for GAAP purposes, must also be reported here. For instance, transactions that would constitute a valid hedge for U.S. federal income tax purposes but constitute hedges of capital assets solely because the asset gives rise to noneffectively connected income are also reported on line 13.

Report hedging transactions entered into by a global dealing operation including those that are “risk transfer agreements” defined in Prop. Reg. section 1.475(g)-2, on Part II, line 16c. However, income with respect to a risk transfer agreement that is held by the foreign corporation’s non-global dealing operations is reported on this line 13 unless the foreign corporation is a foreign bank and its non-global dealing operations is not reported on Part I, line 11.

Report hedging gains and losses with respect to non-dealer transactions that are determined under the mark-to-market method of accounting on the income statement (other than those that are subject to mark-to-market treatment under a valid election under sections 475(e) or (f)) 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 2.

**Example 22.** FC is a foreign bank that enters into a U.S. dollar interest rate notional principal contract to hedge a portfolio of securities held for investment on its U.S. set(s) of books that are reportable on Form 1120F, Schedule L. The hedged portfolio consists of four securities of equal amounts, only two of which give rise to effectively connected income. For financial purposes, the notional principal contract is treated as a hedging transaction. For U.S. tax purposes, the two securities that give rise to noneffectively connected income are capital assets and consequently the notional principal contract does not constitute a hedging transaction under section 1221(b). Regardless, the income gain or loss with respect to the notional principal contract (including any mark-to-market income) is reportable as a hedging transaction on line 13 and is not reported on line 4b.

### **Line 14a through 14c. Mark-to-Market Income (Loss)**

Except as provided for global dealing operations reportable on Line 16 and for certain hedging transactions reported on line 13, report on line 14a through 14c, column (a) any amount that is subject to mark-to-market treatment under section 475. Report income, gain or loss for any securities held by a dealer in securities under section 475(a) on line 14a, a dealer in commodities having made a valid election under section 475(e) on line 14b, or a trader in securities or commodities having made a valid election under section 475(f) on line 14c. "Securities" for these purposes are securities described in section 475(c)(2) and 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 from transactions held in investment capacity or trader capacity not subject to a securities or commodities trading election, but which is determined under the mark-to-market method of accounting, on Part II, line 13, for hedging transactions, and not on line 14.

**Example 23.** Foreign corporation FC, a broker-dealer that is not a foreign bank, is a dealer in securities under section 475(a) and conducts its entire securities dealing operation within the United States. All of the income is recorded on set(s) of books reported on Form 1120F, Schedule L, is effectively connected with FC's trade or business within the United States, and does not constitute income of a global dealing operation. The income of this securities dealing operation is reportable on Part II, line 14. If FC engaged in a global securities dealing operation, however, the income generated from that activity would be reportable on line 16, as partially allocated to effectively connected income in column (e). The permanent book tax difference would be reportable in column (c) if the operation is booked outside of the United States and not included in column (a). If the global dealing set(s) of books are reportable on Form 1120F, Schedule L, the permanent book tax difference would be reportable in column (d) for the portion that needs to be allocated to noneffectively connected income.

### **Line 15. Gains (losses) from Section 988 transactions**

Report on line 15 gains or (losses) from certain section 988 transactions. These are only those section 988 transactions that are not reportable with respect to hedging transactions, mark-to-market gains (losses) or global securities dealing operations on Part II, lines 13, 14 and 16. Section 988 gains (losses) reportable on line 15 will generally be those recognized with respect to foreign currency denominated instruments that are acquired and normally held for investment or otherwise not held by a global securities dealer. Foreign currency transactions entered into by a global securities dealing operation are reportable exclusively on line 16c. Do not report on line 15 qualified integrated foreign currency transactions as defined in Regulations section 1.988-5.

**Example 24.** FC is a foreign corporation that is not a dealer or trader in securities or commodities. FC acquires foreign interest bearing bonds issued by a corporation resident in Country X. The bonds are denominated in a functional currency other than FC's currency and other than the U.S. dollar. FC holds the bonds in connection with its trade or business within the United States and the bonds give rise to effectively connected income gain or (loss). FC accrues interest income on its set(s) of books in U.S. dollars and accounts for currency gains (losses) with respect to each accrual period. When FC receives coupon interest payments, it records section 988 transaction foreign currency gains (losses). These gains (losses) are reportable on line 15.

If FC is a foreign bank and subject to section 475, generally, these gains (losses) are still reportable on line 15 and not on line 14, if the bank acquires and properly identifies the securities as held for investment or if the securities are held for proprietary trading that is not subject to a section 475 trader election under section 475(f).

**Line 16a. Interest Income from Global Securities Dealing**

**Line 16b. Dividends from Global Securities Dealing**

Report on lines 16a through 16b, interest and dividends (including substitute interest defined in Regulations section 1.861-2(a)(7) and substitute dividends defined in Regulation section 1.861-3(a)(6)) earned with respect to transactions entered into in a global securities dealing operation as defined in Prop. Regs. section 1.482-8.

**Line 16c. Gains(losses) and other Fixed and Determinable, Annual or other Periodic Income from Global Securities Dealing**

Report on line 16c gains and losses and other fixed and determinable, annual or other periodic income or expense (FDAP) with respect to notional principal contracts from global securities dealing operations (as defined in Prop. Regs. section 1.482-8) that are subject to source and allocation under Prop. Regs. section 1.863-3(h). Foreign currency gains and losses with respect to securities transactions entered into by a global dealing operation are also included in global dealing gains and (losses) on line 16c. The foreign corporation may be a global securities dealer with respect to some but not all of its securities dealing activities. Gains and losses from securities dealing activities that are not subject to source and allocation under Prop. Regs. section 1.863-3(h) are reportable as mark-to-market income on line 13, and the interest, dividend and other FDAP income earned in such non-global dealer activities is reportable on Part II, lines 3 and 4.

Attach a schedule showing the net income, gains (losses) for each global dealing operation that is allocable in whole or in part to effectively connected income and indicate the amount for each operation that is reportable on lines 16a through 16c. Provide a brief description of each global dealing operation (e.g. interest rate notional principal contracts, equity notional principal contracts, foreign currency options (list each

foreign currency separately for each foreign currency that constitutes a separate global dealing operation)).

Do not report on this line 16c, amounts reportable on lines 13, 14, 15, 16a, and 16b.

**Example 25.** FC, a securities broker-dealer is engaged in trade or business within the United States. FC is engaged in a global securities dealing operation in notional principal contracts that allocates a portion of the income, gains (losses) to effectively connected income. FC is also engaged in a securities dealing operation with respect to currency option contracts in foreign currency X, that is recorded on set(s) of books in FC's home office. The foreign currency X dealing operation is entirely allocable to noneffectively connected income and is not reportable on Form 1120F, Schedule L. Because FC is not a foreign bank described in Regulation section 1.882-5T(c)(4), FC's income, gains (losses) with respect to its securities dealing in foreign currency X is reportable in Part I, line 11. The income, gains and (losses) with respect to FC's notional principal contracts that allocate in part to effectively connected income are reportable on line 16c. The periodic income with respect to the notional principal contracts are also reportable on line 16c. The foreign currency option contracts in foreign currency X are reportable on line 14a, column (a), as mark-to-market gains (losses) of a securities dealer and not on line 16. The amount reported on line 14a, column (a), is reversed on line 14a, column (d) as a permanent difference allocable to noneffectively connected income.

**Example 26.** The facts are the same as in example 25 except that FC is a foreign bank. Because the securities options denominated in foreign currency X is not included in a set(s) of books reported on Form 1120F, Schedule L, the amounts are not reported on Part I, line 11, or Part II, line 14a. The notional principal contracts entered into in a global securities dealing operation are reported on line 16c, column (a). If the set of books is reported on Form 1120F, Schedule L, the amount allocable to noneffectively connected income is reported in column (d) and the amount allocable to effectively connected income is reported in column (e). If the set of books is not reported on Form 1120F, Schedule L, the amount allocable to effectively connected income is reported in column (c) and in column (e).

### **Line 17. Sale Versus Lease (for Sellers and/or Lessors)**

(Also see the instructions at Part III, line 25, 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 17, column (a), report the gross profit or gross rental income for financial income purposes for all sale or lease transactions that must be given the opposite characterization for tax purposes. On Part II, line 17, column (e), 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 4a, Interest income excluding interest equivalents, in column (a), or (e), as applicable. Depreciation expense for such transactions must be reported on Part III, line 23, Depreciation, in column (a), or (e), as applicable. Use columns (b), (c), and (d) of Part II, lines 4a and 17, and Part III, line 23, as applicable to report the differences between column (a) and (e).

**Example 27.** Corporation M sells and leases property to customers. M is a calendar year taxpayer that was required to file Schedule M-3 for its 2007 tax year and is required to file Schedule M-3 for its 2008 tax year. For financial accounting purposes, M accounts for each transaction as a sale. For U.S. federal income tax purposes, each of M's transactions must be treated as a lease. In its income statements, M treats the difference in the financial accounting and the U.S. federal income tax treatment of these transactions as temporary. During 2008, M reports in its income statements \$1,000 of sales and \$700 of cost of goods sold with respect to 2008 lease transactions. M receives periodic payments of \$500 in 2008 with respect to these 2008 transactions and similar transactions from prior years and treats \$400 as principal and \$100 as interest income. For financial income purposes, M reports gross profit of \$300 (\$1,000 - \$700) and interest income of \$100 from these transactions. For U.S. federal 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. It was determined that the entire amount of these items effectively connected income/expense. On its 2008 Schedule M-3, M must report interest income on Part II, line 4a, \$100 in column (a), (\$100) in column (b), and zero in column (e). In addition, M must report on Part II, line 17, \$300 of gross profit in column (a), \$200 in column (b), and \$500 of gross rental income in column (e). Lastly, M must report on Part III, line 23, \$200 in column (b) and (e).

### **Line 18. Section 481(a) Adjustments**

With the exception of a section 481(a) adjustment that is required to be reported on Part II, line 12, 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. federal income tax purposes that results in a section 481(a) adjustment must be reported on Part II, line 18, regardless of whether a separate line for that income or expense item exists in Part II or Part III.

**Example 28.** Corporation N is a calendar year taxpayer that was required to file Schedule M-3 for its 2007 tax year and is required to file Schedule M-3 for its 2008 tax year. N was depreciating certain fixed assets over an erroneous recovery period and, effective for its 2008 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 2008 tax year. It has been determined that the entire amount is attributable to effectively connected income. In its income statements, N treats the section 481(a) adjustment as a temporary difference. N must report on Part II, line 18, \$25,000 in columns (b) and (e) for its 2008 tax year and each of the subsequent three tax years (unless N is otherwise required to recognize the remainder of the section 481(a) adjustment earlier). N must not report the section 481(a) adjustment on Part III, line 23.

If the section 481(a) adjustment was noneffectively connected to N's trade or business within the United States, the amount would be reportable for each year in column (b) as a temporary difference (for U.S. tax principles) and then reversed as a permanent difference in column (d) as an amount allocable to noneffectively connected income. If in addition, N was a foreign bank, the amount would only be reportable in this manner if the section 481(a) adjustment was with respect to transactions recorded on set(s) of books reportable on Form 1120F, Schedule L.

#### **Line 19. Unearned/Deferred Revenue**

Report on line 19, column (a), amounts of revenues included in Part I, line 11, which were deferred from a prior financial accounting year. Report on line 19, column (e), revenues recognizable for federal income tax purposes that are recognized for financial accounting purposes in a different year. Also report on line 19, column (e), any amount of revenues reported on line 19, column (a), that are recognizable for U.S. federal income tax purposes in the current tax year. Use columns (b), (c), and (d) of line 19, as applicable, to report the differences between column (a), and (e). If the amounts are not includible on set(s) of books reportable on Form 1120F, Schedule L, but are reportable in Part I, Line 11, for a foreign corporation other than a bank, then report the entire difference as temporary in column (b). Any amount allocable to noneffectively connected income should, to that extent, be included in column (d) to reverse some or all of the amount included in column (b).

Line 19 must not be used to report income recognized from long-term contracts. Instead, use line 24 (Other income (loss) items with differences).

**Example 29.** FC, a foreign corporation other than a bank, has prepaid commission income of \$1,000 recognizable for U.S. federal income tax purposes in the current tax year that are recognized for financial accounting purposes in a different year. FC treats this difference as a temporary difference on its income statements. Of this amount, \$600 is allocable to effectively connected income. The amount recognized for income statement purposes in 2008 is \$250. FC reports this amount on Part II, line 19, column (a). In column (b), FC reports \$750 as a temporary book tax difference to adjust to the amount recognized by the foreign corporation in 2008 under U.S. tax principles. In column (d), FC reverses \$400 as income allocable to noneffectively connected income.

Finally, in column (e), FC reports \$600, the amount includible on FC's Form 1120F as effectively connected income in 2008.

In 2009, assuming no other commission income earned or accrued for either financial or U.S. tax purposes, FC would include \$750 on Part II, line 20, column (a), the amount recognized currently for financial purposes. FC would then reverse the \$750 in column (b) as a temporary difference since this amount was previously recognized for U.S. tax purposes.

### **Line 20. Original Issue Discount, Imputed Interest, and Phantom Income**

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

1. The difference between issue price and the stated redemption price at maturity of a debt instrument, which may be wholly or partially realized on the disposition of a debt instrument 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;
4. Amounts treated as OID under the below-market interest rate rules under section 7872; and
5. Amounts recognized as phantom income with respect to a noneconomic residual interest in a REMIC, including inducement fees recognized with respect to such interests.

Note: Phantom Income is a term used to describe taxable income that may be derived from the holding of ownership interests in an asset securitization vehicle. The income is "phantom" because it is not economic income - i.e., there is no cash or other property actually received or available for distribution to the equity holder. Income with respect to a residual interest in REMICs is referred to as Excess Inclusion Income and is subject to special rules in the Code and regulations. In a non-REMIC vehicle, it may take the form of OID derived from deep-discount debt held as collateral in the asset securitization entity.

Foreign corporations that accrue phantom income with respect to residual interests in REMICs that are not recognized under the foreign corporation's accounting regime must show all book to tax gross phantom income differences as permanent differences in column (c) whether or not it is effectively connected with a trade or business and whether or not the REMIC interests are recorded on set(s) of books that are reportable on Form 1120F, Schedule L. Amounts that are noneffectively connected with the foreign corporation's trade or business must be reversed and shown as a negative number in column (d).

**Example 30.** FC is a foreign bank that acquires and holds noneconomic residual interests in a REMIC on set(s) of books that are reportable on Form 1120F, Schedule L. Under the foreign corporation's accounting system, the amounts are not recognized for financial income reporting purposes and are treated as permanent differences. FC reports no amounts on Part II, line 20, column (a), for each year that phantom income/deduction is recorded under U.S. tax principles. In column (c), FC records phantom income as a permanent difference because such amounts are not recognizable under the foreign corporation's accounting regime. The amounts are effectively connected with taxpayer's trade or business and therefore, are also reported in column (e).

**Example 31.** The facts are the same as in Example 30, except that the phantom income is treated as noneffectively connected income by taxpayer and subject to tax under section 881(a). Taxpayer must report the phantom income as a permanent difference on Part II, line 20, column (c) and then reverse the amount in column (d) as noneffectively connected income. No amount is reported in column (e). The full amount of phantom income recognized in column (c) is reportable on Form 1120F, Section 1, line 10, as other fixed determinable annual or other periodic income and subject to tax at 30 percent.

**Example 32.** The facts are the same as in Example 30, except FC recognizes \$100 of residual excess inclusion income in on its set(s) of books and records reportable on Form 1120F, Schedule L, for cash received and an additional \$1,000 of phantom income not recognized for financial income purposes. FC treats \$100 as effectively connected income. FC reports on Part II, line 20, \$100 in column (a), \$1,000 in column (c), (\$1,000) in column (d) and \$100 in column (e). The \$1,000 reversed in column (d) is reportable on Form 1120F, Section 1, line 10, as in example 31.

**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 pass-through entities (e.g., on Schedule K-1) that are included in lines 9, 10, or 11. Reverse the amount reported in column (a) in column (b) or (c), as applicable. The corresponding gains and losses for U.S. federal income tax purposes are reported on Part II, lines 21b through 21g, columns, (b), (c) and (e), as applicable. Reverse any additional amounts recognizable under U.S. tax principles that are allocable to noneffectively connected income on Part II, lines 21b through 21g, column (d).

**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, excluding capital gains from pass-through entities that are included in lines 9, 10, or 11, as applicable.



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

Report on line 21c, gross capital losses reported on Schedule D, excluding capital losses from (a) pass-through entities that are included in lines 9, 10 or 11, 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. Do not report on line 21c capital losses carried over from a prior tax year and utilized in the current tax year. See the instructions for Part II, line 22, regarding the reporting requirements for capital loss carryovers utilized in the current tax year.

**Line 21d. Net Gain/Loss Reported on Form 4797, Line 17, Excluding Amounts From pass-Through Entities, 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 included in lines 9, 10, or 11, 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 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. See Regulations section 1.864-4(c)(2)(iii)(a) for limitations on effectively connected treatment under the asset use test and Regulations section 1.864-4(c)(5)(ii)(a) for limited effectively connected eligibility of stock to foreign corporations engaged in a banking, financing or similar business. Attach a schedule that separately states and adequately discloses each transaction that gives rise to a worthless stock loss that is treated as allocable to effectively connected income and the amount of each loss. Do not include on the schedule any worthless stock loss that is wholly allocable to noneffectively connected income. Do not include worthless stock losses that are incurred as part of a securities dealing or global securities dealing operation. Report these securities losses as either mark-to-market loss on lines 14a, 14c or 16c.

**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 and that are not reported on lines 21b through 21f.

**Line 22. Capital loss limitation and carryforward used**

Report as a positive amount on line 22, columns (b) or (c), as applicable, and (e) the excess of the net capital losses over the net capital gains reported on Schedule D, Capital Gains and Losses, by the corporation.

If the corporation utilizes a capital loss carryforward on Schedule D in the current tax year, report the carryforward utilized as a negative amount on Part II, line 22, columns (b) or (c), as applicable, and column (e).

**Line 23. Gross effectively connected income of foreign banks from books that do not give rise to U.S. booked liabilities (as defined in Regulations section 1.882-5(d)(2)(iii)) (attach schedule).**

Line 23 does not apply to foreign corporations other than foreign banks (as described in Regulations section 1.882-5(c)(4)).

Foreign banks report in columns (c) and (e), the gross effectively connected income that is not included on set(s) of books that are reportable on Form 1120F, Schedule L, and not included in the net income shown on Part 11, line 11. Do not report effectively connected income, gain (loss) in column (b) or (d). Gross effectively connected income of this type is that which is recorded on set(s) of books that do not ordinarily engage in effectively connected income producing activities, such as income from securities recorded in a home office that are attributable to a U.S. office under Regulations section 1.864-4(c)(5)(iii). Gross effectively income reportable on line 23 is also income of a type that is recognized under sections 864(c)(6) and 864(c)(7) with respect to property that ceases to be held in connection with a trade or business within the United States (e.g. transferred securities of a non-banking trade or business) or that is recognized under the Code at a time subsequent to cessation of the trade or business within the United States.

**Example 33.** FC, a foreign bank, negotiates and solicits a portfolio of loans and municipal bonds that are attributable to its U.S. office under Regulations section 1.864-4(c)(5)(iii). FC also enters into a number of forward contracts for customers through its U.S. trade or business. These contracts are not entered into in connection with a global securities dealing business. The transactions are initially recorded on FC's set(s) of books that are reported on Form 1120F, Schedule L. After a period of time, FC transfers several of the loans and the forward contracts to its home office in Country X other than in connection with a global securities dealing business. The transferred securities and forward contracts are recorded in FC's home office on set(s) of books that do not give rise to U.S. booked liabilities under Regulations section 1.882-5(d)(2)(iii) and i.e., the securities and contracts are no longer reportable on Form 1120F, Schedule L.

Report on Part II, line 23 column (c), the gross, income, gains (losses) from the transferred loans and municipal bond securities and forward contracts that is effectively connected with the foreign bank's trade or business within the United States.

Report on part II, line 23 column (d), as a negative number, the amount of the effectively connected municipal bond interest reported in column (c).

Report on Part II, line 23, column (e), the aggregate amount of effectively connected gross income, gains (losses) from the transferred loan securities and forward contracts.

The tax-exempt municipal bond interest is netted to zero in column (e).

#### **Line 24. Other Income (Loss) Items With Differences**

Report on Part II, line 24, all items of income (loss) with differences that are not otherwise listed on Part II, lines 1 through 23. Attach a schedule that itemizes the type of income (loss) and the amount of each item. For example, income (loss) with differences from long-term contracts are reportable on line 24.

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. Foreign corporations may report on line 24 net income (loss) from their distributive share of foreign partnership interests that do not have any U.S. source or effectively connected income, that the foreign corporation does not report on line 10. The aggregate income from such partnerships should be reported on line 25, column (d), as a negative number.

#### **Line 26 Total Expense/ Deduction Items**

Report on Part II, line 26, columns (a) through (e), as applicable, the negative of the amounts reported on Part III, line 33, columns (a) through (e). For example, if Part III, line 33, column (a), reflects an amount of \$1 million then report on Part II, line 26, column (a), (\$1 million). Similarly, if Part III, line 33, column (b), reflects an amount of (\$50,000), then report on Part II, line 26, column (b), \$50,000.

#### **Line 27. 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 24, or Part III, lines 1 through 32, report the entire amount of the item in columns (a) and (e) of line 27. 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 27. Instead, report the entire amount of the item (i.e., both the portion with a difference and the portion without a difference) on the applicable line of Part II, lines 1 through 24, or Part III, lines 1 through 32. See Example 12.

#### **Line 28. Reconciliation Totals. Combine lines 25 through 27.**

If a corporation chooses not to complete columns (a) and (e) 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 28, is reconciled by the

corporation in the following manner:

1. Report the amount from Part I, line 11, on Part II, line 28, column (a);
2. Leave blank Part II, lines 1 through 27, columns (a) and (e);
3. Leave blank Part III, columns (a) and (e);
4. Report on Part II, line 28, columns (b) through (d), the total of Part II, lines 1 through 27, columns (b) through (d) respectively, and
5. Report on Part II, line 28, column (e), the sum of Part II, line 28, columns (a), (b), (c) and (d). Note. Part II, line 28, column (e), must equal the amount on Form 1120-F, page 3, line 29.

### **Part III. Reconciliation of Net Income (Loss) per Income Statement of Foreign Corporations With Taxable Income per Return — Expense/ Deduction Items**

For column (a), report the expenses included on the applicable income statement as adjusted and reported in Part I, line 11.

#### **Lines 1 Through 4. Income Tax Expense**

If the corporation does not distinguish between current and deferred income tax expense in its applicable financial statement described in Part I, report income tax expense as current income tax expense using lines 1 and 3, as applicable. U.S. federal taxes and non-U.S. deferred income taxes are not deductible and Column (e) is inapplicable for lines 1, 2, and 4. Column (e) of line 3 is used to report only foreign income tax the corporation is deducting, other than the withholding taxes reported in line 5 below. If the corporation is crediting foreign income tax against the U.S. income tax liability, no amount is reported on line 3, column (e).

#### **Line 5. Non-U.S. Withholding Taxes**

Report on line 5, column (a), the amount of Non-U.S. (foreign) withholding taxes included in determining adjusted financial net income on Part I, line 11. If the corporation is deducting any foreign withholding tax, use column (b), (c) or (d), as applicable, to report any difference between foreign withholding tax included in financial accounting net income and the amount of any foreign withholding tax deduction reported in column (e). If the corporation is crediting foreign withholding taxes against its U.S. income tax liability, no amount is reported in column (e).

#### **Line 6. Corporate Officer's Compensation With Section 162(m) Limitation**

Report on line 6, column (a), the total amount of non-performance-based current

compensation expense (“applicable employee remuneration”) for corporate officers that are “covered employees” under section 162(m)(3). Report the nondeductible amount of current compensation in excess of \$1 million in column (c), the noneffectively connected portion of the deductible compensation in column (d) and the deductible portion of the compensation allocable to effectively connected income in column (e). Do not report the “applicable employee remuneration” for “covered employees” defined under section 162(m) on lines 8, 9 or 15.

**Line 7. Salaries and other base compensation**

Report salary and bonus compensation of the type reported on Form 1120F, Section II, line 13, other than stock option expense and other equity-based compensation reported on lines 8 and 9, below.

**Line 8. Stock Options Expense**

Report on line 8, column (a), amounts expensed on Part I, line 11, net income per the income statement, that are attributable to all stock options. Report on line 9, column (e), deduction amounts attributable to all stock options.

**Line 9. Other Equity-Based Compensation**

Report on line 9 any amounts for equity-based compensation or consideration that are reflected as expense in the financial statements (column (a)) or deducted in the U.S. federal income tax return (column (e)) other than amounts reportable elsewhere on Schedule M-3, Parts II and III (e.g., on Part III, line 8, for stock options expense). Examples of amounts reportable on line 9 include payments attributable to 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 10. Meals and Entertainment**

Report on line 10, 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 (e.g., Part II, line 2).

### **Line 11. Fines and Penalties**

Report on line 11 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 11, 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. In addition, report on line 11, column (a) the reversal of any overaccrual of any amount described in this paragraph. See section 162(f) for additional guidance.

Report on line 11, column (e), any such amounts as are described in the preceding paragraph that are includible in effectively connected taxable income, regardless of the financial accounting period in which such amounts were or are included in financial accounting net income. Complete columns (b), (c), and (d), as appropriate.

Do not report on this line 11, amounts required to be reported in accordance with instructions for Part III, line 12.

Do not report on this line 11, amounts recovered from insurers or any other indemnitors for any fines and penalties described above.

### **Line 12. Judgments, Damages, Awards, and Similar Costs**

Report on line 12, 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 12, column (a) the reversal of any overaccrual of any amount described in this paragraph.

Report on line 12, column (e), 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), (c), and (d), as appropriate.

Do not report on this line 12, amounts required to be reported in accordance with instructions for Part III, line 11.

Do not report on this line 12, amounts recovered from insurers or any other indemnitors for any judgments, damages, awards, or similar costs described above.

### **Line 13. Pension and Profit-Sharing**

Report on line 13 the expenses and deductions attributable to the corporation's pension plans, profit-sharing plans, and any other retirement plans. Complete columns (b), (c), and (d), as applicable.

**Line 14. Other Post-Retirement Benefits**

Report on line 14 the expenses and deductions attributable to other post-retirement benefits not otherwise includible on Part III, line 13, for example, retiree health and life insurance coverage, dental coverage, etc. Complete columns (b), (c), and (d), as appropriate.

**Line 15. Deferred Compensation**

Report on line 15, 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. federal income tax purposes in the current tax year and that was not reported elsewhere on Schedule M-3, column (a). Report on line 15, columns (d) and (e), the noneffectively connected and effectively connected portions of 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 15.

**Line 16 Charitable Contributions**

Report on line 16 any charitable contribution of tangible or intangible property to a U.S. or foreign charity, for example, contributions of:

- Cash;
- Buildings;
- 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 tangible or intangible property.

Include any temporary differences for the charitable contribution carryforward limitation in column (b). Report any net limitation carryforward for the current year as a net negative number. Report any utilization of a prior year limitation carryforward net of the current year limitation as a positive number in column (b). Reports any amounts from column (b) that are allocable to noneffectively connected income in column (d) and the effectively connected portion of the utilization of charitable contribution carryforward in column (e).

### **Line 17. Domestic Production Activities Deduction**

Report on line 17, column (e), the corporation's effectively connected portion of its domestic production activities deduction under section 199 that is reported on Form 1120-F, page 3, line 25. Complete columns (b), (c), as appropriate. Report in column (d), the portion of the deduction permitted under section 199 but is allocated and apportioned as a permanent difference to noneffectively connected income. Do not report any portion of the corporation's domestic production activities deduction on any other line of Schedule M-3.

### **Line 18. Current Year Acquisition or Reorganization Investment Banking Fees, Legal and Accounting Fees**

Report on line 18 any investment banking fees, and any legal and accounting fees paid or incurred in connection with a taxable or tax-free acquisition of property (e.g., 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 line 18 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 19. Current Year Acquisition/Reorganization Other Costs**

Report on line 19 any other fees paid or incurred in connection with a taxable or tax-free acquisition of property (e.g., stock or assets) or a tax-free reorganization not otherwise reportable on Schedule M-3 (e.g., Part III, line 18). 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 line 19 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 20. Amortization/ Impairment of Goodwill**

Report on line 20 amortization of goodwill or amounts attributable to the impairment of goodwill.

### **Line 21. Amortization of Acquisition, Reorganization, and Start-Up Costs**

Report on line 21 amortization of acquisition, reorganization, and start-up costs. For purposes of column (b), (c), (d), and (e), include amounts amortizable under section 167, 195, or 248.

### **Line 22. Other Amortization or Impairment Write-Offs**



Report on line 22 any amortization or impairment write-offs not otherwise includible on Schedule M-3.

### **Line 23. Depreciation**

Report on line 23 any depreciation expense that is not required to be reported elsewhere on Schedule M-3 (e.g., on Part II, lines 2, 9, 10, or 11).

### **Line 24. Bad Debt Expense**

Report on line 24, column (a), any amounts attributable to an allowance for uncollectible accounts receivable or actual write-offs of accounts receivable included in determining net income per the income statement. Report in columns (d) and (e) the effectively connected and the noneffectively connected portions of the deductible amount of bad debt expense determined under section 166 for federal income tax purposes. Foreign corporations, including foreign banks, must treat their section 166 deductions consistently in the same tax year whether or not such amounts are allocable to effectively or noneffectively connected income. A foreign bank may not claim a bad debt expense for Regulation sections 1.882-5(c)(2) and (c)(3) purposes and treat such expense as an involuntary charge-off under Regulation section 1.166-2(d)(2) for purposes of its allocation and apportionment to effectively connected income. For example, if a foreign corporation treats a noneffectively connected loan security for purposes of determining the value of its worldwide assets in step-2 of its Regulation section 1.882-5 interest expense allocation, as having a reduced basis in the current year to take account of partial worthlessness under section 166, such current year adjustment to basis is also reportable in column (d) for all non-banks, and also for foreign banks if such amount is also reportable in column (a). If, however, a current year section 166 reduction in basis is claimed for Regulation section 1.882-5(c)(2) purposes with respect to a security that is effectively connected, but is not included on the Form 1120F Schedule L books, such effectively connected amount must be reported in column (c) and column (e). Otherwise, if the effectively connected security is includible in column (a), no book tax difference is reported in column (b), (c) or (d).

### **Line 25. Purchase Versus Lease (for Purchasers and/or Lessees)**

**Note.** Also, see the instructions at Part II, line 17, on page , for sellers and/or lessors.

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 on, line 25, column (a), gross rent expense for a transaction treated as a lease for income statement purposes but as a sale for U.S. federal income tax purposes. Report on line 25, column (e), gross rental deductions for a transaction treated as a lease for U.S. federal income tax purposes but as a purchase for income statement purposes. Report interest expense for such transactions on Part III, line 29a, Interest expense, in column (a) (e), as applicable. Report depreciation expense or deductions for such transactions on Part III, line 23, Depreciation, in column (a) or (e), as applicable. Use columns (b), (c), and (d) of Part III, lines 23, 25, and 26a, as applicable, to report the differences between column (a) and (e) for such recharacterized transactions.

#### **Line 26a. Interest expense**

The detail for the foreign corporation's interest expense is reported elsewhere on Form 1120F, Schedule I. The scope of the interest expense lines on Part III, line 26, is limited to a summarization of the results from Schedule I that reconcile the foreign corporation's book interest expense to effectively connected taxable income.

On line 26a no amount is allocated and apportioned to effectively or noneffectively connected income. Report in line 26a, column (a) interest expense included in Part I, line 11. Report amounts in columns (b) or (c), as applicable. The corresponding interest expense for U.S. federal income tax purposes is reported on Part III, lines 26b through 26e, column (e). Do not report on this line 26a column (a) amounts for (i) Part II, lines 9, 10, and 11, Income (loss) from U.S. partnerships, foreign partnerships, and other pass-through entities; (ii) Part II, line 12, Items relating to reportable transactions, and; (iii) Part III, lines 26b through 26(e).

#### **Line 26b. Interest Expense allocable under Treasury Regulation 1.882-5**

The interest expense deduction under Regulations section 1.882-5 is based on a three-step formula required to be reported on Form 1120F Schedule I. Report the allocable amount of interest expense from Form 1120-F, Schedule I, line 23, in column (c) and in column (e).

#### **Line 26c. Section 1.882-5 allocation amount subject to deferral or disallowance**

Report as a negative number on line 26c, column (e), the amount reported on Form 1120F, Schedule I, line 24d, as the total amount of the Regulation section 1.882-5 allocation that is deferred or disallowed under other sections of the Code. The column (e) amount may be a positive or a negative number depending on whether deferred interest expense reportable on Schedule I, line 24b, from prior years is deductible in the current year in greater amount than other current year disallowances reportable on Schedule I, lines 24a and 24c. The deferred or disallowed amounts are carried over from Form

1120F, Schedule I, lines 24a, 24b and 24c. For Part III, line 26c, enter in column (b) the amount from Schedule I, line 24b, as a positive or negative number as the case may be for the current year. In column (c), enter the combined amounts from Schedule I lines 24a and 24c.

**Line 26d. Substitute interest payments.**

All foreign corporations, report on line 26d, all U.S. source substitute interest payments with respect to securities lending transactions described in Regulations sections 1.861-2(a)(7) and 1.881-2(b)(2). Foreign banks that record substitute interest payments on set(s) of books that are not reported on Form 1120F, Schedule L, also report foreign source substitute interest payments that are allocable to effectively connected income in whole or in part. Foreign banks report all U.S. source and allocable foreign source substitute interest payments in column (c). The amounts reported in column (c) are apportioned to noneffectively connected income of the foreign corporation in column (d) and to effectively connected income in column (e) as the case may be.

**Line 26e. Interest equivalents (Guarantee fees)**

All foreign corporations, including banks, report on line 26e the foreign corporation's amounts with respect to deductions that are not interest payments but are sourced in the manner of interest ("interest equivalents"). These amounts include fees expensed for financial guarantee and confirmation, acceptance and standby letter of credit transactions. Foreign banks that record U.S. source guarantee fees on set(s) of books not reported on Form 1120F, Schedule L, and not reported in column (a), must report the U.S. source fees as a permanent difference on line 26d, column (c), and allocate and apportion the relevant amounts to noneffectively connected income in column (d) even if there is no amount to allocate to effectively connected amounts in column (e). Foreign corporations other than banks must record all interest equivalent payments in column (a). Do not include on line 26e, substitute payments reportable on line 26d.

**Example 34.** FC is a foreign bank, resident in Country X that files Form 1120F and Schedule M-3. FC enters into a guarantee arrangement with a FC-2, a wholly owned subsidiary, resident in Country Y that guarantees the transactions in FC's global dealing operation. The set(s) of books in FC's global dealing operation are booked in FC's home office and are not reportable on Form 1120F, Schedule L. FC allocates and apportions 40% of the income and applicable expenses from its global dealing operation to effectively connected taxable income. FC's guarantee fee expense to its foreign-related party is allocated directly to the income of the global dealing operation and apportioned 40% to FC's effectively connected income from such operation. FC must report the guarantee fee expense paid to FC2 in column (c). The amount of expense reported in column (c) is apportioned 60% to noneffectively connected income in column (d) and 40% to effectively connected income in column (e).

**Line 27. Substitute dividend payments.**

All foreign corporations, including banks, report on line 27, the amount of U.S. substitute dividend payments with respect to securities lending transactions described in Regulations sections 1.861-3(a)(6) and 1.881-2(b)(2). Foreign banks that record substitute dividend payments on set(s) of books that are not reported on Form 1120F, Schedule L, also report foreign source substitute dividend payments that are allocable to effectively connected income in whole or in part. Foreign banks report such U.S. source and allocable foreign source substitute dividends in column (c) as a permanent difference. Report the amount of the substitute dividend payments that are allocated to noneffectively connected income of the foreign corporation on column (d) and the amount that is allocable to effectively connected income in column (e).

**Line 28. Fee and Commission expense**

Enter on Part III, line 28, column (a), the amounts of fees and commissions included on Part I, line 11. Fee and commission expense generally includes amounts paid or accrued for services rendered to the foreign corporation including expenses paid for brokerage commissions. Fees and commissions reportable 28 do not include amounts that are interest equivalents reportable on line 26e.

**Line 29. Rental Expense**

Report on Line 29, column (a), the amount of rental expense included on Part I, line 11. Rental expense is the amount classifiable as rent under U.S. tax principles.

**Line 30. Royalty Expense**

Report on Line 30, column (a), the amount of royalty expense included on Part I, line 11. Include in columns (b) through (e) amounts that are allocable as imputed royalties under U.S. tax principles that are not included in financial income reported on Part I, line 11.

**Line 31. Expenses allocable under Treasury Regulation 1.861-8**

Line 31 applies only to foreign banks. For purposes of Schedule M-3, all of the home office allocation reportable under Regulations section 1.861-8 (including amounts that are subject to timing differences under U.S. tax principles, such as home office depreciation) are reportable as permanent differences. Report in columns (c) and (e) the amount from Form 1120F, Schedule H, line 20.

**Line 32. Other Expense/ Deduction Items With Differences and reconciliation to eliminate duplicate amounts on line 31**

Report on line 32, all items of expense/deduction that are not otherwise listed on Part III, lines 1 through 31. Amounts included on line 31(e) from Form 1120F, Schedule H, line 21, that are also included in this Form M-3, Part III, lines 3, 5 through 23, 25, 26d, 26e and 27 need to be reversed to avoid duplicate allocation. The combined amounts for these lines reported in column (e) that is duplicative of any amount included in line 31, column (e) is reported and reversed on line 32. Report such duplicative amount as a negative amount includible in line 32, column (c) and column (e). Such negative amount will need to be combined with other expense/deduction items that have differences. Attach a schedule to show the duplicative items that are being reversed.

**Comprehensive income.** If any “comprehensive income” as defined by SFAS No. 130 is reported on this line, describe the item(s) in detail.

**Reserves and contingent liabilities.**

Report on line 32 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 12, 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 24, Bad Debt Expense.

Report on line 32, the amortization of various items of prepaid expense, such as prepaid subscriptions and license fees, prepaid insurance, etc.

Report on line 32, column (a), expenses included in net income reported on Part I, line 11, that are related to reserves and contingent liabilities. Report on line 32, column (e), amounts related to liabilities for reserves and contingent liabilities that are deductible in the current tax year for U.S. federal income tax purposes. Examples of items that must be reported on line 32 include warranty reserves, restructuring reserves, reserves for discontinued operations, and reserves for acquisitions and dispositions. Only report on line 32 items that are not required to be reported elsewhere on Schedule M-3, Parts II and III. For example, the expense for a reserve for inventory obsolescence must be reported on Part II, line 2.

The schedule of details attached to the return for line 32 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 workpapers 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.

Amounts incurred as fixed or determinable or other periodic interest rate or equity notional principal contract expense that is not incurred in a hedging transaction, securities dealing or global securities dealing operation each of which is reportable on Part II, is reportable on Part III, line 32.

**Example 35.** Corporation Q is a calendar year taxpayer that was required to file Schedule M-3 for its 2007 tax year and is required to file Schedule M-3 for its 2008 tax year. On July 1 of each year, Q has a fixed liability for its annual insurance premiums 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, 2008, Q prepays its insurance premium of \$500,000 and advertising expenses of \$800,000. For financial statement purposes, Q capitalizes and amortizes the prepaid insurance and advertising over 12 months. For U.S. federal 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. federal income tax treatment of the prepaid insurance and advertising as temporary differences. Q must separately state and adequately disclose on Part III, line 32, its prepaid insurance premium and report \$250,000 in column (a) ( $\$500,000/12$  months X 6 months), \$250,000 in column (b), and \$500,000 in column (e). Q must also separately state and adequately disclose on Part II, line 24, its prepaid advertising and report \$400,000 in column (a) and (e).

### **Line 33. Total Expense/ Deduction Items**

Report on Part II, line 26, columns (a) through (e), as applicable, the negative of the amounts reported on Part III, line 33, column (a) through (e), as applicable. For example, if Part III, line 33, column (a), reflects an amount of \$1 million, then report on Part II, line 26, column (a), (\$1 million). Similarly, if Part III, line 33, column (b), reflects an amount of (\$50,000), then report on Part II, line 26, column (b), \$50,000.