

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

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

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Volume 1 of 2



Department of the Treasury  
Internal Revenue Service



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

## **Future Developments**

For the latest information about developments related to Schedule M-3

(Form 1120-F) and its instructions, such as legislation enacted after they were published, go to [IRS.gov/Form1120F](https://www.irs.gov/Form1120F).

## **General Instructions**

### **Purpose of Schedule**

Schedule M-3, Part I, determines the adjusted financial net income (loss) of the non-consolidated (see *Non-consolidated financial statement*, later, for the definition) foreign corporation 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 taxable income before the NOL deduction and special deductions on Form 1120-F, Section II, line 29.

For purposes of this reconciliation, Part I, line 1, provides rules for determining the financial 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 financial 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 (see definition in the instructions for Part I, line 1, later), Part I, line 11 includes the worldwide financial net income (loss) of the non-consolidated foreign corporation, adjusted for the results of non-includible entities and includible disregarded entities (see definition later under *Entity Considerations for Schedule M-3*). For foreign banks, Part I, line 11, is generally limited to the financial income (loss) derived from the same set(s) of books that are reported on Form 1120-F, Schedule L. Foreign banks are foreign corporations described in Regulations section 1.882-5(c)(4).

## Who Must File

Any foreign corporation required to file Form 1120-F that reports on Schedule L, line 17, column (d), 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.

**Note.** A foreign corporation that is required to complete (or voluntarily completes) Schedule M-3 is still required to complete Schedule M-2, Analysis of Unappropriated Retained Earnings per Books.

## When and Where To File

Attach Schedule M-3 (Form 1120-F) to the foreign corporation's Form 1120-F income tax return. Be sure to check the box at the top of

Form 1120-F, page 1, indicating that Schedule M-3 is attached.

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

Form 1120-F filers that are required to file Schedule M-3 (Form 1120-F) and have at least \$50 million total assets at the end of the tax year must complete Schedule M-3 (Form 1120-F) in its entirety.

Form 1120-F filers that (a) are required to file Schedule M-3 (Form 1120-F) and have less than \$50 million total assets at the end of the tax year, or (b) are not required to file Schedule M-3 (Form 1120-F) and voluntarily file Schedule M-3 (Form 1120-F) must either (i) complete Schedule M-3 (Form 1120-F) in its entirety, or (ii) complete Schedule M-3 (Form 1120-F) through Part I and complete Schedule M-1 instead of completing Parts II and III of Schedule M-3 (Form 1120-F). If the filer chooses to complete Schedule M-1



instead of completing Parts II and III of Schedule M-3 (Form 1120-F), line 1 of Schedule M-1 must equal line 11 of Part I of Schedule M-3 (Form 1120-F).

Filers must answer all questions on page 1 of the form. Furthermore, for any part of Schedule M-3 (Form 1120-F) that is completed, all columns must be completed, all numerical data requested must be provided, and any statement required to support a line item must be attached. All additional statements specifically referenced in these instructions must be completed and attached to the Schedule M-3 when filed. If Part III is completed, please note that Part III requires that results from Schedule I (Form 1120-F), Interest Expense Allocation Under Regulations Section 1.882-5, and Schedule H (Form 1120-F), Deductions Allocated To Effectively Connected Income Under Regulations Section 1.861-8, also be

included. See instructions for Part III, lines 26b, 26c, and 31, later.

## **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 Regulations section 1.882-5(d)(2)). 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 and liabilities on Schedule L under Regulations section 1.6012-2(g)(1)(iii). 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 for transactions between the set(s) of books and other divisions of the foreign corporation or includible disregarded entities (see definition later under *Entity*

*Considerations for Schedule M-3*) reportable on Schedule M-3, Part I, line 5, are not eliminated for Schedule L purposes (except for certain transactions with disregarded entities that are also reportable on Schedule L), unless the taxpayer elects worldwide reporting under Regulations section 1.6012-2(g)(1)(iii).

***Adaptation of Form 1120-F, Schedule L for treaty-based reporting.*** The set(s) of books that must be reported on Form 1120-F, Schedule L are those of the U.S. permanent establishment. These books will generally be the same set(s) of books reported on Schedule L, as described above. 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 considered transferred from the U.S.

permanent establishment for treaty reporting purposes (see, for example, Regulations section 1.864-4(c)(5)(iii)) if under the facts and circumstances, such assets also constitute a set of books that give rise to U.S. booked liabilities under Regulations section 1.882-5(d) (2). Under such circumstances, the set of books would remain reportable on Schedule L for Code-based reporting purposes, but for treaty-based reporting purposes, such transfer may effect attribution to another part of the corporate enterprise under a functional and factual analysis and no longer be reportable on Schedule L as part of the U.S. permanent establishment after the transfer. Additionally, a set of books having no effectively connected income or U.S. booked liabilities under Regulations 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 expressly authorized by or pursuant to a U.S. income tax treaty and accompanying documents.

## **Schedule M-2**

If the foreign corporation is a bank (and checked the "Yes" box on 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. Both the foreign bank's Form 1120-F, Schedule L reporting and Schedule M-3 (Form 1120-F) reporting are based on the same set(s) of Schedule L books which are generally determined on the basis of Regulations section 1.882-5(d)(2)(iii). If, however, the foreign bank elects to complete its Form 1120-F, Schedule L on the basis of its worldwide books, then the bank will be required to report its net income (loss) on Schedule M-2 and Schedule M-3 from the

same worldwide set(s) of books used for Form 1120-F, Schedule L purposes.

If the foreign corporation is not a bank (and therefore checked the "No" box on Part I, line 1), the amount shown on Schedule M-2, line 2 (Net income (loss) per books) should reflect the net income (loss) associated with the Schedule L books. This amount will equal the amount shown on Schedule M-3, Part I, line 11 only if the corporation voluntarily chooses to complete Form 1120-F, Schedule L on the basis of the corporation's worldwide set(s) of books under Regulations section 1.6012-2(g)(1)(iii), or, if the Schedule L books determined under the facts and circumstances constitute the same results as worldwide income reporting under Regulations section 1.882-5(d)(2)(ii).

However, the Schedule M-3 reporting on Part I, line 11 must always reflect the worldwide profits and losses of the foreign corporation filing the Form 1120-F even if the Schedule L

books determined under Regulations section 1.882-5(d)(2)(ii) gives rise to less than worldwide reporting under the facts and circumstances.

## **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, the financial results of an entity that is disregarded as separate from the foreign corporation filing Form 1120-F for federal income tax purposes ("disregarded entity") are 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, line 9, 10, or 11, as from a partnership or pass-through entity. The applicable financial statement may include a disregarded entity only if it is owned directly or indirectly by the foreign corporation. An applicable financial statement may not include a disregarded entity that is the direct or indirect owner of the foreign corporation filing Form 1120-F.

***Foreign bank disregarded entity books—reporting for lines 4 and 5.*** For foreign banks, the net income (loss) of certain disregarded entities are not combined 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 Regulations 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, the net income (loss) of a U.S. LLC that is a disregarded entity whose set(s) of books do not give rise to U.S. booked liabilities of the foreign bank under Regulations section 1.882-5(d)(2) (iii) is not included on line 4 or line 5.

Transactions between such disregarded entities and set(s) of books reported on line 4 are not eliminated.

## **Related Filing Requirements— Requirements of Reportable Entity Partners**

***Reportable entity partner.*** For purposes of these instructions, a reportable entity partner with respect to a partnership filing Form 1065, U.S. Return of Partnership Income, is an entity that (1) owns or is deemed to own, directly or indirectly, under these instructions

a 50% or greater interest in the income, loss, or capital of the partnership on any day of the tax year, and (2) was required to file Schedule M-3 on its most recently filed U.S. federal income tax return or return of income filed prior to that day.

For purposes of these 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% or more of a corporation by vote on any day of the corporation's 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's tax year; (3) the owner of 50% 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% 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.

***Reporting requirements of reportable entity partner.*** 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 report 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 2023, is owned 50% by Z, a foreign corporation engaged in a trade or business

within the United States. A owns 50% of each of B, C, D, and E, each of which is also an LLC filing a Form 1065 for calendar year 2023. Z was first required to file Schedule M-3 (Form 1120-F) for its corporate tax year ended December 31, 2022, and filed its Form 1120-F with Schedule M-3 for 2022 on October 16, 2023. As of October 17, 2023, Z was a reportable entity partner with respect to A and, through A, with respect to B, C, D, and E. On November 6, 2023, Z reports to A, B, C, D, and E, as it is required to do within 30 days of October 17, 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% interest. Therefore, because Z was a reportable entity partner for 2023, each of A, B, C, D, and E is required to file Schedule M-3 (Form 1065) for 2023, regardless of whether they would otherwise be required to file 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 on November 6, 2023.

## **Specific Instructions for 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, Section II, for taxable income.** If a foreign corporation is a resident in a country having an income tax treaty with the United States, answer “Yes” if the corporation reports income under the treaty method in lieu of the effectively connected income rules under sections 864(c) and 882. For reporting under this method in Parts II

and III, see *Treatment of Items Under an Eligible Treaty-Based Return Position to Attribute Business Profits to a U.S. Permanent Establishment*, later.

**Questions B through D.** For Schedule M-3, Part I, questions B through D, use only the financial statements of the foreign corporation filing Form 1120-F. If the foreign corporation prepares its own financial statements but is controlled by another corporation (U.S. or foreign) that prepares financial statements that include the foreign corporation, the foreign corporation must use for its Schedule M-3, Part I, its own financial statements rather than the financial statements of the controlling corporation. These financial statements are used for completing line 4.

***Non-consolidated financial statement.*** A foreign corporation's "non-consolidated" financial statement may include a financial statement which reports a consolidation of entities or subsidiaries that the foreign



corporation owns. In such a case, the net income or (loss) of such entities or subsidiaries would be included in the amount reported on line 4 and, except for disregarded entities, would be eliminated by reporting these amounts on line 7 (see line 7, later). Any adjustments associated with removing such amounts would be reported on line 8.

**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. FC1 is required to file Form 1120-F. FC1 reports on Schedule L more than \$10 million in assets and, therefore, is required to file Schedule M-3. FC1 is owned 100% by FC, its non-banking parent corporation also resident in Country X. FC1's net income (loss) results are included in a certified audited consolidated financial statement of FC. FC1 also has an unconsolidated financial statement that is not certified. In answering questions B through D, FC1 may not use FC's

consolidated financial statement. FC1's "non-consolidated financial statement" is its own unconsolidated, worldwide financial statement, which is a statement described in question C. If FC was also engaged in a trade or business within the United States with reportable assets over \$10 million, then FC would be required to file its own Schedule M-3 and would be required to use its certified audited financial statement described in question B. In such circumstances, FC1 would continue to use its own non-consolidated 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 1120-F and Schedule M-3. FC's "non-consolidated" financial statement is its consolidated, certified audited financial statement, described in question B, because it

is the financial statement of the company engaged in a trade or business within the United States that is required to file Form 1120-F and Schedule M-3. FC's consolidated entities (other than any disregarded entities) are eliminated as "non-includible" entities on Part I, line 7.

### **Line 1. Foreign Banks Described in Regulations Section 1.882-5(c)(4)**

If a foreign corporation is a foreign bank described in Regulations section 1.882-5(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 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 the current 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. 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 statement providing 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. 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 statement.

For purposes of line 3, if the foreign corporation's stock is not publicly traded (as defined above) and its voting stock is owned or controlled 50% or more by another foreign corporation whose stock is publicly traded (as defined above), check the "Yes" box and report the name of the exchange(s) on the line provided. The foreign corporation whose stock is publicly traded does not need to file Schedule M-3 (Form 1120-F) unless such corporation is also engaged in a trade or business within the United States and has reportable assets of \$10 million or more.

## **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 the type of non-consolidated, worldwide financial statement described in question B or C, the foreign bank should check the “Yes” box for the applicable question B or C. However, do not report these results on Part I, line 4, unless the foreign bank also chooses worldwide reporting of the set(s) of books on Form 1120-F, Schedule L, under Regulations section 1.6012-2(g) (1)(iii). If the foreign bank has certified audited financial statements from which the balance sheet reported on Form 1120-F, Schedule L, is derived (as described in question D), the net income (loss) from such statements is used to complete line 4, except that any disregarded

entities whose results are reportable on Schedule L are excluded from line 4 unless they are included in the corporation's financial consolidation of its Schedule L books in accordance with the bank's ordinary and consistently applied internal accounting practices. Disregarded entities includible in Schedule L that are not included in a non-tax financial consolidation of the corporation's Schedule L books in accordance with the bank's ordinary and consistently applied internal accounting practices, are separately reported on Part I, line 5.

***Ordinary and consistent internal accounting practices.*** If the foreign bank's ordinary and consistently applied accounting practices include the consolidation of more than one set of books that is reportable on Schedule L, as determined under Regulations section 1.882-5(d)(2)(iii), the foreign bank may use such consolidated books for completing Part I, line 4. If additional set(s)

of books that constitute Schedule L books are not included in the consolidated books, then such other Schedule L books must also be reported on line 4, or if such other books are set(s) of books of includible disregarded entities, they must be reported on line 5. Interbranch transactions between the Schedule L books must be eliminated and reported, if necessary, on line 8.

If the foreign bank does not have the certified audited financial statements described in question D, the bank should use any other financial statement from which the balance sheet reported on Form 1120-F, Schedule L, is derived. For this purpose, the term "any other financial statement" includes unaudited financial statements prepared by the corporation under the method of accounting generally used by the corporation's U.S. operations. 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 non-consolidated, worldwide, certified audited financial statement described in question B, report the net income (loss) from such statements on line 4. If the corporation does not have a financial statement of that type but does have the non-consolidated, worldwide, unaudited financial statement described in question C, report the net income (loss) from such statements on line 4. These unaudited financial 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 financial statements may be used, including

trial balances prepared from the corporation's worldwide books and records that are based on the method of accounting generally used by the corporation.

If the foreign corporation has none of these financial 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 corporations other than banks, the set(s) of books described in question D are those that give rise to U.S. booked liabilities under Regulations section 1.882-5(d)(2)(ii).

***All foreign corporations.*** The amount on line 4 must equal the financial 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.

***Combined Reporting of 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 statement that identifies each book (for example, New York Branch, International Banking Facility, Cayman Branch) and its net income (loss) that is included on Part I, line 4. However, if a foreign bank in its ordinary business practice prepares a consolidation of one or more books required to be reported on Schedule L, such consolidated results may be reported on line 4 in lieu of reporting the separate results for each book in the consolidation. If a consolidation of reportable books does not

exist, then transactions recorded between these books must be separately eliminated and shown in the aggregate as a separate reconciling elimination line item on this schedule. In such a case, report on Part I, line 8, the eliminations for transactions between set(s) of books reported on line 4 and includible 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), and the financial results of disregarded U.S. entities are reported on lines 5c (income) and 5d (loss). The applicable financial statement of the disregarded entity to be used 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 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 disregarded entity is either itself engaged in a 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 a 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.

If the income of the includible disregarded 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 the assets giving rise to such income 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, columns (b) through (e), instead of Part I, line 5.

***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 a financial statement identified in question B or C, net income (loss) of a disregarded entity may or may not be included on 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 financial 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 the instructions for Part I, line 8, later.

***All foreign corporations.*** Attach a supporting statement that lists for each includible disregarded entity reported on lines 5a through 5d the name, EIN (if applicable), and net income (loss) per the financial statement of that includible disregarded entity.

### **Line 6. Net Income (Loss) Not Included on Lines 4 and 5 From Includible Foreign Locations**

Line 6 applies only to foreign corporations other than banks whose books and records are not sufficient to report worldwide income

on lines 4 and 5. Line 6 reporting will be necessary only when the corporation does not have a worldwide trial balance to report its worldwide income as satisfaction of the requirements of question C. In such circumstances, the corporation will have used Form 1120-F, Schedule L, books determined under Regulations section 1.882-5(d)(2)(ii) on lines 4 and 5 and will need to report the net income (loss) from all non-Schedule L books on line 6. Line 6 reporting does not apply to corporations that are able to report worldwide net income (loss) on lines 4 and 5 from financial statements described in questions B or C, or from worldwide trial balances.

Attach a supporting statement that provides, by country, the name and net income (loss) per the financial 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 statement 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 will generally not apply to foreign banks (unless a nonincludible entity is consolidated in the Schedule L set(s) of books for line 4 purposes), nor does it apply to foreign corporations other than banks that report on Part I, lines 4 and 5, income (loss) from the financial statements described in question D. For other corporations, remove the net income (in line 7a) or loss (in 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 subsidiaries (other than disregarded entities) and partnerships that were combined with the corporation in the type of consolidated financial 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 financial statements on the equity method. Adjustments are made for these entities 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.

Attach a supporting statement that provides the name, EIN (if applicable), and net income (loss) per the financial 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 (see line 4 instructions), required as a result of adding amounts on Part I, lines 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 account for the elimination of certain transactions between the Schedule L books reported on line 4 and 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 in Part I (for example, because it does not give rise to U.S. booked liabilities under Regulations section 1.882-5(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 on Part II, line 3, column (c).

***Foreign corporations other than banks.***

For foreign corporations other than a bank, adjustments are necessary in order to ensure that the consolidation entries and intercompany elimination entries included in the amount reported on Part I, line 11, are only those applicable to worldwide income of the non-consolidated 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 a financial statement described in Part I, questions B or C. For example, adjustments must be reported on line 8 to remove minority interests 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 financial 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 non-consolidated, worldwide financial statement purposes, and therefore will have no elimination of equity income to reverse.

The attached supporting statement for Part I, line 8, must identify the type (for example, minority interest, intercompany dividends, etc.) and amount of consolidation or

elimination entries reported, as well as the names of the entities to which they pertain. It is not necessary 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 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 non-consolidated, worldwide, certified audited financial statements.

However, S1's income and expenses are not included in F's non-consolidated, worldwide, certified audited financial statements.

On Schedule M-3, F must check "Yes" to question B. F must report its net income (loss) from its non-consolidated, worldwide, certified audited financial 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 U.S. entity. Because S2 is included in the non-consolidated, worldwide, certified audited financial 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. Adjustments 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 statement 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 statement 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. Adjusted Financial Net Income (Loss) of the Non-Consolidated Foreign Corporation**

The sum of lines 4 through 10 constitutes the adjusted financial net income (loss) of the non-consolidated foreign corporation that is to be reconciled in Parts II and III with the foreign corporation's taxable income reported on Form 1120-F, Section II, line 29.

***Example 5. Foreign corporations other than a bank.*** FC is a non-bank foreign corporation engaged in trade or business within the United States and required to file Form 1120-F and Schedule M-3. FC does not have income statements that report its non-consolidated, 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. 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 any effectively connected income and do not have books that give rise to U.S. booked liabilities under Regulations section 1.882-5(d)(2)(ii). FC reports net income on these financial statements of \$50,000. 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 financial net income of such foreign locations is \$25,000.

FC must answer “No” to questions B through D in 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, such that \$75,000 is the net income reportable on line 11.

***Example 6. Foreign corporations other than a bank.*** FC is a non-bank foreign corporation engaged in trade or business within the United States and is required to file Form 1120-F and Schedule M-3. FC owns NI, a C corporation for federal income tax purposes. FC has certified audited income statements that report its worldwide income and that of NI. 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 gives rise to U.S. booked liabilities. Interest income of \$5,000

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 reported 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 11, 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 1120-F and Schedule M-3. FC has certified audited income statements that report its non-consolidated, 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 non-consolidated, 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 USDE1 and USDE2 which also give rise to effectively connected income and are set(s) of books included in Form 1120-F, Schedule L). On Part I, line 5c, FC will include the \$15,000 of net income of USDE1 and will include on Part I, line 5d, the (\$5,000) net

loss of USDE2. Assuming no other adjustments are required on Part I, lines 8 through 10, the net income reported on Part I, line 4, is \$40,000, and the net income reported on line 11 is \$50,000.

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

### **General Reporting Information**

A statement or explanation may be attached to any line item even if none is required. For each line item in Parts II and III, report in column (a) the amount of the item included in the net income (loss) reported on Part I, line 11. For each line item, report in column (e) the amount included in determining taxable income (loss) on Form 1120-F, Section II, line 29.

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

The temporary and permanent differences reportable in columns (b) and (c) are those

book-to-tax differences determined through a comparison of the financial statement and tax amounts, under the Code or an applicable income tax treaty, for each of the line items included on Part I, line 11, and shown in Parts II and III.

***Column (b). Temporary book-to-tax differences.*** In column (b), report the book-to-tax difference for each item expected to reverse in a future year or which reverses a prior year difference (whether or not so reported on a prior year's Schedule M-3). Temporary differences that increase the amount shown in column (a) are reported as a positive number.

***Column (c). Permanent book-to-tax differences.*** In column (c) report any book-to-tax difference not expected to reverse in a future year, and that also does not constitute a reversal of a prior year difference. The determination as to whether a difference is temporary or permanent should be based on



the facts available at the time the foreign corporation files its U.S. tax return. 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 reverses a prior year book-to-tax difference, report the difference for that item in column (c).

Amounts that are permanent differences that reduce the income or expense amount shown in column (a) are recorded as negative numbers. For example, interbranch income and expense amounts recorded on a foreign bank's books reportable on Schedule L (and therefore included in column (a)) that are disregarded under U.S. tax principles are permanent differences reportable as negative amounts in column (c).

If interbranch amounts recorded on Schedule L books are treated as third-party amounts under Proposed Regulations sections 1.863-3(h) and 1.475(g)-2 of the global dealing

rules, or recognition treatment is otherwise provided under an Advance Pricing Agreement or Mutual Agreement Procedure, then such interbranch amounts are treated as amounts subject to apportionment between non-ECI and ECI in columns (d) and (e) and not as permanent differences in column (c).

**Note.** References in Proposed Regulations section 1.863-3(h) to Regulations section 1.482-8 should instead refer to Proposed Regulations section 1.482-8, which deals with allocating income earned in a global dealing operation.

Amounts that are apportionable to non-ECI are generally reportable only in column (d). However, some amounts may be both permanent differences under U.S. tax principles and also be apportioned to non-ECI under section 864(c). In such cases, a permanent difference may not be double counted by including it a second time in column (d). In such circumstances, where an

amount includible in column (a) is both a permanent difference and apportionable to non-ECI, the amount is reported in column (c) and not in column (d). Accordingly, non-ECI tax-exempt interest is reported in column (c) as a permanent difference under U.S. tax principles. No additional apportionment is necessary in column (d) for such amounts.

Special treatment may apply for column (c) reporting on Part III, lines 26d (substitute interest payments), 26e (interest equivalents), and 27 (substitute dividend payments). See instructions for those lines below.

***Apportionments between effectively and non-effectively connected income (ECI and non-ECI).*** The combination of columns (a), (b), and (c) results in the gross taxable income or deduction amount under U.S. tax principles for each line item in Parts II and III that is eligible for allocation and apportionment between ECI and non-ECI.

### ***Column (d). Foreign bank.***

Column (d) is used to report the portion of the combined amount of columns (a), (b), and (c) that is allocated and apportioned to non-ECI. If an amount apportioned to non-ECI is included in column (a), then report such amount as a negative number in column (d). If the apportioned amount included in column (a) is a loss, then include the apportioned loss as a positive number in column (d). Certain income may be apportioned to ECI that is not reported on the Schedule L books and is not reportable in column (a). These amounts include allocable global dealing income in Part II, line 16, and other income from non-Schedule L books reportable in Part II, line 23. Such income is apportioned to ECI and reported in column (d) as a positive number. For amounts reportable in Part II, if the apportioned amount is a loss, report such loss as a negative number in column (d). In column

(e), combine the amounts in columns (a), (b), (c), and (d) to determine the amount of each line item apportioned to ECI. See special reporting instructions for reporting amounts in column (d) for substitute dividends and substitute interest income in Part II, lines 3c and 4b, and for the allocation and apportionment of interest expense in Part III, line 26. Expenses allocable from Schedule H, line 20, are reportable in Part III, line 31, in columns (d) and (e) as a positive number.

***Column (d). Foreign corporations other than banks.*** Foreign corporations other than banks use column (d) to report apportionments only to non-ECI. In Part II, column (d), report apportionments of income as a negative amount and report losses as a positive number. Combine columns (a), (b), (c), and (d) to reconcile the amount apportioned to ECI in column (e). For Part III, except for lines 26 and 31, report expenses that are apportioned to non-ECI as a negative

number in column (d). See special instructions for the reporting of interest expense on line 26. Corporations other than banks do not report the allocation of expenses under Regulations section 1.861-8 from Schedule H (Form 1120-F), line 20, on Schedule M-3, Part III, line 31.

***Part III, lines 26d, 26e, and 27.*** In Part III, line 26d (substitute interest payments), line 26e (interest equivalents), and line 27 (substitute dividend payments), amounts in these categories paid by the foreign corporation that are not included in column (a) are reported in column (c) as a positive number. Amounts described in lines 26d, 26e, and 27 are reported in column (c) whether or not any of the amount is apportionable in whole or in part to ECI in column (e). Column (d) is used for these line items only to apportion amounts to non-ECI.

**Example 9.** FC is a foreign bank that is required to file Form 1120-F 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 reports on Part II, line 4a, column (a), the \$100 of tax-exempt interest income. FC reports (\$100) of permanent book-to-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).

**Example 10.** The facts are the same as in *Example 9*, 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 allocable to both ECI and non-ECI, it has significance in determining the allocation of expenses under indirect methods under Regulations section 1.861-8, and is therefore required to be reported on Part II, line 23, as income not included in the Schedule L books that is allocable and apportionable to ECI. Because no amount is includible in column (a), the full \$100 of tax-exempt interest is reported in column (d) as a positive number and in column (c) as a negative number. As a result, there is no amount 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 that provides a permissible method other than the rules of section 864(c) and 882 to determine its business profits attributable to a U.S. permanent establishment, the foreign corporation must report on Form 1120-F, 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. In such a case, 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.** For foreign banks, 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 (c) and (d). Report in column (e) all amounts that are business profits attributable to the U.S. permanent establishment. When a treaty-based position modifies the amount(s) reportable for any of the line items shown in Parts II and/or III of Schedule M-3 from the amounts otherwise reportable based on Code principles, either (1) attach a separate statement identifying each such line item, or (2) on Part II or III, as applicable, include footnotes or similar references for each such item to indicate that a treaty-based position was claimed for determining the amount reportable in column (e). If no amount is reportable in column (e), see *Treaty-based reporting*, later.

***Interbranch reporting.*** If the foreign corporation is a foreign bank electing to use an eligible treaty, interbranch income and expense and noneffectively connected income are not treated as permanent differences to the extent such items are attributable to the U.S. permanent establishment and are also included in the 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. permanent establishment, such amounts may have temporary differences under U.S. tax principles (for example, depreciation deductions includible in column (a) may have temporary book-to-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 effectively connected income under

section 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. Report on any such applicable lines in Part II or III using either of the methods of identification specified under *Foreign bank treaty-based reporting* above, indicating that the amount reported in column (e) reflects interbranch income or loss attributable to the U.S. permanent establishment.

**Treaty-based reporting for foreign corporations other than banks.** Foreign corporations other than banks must include interbranch income and expense as book-to-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 non-consolidated income reportable

on Part I, line 11. To the extent such interbranch amounts are attributable to a U.S. permanent establishment under Article 7 (Business Profits) of an applicable income tax treaty, the amounts are also includible as a book-to-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.

***Columns (b) and (c).*** Temporary and permanent differences are determined in accordance with the instructions for these columns, earlier, except that each line in column (e) is as determined below.

***Column (d).*** Differences for amounts not attributable to a U.S. permanent establishment are reported as a negative

number in column (d). Differences for losses not attributable to a U.S. permanent establishment are reported as a positive number in Part II.

**Column (e).** Combine columns (a), (b), (c), and (d) and report the income or deduction for each line item that is includible in business profits attributable to the U.S. permanent establishment in column (e).

**Example 11. Treaty-based reporting of business profits of a foreign bank.** FC is a foreign bank that has three sets of books that give rise to U.S. booked liabilities under Regulations section 1.882-5(d)(2)(iii) and that are reportable on Form 1120-F, 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 1120-F, Schedule L, reporting purposes. FC files its

Form 1120-F 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(c) 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 constitutes a set of books for Regulations section 1.882-5(d)(2)(iii) purposes is not attributable to FC's permanent establishment in the year FC files its Form 1120-F 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 \$175. (FC has the following income: \$500 of interbranch interest income, \$200 of noneffectively connected interest income, and \$1,200 of effectively connected income under Code-based principles. FC has \$1,000 of third party interest expense and

\$400 of interbranch interest expense on the books of its U.S. permanent establishment that is priced at arm's length with its home office. Each type of interest expense is also attributable to its U.S. permanent establishment. On the two sets of books maintained in the United States, FC has other third party expenses of \$325 attributable to the permanent establishment.) 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 Guidelines applicable to Article 7 (Business Profits) 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 1120-F, 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 26a, 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 26a in either column (b) or (c). The \$1,400 from column (a) is reported in columns (b) and/or (c) as a negative number. This includes the \$75 portion of the \$1,400 that constitutes equity capital allocated to the U.S. permanent establishment. On Part III, line 26b, column (d), the \$1,325 tax amount of the interest

expense (after the \$75 allocation of equity capital is taken into account) is reported. This \$1,325 amount reported in column (d) is carried to column (e) and constitutes the amount from line 26a that is treated as interest expense attributable to the business profits of the U.S. permanent establishment. A footnote should be included indicating that interbranch income was included in the column (e) amount.

In 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 column (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 have been reportable in column (d). A footnote should

be referenced to this line indicating that a treaty-based position was used in determining the interest expense.

## **Schedule M-3 Reporting Requirements for Regulations Section 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 another line in 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. However, this reporting is not required in cases where (a) these instructions provide otherwise, 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-3 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. 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.

If 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 financial statement balance sheet or in asset and liability accounts maintained in the corporation's books and records instead of in its income statement, 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 on 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, 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, are 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"). 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 or not there is any 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"). 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 or not 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 a statement,” and the specific instructions for the line do not call for an attachment of a 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 statement 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 statement required to be attached, even if the amounts are below a certain dollar amount.

***Required statements for Part II, line 24, and Part III, line 32.*** A separate statement must be attached to Schedule M-3 (Form 1120-F) that includes a detailed description of each item and adjustment entered on Part II, line 24, and Part III, line 32.

The description for each amount entered in column (a) must be readily identifiable to the name of the account in the financial statements or books and records of the taxpayer, under which the amount in column (a) of the statement was recorded in the accounting records. Also, the description for each amount entered in column (a) must include detailed information supporting each adjustment reported in columns (b), (c), and (d), including how the adjustment is identified in the accounting records. The entire description is considered the tax description for the amount reported in column (e) for each item reported on Part II, line 24, or Part III, line 32.

Each description should adequately describe all five columns of Part II, line 24, or Part III, line 32. If additional information is required to provide an acceptable description, provide a supporting statement.

***Example 12. Temporary differences.***

Foreign corporation FC is a calendar year taxpayer that placed in service ten depreciable, fixed, U.S. assets in a previous tax year. FC is required to file Schedule M-3 for the current tax year. FC's total depreciation expense for its 2023 tax year for five of the assets is \$50,000 for income statement purposes and \$70,000 for U.S. income tax purposes. FC's total annual depreciation expense for its 2023 tax year for the other five assets is \$40,000 for income statement purposes and \$30,000 for U.S. income tax purposes. In its income statements, FC treats the differences between income statement and U.S. 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, for its 2023 tax year, FC must report on Part III, line 23, depreciation expense as shown on its income statement of \$90,000 in column (a), a

temporary difference of \$10,000 in column (b), and U.S. income tax depreciation expense of \$100,000 apportionable between non-ECI and ECI in column (d) and column (e).

***Example 13. Bad debt and warranty reserves.*** Foreign Corporation D files and completes Schedule M-3 for its 2023 tax year. The income statement year is identical to the tax year. On the last day of its 2023 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 assets that give rise to effectively connected income. 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 2023

income statements but are not deductions for U.S. income tax purposes in 2023. 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 statement that supports the amounts on Part III, line 32.

D must also provide a description for each reserve that meets the requirements for Part III, line 32, discussed earlier under *Required statements for Part II, line 24, and Part III, line 32*. In this example, an acceptable description would be "Future Warranty Expense Reserve."

**Note.** There is no need to add the title of the reserve account to the description if the account name for the amount in column (a) is already part of the adjustment description.

***Example 14. Non-ECI and ECI apportionment of temporary differences.***

Corporation E files and completes Schedule M-3 for its 2023 tax year. The income statement year is identical to the tax year. At the beginning of the 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 2023, 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 2023, E decreases the reserve by \$75,000 for accounts receivable that were discharged in bankruptcy during 2023, 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 2023 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 2023 income statements, but are not deductible for U.S. income tax purposes in 2023. 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. income tax purposes in 2023.

In its income statements, E treats the reserve account as giving rise to a temporary difference that will reverse in future tax years. For its 2023 tax year, E must report its income statement bad debt expense of \$350,000 in Part III, line 24, column (a). The temporary difference of (\$275,000) is

determined under U.S. 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). E must report the (\$25,000) allocable to noneffectively connected income in column (d) and U.S. income tax bad debt expense of \$50,000 in column (e).

## **Specific Instructions for Part II. Reconciliation of Net Income (Loss) per Income Statement of Non-Consolidated Foreign Corporations With Taxable Income per Return**

**Note.** Foreign corporations report, on lines 1 through 17, 19 through 21a, 24, and 27 in

column (a), the income (loss) items included in the financial net income (loss) reported on Part I, line 11. See the instructions for Part I, line 11, for reporting differences between foreign banks and foreign corporations other than a bank.

**Tiebreaker rules.** There are tiebreaker rules described in detail below under each applicable line instruction for Part II. For example, for foreign corporations that report income from their U.S. trade or business associated with global dealing activities in securities or financial instruments, global dealing income is prioritized on line 16 even though some income or loss amounts in the global dealing book might otherwise appear to be reportable on another line (for example, dividends on line 3a or 3b, or hedges on line 13).

### **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 1120-F, 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 treated 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 statement 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;
- Judgments, damages, awards, and similar costs, reportable on Part III, line 12;
- Amounts reported on Part II, line 17, Sales versus lease; and
- Amounts reported on Part III, line 25, Purchase versus lease.

### **Lines 3a and 3b. Dividends**

Report on lines 3a through 3b, column

(a), the amount of dividends included on 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, Section II, line 4. Do not include on lines 3a through 3b dividends from global securities dealings which are reportable on Part II, line 16b, or dividends reported elsewhere (for example, substitute dividends reportable on line 3c and

reportable transactions reportable on line 12). Any effectively connected dividends from corporations reported by the foreign corporation under the equity method are reported in columns (c) and (e) of this line, as described in the instructions for Part II, line 8.

### **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—worldwide reporting.**

Foreign banks must also report in column (c) all U.S. source substitute dividend payments

received as beneficial owner to the extent they are not already included on Part I, line 11, and without regard to whether such payments received are effectively connected income. For example, substitute dividends received by a foreign bank that are not reported on Form 1120-F, Schedule L, must be reported as U.S. source payments received in column (c) and reversed to the extent of the non-ECI portion of the payments in column (c) as a negative number in column (d). Reporting in columns (c) and (d) for substitute dividends is required even if no amount would be reported in columns (a) and (e). Any U.S. source substitute dividends 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 any line substitute dividend payments received in custody for another owner of the substitute payment or such payments reportable on line 16b.



**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 a 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 1120-F, Schedule L. FC receives \$200 of substitute dividends from transactions described in section 1058, all of which are not effectively 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 sourced and characterized as U.S. source dividends. Under FC's treaty with the United States, the dividends are subject to a 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, column (c), as a positive number. On line 3d, column (d), the \$200 is reported as a negative number. FC enters zero in column (e). On Form 1120-F, Section I, FC must report the substitute dividends received that are not properly withheld upon and 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 on Part I, line 11, and report on Part II, line 4a, column (e), the total amount of interest income included on Form 1120-F, Section II,

line 5, that is not required to be reported elsewhere in Part II. In column (b) or (c), as applicable, adjust for amounts treated for U.S. income tax purposes as interest income that are treated as some other character 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). For 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 through 13, 16a, 20, and 23.

**Example 16.** FC is a foreign bank that is required to file Form 1120-F and Schedule M-3 for the current tax year. FC included on Part I, line 11, the following interest income items totaling \$2,000: \$600 of interbranch interest

income; \$100 of tax-exempt interest, \$60 of which is effectively connected; \$300 of interest income 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.

FC 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 all \$600 of the interbranch interest income. FC must also report (\$150) of noneffectively connected interest income from its "10% rule securities" in column (d) as a negative amount. FC combines columns (a), (b), (c), and (d) and 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(b)(2). Do not net substitute interest payments received against substitute interest payments made by the foreign corporation with respect to any section 1058 sale repurchase transactions, including payments made with respect to “matched book” transactions, or any similar transaction.

### **Foreign banks—worldwide reporting.**

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 are effectively connected income. All U.S. sourced substitute interest received by a

foreign bank that is not reported on Form 1120-F, Schedule L, is reportable in column (c) and the non-ECI portion is reversed as a negative amount in column (d). Both U.S. and foreign source substitute interest that is effectively connected with the foreign corporation's trade or business within the United States is reportable in column (e).

Do not report on line 4b substitute interest payments received in custody for another owner of the substitute payment or such payments reportable on line 16a.

Report all substitute interest payments received on line 4b whether or not such amounts are characterized as interest or other income under the Code.

***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 \$200 of 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 was included on FC's set(s) of books reported on Form 1120-F, Schedule L, and is reportable on Part I, line 11.

FC must report all \$1,200 of the substitute interest in column (e) as effectively connected income. The \$200 of U.S. source ECI substitute interest received from the municipal bond securities loans is not characterized as tax-exempt municipal bond interest, but is U.S. source "other income" consistent with the characterization provisions applicable only to substitute interest payments described in Regulations section 1.881-2(a)(2). Accordingly, no amount of the payment is reportable in column (c) as a permanent difference.

## **Line 4c. Interest Equivalents Other Than Substitute Interest Reported on Line 4b**

Report on line 4c interest income equivalents other than substitute interest reportable on line 4b or other interest equivalents reportable on other lines in Part II. Interest equivalents reportable on line 4c generally consist of fees and commission income with respect to certain financial transactions that do not give rise to interest under section 163 (for example, financial guarantee fees, and acceptance confirmation and standby letter of credit fees). Do not report periodic income with respect to notional principal contracts on Part II, line 4c.

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