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

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

Volume 2 of 2

Department of the Treasury
Internal Revenue Service

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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. income tax purposes. Gross rents that are recorded as a sale for financial purposes 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 (for example, 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. Remove such amount in column (b) or (c), as applicable. Include on Part II, line 3, columns (c) and (e), dividends received from any corporation accounted for on the equity method to the extent the dividends constitute effectively connected income.

Lines 9 and 10. Net Income (Loss) from U.S. and Certain Foreign Partnerships

Note. The income (loss) reported in column (e) must reconcile with the effectively connected income reportable to the foreign corporation on all Schedules K-3 (Form 1065) and which the foreign corporation is required to report on Schedule P (Form 1120-F), Part II.

Except as provided below for certain foreign partnership interests of corporations other than a bank, 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 all U.S. and foreign partnership interests that are included in Schedule M-3, Part I, line 11.

2. Report in column (b) or (c), as applicable, the sum of all differences, if any, attributable to the U.S. and foreign partnership interests. The corporation's distributive share of book interest expense from all its U.S. and foreign partnership interests reported in column (a) must be reported as a positive amount in column (c) as a permanent difference. The amount of interest expense, from all U.S. and foreign partnership interests, allowed

as a deduction against effectively connected income is entered on Part III, lines 26b and 26c, from Schedule I (Form 1120-F), lines 23 and 24g, respectively.

3. Report in column (d) the amounts of gross non-effectively connected income and expenses that relate to the distributive share of income or loss from all U.S. and foreign partnership interests. These amounts will have been reported to you on columns (e), (f), and (g) of Schedule K-3 (Form 1065), Part X, Section 1, line 21, and Section 2, line 24.

4. Report in column (e), except for amounts described below in “Exclusion of certain foreign partnership interests from line 10,” the sum of all amounts attributable to the corporation's distributive share of income or loss from all U.S. and foreign partnership

interests that are included in taxable income. The amount reported in column (e) of lines 9 and 10 should reconcile with an amount that is:

- The sum of the gross income amounts reported on Schedule P (Form 1120-F), Part II, lines 2 and 3 ("Total" column), minus
- The sum of the deductions/loss amounts reported on Schedule P (Form 1120-F), Part II, lines 5 and 6 ("Total" column), plus
- The sum of the amounts reported on Schedule P (Form 1120-F), Part II, lines 7 and 8 ("Total" column).

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 I, 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)(5), and interest expense included in the foreign corporation's distributive share of a foreign partnership is included in such allocation, see the instructions for Part III, line 26a, for the required reporting.

Example 18. FC is a calendar year taxpayer that is required to file Schedule M-3 for the current tax year. FC, which is not a foreign bank, is a partner in foreign partnership FP. 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 FP as a permanent difference. For its 2023 tax year, FC's income statement includes $10,000 of income attributable to its share of FP's net income. FC's Schedule K-3 from FP 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. Consequently, FC must enter the following amounts on Part II, line 10: $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 column (a) and column (e) after temporary differences in column (b).

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

from all of its pass-through entities reported in column (a) must be reversed as a permanent difference. Enter the amount of all such interest expense as a negative number in column (c). The amount of pass-through interest expense allowed as a deduction against effectively connected income is included on Part III, lines 26b and 26c, from Schedule I (Form 1120-F), lines 23 and 24g.

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-3 received from the pass-through entity (if applicable).

Foreign corporations other than banks that have interests in foreign pass-through entities with no effectively connected income for the year need not separately report those interests on this line. If, however, the foreign corporation reports a pass-through interest on the equity method in the income statement used for Part I, 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 pass-through interest in column (a), it should not report any amounts in column (e) for the pass-through interest. It would instead report the income and other items from the pass-through 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)(5), and interest expense included in the foreign corporation's pass-through amount is included in such allocation, see the instructions for Part III, line 26a, for the required reporting.

For each pass-through entity reported on line 11, attach a supporting statement 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, Reportable Transaction Disclosure Statement, 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 financial amounts and the taxable amounts.

Each difference attributable to a reportable transaction must be separately stated and adequately disclosed. A corporation will be considered to have separately stated and adequately disclosed a reportable transaction on line 12 if the corporation sequentially numbers each Form 8886 and lists by identifying number on the supporting statement 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 statement 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 1c, respectively, of Form 8886; and
3. The type of reportable transaction (that is, listed transaction, confidential

transaction, transaction with contractual protection, etc.) as reported on line 2 of Form 8886.

If a transaction is a listed transaction described in Regulations section 1.6011-4(b)(2), the supporting statement must also include the information requested 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 supporting statement 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 is required to file Schedule M-3 for the current tax year. J incurred seven different abandonment losses during its 2023 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 statement 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 statement 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 is required to file Schedule M-3 for the current 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 2023 tax year and results in a $7 million capital loss for both financial statement purposes and U.S. 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 statement 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 (including hedges of inventory) included in the amount reported on Part I, line 11, 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(a) (report these transactions on either Part II, line 4, or in Part III, line 26a, column (a), as applicable);
- Hedging transactions of securities dealer property (other than a global dealing operation) that is marked-to-market under section 475(a) (see instructions for line 14a);
- Hedging transactions entered into by a commodities dealer that makes a mark-to-market election under section 475(e) (see instructions for line 14c); and
- Hedging transactions entered into by a securities or commodities trader that makes a mark-to-market election under

section 475(f) (see instructions for line 14d).

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. income tax purposes. For example, if a portion of a hedge is considered ineffective under GAAP but still is a valid hedge under section 1221(b)(2), the difference must be reported on line 13. The hedge of a capital asset, which is not a valid hedge for U.S. income tax purposes pursuant to section 1221(b) (2), must also be reported here if it is considered a hedge under the corporation's method of accounting. Transactions that are treated as hedging capital assets solely because the hedged asset gives rise to noneffectively connected income and is not eligible for ordinary treatment under section 582(c), are also reported on line 13. See *Example 22*.

Report on Part II, line 16c, hedging transactions entered into by a global dealing operation including those that are “risk transfer agreements” defined in Proposed Regulations section 1.475(g)-2. However, income with respect to a risk transfer agreement that is held by the foreign corporation's non-global dealing operations is, unless reported elsewhere in Part II, reported on line 13 to the extent it is reported on Part I, line 11. If a foreign bank does not so report a risk transfer agreement held by a non-global dealing operation on Part I, line 11, any ECI from such risk transfer agreement earned by the non-global dealing operation must be reported on Part II, line 23, column (d).

Report on this line 13 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)).

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 1120-F, Schedule L. The hedged portfolio consists of four securities of equal amounts, only two of which give rise to effectively connected income. For financial statement 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 that are not eligible for ordinary treatment on disposition under section

582(c). Consequently, the notional principal contract does not constitute a hedging transaction under section 1221(b)(2). Regardless, the income gain or loss with respect to the notional principal contract (including any mark-to-market income from the hedge) is reportable as a hedging transaction on line 13 and is not reported on line 4b or 14b.

Lines 14a Through 14d.

Mark-to-Market Income (Loss)

Except for global dealing operations reportable on line 16 and for certain hedging transactions reported on line 13, report on lines 14a through 14d, column (a), any amount that is subject to mark-to-market treatment under section 475. Report on line 14a income or (loss) from securities held by a dealer in securities, in its capacity as a dealer under section 475(a). On line 14b, report the mark-to-market treatment of securities held by a dealer other than in its capacity as a dealer that is subject to the characterization provisions of section 475(d)(3)(B). Report on line 14c the mark-to-market income of a dealer in commodities having made a valid election under section 475(e), and on line 14d, report the mark-to-market income of a trader in securities or commodities having made a valid election under section 475(f). “Securities” for these purposes are securities described in section 475(c)(2) and commodities described in section 475(e)(2). “Securities” do not include any items specifically excluded from sections 475(c)(2) and 475(e)(2), such as certain contracts to which section 1256(a) applies (which may be reportable on line 13 as hedges).

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 are determined under the mark-to-market method of accounting, on Part II, line 13 (hedging transactions), and not on line 14.

Traders in securities and commodities. For a trader in securities or commodities that made a valid election under section 475(f) to use the mark-to-market method to account for securities or commodities held in connection with a trading business that files Form 4797, any Schedule M-3 entries required as a result of marking to market these securities or commodities are reported as follows: (a) mark-to-market gains and losses from Form 4797, line 10, are included on Part II, line 14d, of Schedule M-3 (Form 1120-F); (b) any other Schedule M-3 entries required based on other results (non-mark-to-market gains and losses) included in the total reported on Form 4797, line 17, should be reported on Part II, line 21d, of Schedule M-3 (Form 1120-F), unless the instructions for Schedule M-3 require the amounts to be reported on another line.

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 1120-F, Schedule L; is effectively connected with FC's trade or business within the United States; and constitutes income of a securities dealer, as defined in Regulations section 1.864-2(c)(2)(iv) only, and not 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, columns (d) and (e), as sourced and allocated under Proposed Regulations section 1.863-3(h) between non-ECI and ECI (see “Note” on page 8 for a clarification regarding Proposed Regulations section 1.863-3(h)). If the global dealing operation is of a foreign bank and is not includible in column (a), the apportionment of the global dealing operation's results would be reportable in column (d) for the amount of income or loss that is allocable to ECI. Income would be reportable as a positive number and losses would be reportable as a negative number. If the global dealing set(s) of books are reportable in column (a), either because like FC, it is a broker dealer and not a foreign bank, or it is a foreign bank whose global dealing operation is reportable on Form 1120-F, Schedule L, the apportionment of the global dealing operation's results would be reportable in column (d) for the portion that needs to be allocated to noneffectively connected income. In such instance, the amount of income allocable to non-ECI would be reportable as a negative amount and the amount of loss would be reportable as a positive number in column (d). For all filers, columns (a), (b), (c), and (d) are combined to determine the ECI amount reportable in column (e).

Line 15. Gains (Losses) From Certain 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 hedging transactions, as defined in

Regulations section 1.988-5(a) (see line 13 instructions).

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 currency other than FC's functional currency. 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).

Lines 16a and 16b. Interest Income and Dividends From Global Securities Dealing

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

Line 16c. Gains (Losses) and Other Fixed and Determinable, Annual, or 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 Proposed Regulations section 1.482-8) that would be subject to source and allocation under Proposed Regulations section 1.863-3(h) (see “Note” on page 8 for a clarification regarding Proposed Regulations 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 would not be subject to source and allocation under Proposed Regulations section 1.863-3(h) are reportable as mark-to-market income on line 14, and the interest, dividend, and other FDAP income earned in such non-global dealer activities is reportable on Part II, lines 3 and 4. Reporting on line 16 is determined by whether the income, gains and (losses) would be subject to allocation under Proposed Regulations section 1.863-3(h) and not by whether all or none of the amount would be allocable to ECI. If income of a global dealing operation would be entirely allocable to ECI or non-ECI under Proposed Regulations section 1.863-3(h), the amount is reportable on line 16 and not on line 14.

If the income or losses from global dealing operations of foreign banks reportable on any of lines 16a through 16c are allocable in whole or in part to effectively connected income but not reportable in column (a), apportion the ECI amounts of the global dealing operation in columns (d) and (e). If the foreign bank does include a global dealing operation in column (a), then report the apportionment of such operation to non-ECI in column (d) and the residual ECI amount in column (e). Attach a statement providing a brief description of each global dealing operation (for example, 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)).

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 and (losses) to effectively connected income. FC is also engaged in a securities dealing operation that is not a global 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 1120-F, Schedule L. Because FC is not a foreign bank described in Regulations section 1.882-5(c)(4), FC's income, gains and (losses) with respect to its securities dealing in foreign currency X is reportable on 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 is 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 an apportionment 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 1120-F, Schedule L, the amounts are not reported on Part I, line 11, or Part II, line 14a. If the notional principal contract book was not reportable on a set of books reportable in column (a), such operation would not be included on line 16c, column (a). As a result, the amount allocable to effectively connected income from this operation is reported in column (d) and in column (e). If the set of books reported on Form 1120-F, Schedule L, had included the notional principal contract operation, FC would have reported such amount in column (a), and the apportionment in column (d) would have included a negative number for the amount of income and gains allocable to noneffectively connected income. Losses allocable to non-ECI would be reported as a positive number. In column (e), FC combines columns (a), (b), (c), and (d) to report the amount allocable to effectively connected income.

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

Note. See the instructions for Part III, line 25, later, 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 statement 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 columns (a) and (e), as applicable. Depreciation expense for such transactions must be reported on Part III, line 23 (depreciation), in columns (a) and (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 columns (a) and (e).

Example 27. Corporation M sells and leases property to customers. M is a calendar year taxpayer that files and entirely completes Schedule M-3 for its 2023 tax year. For financial accounting purposes, M accounts for each transaction as a sale. For U.S. income tax purposes, each of M's transactions must be treated as a lease. In its income statements, M treats the difference in the financial accounting and the U.S. income tax treatment of these transactions as temporary. During 2023, M reports on its income statements $1,000 of sales and $700 of cost of goods sold with respect to 2023 lease transactions. M receives periodic payments of $500 in 2023 with respect to these 2023 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. 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 is effectively connected income/expense. On its 2023 Schedule M-3, M must report on Part II, line 4a (interest income), $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 enter $200 in each of columns (b) and (e) on Part III, line 23.

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. 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 files and entirely completes Schedule M-3 for its 2023 tax year. N was depreciating certain fixed assets over an erroneous recovery period and, effective for its 2023 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 4 tax years, beginning with the 2023 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 2023 tax year and each of the subsequent 3 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 not effectively connected to N's trade or business within the United States and is not includible in column (a), the amount would be reportable for each year in column (b) as a temporary difference (for U.S. tax principles) and then reversed as an apportionment to non-ECI in column (d). If N were a foreign bank, the amount would only be so reportable if the section 481(a) adjustment was with respect to transactions recorded on set(s) of books reportable on Form 1120-F, 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. 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 column (e). If the amounts are not includible on set(s) of books reportable on Form 1120-F, 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. income tax purposes in the current tax year that is 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 2023 is $250. FC reports this amount on Part II, line 19, column (a). In column (b), FC reports $750 as a temporary book-to-tax difference to adjust to the amount recognized by the foreign corporation in 2023 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 1120-F as effectively connected income in 2023.

In 2023, assuming no other commission income is earned or accrued for either financial or U.S. tax purposes, FC would include $750 on Part II, line 19, 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, phantom income, or OID includible on line 16a. The term “original issue discount and other imputed interest” includes, but is not limited to:

1. The excess of a debt instrument's stated redemption price at maturity over its issue price, as determined under section 1273;
2. Amounts that are imputed interest on a deferred sales contract under section 483;
3. Amounts treated as interest or OID under the stripped bond rules under section 1286;
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 Real Estate Mortgage Investment Conduit (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 (that is, 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 1120-F, Schedule L. Amounts that are not effectively 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 1120-F, 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 FC'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 FC and subject to tax under section 881(a). FC 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 1120-F, Section I, line 10, as other fixed or determinable, annual, or other periodic income and subject to tax at

30%.

Example 32. The facts are the same as in *Example 30*, except FC recognizes $100 of residual excess inclusion income on its set(s) of books and records reportable on Form

1120-F, Schedule L, for cash received, and an additional $1,000 of phantom income not recognized for financial accounting 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 1120-F, Section I, 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 (for example, on Schedule K-3) that are included on line 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. 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 (Form 1120), Capital Gains and Losses, excluding capital gains from pass-through entities that are included on line 9, 10, or 11, as applicable.

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

Report on line 21c gross capital losses reported on Schedule D (Form 1120), excluding capital losses from (a) pass-through entities that are included on line 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, Abandonment Losses, and Worthless Stock Losses

Report on line 21d the net gain or loss reported on line 17 of Form 4797, Sales of Business Property, excluding amounts from (a) pass-through entities included on line 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.

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

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 statement 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 statement 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 mark-to-market loss on line 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, column (b) or (c), as applicable, and column (e) the excess of the net capital losses over the net capital gains reported on Schedule D (Form 1120) by the corporation.

If the corporation utilizes a capital loss carryforward on Schedule D (Form 1120) 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

Line 23 applies only to foreign banks (as described in Regulations section 1.882-5(c)(4)). Foreign banks report in columns (d) and (e) the gross effectively connected income or loss (other than income or loss from a global dealing operation) that is excluded from the set(s) of books reportable on Form 1120-F, Schedule L, and excluded from the net income shown on Part I, line 11. Gross effectively connected income or loss of this type is that which is ordinarily recorded on books of non-U.S. branches or locations 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 connected income or loss 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 (for example, transferred securities of a non-banking, financing or similar business or of a former banking, financing or similar business) or that is recognized under the Code at a time subsequent to cessation of the trade or business within the United States. Amounts from a global dealing operation that are apportionable in whole or in part to effectively connected income are reported on line 16 and not on this line 23.

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 operation. The transactions are initially recorded on FC's set(s) of books that are reported on Form 1120-F, Schedule L. In a later year, FC transfers several of the loans, the forward contracts, and the municipal bonds to its home office in Country X to be held other than in connection with a global securities dealing operation. These assets 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). As a result, the transferred assets are no longer reportable on Form 1120-F, Schedule L.

Report on Part II, line 23, column (c), as a negative number, the amount of the effectively connected municipal bond interest. The municipal bond interest is a permanent difference that must be reversed in column (d) since it is no longer taken into account in column (a) on FC's set(s) of books reportable on Schedule L.

Report on Part II, line 23, column (d), the gross income, gains and (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 the income and gains as positive numbers and losses as negative amounts.

Report on Part II, line 23, column (e), the combined column (b), (c), and (d) amounts to determine the aggregate amount of effectively connected gross income, gains and (losses) from the transferred loan securities and forward contracts. The tax-exempt municipal bond interest is netted to zero in column (e).

Treaty-based reporting. If a corporation excludes any amounts from column (a) on the grounds that it is reporting the books of a U.S. permanent establishment (see

Adaptation of Form 1120-F, Schedule L for treaty-based reporting, earlier, in these instructions for such reporting) and further excludes from the same line any amounts from column (e) that would otherwise be reportable under Code principles, the corporation should report the Code-based amount in column (c) and reverse the amount in column (d), with a footnote reference explaining that column (d) reports a treaty-based exclusion, or attach a statement which identifies the portion of such exclusion reported in the total amount shown in column (d).

Line 24. Other Income (Loss) Items With Differences

Separately state and adequately disclose 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 statement that describes and itemizes the type of income (loss) and the amount of each item and provides a description that states the income (loss) name for book purposes for the amount recorded in column (a) and describes the adjustment being recorded in column (b), (c), or (d). The entire description completes the tax description for the amount included in column (e) for each item separately stated on this line.

The attached statement should have six columns. The first column has the description for the next five columns. The second column is column (a), income (loss) per income statement. The third column is column (b), temporary differences. The fourth column is column (c), permanent differences. The fifth column is column (d), other permanent differences for allocations to non-ECI and ECI. The sixth column is column (e), income (loss) per tax return. For each item listed on the attached statement for line 24, columns (a) through (d) when combined must equal column (e). The amounts in columns (a) through (e) for all items must be totaled on the attached statement and the total amounts must be included on Part II, 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 24, 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 inverse 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 (that is, 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*.

Specific Instructions for Part III. Reconciliation of Net Income (Loss) per Income Statement of Non-Consolidated 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. current and deferred income 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 on 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 in column (b) or (c), as applicable, the nondeductible amount of current compensation in excess of $1 million ($500,000 if the corporation receives or has received financial assistance under the Treasury Troubled Asset Relief Program (TARP)). Report 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 line 8, 9, or 15.

Line 7. Salaries and Other Base Compensation

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

Line 8. Stock Option 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 8, 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. income tax return (column (e)) other than amounts reportable elsewhere on Schedule M-3, Parts II and III (for example, 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, qualified equity grants, 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 (for example, 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. 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, include 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). Report 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. Section 162(r)—FDIC Premiums Paid by Certain Large Financial Institutions

Report on line 17, column (a), the total amount paid or accrued as FDIC premiums included on Part I, line 11. Report on line 17, column (c), any disallowed amounts, subject to the applicable percentage, of any FDIC premiums paid or included by the large financial institution. For this purpose, the large financial institution includes members of its expanded affiliated group, as defined in section 162(r)(6) (B). This disallowance does not apply if the institution's (including members of its expanded affiliated group's) total consolidated assets (determined as of the close of the tax year) do not exceed $10 billion.

The applicable percentage is the excess of the corporation's total consolidated assets over $10 billion, divided by $40 billion. For taxpayers with total consolidated assets of $50 billion or more, the applicable percentage is 100%. See section 162(r).

Example 34. Corporation X has total consolidated assets of $20 billion. Under section 162(r), no deduction is allowed for

25% ((20,000,000,000 – 10,000,000,000) / 40,000,000,000) of FDIC premiums.

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 (for example, stock or assets) or a tax-free reorganization. Report on this line any investment banking fees incurred at any stage of the acquisition or reorganization process including, for example, fees paid or incurred to evaluate whether to investigate an acquisition, fees to conduct an actual investigation, and fees to consummate the acquisition. Also, include on 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 (for example, stock or assets) or a tax-free reorganization not otherwise reportable on Schedule M-3 (for example, 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 columns (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 (for example, on Part II, line 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 respective noneffectively connected and the effectively connected portions of the deductible amount of bad debt expense determined under section 166 for federal income tax purposes that is also included in column (a). If a foreign bank has an effectively connected bad debt expense that is not reportable in column (a), the ECI amount is included in column (b) if it is a temporary difference and in column (e) to report the ECI treatment. If there is no temporary difference between the foreign bank's books and tax treatment, then such ECI amount that is not included in column (a) is apportioned in column (d), and its total is reflected in column (e).

Line 25. Purchase versus Lease (for Purchasers and/or Lessees)

Note. See the instructions for Part II, line 17, earlier, 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. income tax purposes. Report on line 25, column (e), gross rental deductions for a transaction treated as a lease for U.S. income tax purposes but as a purchase for income statement purposes. Report interest expense for such transactions on Part III, lines 26a through 26e, columns (a) and (e), as applicable. Report depreciation expense or deductions for such transactions on Part III, line 23 (depreciation), columns (a) and (e), as applicable. Use columns (b), (c), and (d) of Part III, lines 23, 25, and 26a through 26e, as applicable, to report the differences between columns (a) and (e) for such recharacterized transactions.

Line 26a. Interest Expense Per Books

The detail for the foreign corporation's interest expense is reported on Schedule I (Form 1120-F). 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 column (b) or (c), as applicable. The corresponding interest expense for U.S. income tax purposes is reported on Part III, lines 26b through 26e, column (e). Do not report on this line 26a, column (a), amounts reportable on:

1. Part II, lines 9, 10, and 11 (income (loss) from U.S. partnerships, foreign partnerships, and other pass-through entities);

Note. Interest expense from partnerships and pass-through entities is adjusted as a permanent difference in column (c) of Part II, lines 9, 10, and 11. The deductible portion of such interest expense reported on Part II, lines 9, 10, and 11 is included in the interest expense allocation under Regulations section 1.882-5 as reported on Schedule I and is also included on Schedule M-3, Part III, lines 26b and 26c.

2. Part II, line 12 (items relating to reportable transactions); and
3. Part III, lines 26b through 26e.

Line 26b. Interest Expense Allocable Under Regulations Section 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 Schedule I (Form 1120-F). Report the allocable amount of interest expense from Schedule I, line 23, in column (d) and in column (e) of line 26b.

Line 26c. Regulations Section 1.882-5 Allocation Amount Subject to Deferral or Disallowance

Enter in column (e) the amount reported on Schedule I (Form 1120-F), line 24g.

Enter in column (b) the combined amounts from Schedule I, lines 24b, 24c, 24e, and 24f, 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 24d as a negative number.

Line 26d. Substitute Interest Payments

All foreign corporations, report on line 26d all U.S. source substitute interest payments (as to the recipient) 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 1120-F, Schedule L, might also report foreign source substitute interest payments whether or not they are allocable in whole or in part to ECI. Foreign banks report in column (c) all U.S. source and allocable foreign source substitute interest payments not already reflected in column (a). The amounts reported in column (c) are apportioned to noneffectively connected income of the foreign corporation in column (d) and reported as a negative number. Amounts included in column (a) that are also apportioned to non-ECI are also reported in column (d) as a negative number. The combined amounts of columns (a), (b), (c), and (d) are apportioned to effectively connected income in column (e) as the case may be.

Note. In using column (d) to apportion amounts to non-ECI that are not included in column (a), line 26d contains an exception to the general instructions for Schedule M-3 reporting by foreign banks.

Line 26e. Interest Equivalents (Guarantee Fees)

All foreign corporations, report on line 26e the foreign corporation's amounts with respect to deductions that are not interest payments but are sourced to the recipient 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 1120-F, Schedule L, and not reported in column (a), must report the U.S. source fees as a permanent difference on line 26e, 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).

Note. In using column (d) to apportion amounts to non-ECI that are not included in column (a), line 26e contains an exception to the general instructions for Schedule M-3 reporting by foreign banks.

Example 35. FC is a foreign bank, resident in Country X, that files Form 1120-F and Schedule M-3. FC enters into a guarantee arrangement with FC2, 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 1120-F, 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 paid 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 report on line 27 the amount of U.S. source 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 1120-F, Schedule L, might also report foreign source substitute dividend payments whether or not they are allocable in whole or in part to ECI. Foreign banks report in column (c) U.S. source and allocable foreign source substitute dividends not already reflected in column (a). The amounts reported in column (c) are apportioned to noneffectively connected income of the foreign corporation in column (d) and reported as a negative number. Amounts included in column (a) that are also apportioned to non-ECI are also reported in column (d) as a negative number. The combined amounts of columns (a), (b), (c), and (d) are apportioned to effectively connected income in column (e) as the case may be.

Note. In using column (d) to apportion amounts to non-ECI that are not included in column (a), line 27 contains an exception to the general instructions for Schedule M-3 reporting by foreign banks.

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 on line 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 Regulations Section 1.861-8

Line 31 applies only to foreign banks. For purposes of Schedule M-3, all of the home office and other allocations to U.S. effectively connected income that are reportable on Schedule H (Form 1120-F) 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 apportionments to ECI in column (d). Report in columns (d) and (e) the amount from Schedule H, line 20.

Note. Foreign corporations other than banks that are required to file Form 1120-F to report effectively connected income in Section II of that form are still required to complete and attach Schedule H to their U.S. income tax return. The amounts from Schedule H, line 20, are not reportable by a foreign corporation other than a bank on this line of Schedule M-3 because worldwide expenses are already includible in Schedule M-3, Part I, line 11, and in each expense line item in Schedule M-3, Part III. Such amounts are subject to individual line-item apportionment to non-ECI in column (d).

Line 32. Other Expense/ Deduction Items With Differences and Reconciliation to Eliminate Duplicate Amounts on Line 31

Separately state and adequately disclose 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, column (e), from Schedule H (Form 1120-F), line 20, that are also included in this Schedule 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 statement to show the duplicative items that are being reversed.

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

The statement attached to the Schedule M-3 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 statement that lists those categories of expenses and their details will satisfy the requirement to separately state and adequately disclose. In order to separately state and adequately disclose the employee termination costs, it is not required that an anticipated termination cost amount be listed for each employee, or that each asset (or category of asset) be listed along with the anticipated loss on disposition.

The attached statement should have six columns. The first column has the description for the next five columns. The second column is column (a), expense per income statement. The third column is column (b), temporary differences. The fourth column is column (c), permanent differences. The fifth column is column (d), other permanent differences for allocations to non-ECI and ECI. The sixth column is column (e), deduction per tax return. For each item listed on the attached statement for line 32, columns (a) through (d) when combined must equal column (e). The amounts in columns (a) through (e) for all items must be totaled on the attached statement and the total amounts must be included on line 32 of the face of the statement.

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. income tax purposes. Examples of reserves that are allowed for book purposes, but not for tax purposes, include warranty reserves, restructuring reserves, reserves for discontinued operations, and reserves for acquisitions and dispositions. Only report on line 32 items that are not required to be reported elsewhere on Schedule M-3, Parts II and III.

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, are reportable on Part III, line 32.

Example 36. Corporation Q is a calendar year taxpayer that is required to file Schedule M-3 for the current tax year. On July 1 of each year, Q has a fixed liability for its annual insurance premiums on its home office building that provides a 12-month coverage period beginning July 1 through June 30. In addition, Q historically prepays 12 months of advertising expense on July 1. On July 1, Q prepays its insurance premium of $500,000 and advertising expenses of $800,000. For statutory accounting purposes, Q capitalizes and amortizes the prepaid insurance and advertising over 12 months. For U.S. income tax purposes, Q deducts the insurance premium when paid and amortizes the advertising over the 12-month period. In its annual statement, Q treats the differences attributable to the annual statement treatment and U.S. income tax treatment of the prepaid insurance and advertising as temporary differences.

Q also has a legal reserve where $300,000 was expensed for financial accounting purposes and a ($100,000) temporary difference was calculated to arrive at the income tax deduction of $200,000. The statement attached to Q’s return for Part III, line 32, must be separately stated and adequately disclosed, as indicated in the table below.

Line 33. Total Expense/Deduction Items

Report on Part II, line 26, columns (a) through (e), as applicable, the inverse 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.

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Line 32—Example 36Statement

Concerning Other Expense/Deduction Items With Differences

Description	Column (a) Expense per Income Statement	Column (b) Temporary Difference	Column (c) Permanent Difference	Column (d) Other Permanent Differences for Allocations to non-ECI and ECI	Column (e) Deduction per Tax Return
Prepaid insurance premium expensed not capitalized	$250,000	$250,000	-0-	-0-	$500,000
Legal expense reserve	$300,000	($100,000)	-0-	-0-	$200,000
Total Line 32	$550,000	$150,000	-0-	-0-	$700,000

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