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

(Rev. December 2026)

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

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

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*.

What's New

Continuous-use schedule and instructions. Schedule M-3 (Form 1120-F) and these instructions have been converted from an annual revision to a continuous-use revision. Use the December 2026 revision of the schedule and instructions until a superseding revision is issued.

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 affect 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 Organization for Economic Co-operation and Development (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 employer identification number (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, a limited liability company (LLC) filing a Form 1065 for 2026, 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 2026. Z was first required to file Schedule M-3 (Form 1120-F) for its corporate tax year ended December 31, 2025, and filed its Form 1120-F with Schedule M-3 for 2025 on October 15, 2026. As of October 16, 2026, Z was a reportable entity partner with respect to A and, through A, with respect to B, C, D, and E. On November 5, 2026, Z reports to A, B, C, D, and E, as it is required to do within 30 days of October 16, that Z is a reportable entity partner directly owning (with respect to A) or deemed to own indirectly (with respect to B, C, D, and E) a 50% interest. Therefore, because Z was a reportable entity partner for 2026, each of A, B, C, D, and E is required to file Schedule M-3 (Form 1065) for 2026, 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 5, 2026.

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 "nonincludible" 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 on 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.
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 not generally 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 (on line 7a) or loss (on 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 that 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 noneffectively 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 on 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 for foreign corporations other than banks*, 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 on 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 2026 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 2026 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 2026 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 2026 tax year. The income statement year is identical to the tax year. On the last day of its 2026 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 2026 income statements but are not deductions for U.S. income tax purposes in 2026. 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 2026 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 2026, 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 2026, E decreases the reserve by $75,000 for accounts receivable that were discharged in bankruptcy during 2026, 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 2026 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 2026 income statements but are not deductible for U.S. income tax purposes in 2026. 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 2026.

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 2026 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.

One line 2, do not report:

- 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.

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 noneffectively 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 Generally Accepted Accounting Principles (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 2026 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 2026 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 2026 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*, later.

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 11, 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 19, 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 Fixed and Determinable Periodic (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 2026 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 2026, M reports on its income statements $1,000 of sales and $700 of cost of goods sold with respect to 2026 lease transactions. M receives periodic payments of $500 in 2026 with respect to these 2026 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 2026 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 2026 tax year. N was depreciating certain fixed assets over an erroneous recovery period and, effective for its 2026 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 2026 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 2026 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 2026 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 2026 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 2026.

In 2026, 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), (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, Excluding Amounts From Pass-Through Entities, Abandonment Losses, and Worthless Stock Losses

Report on line 21d the net gain or loss reported on line 19 of Form 4797, Sales of Business Property, excluding amounts from (a) pass-through entities included on Schedule M-3 (Form 1120-F), 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, columns (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 columns (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 columns (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*, earlier.

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 on 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 Federal Deposit Insurance Corporation (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 on line 31, column (e), is reported and reversed on line 32. Report such duplicative amount as a negative amount includible on 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 Statements of Financial Accounting Standards (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 in 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 32—Example 36
Statement 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

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.