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2016

Department of the Treasury
Internal Revenue Service

Instructions for Schedule M-3 (Form 1065)

Net Income (Loss) Reconciliation for Certain Partnerships

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

Future Developments

For the latest information about developments related to Schedule M-3 (Form 1065) and its instructions, such as legislation enacted after they were published, go to *www.irs.gov/form1065*.

General Instructions

Applicable schedule and instructions. Use the 2016 Schedule M-3 (Form 1065) with these instructions for tax years ending December 31, 2016, through December 30, 2017. For previous tax years, see the applicable Schedule M-3 (Form 1065) and instructions. (For example, use the 2015 Schedule M-3 (Form 1065) with the 2015 instructions for tax years ending December 31, 2015, through December 30, 2016.)

Forms 1065 and 1065-B. Schedule M-3 (Form 1065) is filed with Forms 1065, U.S. Return of Partnership Income, and 1065-B, U.S. Return of Income for Electing Large Partnerships. Line references to these returns are the same unless otherwise noted.

Purpose of Schedule

Schedule M-3, Part I, asks certain questions about the partnership's financial statements and reconciles financial statement net income (loss) for the consolidated financial statement group to income (loss) per the income statement for the partnership.

Schedule M-3, Parts II and III, reconcile financial statement net income (loss) for the partnership (per Schedule M-3, Part I, line 11) to line 1 of the *Analysis of Net Income (Loss)* found on Form 1065 and Form 1065-B.

Where To File

If the partnership is required to file (or voluntarily files) Schedule M-3 (Form 1065), the partnership **must** file Form 1065 or Form 1065-B and all attachments and schedules, including Schedule M-3 (Form 1065), at the following address.

Department of the Treasury
Internal Revenue Service Center
Ogden, UT 84201-0011

Who Must File

Any entity that files Form 1065 or Form 1065-B must file Schedule M-3 (Form 1065), if any of the following is true:

1. The amount of total assets at the end of the tax year reported on Schedule L, line 14, column (d), is equal to $10 million or more.

2. The amount of adjusted total assets for the tax year is equal to $10 million or more. See *Total Assets and Adjusted Total Assets*, below.

3. The amount of total receipts for the tax year is equal to $35 million or more. Total receipts is defined in the instructions for *Codes for Principal Business Activity and Principal Product or Service* in the Instructions for Form 1065 or Instructions for Form 1065-B.

4. An entity that is a reportable entity partner with respect to the partnership (as defined under these instructions) owns or is deemed to own, directly or indirectly, an interest of 50% or more in the partnership's capital, profit, or loss, on any day during the tax year of the partnership.

A common trust fund or foreign partnership must file Schedule M-3 if it meets any of the tests discussed above.

Note. All references to a U.S. partnership in these instructions refer to any entity required to file Schedule M-3 (Form 1065), where appropriate.

Partnerships not required to file Schedule M-3 may voluntarily file Schedule M-3.

Completing Schedule M-3 (Form 1065)

Form 1065 and Form 1065-B filers that are required to file Schedule M-3 (Form 1065) and have at least $50 million total assets at the end of the tax year must complete Schedule M-3 (Form 1065) entirely.

Form 1065 and Form 1065-B filers that (a) are required to file Schedule M-3 (Form 1065) and have less than $50 million total assets at the end of the tax year or (b) aren't required to file Schedule M-3 (Form 1065) and voluntarily file Schedule M-3 (Form 1065) must either (i) complete Schedule M-3 (Form 1065) entirely or (ii) complete Schedule M-3 (Form 1065) through Part I and complete Schedule M-1 instead of completing Parts II and III of Schedule M-3 (Form 1065). If the filer chooses to complete Schedule M-1 instead of completing Parts II and III of Schedule M-3 (Form 1065), line 1 of Schedule M-1 must equal line 11 of Part I of Schedule M-3 (Form 1065).

For any part of Schedule M-3 (Form 1065) that is completed, all columns must be completed, all applicable questions must be answered, all numerical data requested must be provided, any statement required to support a line item must be attached and provide the information required for that line item. Any partnership required to file Schedule M-3 must check all boxes above Part I that apply for the reason(s) for which the Schedule M-3 is required to be filed. A partnership not required to file Schedule M-3, but that is doing so voluntarily, should check box E above Part I.

Total Assets and Adjusted Total Assets

The partnership should figure its adjusted total assets using the *Adjusted Total Assets Worksheet*, below.

For purposes of determining for Schedule M-3 whether the partnership's adjusted total assets (under these instructions) equal $10 million or more, the partnership's total assets at the end of the tax year must be determined on an overall accrual method of accounting unless both of the following apply: (a) the tax return of the partnership is prepared using an overall cash method of accounting, and (b) the partnership doesn't prepare financial statements using, and isn't included in financial statements prepared on, an accrual basis.

See the instructions for Schedule M-3, Part I, line 1, regarding non-tax-basis income statements and related non-tax-basis balance sheets to be used in the preparation of Schedule M-3 and the related non-tax-basis balance sheets to be used in the preparation of Schedule L.

In the case of a partnership year ending because of a section 708 termination (sale or exchange within a 12-month period of 50% or more of the partnership interest in

income and capital), the total assets of the partnership at the end of the year for determining the requirement to file Schedule M-3 are determined immediately before the section 708 termination and any actual or deemed contribution or distribution of the partnership assets under the provisions of section 708.

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Example 1.

1. U.S. partnership A, a limited liability company (LLC), owns 60% of the income and capital of U.S. partnership B, also an LLC. For its tax year ending December 31, 2016, A prepares non-tax-basis GAAP (generally accepted accounting principles) consolidated financial statements with B that report total assets at the end of the year of $12 million. A files Form 1065 and reports on its non-tax-basis unconsolidated GAAP Schedule L total assets at the end of the year of $7 million. The $7 million total includes $3 million for its investment in B under the equity method of accounting. The amount of total liabilities at the end of the year reported to A's partners on Schedules K-1 is $5 million. A made distributions of $1 million during the year reflected on Schedule M-2, line 6. The amount of A's adjusted total assets is $8 million for the tax year. A has total receipts for the tax year of $15 million. A has no reportable entity partners (as defined under *Reportable Entity Partner Reporting Responsibilities,* later). A isn't required to file Schedule M-3 under any of the four tests discussed earlier. A may voluntarily file Schedule M-3 for the tax year. If A doesn't file Schedule M-3, it must complete Schedule M-1. If A files Schedule M-3, it must either: (i) complete Schedule M-3 entirely; or (ii) complete Schedule M-3 through Part I and complete Schedule M-1 instead of completing Parts II and III of Schedule M-3.

2. Same facts as in Example 1.1 except that A has total receipts for 2016 of $40 million. A must file Schedule M-3 for 2016 and either: (i) complete Schedule M-3 entirely; or (ii) complete Schedule M-3 through Part I and complete Schedule M-1 instead of completing Parts II and III of Schedule M-3.

3. R, a U.S. partnership, files Form 1065 for the tax year ending December 31, 2016. R has total assets at the end of 2016 reported on Schedule L, line 14, column (d), of $7.5 million. The aggregate amount of total liabilities at the end of 2016 reported to R's partners on Schedules K-1 is $5 million. R made distributions of $3 million during 2016 reflected on Schedule M-2, line 6. R didn't report a loss for 2016 on Schedule M-2, line 3. R didn't report adjustments to capital on Schedule M-2, lines 4 or 7. R has adjusted total assets for 2016 in the tentative amount of $10.5 million, the sum of $7.5 million plus $3 million (the amount of distributions that must be added back to determine adjusted total assets for 2016), an amount that isn't less than the total liabilities at the end of 2016 reported to R's partners on Schedules K-1. Because R has adjusted total assets of $10 million or more for its tax year ending December 31, 2016, R must file Schedule M-3 for 2016 and either: (i) complete Schedule M-3 entirely; or (ii) complete Schedule M-3 through Part I and complete Schedule M-1 instead of completing Parts II and III of Schedule M-3.

4. Same facts as in Example 1.3 except that the amount of total liabilities at the end of 2016 reported to R's partners on Schedules K-1 is $11 million. R made distributions of $1.5 million during 2016 as reflected on Schedule M-2, line 6. R has adjusted total assets for 2016 equal to $11 million, the greater of the tentative amount of $9 million, the sum of $7.5 million plus $1.5 million (the amount of distributions that must be added back to determine adjusted total assets for 2016), or $11 million (the amount of the total liabilities at the end of 2016 reported to R's partners on Schedules K-1). Because R has adjusted total assets of $10 million or more for its tax year ending December 31, 2016, R must file Schedule M-3 for 2016 and either: (i) complete Schedule M-3 entirely; or (ii) complete Schedule M-3 through Part I and complete Schedule M-1 instead of completing Parts II and III of Schedule M-3.

5. S, a U.S. partnership, files Form 1065 for the tax year ending December 31, 2016. S has total assets at the end of 2016 reported on Schedule L, line 14, column (d), of $7.5 million. The amount of total liabilities at the end of 2016 reported to S's partners on Schedules K-1 is $5 million. S made no distributions during 2016 reflected on Schedule M-2, line 6. S reported a loss of ($3 million) for 2016 on Schedule M-2, line 3. S didn't report adjustments to capital on Schedule M-2, lines 4 or 7. S has adjusted total assets for 2016 in the tentative amount of $10.5 million, the sum of $7.5 million plus $3 million (the amount of the loss stated as a positive amount that must be added back to determine adjusted total assets for 2016). This tentative amount is compared to the total liabilities at the end of 2016 as reported to S's partners on Schedules K-1, and the greater of the two amounts is considered the adjusted total assets. Because S has adjusted total assets of $10 million or more for its tax year ending December 31, 2016, S must file Schedule M-3 for 2016 and either: (i) complete Schedule M-3 entirely; or (ii) complete Schedule M-3 through Part I and complete Schedule M-1 instead of completing Parts II and III of Schedule M-3.

6. T, a U.S. partnership, files Form 1065 for the tax year ending December 31, 2016. T has total assets at the end of 2016 reported on Schedule L, line 14, column (d), of $7.5 million. The amount of total liabilities at the end of 2016 reported to T's partners on Schedules K-1 is $5 million. T made no distributions during 2016 reflected on Schedule M-2, line 6. T didn't report a loss for 2016 on Schedule M-2, line 3. T didn't report adjustments to capital on Schedule M-2, line 7, but did report a negative adjustment of ($3 million) on Schedule M-2, line 4. T has adjusted total assets for 2016 in the tentative amount of $10.5 million, the sum of $7.5 million plus $3 million (the amount of the negative adjustment stated as a positive amount that must be added back to determine adjusted total assets for 2016), an amount that isn't less than the total liabilities at the end of 2016 reported to T's partners on Schedules K-1. Because T has adjusted total assets of $10 million or more for its tax year ending December 31, 2016, T must file Schedule M-3 for 2016 and either: (i) complete Schedule M-3 entirely; or (ii) complete Schedule M-3 through Part I and complete Schedule M-1 instead of completing Parts II and III of Schedule M-3.

7. Z has $50 million in total assets at the end of its 2016 tax year ending December 31, 2016, and files Form 1065. Z must file Schedule M-3 and complete it entirely.

Reportable Entity Partner Reporting Responsibilities

For the purposes of these instructions, a reportable entity partner with respect to a partnership filing Form 1065 or Form 1065-B is an entity that:

- 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
- 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 the purposes of these instructions, the following rules apply.

1. The parent corporation of a consolidated tax group is deemed to own all corporate and partnership interests owned or deemed to be owned under these instructions by any member of the tax consolidated group.

2. The owner of a disregarded entity is deemed to own all corporate and partnership interests owned or deemed to

Adjusted Total Assets Worksheet

Keep for Your Records

1.	Enter total assets at the end of the tax year on Schedule L, line 14, column (d)	**1.**
2.	Enter capital distributions on Schedule M-2, lines 6a and 6b (shown as a positive amount)	**2.**
3.	Enter any loss reported on Schedule M-2, line 3 (shown as a positive amount)	**3.**
4.	Enter the amount of any positive adjustment on Schedule M-2, line 7	**4.**
5.	Enter the amount of any negative adjustment on Schedule M-2, line 4 (shown as a positive amount)	**5.**
6.	Add lines 1 through 5	**6.**
7.	Enter combined total liabilities (recourse and nonrecourse) on all Schedules K-1 (Form 1065), Part II, Item K, or Schedules K-1 (Form 1065-B)	**7.**
8.	Adjusted Total Assets. Enter the greater of line 6 or line 7	**8.**

Note: For line 2 above, if the partnership reflects partner capital account changes resulting from the sale of a partnership interest on Schedule M-2 as matching contributions and distributions (on lines 2a and 2b and on lines 6a and 6b, respectively), reduce the amounts shown on lines 6a and 6b by such matching amounts.

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be owned under these instructions by the disregarded entity.

3. The owner of 50% or more of a corporation by vote on any day of the corporation tax year is deemed to own all corporate and partnership interests owned or deemed to be owned under these instructions by the corporation during the corporation tax year.

4. 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.

5. 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.

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. Name.

2. Mailing address.

3. Employer identification number (EIN), if applicable.

4. Entity or organization type.

5. State or country in which it is organized.

6. Date on which it first became a reportable entity partner.

7. 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.

9. Any change in that interest as of the date with respect to which it is reporting.

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

For more information, see *Item D. Reportable Entity Partner*, below.

Example 2.

1. P, a U.S. corporation, is the parent of a financial consolidation group with 50 domestic subsidiaries, DS1 through DS50, and 50 foreign subsidiaries, FS1 through FS50, all 100% owned on September 16, 2016. On September 15, 2016, P filed a consolidated tax return on Form 1120 and was required to file Schedule M-3 for the tax year ending December 31, 2015. On September 16, 2016, DS1, DS2, DS3, FS1, and FS2 each acquire a 10% partnership interest in partnership K, which files Form 1065 for the tax year ending December 31, 2016. P is deemed to own, directly or indirectly, under these instructions, all corporate and partnership interests of DS1, DS2, and DS3, as the parent of the tax consolidation group, and therefore is deemed to own 30% of K on September 16, 2016. P is deemed to own, directly or indirectly, under these instructions all corporate and partnership interests of FS1 and FS2 as the owner of 50% or more of each corporation by vote and therefore is deemed to own 20% of K on September 16, 2016. P is therefore deemed to own 50% of K on September 16, 2016. P owns or is deemed to own, directly or indirectly, under these instructions 50% or more of K on September 16, 2016, and was required to file Schedule M-3 on its most recently filed U.S. income tax return filed before that date. Therefore, P is a reportable entity partner of K as of September 16, 2016. On October 5, 2016, P reports to K, as it is required to do, that P is a reportable entity partner as of September 16, 2016, deemed to own under these instructions a 50% interest in K. K is therefore required to file Schedule M-3 when it files its Form 1065 for its tax year ending December 31, 2016.

2. Throughout 2016, A, a limited liability company (LLC) filing Form 1065 for calendar year 2016, owns, as its only asset, 50% of each of B, C, D, and E, each also an LLC filing Form 1065 for calendar year 2016. A is owned by individuals and S corporations not required to file Schedule M-3 for 2015, 2016, or 2017. B, C, D, and E are owned by A and by individuals and S corporations not required to file Schedule M-3 for 2015, 2016, or 2017. For the partnership tax years ending December 31, 2016, each of B, C, D, and E has no year-end liabilities, $3 million in total assets and $6 million in adjusted total assets (the difference equal to the distributions by each in 2016), and 2016 total receipts of $20 million. As of December 31, 2016, no owner, direct or indirect, of B, C, D, or E was required to file Schedule M-3 on its most recently filed U.S. income tax return or return of income. Neither B, C, D, or E is required to file Schedule M-3 for 2016. For the partnership tax year ending December 31, 2016, A has no year-end liabilities, $6 million in total assets and $12 million in adjusted total assets (the difference equal to the distributions in 2016), and 2016 total receipts of $6 million. As of December 31, 2016, no owner, direct or indirect, of A was required to file Schedule M-3 on its most recently filed U.S. income tax return. A must file Schedule M-3 when it files its Form 1065 for 2016 because A has adjusted total assets of $10 million or more.

3. Same ownership facts as in Example 2.2 continued to calendar year 2017. On March 3, 2017, A files its Form 1065 with Schedule M-3 for the partnership tax year ending December 31, 2016. As of March 4, 2017, A becomes a reportable entity partner with respect to

any partnership in which it 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. A owns 50% of each of B, C, D, and E and is therefore a reportable entity partner with respect to each as of March 4, 2017, the day after it filed its 2016 Form 1065 with a required Schedule M-3. On March 20, 2017, A reports to B, C, D, and E, as it is required to do within 30 days of March 4, that it is a reportable entity partner owning a 50% interest. Each of B, C, D, and E is required to file Schedule M-3 for 2017 because each has a reportable entity partner. A will determine if it must file Schedule M-3 for 2017 based on its separate facts for 2017.

4. Same ownership facts as in Example 2.2 for calendar year 2016 except that A is owned 50% by corporation Z that was first required to file Schedule M-3 for its corporate tax year ending December 31, 2015, and that filed its Form 1120 with Schedule M-3 for 2015 on September 15, 2016. As of September 16, 2016, Z was a reportable entity partner with respect to A and, through A, with respect to B, C, D, and E. On October 5, 2016, Z reports to A, B, C, D, and E, as it is required to do within 30 days of September 16, that Z is a reportable entity partner directly owning (with respect to A) or deemed to own indirectly (with respect to B, C, D, and E) a 50% interest. Therefore, because Z was a reportable entity partner for 2016, each of A, B, C, D, and E is required to file Schedule M-3 for 2016, regardless of whether it would otherwise be required to file Schedule M-3 for that year.

Other Form 1065 Schedules Affected by Schedule M-3 Requirements

Schedule L

If a non-tax-basis income statement and related non-tax-basis balance sheet are prepared for any purpose for a period ending with or within the tax year, Schedule L must be prepared showing non-tax-basis amounts. See the discussion in the instructions for Schedule M-3, Part I, line 1, of non-tax-basis income statements and related non-tax-basis balance sheets prepared for any purpose and the impact on the selection of the income statement used for Schedule M-3 and the related non-tax-basis balance sheet amounts that must be used for Schedule L.

Total assets at the end of the tax year shown on Schedule L, line 14, column (d), must equal the total assets of the partnership as of the last day of the tax year, and must be the same total assets reported by the partnership in the non-tax-basis financial statements, if any, used for Schedule M-3. If the partnership prepares non-tax-basis financial statements, Schedule L must report the non-tax-basis financial statement total assets. If the partnership doesn't prepare non-tax-basis financial statements, Schedule L must be based on the partnership's books and records. The Schedule L balance sheet can show tax-basis balance sheet amounts if the partnership is allowed to use books and records for Schedule M-3 and the partnership's books and records reflect only tax-basis amounts.

Generally, total assets at the beginning of the year (Schedule L, line 14, column (b)) must equal total assets at the close of the prior year (Schedule L, line 14, column (d)). For each Schedule L balance sheet item reported for which there is a difference between the current opening balance sheet amount and the prior closing balance sheet amount, attach a statement that reports the balance sheet item, the prior closing amount, the current opening amount, and a short explanation of the change. Such reasons for these differences include technical terminations and mergers.

For purposes of measuring total assets at the end of the year, the partnership's assets may not be netted or reduced by partnership liabilities. In addition, total assets may not be reported as a negative amount. If Schedule L is prepared on a non-tax-basis method, an investment in another partnership may be shown as appropriate under the partnership's non-tax-basis method of accounting, including, if required by the partnership's reporting methodology, the equity method of accounting for investments. If Schedule L is prepared on a tax-basis method, an investment by the partnership in another partnership must be shown as an asset and measured by the partnership's adjusted basis in its partnership interest. Any liabilities contributing to such adjusted basis must be shown on Schedule L as partnership liabilities.

Example 3. A, a limited liability company (LLC), files Form 1065 for calendar year 2016. B, a general partnership, also files Form 1065 for calendar year 2016. A is a general partner in B. A's capital account in B at the close of 2016 is negative $4 million. This reflects A's 2016 contribution to B's capital of $2 million reduced by A's share of 2016 losses passing through to it from B, $6 million. A's adjusted basis in B at December 31, 2016, is $16 million, its $4 million negative tax capital account in B plus its $20 million share of B's liabilities under section 752. A prepares only tax-basis income statements and balance sheets. On its Schedule L, A reports as an asset the adjusted basis of its investment in B, $16 million. A also reports its $20 million share of B's liabilities in the liabilities section of Schedule L. A doesn't report its $4 million negative capital account in B on Schedule L.

Example 4. Same facts as in Example 3, except that B is an LLC and A is a member of B. None of B's liabilities are recourse with respect to A. A isn't obligated to restore any deficit capital account in B. A prepares non-tax-basis income statements and balance sheets under an accounting method that requires the use of the equity method of accounting to account for its investment in B. On its non-tax-basis books and records, A initially reports $2 million as its investment in B, the amount of A's capital contribution. A then reduces its $2 million investment in B by its share of B's allocable losses. Because A's allocable share of B's losses is $6 million, A's investment in B under the equity method is reduced to $0. Because A isn't liable to repay any of B's liabilities and isn't obligated to restore any deficit with respect to its capital account in B, A doesn't report any of B's liabilities on A's Schedule L balance sheet.

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 references to the treatment of the entity for U.S. income tax purposes. An entity that generally is disregarded as separate from its owner for U.S. income tax purposes (disregarded entity) must not be separately reported on Schedule M-3 except, if required, on Part I, line 7a or 7b. On Schedule M-3, Parts II and III, any item of income, gain, loss, deduction, or credit of a disregarded entity must be reported as an item of its owner. In particular, the income or loss of a disregarded entity must not be reported on Part II, lines 7, 8, or 9 as from a separate partnership or other pass-through. The financial statement income or loss of a disregarded entity is included on Part I, line 7a or 7b, only if its financial statement income or loss is included on Part I, line 11, but not on Part I, line 4a.

Specific Instructions

Item D. Reportable Entity Partner

On Schedule M-3, page 1, if the partnership has any reportable entity partners for the year, check Item D. A partnership must report the name, EIN if applicable, and maximum percentage of

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actual or deemed ownership of each reportable entity partner if there are one or two reportable entity partners for the tax year of the partnership, or, if there are more than two reportable entity partners for the tax year of the partnership, of the two reportable entity partners with the largest maximum percentage of actual or deemed ownership for the tax year of the partnership. The maximum percentage of actual or deemed ownership for a reportable entity partner for a tax year of the partnership is the maximum percentage interest owned or deemed owned under these instructions by the reportable entity partner in the partnership's capital, profit, or loss on any day during the tax year of the partnership.

The reportable entity partner must retain copies of required reports it makes to partnerships under these instructions. Each partnership must retain copies of the required reports it received under these instructions from reportable entity partners. See *Reportable Entity Partner Reporting Responsibilities*, above.

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Part I. Financial Information and Net Income (Loss) Reconciliation

Line 1. Questions Regarding the Type of Income Statement Prepared

For lines 1 through 11, use only the financial statements of the U.S. partnership filing Form 1065 or Form 1065-B. If the U.S. partnership filing Form 1065 or Form 1065-B is controlled by another entity, the U.S. partnership must use for its Schedule M-3, Part I, its own financial statements and not the financial statements of the controlling entity.

Non-Tax-Basis Financial Statements and Tax-Basis Financial Statements

A tax-basis income statement is allowed for Schedule M-3 and a tax-basis balance sheet for Schedule L only if no non-tax-basis income statement and no non-tax-basis balance sheet were prepared for any purpose and the books and records of the partnership reflect only tax-basis amounts. The partnership is deemed to have non-tax-basis income statements and the related non-tax-basis balance sheets for the current tax year for purposes of Schedule M-3 and Schedule L if such non-tax-basis financial statements were prepared for and presented to management, creditors, members or partners, government regulators, or any other third parties for a period ending with or within the tax year.

If a Form 10-K is filed with the Securities and Exchange Commission (SEC) for the period ending with or within the tax year, the partnership must check "Yes" for line 1a and use that income statement for Schedule M-3. If Form 10-K isn't filed and a non-tax-basis income statement is prepared that is a certified non-tax-basis income statement for the period ending with or within the tax year, the partnership must check "Yes" for line 1b and use that income statement for Schedule M-3. If Form 10-K isn't filed and no certified non-tax-basis income statement is prepared but an unaudited non-tax-basis income statement is prepared for the period ending with or within the tax year, the partnership must check "Yes" for line 1c and use that income statement for Schedule M-3.

Order of priority in accounting standards. If no Form 10-K is filed and two or more non-tax-basis income statements are both certified non-tax-basis income statements for the period, the income statement prepared according to the following order of priority in accounting standards must be used.

1. U.S. Generally Accepted Accounting Principles (GAAP).
2. International Financial Reporting Standards (IFRS).
3. Any other International Accounting Standards (IAS).
4. Any regulatory accrual accounting.
5. Any other accrual accounting standard.
6. Section 704(b) book accounting.
7. Any other fair market value reporting standard.
8. Any cash basis standard.

If no non-tax-basis income statement is certified and two or more non-tax-basis income statements are prepared, the income statement prepared according to the first listed of the accounting standards above must be used.

If no non-tax-basis financial statements are prepared for the U.S. partnership filing Schedule M-3, the U.S. partnership must check "No" on questions 1a, 1b, and 1c, skip lines 2 through 3b, and enter the net income (loss) per the books and records of the U.S. partnership on line 4a.

Consolidated Financial Statements

If a partnership filing a Schedule M-3 **(a)** is included in the non-tax-basis consolidated financial statements of a group (consolidated financial statement group) with an entity parent filing a U.S tax return and Schedule M-3, **(b)** has its income (loss) included and removed by the entity parent on that entity parent's Schedule M-3, Part I, and **(c)** doesn't have a separate non-tax-basis financial statement (certified or otherwise) of its own, the partnership must answer questions 1a, 1b, and 1c as appropriate for its own tax return and must report on its own Schedule M-3, as appropriate, the amount for the partnership's net income (loss) that is equal to the amount included and removed in the entity parent's Schedule M-3, Part I. However, if in the circumstances described immediately above, the partnership does have separate non-tax-basis financial statements (certified or otherwise) of its own, independent of the amount of the partnership's net income included in the consolidated financial statements with the entity parent, the partnership must answer questions 1a, 1b, and 1c, as appropriate, for its own tax return, based on its own separate non-tax-basis income statement, and must report on line 4a the net income (loss) amounts shown on its separate income statement.

Lines 2 and 3. Questions Regarding Income Statement Period and Restatements

Enter the beginning and ending dates on line 2 for the partnership's annual income statement period ending with or within the current tax year.

The questions on lines 3a and 3b, regarding income statement restatements, refer to the worldwide consolidated income statement issued by the partnership filing Form 1065 or Form 1065-B and used to prepare Schedule M-3. Answer "Yes" on lines 3a and/or 3b if the partnership's annual income statement has been restated for any reason. Attach a short statement of the reasons for the restatement in net income for each annual income statement period that is restated, including the original amount and restated amount of each annual statement period's net income. The attached statement isn't required to report restatements on an entity-by-entity basis.

Line 4. Worldwide Consolidated Net Income (Loss) per Income Statement

Report on line 4a the worldwide consolidated net income (loss) per the income statement (or books and records, if applicable) of the partnership.

In completing Schedule M-3, the partnership must use financial statement amounts from the financial statement type checked "Yes" on line 1, or from its books and records if line 1c is checked "No." If line 1a is checked "Yes," report on line 4a the net income amount reported in the

income statement presented to the SEC on the partnership's Form 10-K.

If a partnership prepares non-tax-basis financial statements, the amount on line 4a must equal the financial statement net income (loss) for the income statement period ending with or within the tax year as indicated on line 2.

If the partnership prepares non-tax-basis financial statements and the income statement period differs from the partnership's tax year, the income statement period indicated on line 2 applies for purposes of lines 4a through 8.

If the partnership doesn't prepare non-tax-basis financial statements and has checked “No” on line 1c, enter the net income (loss) per the books and records of the partnership on line 4a.

Check the appropriate box on line 4b to indicate which of the following accounting standards was used for line 4a:

1. U.S. Generally Accepted Accounting Principles (GAAP).
2. International Financial Reporting Standards (IFRS).
3. Section 704(b).
4. Tax-basis.
5. Other (specify).

Report on lines 5a through 10, as instructed below, all adjustment amounts required to adjust worldwide net income (loss) reported on line 4a (whether from financial statements or books and records) to net income (loss) of the partnership that must be reported on line 11. Report on line 12a the worldwide consolidated total assets and total liabilities amounts for the partnership using the same financial statements (or books and records) used for the worldwide consolidated income (loss) amount reported on line 4a.

Line 5. Net Income (Loss) of Nonincludible Foreign Entities

Remove the financial statement net income (line 5a) or loss (line 5b) of each foreign entity that is included on line 4a and isn't the partnership (nonincludible foreign entity). In addition, on line 8, adjust for consolidation eliminations and correct for minority interest and intercompany dividends between any nonincludible foreign entity and the partnership filing Form 1065 or Form 1065-B. Don't remove in Part I the financial statement net income (loss) of any nonincludible foreign entity accounted for on line 4a using the equity method.

Attach a supporting statement that provides the name, EIN (if applicable), and net income (loss) included on line 4a that is removed on this line 5 for each separate nonincludible foreign entity. Also state the total assets and total liabilities for each such separate nonincludible foreign entity and include those assets and liabilities amounts in the total assets and total liabilities reported on Part I, line 12b. The amounts of income (loss) detailed on the supporting statement should be reported for each separate nonincludible foreign entity without regard to the effect of consolidation or elimination entries. If there are consolidation or elimination entries relating to nonincludible foreign entities whose income (loss) is reported on the attached statement that aren't reportable on line 8, the net amounts of all such consolidation and elimination entries must be reported on a separate line on the attached statement, so that the separate financial accounting income (loss) of each nonincludible foreign entity remains separately stated.

For example, if the net income (after consolidation and elimination entries) of a nonincludible foreign sub-consolidated group is being reported on line 5a, the attached supporting statement should report the income (loss) of each separate nonincludible foreign legal entity from each such entity's own financial accounting net income statement or books and records, and any consolidation or elimination entries (for intercompany dividends, minority interests, etc.) not reportable on line 8 should be reported on the attached supporting statement as a net amount on a line separate and apart from lines that report each nonincludible foreign entity's separate net income (loss).

Line 6. Net Income (Loss) of Nonincludible U.S. Entities

Remove the financial statement net income (line 6a) or loss (line 6b) of each U.S. entity that is included on line 4a and isn't an includible entity in the partnership return (nonincludible U.S. entity). In addition, on line 8, adjust for consolidation eliminations and correct for minority interest and intercompany dividends between any nonincludible U.S. entity and any includible entity. Don't remove in Part I the financial statement net income (loss) of any nonincludible U.S. entity accounted for on line 4a using the equity method.

Attach a supporting statement that provides the name, EIN (if applicable), and net income (loss) included on line 4a that is removed on line 6 for each separate nonincludible U.S. entity. Also state the total assets and total liabilities for each such separate nonincludible U.S. entity and include those assets and liabilities amounts in the total assets and total liabilities reported on Part I, line 12c. The amounts of income (loss) detailed on the supporting statement should be reported for each separate nonincludible U.S. entity without regard to the effect of consolidation or elimination entries. If there are consolidation or elimination entries relating to nonincludible U.S. entities whose income (loss) is reported on the attached statement that aren't reportable on line 8, the net amounts of all such consolidation and elimination entries must be reported on a separate line on the attached statement, so that the separate financial accounting income (loss) of each nonincludible U.S. entity remains separately stated.

For example, if the net income (after consolidation and elimination entries) of a nonincludible U.S. sub-consolidated group is being reported on line 6a, the attached supporting statement should report the income (loss) of each separate nonincludible U.S. legal entity from each such entity's own financial accounting net income statement or books and records, and any consolidation or elimination entries (for intercompany dividends, minority interests, etc.) not reportable on line 8 should be reported on the attached supporting statement as a net amount on a line separate and apart from lines that report each nonincludible U.S. entity's separate net income (loss).

Lines 7a and 7b. Net Income (Loss) of Other Foreign Disregarded Entities and Net Income (Loss) of Other U.S. Disregarded Entities

Include on line 7a or 7b the financial net income or (loss) of each disregarded entity in the U.S. tax return that isn't included in the consolidated financial group, and therefore not included in the income reported on line 4a, but that is included on line 11. Include on line 7a the financial income or (loss) of any foreign disregarded entity that isn't included in the income reported on line 4a but that is included on line 11 (other foreign disregarded entities). Include on line 7b the financial income or (loss) of any U.S. disregarded entity that isn't included in the income reported on line 4a but that is included on line 11 (other U.S. disregarded entities). In addition, on line 8, adjust for consolidation eliminations and correct for minority interest and intercompany dividends for any other disregarded entity.

Attach a supporting statement that provides the name, EIN, and net income (loss) per the financial statement or books and records included on line 7a or 7b for each separate foreign or U.S. disregarded entity. Also state the total assets and total liabilities for each such separate included entity and include those assets and liabilities amounts in the total assets and total liabilities reported on Part I, line 12d. The amounts of income (loss) detailed on the supporting statement should be reported for each separate other disregarded entity without regard to the

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effect of consolidation or elimination entries solely between or among the entities listed. If there are consolidation or elimination entries relating to such separate other disregarded entities whose income (loss) is reported on the attached statement that aren't reportable on line 8, the net amounts of all such consolidation and elimination entries must be reported on a separate line on the attached statement, so that the separate financial accounting income (loss) of each separate other disregarded entity remains separately stated.

For example, if the net income (after consolidation and elimination entries) of a sub-consolidated group of other foreign disregarded entities is being reported on line 7a, the attached supporting statement should report the income (loss) of each separate other foreign disregarded entity from each disregarded entity's own financial accounting net income statement or books and records, and any consolidation or elimination entries (for intercompany dividends, minority interests, etc.) not reportable on line 8 should be reported on the attached supporting statement as a net amount on a line separate and apart from lines that report each other foreign disregarded entity's separate net income (loss).

Line 8. Adjustment to Eliminations of Transactions Between Includible Entities and Nonincludible Entities

Adjustments on line 8 to reverse certain financial accounting consolidation or elimination entries are necessary to ensure that transactions between includible entities and nonincludible U.S. or foreign entities aren't eliminated, in order to report the correct total amount on line 11. Also, additional consolidation entries and elimination entries may be necessary on line 8 related to transactions between includible entities that are in the consolidated financial statement group and other includible entities that aren't in the consolidated financial statement group but that are reported on line 7a or 7b in order to report the correct total amount on line 11.

Include on line 8 the total of the following: **(a)** amounts of any adjustments to consolidation entries and elimination entries that are contained in the amount reported on line 4a, required as a result of removing amounts on line 5 or 6; and **(b)** amounts of any additional consolidation entries and elimination entries that are required as a result of including amounts on line 7a or 7b. This is necessary in order that the consolidation entries and intercompany elimination entries included in the amount reported on line 11 are only those applicable to the financial net income (loss) of includible entities for the financial statement period. For example, adjustments must be reported on line 8 to remove minority interest and to reverse the elimination of intercompany dividends included on line 4a that relate to the net income of entities removed on line 5 or 6 because the income to which the consolidation or elimination entries relate has been removed. Also, for example, consolidation or elimination entries must be reported on line 8 to eliminate any intercompany dividends between entities whose income is included on line 7a or 7b and other entities included in the U.S. income tax return.

If an entity owner of an interest in another entity **(a)** accounts for the interest in the other entity in the owner's separate general ledger on the equity method, and **(b)** fully consolidates the other entity in the owner's consolidated financial statements, but that entity isn't includible in the owner's Form 1065 or Form 1065-B, then, as part of reversing all consolidation and elimination entries for the nonincludible entity, the owner must reverse on line 8 the elimination of the equity income inclusion from the other entity. If the owner doesn't account for the other entity on the equity method on its own general ledger, it won't have eliminated the equity income for consolidated financial statement purposes, and therefore will have no elimination of equity income to reverse.

The attached supporting statement for 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 isn't necessary, but it is permitted, to report on line 8 intercompany eliminations that net to zero, such as intercompany interest income and expense.

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

Include on line 9 any adjustments necessary to the income (loss) of the partnership to reconcile differences between the partnership's income statement period reported on line 2 and the partnership's tax year. Attach a statement describing the adjustment.

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

Include on line 10 any other adjustments to reconcile net income (loss) on line 4a through line 9, with net income (loss) of the partnership reported on line 11.

For any adjustment reported on line 10, attach a supporting statement with an explanation of each net adjustment included on line 10.

Line 11. Net Income (Loss) per Income Statement of the Partnership

Report on line 11 the net income (loss) per the income statement (or books and records, if applicable) of the partnership. Amounts reported in column (a) of Parts II and III (see later) must be reported on the same accounting method as is used to report the amount of net income (loss) per income statement of the partnership on line 11.

Don't, in any event, report on line 11 the net income of entities other than the partnership filing Form 1065 or Form 1065-B for the tax year. For example, it isn't permissible to remove the income of nonincludible entities on lines 5 and/or 6, above, then to add back such income on lines 7 through 10, such that the amount reported on line 11 includes the net income of entities not includible in the U.S. income tax return. A principal purpose of Schedule M-3 is to report on line 11 only the financial accounting net income of only the partnership (including any other includible entities) filing Form 1065 or Form 1065-B.

Whether or not the partnership prepares financial statements, line 11 must include all items that impact the net income (loss) of the partnership even if they aren't recorded in the profit and loss accounts in the partnership's general ledger, including, for example, all post-closing adjusting entries (including workpaper adjustments) and dividend income or other income received from nonincludible entities. If the partnership prepares unconsolidated financial statements using the same accounting method used to determine worldwide consolidated net income (loss) for Part I, line 4, and if it uses the equity method for investments, the amount reported on Part I, line 11, will equal the amount of the unconsolidated net income (loss) reported on the unconsolidated financial statements. See Examples 5.3, 5.4, and 5.5.

Example 5.

1. U.S. partnership P owns 60% of corporation DS1 which is fully consolidated in P's financial statements. P doesn't account for DS1 in P's separate general ledger on the equity method. DS1 has net income of $100 (before minority interests) and pays dividends of $50, of which P receives $30. The dividend is eliminated in the consolidated financial statements. In its financial statements, P consolidates DS1 and includes $60 of net income ($100 less the minority interest of $40) on line 4a.

P must remove the $100 net income of DS1 on line 6a. P must reverse on line 8 the elimination of the $40 minority interest

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net income of DS1. In addition, P reverses its elimination of the $30 intercompany dividend in its financial statements on line 8. The net result is that P includes the $30 dividend from DS1 on line 11 and on Part II, line 6, column (a). P's dividend income included on the tax return from DS1 must be reported on Part II, line 6, column (d).

2. U.S. partnership C owns 60% of the capital and profits interests in U.S. LLC N. C doesn't account for N in C's separate general ledger on the equity method. N has net income of $100 (before minority interests) and makes no distributions during the tax year. C treats N as a corporation for financial statement purposes and as a partnership for U.S. income tax purposes. In its financial statements, C consolidates N and includes $60 of net income ($100 less the minority interest of $40) on line 4a.

C must remove the $100 net income of N on line 6a. C must reverse on line 8 the elimination of the $40 minority interest net income of N. The result is that C includes no income for N either on line 11 or on Part II, line 7, column (a). C's taxable income from N must be reported by C on Part II, line 7, column (d).

3. U.S. partnership P owns 60% of corporation DS1, which is fully consolidated in P's financial statements. P accounts for DS1 in P's separate general ledger on the equity method. DS1 has net income of $100 (before minority interests) and pays dividends of $50, of which P receives $30. The dividend reduces P's investment in DS1 for equity method reporting on P's separate general ledger where P includes its 60% equity share of DS1 income, which is $60. In its financial statements, P eliminates the DS1 equity method income of $60 and consolidates DS1, including $60 of net income ($100 less the minority interest of $40) on line 4a.

P must remove the $100 net income of DS1 on line 6a. P must reverse on line 8 the elimination of the $40 minority interest net income of DS1 and the elimination of the $60 of DS1 equity income. The net result is that P includes the $60 of equity method income from DS1 on line 11 and on Part II, line 5, column (a). P's dividend income on the tax return from its investment in DS1 must be reported on Part II, line 6, column (d).

4. U.S. partnership C owns 60% of the capital and profits interests in U.S. LLC N. C accounts for N in C's separate general ledger on the equity method. N has net income of $100 (before minority interests) and makes no distributions during the tax year. C treats N as a corporation for financial statement purposes and as a partnership for U.S. income tax purposes. For equity method reporting on C's separate general ledger, C includes its 60% equity share of N income, which is $60. In its financial statements, C eliminates the $60 of N equity method income and consolidates N, including $60 of net income ($100 less the minority interest of $40) on line 4a.

C must remove the $100 net income of N on line 6a. C must reverse on line 8 the elimination of the $40 minority interest net income of N and the elimination of the $60 of N equity method income. The result is that C includes the $60 of equity method income for N on line 11 and on Part II, line 7, column (a). C's taxable income from N must be reported by C on Part II, line 7, column (d).

5. U.S. partnership C owns 60% of the capital and profits interests in U.S. LLC N. C accounts for N in C's separate general ledger on the equity method. N has net income of $100 (before minority interests) and pays a $50 cash distribution, of which C receives $30. The distribution reduces C's investment in N for equity method reporting on C's separate general ledger. C treats N as a corporation for financial statement purposes and as a partnership for U.S. income tax purposes. For equity method reporting on C's separate general ledger, C includes its 60% equity share of N income, which is $60. In its financial statements, C eliminates the $60 of N equity method income and consolidates N and includes $60 of net income ($100 less the minority interest of $40) on line 4a.

C must remove the $100 net income of N on line 6a. C must reverse on line 8 the elimination of the $40 minority interest net income of N and the elimination of the $60 of N equity method income. The result is that C includes the $60 of equity method income for N on line 11 and on Part II, line 7, column (a). C's taxable income from N must be reported by C on Part II, line 7, column (d).

6. U.S. partnership P owns 100% of the stock of U.S. LLC Q, a disregarded entity. Q is included in P's federal income tax return, even though Q isn't included in P's consolidated financial statements on either a consolidated basis or on the equity method. Q has current year net income of $100 after taking into account its $40 interest payment to P. P has net income of $1,040 after recognition of the interest income from Q. Because Q is a disregarded entity, 100% of the net income of both P and Q must be reported on P's Form 1065 or Form 1065-B and the intercompany interest income and expense must be removed by consolidation elimination entries.

P must report its financial statement net income of $1,040 on line 4a and reports Q's net income of $100 on line 7b as a U.S. disregarded entity not included on line 4a, but included on line 11. Then, in order to reflect the full consolidation of the financial accounting net income of P and Q at line 11, the following consolidation and elimination entry is reported on line 8: offsetting entries to remove the $40 of interest income received from Q included by P on line 4a, and to remove the $40 of interest expense of Q included in line 7b for a net change of zero. The result is that line 11 reports $1,140: $1,040 from line 4a, and $100 from line 7. Stated another way, line 11 includes the entire $1,000 net income of P, measured before recognition of the intercompany interest income from Q and the consolidation of Q operations, plus the entire $140 net income of Q, measured before interest expense to P. P isn't required to include on the attached supporting statement for line 8 the offsetting adjustment to the intercompany elimination of interest income and interest expense (though it is permitted to do so).

Line 12. Total Assets and Liabilities of Entities Included or Removed on Part I, Lines 4, 5, 6, and 7

Line 12 must be completed by all partnerships that file Schedule M-3. Report on lines 12a, 12b, 12c, and 12d the total amounts (not just the partnership's share) of assets and liabilities of entities included or removed on Part I, lines 4, 5, 6, and 7. All assets and liabilities reported on Part I, lines 12a through 12d must be reported as positive amounts. On line 12a, enter the worldwide consolidated total assets and total liabilities of all of the entities included in completing Part I, line 4. On line 12b, enter the total assets and total liabilities of the entities removed in completing Part I, line 5. On line 12c, enter the total assets and total liabilities of the entities removed in completing Part I, line 6. On line 12d, enter the total assets and total liabilities of the entities included in completing Part I, line 7.

Parts II and III

General Reporting Information

A schedule or statement may be attached to any line even if none is required.

For each line item in Parts II and III, report in column (a) the amount of net income (loss) included on Part I, line 11, and report in column (d) the amount included on line 1 of the *Analysis of Net Income (Loss)* found on Form 1065 and Form 1065-B.

Note. Part II, line 26, column (a) must equal Part I, line 11, and column (d) must equal line 1 of the *Analysis of Net Income (Loss)* found on Form 1065 and Form 1065-B. Thus, column (d) on Part II and

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Part III must include certain of the separately stated items on Schedule K.

For any item of income, gain, loss, expense, or deduction for which there is a difference between columns (a) and (d), the portion of the difference that is temporary must be entered in column (b) and the portion of the difference that is permanent must be entered in column (c).

If financial statements are prepared by the partnership under generally accepted accounting principles (GAAP), differences that are treated as temporary under GAAP must be reported in column (b) and differences that are permanent (that is, not temporary) for GAAP must be reported in column (c). Generally, under GAAP, a temporary difference affects (creates, increases, or decreases) a deferred tax asset or liability.

If the partnership doesn't prepare financial statements, or the financial statements aren't prepared under GAAP, report in column (b) any difference that the partnership believes will reverse in a future tax year (that is, have an opposite effect on taxable income in a future tax year (or years) due to the difference in timing of recognition for financial accounting and U.S. income tax purposes) or is the reversal of such a difference that arose in a prior tax year. Report in column (c) any difference that the partnership believes won't reverse in a future tax year (and isn't the reversal of such a difference that arose in a prior tax year).

If the partnership is unable to determine whether a difference between column (a) and column (d) for an item will reverse in a future tax year or is the reversal of a difference that arose in a prior tax year, report the difference for that item in column (c).

Example 6. At the end of Partnership A's first tax year, December 31, 2016, it wasn't required to file Schedule M-3 for any reason.

A may elect to file Schedule M-3 instead of completing Schedule M-1.

If A elects to file Schedule M-3, it must either (i) complete Schedule M-3 entirely or (ii) complete Schedule M-3 through Part I and complete Schedule M-1 instead of completing Parts II and III of Schedule M-3.

If A elects to complete Schedule M-3 entirely, it must complete all columns of Parts II and III.

If A completes Schedule M-3 through Part I and completes Schedule M-1 instead of completing Parts II and III of Schedule M-3, line 11 of Part I of Schedule M-3 must equal line 1 of Schedule M-1.

Reporting Requirements for Parts II and III

General Reporting Requirements

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), and (d), as applicable, of Part II, line 10, Items relating to reportable transactions, regardless of whether the amount would otherwise be reported on Schedule M-3, Part II or Part III. 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 10.

A partnership 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 in any manner included in the partnership's current year financial statement net income (loss) or in an income or expense account maintained in the partnership's books and records, even if there is no difference between that amount and the amount included in net income (loss) for tax purposes unless **(a)** otherwise instructed in these instructions or **(b)** the amount is attributable to a reportable transaction described in Regulations section 1.6011-4(b) and is therefore reported on Part II, line 10. For example, with the exception of interest income reflected on a Schedule K-1 received by the partnership as a result of the partnership's investment in a partnership or other pass-through entity, all interest income included on Part I, line 11, whether from unconsolidated affiliated entities, 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 11, column (a). Likewise, 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 7, column (a), regardless of the government 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 partnership would be required to report in column (a) of Parts II and III the amount of any item specifically listed on Schedule M-3 in accordance with the preceding paragraph, except that the partnership 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 partnership's books and records, the partnership must report the proper tax treatment of the item in columns (b), (c), and (d), as applicable.

Furthermore, in applying the two preceding paragraphs, a partnership is required to report in column (a) of Parts II and III the amount of any item specifically listed on Schedule M-3 that is included in the partnership's financial statements or exists in the partnership's books and records, regardless of the nomenclature associated with that item in the financial 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 financial statements or exist in the books and records that represent some form of "Bad debt expense" must be reported on Part III, line 26, in column (a), regardless of whether the amounts are recorded or stated under different nomenclature in the financial statements or the books and records such as: "Provision for doubtful accounts"; "Expense for uncollectible notes receivable"; or "Impairment of trade accounts receivable." Likewise, as stated in the preceding paragraph, all fines and penalties must be included on Part III, line 7, column (a), regardless of the terminology or nomenclature attached to them by the partnership in its books and records or financial statements.

With limited exceptions, Part II includes lines for specific items of income, gain, or loss (income items). (See lines 1 through 21.) If an income item is described on lines 1 through 21, report the amount of the item on the applicable line, regardless of whether there is a difference for the item. If there is a difference for the income item, or only a portion of the income item has a difference and a portion of the item doesn't have a difference, and the item isn't described on lines 1 through 21, report and describe the entire amount of the item on line 22.

With limited exceptions, Part III includes lines for specific items of expense or deduction (expense items). (See lines 1 through 29.) If an expense item is described on lines 1 through 29, report the amount of the item on the applicable line, regardless of whether there is a difference for the item. If there is a difference for the expense item, or only a portion of the expense item has a difference and a portion of the item doesn't have a difference and the item

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isn't described on lines 1 through 29, report and describe the entire amount of the item on line 30.

If there is no difference between the financial accounting amount and the amount reported for tax purposes of an entire item of income, loss, expense, or deduction and the item isn't described or included on Part II, lines 1 through 22, or Part III, lines 1 through 30, report the entire amount of the item in column (a) and (d) of Part II, line 25.

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). If a specific item of income, gain, loss, expense, or deduction is described on Part II, lines 7 through 21, or Part III, lines 1 through 29, and the line doesn't indicate to "attach schedule" or "attach details," and the specific instructions for the line don't call for an attachment of a schedule or explanation, 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. See the instructions for Part II, lines 1 through 9, for specific additional information required to be provided for these particular lines.

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 22 and Part III, line 30. A separate statement must be attached to Schedule M-3 (Form 1065) that includes a detailed description of each item and adjustment entered on Part II, line 22, and Part III, line 30.

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) 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) and (c), including how the adjustment is identified in the accounting records. The entire description is considered the tax description for the amount reported in column (d) for each item reported on Part II, line 22, or Part III, line 30.

Each description should adequately describe all four columns of Part II, line 22, or Part III, line 30. If additional information is required to provide an acceptable description, provide a supporting statement.

Example 7. Partnership B prepares GAAP financial statements. In prior years, B acquired intellectual property (IP) and goodwill. The IP is amortizable for both U.S. income tax and financial statement purposes. In the current year, B's annual amortization expense for IP is $9,000 for U.S. income tax purposes and $6,000 for financial statement purposes. The goodwill isn't amortizable for U.S. income tax purposes and is subject to impairment for financial statement purposes. In the current year, B records an impairment charge on the goodwill of $5,000. B must report the amortization attributable to the IP on Part III, line 21, and report $6,000 in column (a), a temporary difference of $3,000 in column (b), and $9,000 in column (d). B must report the goodwill impairment on Part III, line 19, and report $5,000 in column (a), a permanent difference of ($5,000) in column (c), and $0 in column (d).

Example 8. Partnership C is a calendar year partnership that files and entirely completes Schedule M-3 for its 2016 tax year. C placed in service 10 depreciable fixed assets in a previous tax year. C's total depreciation expense for its 2016 tax year for five of the assets is $50,000 for income statement purposes and $70,000 for U.S. income tax purposes. C's total annual depreciation expense for its 2016 tax year for the other five assets is $40,000 for income statement purposes and $30,000 for U.S. income tax purposes. C treats the differences between financial statement and U.S. income tax depreciation expense as giving rise to temporary differences that will reverse in future years. C must combine all of its depreciation adjustments. Accordingly, C must report on Part III, line 25, for its 2016 tax year income statement depreciation expense 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 in column (d).

Example 9. Partnership D is a calendar year partnership that files and entirely completes Schedule M-3 for its 2016 tax year. On December 31, 2016, D establishes three 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 coupons outstanding that may have to be paid. The third reserve is an estimate of future warranty expenses. In its financial statements, D treats the three reserve accounts as giving rise to temporary differences that will reverse in future years. The three reserves are expenses in D's 2016 financial statements but aren't deductions for U.S. income tax purposes in 2016. D must not combine the Schedule M-3 differences for the three reserve accounts. D must report the amounts attributable to the allowance for uncollectible accounts receivable on Part III, line 26, Bad debt expense, and must separately state and adequately disclose the amounts attributable to each of the other two reserves, coupons outstanding and warranty costs, on a required, attached statement that supports the amounts on Part III, line 30. D must also provide a description for each reserve that meets the requirements for Part III, line 30, discussed earlier under *Required statements for Part II, line 22, and Part III, line 30*. In this example, an acceptable description for warranty costs 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 10. Partnership E is a calendar year partnership that files and entirely completes Schedule M-3 for its 2016 tax year. On January 2, 2016, E establishes an allowance for uncollectible accounts receivable (bad debt reserve) of $100,000. During 2016, E increases the reserve by $250,000 for additional accounts receivable that may become uncollectible. Additionally, during 2016, E decreases the reserve by $75,000 for accounts receivable that were discharged in bankruptcy during 2016. The balance in the reserve account on December 31, 2016, is $275,000. The $100,000 amount to establish the reserve account and the $250,000 to increase the reserve account are expenses on E's 2016 financial statements but aren't deductible for U.S. income tax purposes in 2016. However, the $75,000 decrease to the reserve is deductible for U.S. income tax purposes in 2016. In its financial statements, E treats the reserve account as giving rise to a temporary difference that will reverse in future tax years. E must report on Part III, line 26, Bad debt expense, for its 2016 tax year income statement bad debt expense of $350,000 in column (a), a temporary

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difference of ($275,000) in column (b), and U.S. income tax bad debt expense of $75,000 in column (d).

Example 11. Partnership F is a calendar year partnership that files and entirely completes Schedule M-3 for its 2016 tax year. During 2016, F incurs $200 of meals and entertainment expenses that F deducts in computing net income per the income statement. $50 of the $200 is subject to the 50% limitation under section 274(n). In its financial statements, F treats the limitation on deductions for meals and entertainment as a permanent difference. Because meals and entertainment expenses are specifically described on Part III, line 6, Meals and entertainment, F must report all of its meals and entertainment expenses on this line, regardless of whether there is a difference. Accordingly, F must report $200 in column (a), $25 in column (c), and $175 in column (d). F must not report the $150 of meals and entertainment expenses that are deducted in F's financial statement net income and are fully deductible for U.S. income tax purposes on Part II, line 25, Other items with no differences, nor the $50 subject to the limitation under section 274(n) on Part III, line 6.

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Part II. Reconciliation of Net Income (Loss) per Income Statement of Partnership With Income (Loss) per Return

Lines 1 Through 9. Additional Information for Each Entity

For any item reported on lines 1 or 3 through 5, attach a supporting statement that provides the name of the entity for which the item is reported, the entity's EIN (if applicable), the type of entity (corporation, partnership, etc.), and the item amounts for columns (a) through (d). See the instructions for lines 2 and 6 through 9 for the specific information required for those particular lines.

Line 1. Income (Loss) From Equity Method Foreign Corporations

Report on line 1, column (a), the financial income (loss) included on Part I, line 11, for any foreign corporation accounted for on the equity method and remove such amount in column (b) or (c), as applicable. Report the amount of dividends received and other taxable amounts received or includible from foreign corporations on lines 2 through 4, as applicable.

Line 2. Gross Foreign Dividends Not Previously Taxed

Except as otherwise provided in this paragraph, report on line 2, column (d), the amount (before any withholding tax) of any foreign dividends included on line 1 of the *Analysis of Net Income (Loss)* found on Form 1065 and Form 1065-B, and report on line 2, column (a), the amount of dividends from any foreign corporation included on Part I, line 11. Don't report on line 2 any amounts that must be reported on line 3 or dividends that were previously taxed and must be reported on line 4. (See the instructions below for lines 3 and 4.) Report withholding taxes on Part III, line 30, Other expense/deduction items with differences, or line 25, Other items with no differences, as applicable.

For any dividends reported on line 2 that are received on a class of voting stock of which the partnership directly or indirectly owned 10% or more of the outstanding shares of that class at any time during the tax year, report on an attached supporting statement for line 2: **(a)** the name of the dividend payer, **(b)** the payer's EIN (if applicable), **(c)** the class of voting stock on which the dividend was paid, **(d)** the percentage of the class directly or indirectly owned, and **(e)** the amounts for columns (a) through (d).

Line 3. Subpart F, QEF, and Similar Income Inclusions

Report on line 3, column (d), the amount included in taxable income under section 951 (relating to Subpart F), gains or other income inclusions resulting from elections under sections 1291(d)(2) and 1298(b)(1), and any amount included in taxable income pursuant to section 1293 (relating to qualified electing funds). The amount of Subpart F income corresponds to the total of the amounts reported by the partnership on line 6, Schedule I, of all Forms 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations. The amount of qualified electing fund income corresponds to the total of the amounts reported by the partnership on Part III, line 8a, of all Forms 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.

Also include on line 3 passive foreign investment company mark-to-market gains and losses under section 1296. Don't report such gains and losses on line 14.

Line 4. Gross Foreign Distributions Previously Taxed

Report on line 4, column (a), any distributions received from foreign corporations that were included on Part I, line 11, and that were previously taxed for U.S. income tax purposes. For example, include in column (a) amounts that are excluded from taxable income under sections 959 and 1293(c). Remove such amounts in column (b) or (c), as applicable. Report the full amount of the distribution before any withholding tax. Report withholding taxes on Part III, line 30, Other expense/deduction items with differences, or line 25, Other items with no differences, as applicable. Since previously taxed foreign distributions aren't currently taxable, line 4, column (d), is shaded. (Also, see instructions above for line 2.)

Line 5. Income (Loss) From Equity Method U.S. Corporations

Report on line 5, column (a), the financial income (loss) included on Part I, line 11, for any U.S. corporation accounted for on the equity method and remove such amount in column (b) or (c), as applicable. Report on line 6 the amount of dividends received from any U.S. corporations.

Line 6. U.S. Dividends

Report on line 6, column (a), the amount of dividends included on Part I, line 11, that were received from any U.S. corporation. Report on line 6, column (d), the amount of any U.S. dividends included in taxable income on line 1 of the *Analysis of Net Income (Loss)* found on Form 1065 and Form 1065-B.

For any dividends reported on line 6 that are received on classes of voting stock in which the partnership directly or indirectly owned 10% or more of the outstanding shares of that class at any time during the tax year, report on an attached supporting statement for line 6: **(1)** the name of the dividend payer, **(2)** the payer's EIN (if applicable), **(3)** the class of voting stock on which the dividend was paid, **(4)** the percentage of the class directly or indirectly owned, and **(5)** the amounts for columns (a) through (d).

Line 7. Income (Loss) From U.S. Partnerships and Line 8. Income (Loss) From Foreign Partnerships

For any interest owned by the partnership that is treated as an investment in a partnership for U.S. income tax purposes (other than an interest in a disregarded entity), report amounts on line 7 or 8, as described below:

1. In column (a), the sum of the partnership's distributive share of income or loss from a U.S. or foreign partnership that is included on Part I, line 11;

2. In column (b) or (c), as applicable, the sum of all differences, if any, attributable to the partnership's distributive

share of income or loss from a U.S. or foreign partnership; and

3. In column (d), the sum of all amounts of income, gain, loss, or deduction attributable to the partnership's distributive share of income or loss from a U.S. or foreign partnership (that is, the sum of all amounts reportable on the partnership's Schedule(s) K-1 received from the partnership (if applicable)), without regard to any limitations computed at the partner level (for example, limitations on utilization of charitable contributions, capital losses, and interest expense).

For each partnership reported on line 7 or 8, attach a supporting statement that provides the name, EIN (if applicable), end of year profit-sharing percentage (if applicable), end of year loss-sharing percentage (if applicable), and the amount reported in column (a), (b), (c), or (d) of lines 7 or 8, as applicable.

Example 12. U.S. partnership H is a calendar year partnership that files and entirely completes Schedule M-3 for its 2016 tax year. H has an investment in a U.S. partnership USP. H prepares financial statements in accordance with GAAP. For its 2016 tax year, H's financial statement net income includes $10,000 of income attributable to its share of USP's net income. H's Schedule K-1 from USP reports $5,000 of ordinary income, $7,000 of long-term capital gains, $4,000 of charitable contributions, and $200 of section 179 expense. H must report on line 7 $10,000 in column (a), a permanent difference of ($2,200) in column (c), and $7,800 in column (d).

Line 9. Income (Loss) From Other Pass-Through Entities

For any interest in a pass-through entity (other than an interest in a partnership reportable on line 7 or 8, as applicable) owned by the U.S. partnership (other than an interest in a disregarded entity), report the following on line 9:

1. In column (a), the sum of the partnership's distributive share of income or loss from the pass-through entity that is included on Part I, line 11;

2. In column (b) or (c), as applicable, the sum of all differences, if any, attributable to the pass-through entity; and

3. In column (d), the sum of all taxable amounts of income, gain, loss, or deduction reportable on the partnership's Schedule(s) K-1 received from the pass-through entity (if applicable).

For each pass-through entity reported on line 9, attach a supporting statement that provides that entity's name, EIN (if applicable), the partnership's end of year profit-sharing percentage (if applicable), the partnership's end of year loss-sharing percentage (if applicable), and the amounts reported by the partnership in column (a), (b), (c), or (d), of line 9, as applicable.

Line 10. Items Relating to Reportable Transactions

Any amounts attributable to any reportable transactions (as described in Regulations section 1.6011-4) must be included on line 10 regardless of whether the difference, or differences, would otherwise be reported elsewhere in Part II or Part III. Thus, if a taxpayer files Form 8886 for any reportable transaction described in Regulations section 1.6011-4, the amounts attributable to that reportable transaction must be reported on line 10. In addition, all income and expense amounts attributable to a reportable transaction must be reported on line 10, columns (a) and (d), even if there is no difference between the financial statement amounts and the tax return amounts.

Each difference attributable to a reportable transaction must be separately stated and adequately disclosed. A partnership will be considered to have separately stated and adequately disclosed a reportable transaction on line 10 if the partnership sequentially numbers each Form 8886 and lists by statement number (shown on line A of Form 8886) on the supporting statement for line 10 each sequentially numbered reportable transaction and the amounts required for line 10, columns (a) through (d).

Instead of satisfying the requirements of the preceding paragraph, a partnership will be considered to have separately stated and adequately disclosed a reportable transaction if the partnership 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 line 10;

2. The name and reportable transaction or 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 description also must include the published guidance number shown on line 3 of Form 8886. In addition, if the reportable transaction involves an investment in the transaction through another entity such as a partnership, the description must include the name and EIN (if applicable) of that entity as reported on line 5 of Form 8886.

Example 13. Partnership J is a calendar year partnership that files and entirely completes Schedule M-3 for its 2016 tax year. J incurred seven different abandonment losses during its 2016 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 aren't 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 line 10. The $12 million loss and the $5 million loss will be adequately disclosed if J attaches a supporting statement for line 10 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 line 10, columns (a) through (d). Alternatively, J's disclosures will be adequate if the description provided for each loss on the supporting statement includes the names and reportable transaction or 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 line 10, columns (a) through (d). J must report the losses attributable to the other five abandonment losses on line 21e, regardless of whether a difference exists for any or all of those abandonment losses.

Example 14. Partnership K is a calendar year partnership that files and entirely completes Schedule M-3 for its 2016 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 2016 tax year and results in a $7 million capital loss for both financial accounting purposes and U.S. income tax purposes. Although the transaction doesn't result in a difference, K is required to report on line 10 the following amounts: ($7 million) in column (a), zero in columns (b) and (c), and ($7 million) in column (d). The transaction will be adequately disclosed if K attaches a supporting statement for line 10 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 10, columns (a)

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through (d). Alternatively, the transaction will be adequately disclosed if the supporting statement for line 10 includes a description of the transaction, the name and reportable transaction number, if any, and the type of reportable transaction disclosed on Form 8886.

Line 11. Interest Income

Attach Form 8916-A, Supplemental Attachment to Schedule M-3. Complete Part II and enter the amounts shown on line 6, columns (a) through (d), on Schedule M-3, line 11, columns (a) through (d), as applicable.

An entity that (a) is required to file a Schedule M-3 and has less than $50 million in total assets at the end of the tax year or (b) isn't required to file a Schedule M-3 and voluntarily files a Schedule M-3, isn't required to file Form 8916-A but may voluntarily do so.

Report on line 11, column (a), the total amount of interest income included on Part I, line 11, and report on line 11, column (d), the total amount of interest income included on line 1 of the *Analysis of Net Income (Loss)* found on Form 1065 and Form 1065-B that isn't required to be reported elsewhere on Schedule M-3. In columns (b) or (c), as applicable, adjust for any amounts treated for U.S. income tax purposes as interest income that are treated as some other form of income for financial accounting purposes, or vice versa. For example, adjustments to interest income resulting from adjustments made in accordance with instructions for line 16, Sale versus lease, should be made in columns (b) and (c) of line 11.

Don't report on line 11 amounts reported in accordance with instructions for lines 7, 8, 9, 10, and 20.

Line 12. Total Accrual to Cash Adjustment

This line is completed by a partnership that prepares financial statements (or books and records, if permitted) using an overall accrual method of accounting and uses an overall cash method of accounting for U.S. income tax purposes (or vice versa). With the exception of amounts required to be reported on line 10, the partnership must report on line 12 a single amount net of all adjustments attributable solely to the use of the different overall methods of accounting (for example, adjustments related to accounts receivable, accounts payable, compensation, accrued liabilities, etc.), regardless of whether a separate line on Schedule M-3 corresponds to an item within the accrual to cash reconciliation. Differences not attributable to the use of the different overall methods of accounting must be reported on the appropriate lines of Schedule M-3 (for example, a depreciation difference must be reported on Part III, line 25).

Example 15. Partnership L is a calendar year partnership that files and entirely completes Schedule M-3 for its 2016 tax year. L prepares financial statements in accordance with GAAP using an overall accrual method of accounting. L uses an overall cash method of accounting for U.S. income tax purposes. L's financial statements for the year ending December 31, 2016, report accounts receivable of $35,000, an allowance for bad debts of $10,000, and accounts payable of $17,000 related to current year acquisition and reorganization legal and accounting fees. In addition, for L's year ending December 31, 2016, L reported financial statement depreciation expense of $15,000 and depreciation for U.S. income tax purposes of $25,000. For L's 2016 tax year using an overall cash method of accounting, L doesn't recognize the $35,000 of revenue attributable to the accounts receivable, can't deduct the $10,000 allowance for bad debt, and can't deduct the $17,000 of accounts payable. In its financial statements, L treats both the difference in overall accounting methods used for financial statement and U.S. income tax purposes and the difference in depreciation expense as temporary differences. L must combine all adjustments attributable to the differences related to the overall accounting methods on line 12. As a result, L must report on line 12 $8,000 in column (a) ($35,000 – $10,000 – $17,000), ($8,000) in column (b), and zero in column (d). L must not report the accrual to cash adjustment attributable to the legal and accounting fees on Part III, line 18, Current year acquisition/reorganization legal and accounting fees. Because the difference in depreciation expense doesn't relate to the use of the cash or accrual method of accounting, L must report the depreciation difference on Part III, line 25, Depreciation, and report $15,000 in column (a), $10,000 in column (b), and $25,000 in column (d).

Line 13. Hedging Transactions

Report on line 13, column (a), the net gain or loss from hedging transactions on Part I, line 11. Report in column (d) 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 isn't a valid hedge for U.S. income tax purposes but may be considered a hedge for GAAP purposes, must also be reported here.

Report hedging gains and losses computed under the mark-to-market method of accounting on line 13 and not on line 14.

Report any gain or loss from inventory hedging transactions on line 13 and not on line 15.

Line 14. Mark-to-Market Income (Loss)

Report on line 14 any amount representing the mark-to-market income or loss for any securities held by a dealer in securities, a dealer in commodities having made a valid election under section 475(e), or 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” don't include any items specifically excluded from sections 475(c)(2) and 475(e)(2), such as certain contracts to which section 1256(a) applies.

Report hedging gains and losses computed under the mark-to-market method of accounting on line 13, Hedging transactions, and not on line 14.

Traders in securities or 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, Sales of Business Property, any Schedule M-3 entries required as a result of marking to market these securities or commodities are reported as follows: (a) mark-to-market gains and losses from Form 4797, line 10, are included on Schedule M-3, Part II, line 14; (b) any other Schedule M-3 entries required based on other results (non-mark-to-market gains and losses) included in the total reported on Form 4797, line 17, should be reported on Schedule M-3, Part II, line 21d, unless the instructions for Schedule M-3 require the amounts to be reported on another line.

Line 15. Cost of Goods Sold

Report on line 15 any amounts deducted as part of cost of goods sold during the tax year, regardless of whether the amounts would otherwise be reported elsewhere in Part II or Part III. However, don't report the items mentioned in the next paragraph on line 15. Examples of amounts that must be included on line 15 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

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shrinkage accruals, inventory obsolescence reserves, and lower of cost or market (LCM) write-downs.

Note. The entries in columns (a) and (d) are negative amounts.

Don't report the following on line 15 or on Form 8916-A:

- Amounts reportable on line 10;
- Any gain or loss from inventory hedging transactions reportable on line 13;
- Amounts reportable on line 16;
- Amounts reportable on line 19;
- Mark-to-market income or (loss) associated with the inventories of dealers in securities under section 475 reportable on line 14;
- Section 481(a) adjustments related to cost of goods sold or inventory valuation reportable on line 17;
- Fines and penalties reportable on Part III, line 7;
- Judgments, damages, awards, and similar costs, reportable on Part III, line 8; and
- Amounts included on Part III, line 28, Purchase versus lease.

Important. Complete and attach Form 8916-A, Part I, for each item listed on line 15 in columns (a) through (d).

An entity that (a) is required to file a Schedule M-3 and has less than $50 million in total assets at the end of the tax year or (b) isn't required to file a Schedule M-3 and voluntarily files a Schedule M-3, isn't required to file Form 8916-A but may voluntarily do so.

Example 16. Partnership C is a calendar year partnership that files and entirely completes Schedule M-3 for its 2016 tax year. C placed in service 10 depreciable fixed assets in a previous tax year. C's total depreciation expense for its 2016 tax year for five of the assets is $50,000 for financial accounting purposes and $70,000 for U.S. income tax purposes. C's total annual depreciation expense for its 2016 tax year for the other five assets is $40,000 for financial accounting purposes and $30,000 for U.S. income tax purposes. In addition, C incurs $200 of meals and entertainment expenses that C deducts in computing net income for financial accounting purposes. All $200 of the meals and entertainment expenses is subject to the 50% limitation under section 274(n). In its financial statements, C treats the $50,000 depreciation and $100 of the meals and entertainment as other costs in computing cost of goods sold. C must include on Form 8916-A and on line 15, in column (a), the $50,000 of depreciation and $100 of meals and entertainment. C must also include a temporary difference of $20,000 in column (b), a permanent difference of ($50) in column (c), and $70,050 in column (d) ($70,000 depreciation and $50 meals). In addition, C must report on Part III, line 25, for its 2016 tax year income statement, depreciation expense of $40,000 in column (a), a temporary difference of ($10,000) in column (b), and $30,000 in column (d); and on Part III, line 6, meals and entertainment expense of $100 in column (a), a permanent difference of ($50) in column (c), and $50 in column (d). All other cost of goods sold items would be added to the amounts included on line 15, detailed in this example, and reported on Form 8916-A and on line 15 in the appropriate columns.

Line 16. Sale Versus Lease (for Sellers and/or Lessors)

Note. Also see the instructions at Part III, line 28, Purchase Versus Lease (for Purchasers and/or Lessees), later.

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 line 16, column (a), report the gross profit or gross rental income for financial accounting purposes for all sale or lease transactions that must be given the opposite characterization for tax purposes. On line 16, column (d), report the gross profit or gross rental income for federal income tax purposes. Interest income amounts for such transactions must be reported on line 11, in column (a) or (d), as applicable. Depreciation expense for such transactions must be reported on Part III, line 25, in column (a) or (d), as applicable. Use columns (b) and (c) of lines 11 and 16, and Part III, line 25, as applicable, to report the differences between columns (a) and (d).

Example 17. M is a calendar year partnership that files and entirely completes Schedule M-3 for its 2016 tax year. M sells and leases property to customers. 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 financial statements, M treats the difference in the financial accounting and the U.S. income tax treatment of these transactions as temporary. During 2016, M reports in its financial statements $1,000 of sales and $700 of cost of goods sold with respect to 2016 lease transactions. M receives periodic payments of $500 in 2016 with respect to these 2016 transactions and similar transactions from prior years and treats $400 as principal and $100 as interest income. For financial accounting 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. On its 2016 Schedule M-3, M must report on line 11 $100 in column (a), ($100) in column (b), and zero in column (d). In addition, M must report on line 16 $300 of gross profit in column (a), $200 in column (b), and $500 of gross rental income in column (d). Lastly, M must report on Part III, line 25, $200 in columns (b) and (d).

Line 17. Section 481(a) Adjustments

With the exception of a section 481(a) adjustment that is required to be reported on Part I, line 10, 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 line 17, regardless of whether a separate line for that income or expense item exists in Part II or Part III.

Example 18. Partnership N is a calendar year partnership that files and entirely completes Schedule M-3 for its 2016 tax year. N was depreciating certain fixed assets over an erroneous recovery period and, effective for its 2016 tax year, N receives IRS consent to change its method of accounting for the depreciable fixed assets and begins using the proper recovery period. The change in method of accounting results in a positive section 481(a) adjustment of $100,000 that is required to be spread over four tax years, beginning with the 2016 tax year. In its financial statements, N treats the section 481(a) adjustment as a temporary difference. N must report on line 17, $25,000, in columns (b) and (d) for its 2016 tax year and each of the subsequent three tax years (unless N is otherwise required to recognize the remainder of the section 481(a) adjustment earlier). N must not report the section 481(a) adjustment on Part III, line 25.

Line 18. Unearned/Deferred Revenue

Report on line 18, column (a), amounts of revenues included on Part I, line 11, that were deferred from a prior financial accounting year. Report on line 18, column (d), amounts of revenues recognizable for U.S. income tax purposes in the current tax year that are recognized

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for financial accounting purposes in a different year. Also report on line 18, column (d), any amount of revenues reported on line 18, column (a), that are recognizable for U.S. income tax purposes in the current tax year. Use columns (b) and (c) of line 18, as applicable, to report differences between columns (a) and (d).

Line 18 must not be used to report income recognized from long-term contracts. Instead, use line 19.

Line 19. Income Recognition From Long-Term Contracts

Report on line 19 the amount of net income or loss for financial statement purposes (or books and records, if applicable) or U.S. income tax purposes for any contract accounted for under a long-term contract method of accounting.

Line 20. Original Issue Discount and Other Imputed Interest

Report on line 20 any amounts of original issue discount (OID) and other imputed interest. The term "original issue discount and other imputed interest" includes, but isn't 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; and

4. Amounts treated as OID under the below-market interest rate rules under section 7872.

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 partnership from a pass-through entity (for example, on Schedule K-1) that are included in the net income (loss) of the partnership reported on Part I, line 11. Reverse the amount reported in column (a) in column (b) or (c), as applicable. The corresponding gains and losses for U.S. income tax purposes are reported on lines 21b through 21g, as applicable.

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, Capital Gains and Losses, excluding capital gains from pass-through entities, which must be reported on line 7, 8, or 9, 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, excluding capital losses from **(a)** pass-through entities, which must be reported on line 7, 8, or 9, as applicable; **(b)** abandonment losses, which must be reported on line 21e; and **(c)** worthless stock losses, which must be reported on line 21f.

Line 21d. Net Gain/Loss Reported on Form 4797, Line 17, Excluding Amounts From Pass-Through Entities, Abandonment Losses, and Worthless Stock Losses

Report on line 21d the net gain or loss reported on line 17 of Form 4797, excluding amounts from **(a)** pass-through entities, which must be reported on line 7, 8, or 9, as applicable; **(b)** abandonment losses, which must be reported on line 21e; and **(c)** worthless stock losses, which must be reported on 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, line 14, above.

Line 21e. Abandonment Losses

Report on line 21e any abandonment losses, regardless of whether the loss is characterized as an ordinary loss or a capital loss.

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. Attach a statement that separately states and adequately discloses each transaction that gives rise to a worthless stock loss and the amount of each loss.

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 that aren't reported on lines 21b through 21f.

Line 22. Other Income (Loss) Items With Differences

Separately state and adequately disclose on line 22 all items of income (loss) with differences that aren't otherwise listed on lines 1 through 21. Attach a statement that describes and itemizes the type of income (loss) and the amount of each item and provides a description that states the income (loss) name for book purposes for the amount recorded in column (a) and describes the adjustment being recorded in column (b) or (c). The entire description completes the tax description for the amount included in column (d) for each item separately stated on this line.

The attached statement should have five columns. The first column has the description for the next four columns. The second column is column (a), income (loss) per income statement. The third column is column (b), temporary difference. The fourth column is column (c), permanent difference. The fifth column is column (d), income (loss) per tax return. Every item listed on the attached statement for line 22 must always have columns (a) + (b) + (c) = (d). Each item with amounts in columns (a), (b), (c), and (d) will be totaled and included as one line on line 22.

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. Examples of sufficiently detailed descriptions include "Foreign currency translation adjustments - comprehensive income" and "Gains and losses on available-for-sale securities - comprehensive income."

Line 23. Total Income (Loss) Items

Combine lines 1 through 22 and enter the total on line 23.

Note. Line 15, Cost of goods sold, columns (a) and (d), are negative amounts that will affect the totals entered on line 23.

Line 24. Total Expense/ Deduction Items

Report on line 24, columns (a) through (d), as applicable, the negative of the amounts reported on Part III, line 31, columns (a) through (d). For example, if Part III, line 31, column (a), reflects an amount of $1 million, then report on line 24, column (a),

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($1 million). Similarly, if Part III, line 31, column (b), reflects an amount of ($50,000), then report on line 24, column (b), $50,000.

Line 25. 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 isn't described or included on lines 1 through 22, or Part III, lines 1 through 30, report the entire amount of the item in columns (a) and (d) of line 25. If a portion of an item of income, loss, expense, or deduction has a difference and a portion of the item doesn't have a difference, don't report any portion of the item on line 25. 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 lines 1 through 22, or Part III, lines 1 through 30. See *Example 11*, above.

Part III. Reconciliation of Net Income (Loss) per Income Statement of Partnership With Income (Loss) per Return — Expense/Deduction Items

Note. Expense amounts that reduce financial income must be reported on Part III, column (a), as positive amounts. Deduction amounts that reduce taxable income must be reported on Part III, column (d), as positive amounts. Amounts reported on Part II, line 24, must be the negative of the amounts reported on Part III, line 31.

Lines 1 Through 4. Income Tax Expense

If the partnership doesn't distinguish between current and deferred income tax expense in its financial statements (or its books and records, if applicable), report income tax expense as current income tax expense using lines 1 and 3, as applicable.

Line 5. Equity-Based Compensation

Report on line 5 any amounts for equity-based compensation or consideration that are reflected as expense for financial accounting purposes (column (a)) or deducted in the U.S. income tax return (column (d)) other than amounts reportable elsewhere on Schedule M-3, Parts II and III. Examples of amounts reportable on line 5 include expense/deduction items attributable to options to acquire capital interest units, profits interest units, and other rights to acquire partnership equity, regardless of whether such payments are made to employees or non-employees, or as payment for property or compensation for services.

Line 6. Meals and Entertainment

Report on line 6, column (a), any amounts paid or accrued by the partnership 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 partnership's financial income statement or the income and expense accounts maintained in the partnership's books and records. Report only amounts not otherwise reportable elsewhere on Schedule M-3, Parts II and III (for example, Part II, line 15).

Line 7. Fines and Penalties

Report on line 7 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 line 7, 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 partnership's financial income statement or the income and expense accounts maintained in the partnership's books and records. Also report on line 7, column (a), the reversal of any overaccrual of any amount described in this paragraph. See sections 162(f) and 162(g) for additional guidance.

Report on line 7, column (d), any such amounts 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) and (c), as appropriate.

Don't report on line 7 amounts required to be reported in accordance with instructions for line 8.

Don't report on line 7 amounts recovered from insurers or any other indemnitors for any fines and penalties described above.

Line 8. Judgments, Damages, Awards, and Similar Costs

Report on line 8, 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 8, column (a), the reversal of any overaccrual of any amount described in this paragraph.

Report on line 8, column (d), any such amounts 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) and (c), as appropriate.

Don't report on line 8 amounts required to be reported in accordance with instructions for line 7.

Don't report on line 8 amounts recovered from insurers or any other indemnitors for any judgments, damages, awards, or similar costs described above.

Line 9. Guaranteed Payments

Include on line 9, column (a), the amount of guaranteed payments expense that is included on Part I, line 11. Report in column (d) the net amount of guaranteed payments deduction. The net amount of the deduction reported in column (d) is the amount reported as a deduction on Form 1065, page 1, line 10, or on Form 1065-B, page 1, line 13, reduced by the amount reported as income on Form 1065, Schedule K, line 4 or Form 1065-B, Schedule K, line 7. The net amount of the guaranteed payments reported in column (d) will be zero if no guaranteed payments are capitalized and all are deducted on Form 1065, page 1, line 10, or Form 1065-B, page 1, line 13, or a negative amount (reported in parentheses), if any of the guaranteed payments are capitalized by the partnership. Generally, if guaranteed payments expense is recognized for financial accounting purposes, the amount reported in column (c) as a permanent difference will be the negative of the guaranteed payment income reported on Form 1065, Schedule K, line 4 or Form 1065-B, Schedule K, line 7. If no guaranteed payment expense is recognized for financial accounting purposes, the amount reported in column (c) as a permanent difference generally will be zero. Any amount of guaranteed payments capitalized for tax purposes on Form 1065 or Form 1065-B, page 1, but not capitalized for financial accounting purposes, generally will be reported as a

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negative temporary difference amount in column (b).

Example 19.

1. AZ is a calendar year partnership that files and entirely completes Schedule M-3 for its 2016 tax year. AZ has total income in 2016 of $5,000 for both financial accounting and tax accounting purposes before taking into account guaranteed payments expense or deductions. Partner A is paid a deductible guaranteed payment of $3,000 for services rendered to the partnership during the tax year. Partner Z is paid a $1,000 guaranteed payment, which is capitalized to land for tax accounting. Both guaranteed payments, in the total amount of $4,000, are treated as expenses in arriving at net financial accounting income. There are no other expenses or deductions for financial accounting or tax accounting purposes. The amount shown on Part I, line 11, Net income (loss) per income statement of the partnership, is $1,000 ($5,000 – $3,000 – $1,000 = $1,000). The amount shown on line 9, column (a), is $4,000, the amount of guaranteed payments expenses for financial accounting purposes. The amount shown on line 9, column (d), is ($1,000), the net amount deducted after taking into consideration the $4,000 of total guaranteed payments allocated to the partners as income on Schedule K, netted against $3,000 deducted on Form 1065, page 1, line 10. The amount reported on line 9, column (b), is a temporary difference of ($1,000), the negative of the amount of guaranteed payments capitalized for Form 1065, page 1. The amount reported on line 9, column (c), is a permanent difference of ($4,000), equal to the guaranteed payment income shown on Form 1065, Schedule K, line 4 or Form 1065-B, Schedule K, line 7, expressed as a negative amount. Part II, line 23, reports $5,000 in column (a), 0 in column (b), 0 in column (c), and $5,000 in column (d). Part II, line 24, reports ($4,000) in column (a), $1,000 in column (b), $4,000 in column (c), and $1,000 in column (d). Part II, line 26, reports $1,000 in column (a), $1,000 in column (b), $4,000 in column (c), and $6,000 in column (d).

2. Same facts as in Example 19.1, except that no guaranteed payments expense is recognized for financial accounting purposes. The amount shown on Part I, line 11, is $5,000. On line 9, AZ reports 0 in column (a), ($1,000) in column (b), 0 in column (c), and ($1,000) in column (d). Part II, line 23, reports 0 in column (a), $1,000 in column (b), 0 in column (c), and $1,000 in column (d). On Part II, line 25, AZ reports $5,000 in column (a), $1,000 in column (b), 0 in column (c), and $6,000 in column (d).

Line 10. Pension and Profit-Sharing

Report on line 10 any amounts attributable to the partnership's pension plans, profit-sharing plans, and any other retirement plans.

Line 11. Other Post-Retirement Benefits

Report on line 11 any amounts attributable to other post-retirement benefits not otherwise includible on line 10 (for example, retiree health and life insurance coverage, dental coverage, etc.).

Line 12. Deferred Compensation

Report on line 12, column (a), any compensation expense included in the net income (loss) amount reported on Part I, line 11, that isn't deductible for U.S. income tax purposes in the current tax year and that wasn't reported elsewhere on Schedule M-3, column (a). Report on line 12, column (d), any compensation deductible in the current tax year that wasn't included in the net income (loss) amount reported on Part I, line 11, for the current tax year and that isn't reportable elsewhere on Schedule M-3, including any compensation deductions deferred in a prior tax year. For example, report originations and reversals of deferred compensation subject to section 409A on line 12.

Line 14. Charitable Contribution of Intangible Property

Report on line 14 any charitable contribution of intangible property, for example, contributions of:

- 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 intangible property.

Line 15. Organizational Expenses as per Regulations section 1.709-2(a)

Include on line 15, column (a), organizational expenses as defined in Regulations section 1.709-2(a). Include on line 15, column (d), the amount of organizational expense deducted per section 709(b).

Line 16. Syndication Expenses as per Regulations section 1.709-2(b)

Include on line 16 syndication expenses as defined in Regulations section 1.709-2(b).

Line 17. Current Year Acquisition/Reorganization Investment Banking Fees

Report on line 17 any investment banking fees paid or incurred in connection with a taxable or tax-free acquisition of property (for example, ownership interests or assets) or a tax-free reorganization not otherwise reportable on Schedule M-3 (for example, line 15 or 16). Report on this line any investment banking 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 or reorganization.

Line 18. Current Year Acquisition/Reorganization Legal and Accounting Fees

Report on line 18 any legal and accounting fees paid or incurred in connection with a taxable or tax-free acquisition of property (for example, ownership interests or assets) or a tax-free reorganization not otherwise reportable on Schedule M-3 (for example, line 15 or 16). Report on this line any legal and accounting 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 or reorganization.

Line 19. Amortization/ Impairment of Goodwill

Report on line 19 amortization of goodwill or amounts attributable to the impairment of goodwill.

Line 20. Amortization of Acquisition, Reorganization, and Start-Up Costs

Report on line 20 amortization of acquisition, reorganization, and start-up costs. For purposes of columns (b), (c), and (d), include amounts amortizable under section 167 or 195.

Line 21. Other Amortization or Impairment Write-Offs

Report on line 21 any amortization or impairment write-offs not otherwise includible on Schedule M-3.

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Line 22. Reserved

When using this line to figure amounts on other tax forms or worksheets, this line should be considered to be zero.

Line 23a. Depletion—Oil & Gas

Form 1065 filers report on line 23a, column (a), any oil and gas depletion included on Part I, line 11.

Note. Form 1065-B filers report oil and gas depletion on line 23b.

Line 23b. Depletion—Other than Oil & Gas

Report on line 23b any depletion expense/deduction other than oil and gas that isn't required to be reported elsewhere on Schedule M-3 (for example, on Part II, line 7, 8, 9, or 15).

Additionally, Form 1065-B filers also report oil and gas depletion on line 23b.

Line 24. Intangible Drilling and Development Costs (IDC)

Intangible Drilling and Development Costs (IDC) are costs of developing oil, gas, or geothermal wells. Report on line 24, column (a), the total amount of intangible drilling and development costs (or such equivalent costs as classified in the partnership's financial statements) included on Part I, line 11, and report on line 24, column (d), the total amount of IDC paid or incurred during the current tax year under section 263(c) and Regulations section 1.612-4.

Line 25. Depreciation

Report on line 25 any depreciation expense/deduction that isn't required to be reported elsewhere on Schedule M-3 (for example, on Part II, line 7, 8, 9, or 15).

Line 26. Bad Debt Expense

Report on line 26, column (a), any amounts attributable to an allowance for uncollectible accounts receivable or actual write-offs of accounts receivable included on Part I, line 11. Report in column (d) the amount of bad debt expense deductible for federal income tax purposes under section 166.

Line 27. Interest Expense

Attach Form 8916-A. Complete Part III and enter the amounts shown on line 5, columns (a) through (d), on Schedule M-3, line 27, columns (a) through (d), as applicable.

An entity that (a) is required to file a Schedule M-3 and has less than $50 million in total assets at the end of the tax year or (b) isn't required to file a Schedule M-3 and voluntarily files a Schedule M-3, isn't required to file Form 8916-A but may voluntarily do so.

Report on line 27, column (a), the total amount of interest expense included on Part I, line 11, and report on line 27, column (d), the total amount of interest deduction included on line 1 of the *Analysis of Net Income (Loss)* found on Form 1065 and Form 1065-B that isn't reported elsewhere on Schedule M-3. In columns (b) or (c), as applicable, adjust for any amounts treated for U.S. income tax purposes as interest deduction that are treated as some other form of expense for financial accounting purposes, or vice versa. For example, adjustments to interest expense/deduction resulting from adjustments made in accordance with instructions for line 28 should be made in columns (b) and (c), as applicable, of line 27.

Don't report on Form 8916-A and on line 27 amounts reported in accordance with instructions for **(a)** Part II, lines 7, 8 and 9, Income (loss) from U.S. partnerships, foreign partnerships and other pass-through entities, and **(b)** Part II, line 10, Items relating to reportable transactions.

Line 28. Purchase Versus Lease (for Purchasers and/or Lessees)

Note. Also see the instructions for Part II, line 16, 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 in column (a) gross rent expense for a transaction treated as a lease for financial accounting purposes but as a sale for U.S. income tax purposes. Report in column (d) gross rental deductions for a transaction treated as a lease for U.S. income tax purposes but as a purchase for financial accounting purposes. Report interest expense or deduction amounts for such transactions on line 27, in column (a) or (d), as applicable. Report depreciation expense or deductions for such transactions on line 25, in column (a) or (d), as applicable. Use columns (b) and (c) of lines 25, 27, and 28, as applicable, to report the differences between columns (a) and (d) for such recharacterized transactions.

Example 20. X is a calendar year U.S. partnership that files and entirely completes Schedule M-3 for its 2016 tax year. X acquired property in a transaction that, for financial accounting purposes, X treats as a lease. Because of its terms, the transaction is treated for U.S. income tax purposes as a purchase, and X must treat the periodic payments it makes partially as a payment of principal and partially as a payment of interest. In its financial statements, X treats the difference between the financial accounting and U.S. income tax treatment of this transaction as a temporary difference. During 2016, X reports in its financial statements $1,000 of gross rental expense that, for U.S. income tax purposes, is recharacterized as a $700 payment of principal and a $300 payment of interest, accompanied by a depreciation deduction of $1,200 (based on other facts). On its 2016 Schedule M-3, X must report the following on line 28: column (a), $1,000, its financial accounting gross rental expense; column (b), ($1,000); and column (d), zero. On line 27, X reports zero in column (a) and $300 in columns (b) and (d) for the interest deduction. On line 25, X reports zero in column (a) and $1,200 in columns (b) and (d) for the depreciation deduction.

Line 29. Research and Development Costs

Report in column (a) the amount of expenses included in net income reported on Part I, line 11, that are related to research and development expenses. Report in column (d) the amount of deductions included on page 1 of the return and/or separately reported on Schedule K of the return, that are recognized and reported as section 174 research and experimental expenditures consistent with the partnership's adopted method of accounting for such expenditures. In column (c), as applicable, include any adjustments for any amounts treated for U.S. income tax purposes as research or experimental expenditures that are treated as some other form of expense for financial accounting purposes, or vice versa. Report any difference in timing recognition in column (b). For example, if the partnership's financial accounting method doesn't specify otherwise, column (b) adjustments include adjustments for timing differences between financial and tax accounting for deferral and amortization of research expenditures, section 59(e) election, reduction of section 174 expenditures under section 280C or section 482, costs attributable to obtaining a patent, research in social sciences, and cost elements for property of a character subject to depreciation.

Section 174 provides two methods for treating research and experimental expenditures paid or incurred by a taxpayer in connection with the taxpayer's

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trade or business. These expenditures may be treated as expenses not chargeable to capital account and deducted in the year in which they are paid or incurred, or they may be deferred and amortized. The method for treatment of research and experimental expenditures is adopted at the partnership level.

Example 21.

1. Partnership X is a calendar year taxpayer that files and entirely completes Schedule M-3 for its 2016 tax year. During 2016, X incurred $100,000 of research and development costs that X recognized as an expense in its financial statements. Also, X incurred $20,000 in attorney fees in obtaining a patent application that X capitalized and amortized in its financial statements. X recognized $2,000 of amortization deduction. In compliance with its adopted method of accounting under section 174, X deducts research and experimental expenditures for U.S. income tax purposes. Accordingly, X must report $100,000 in column (a), $20,000 in column (b), and $120,000 in column (d). X must also report $2,000 in column (a), ($2,000) in column (b), and $0 in column (d) on Part III, line 21.

2. Assume the same facts as Example 21.1 except X elected to capitalize and amortize its research and expenditures over 60 months with respect to all its research programs for U.S. tax purposes. X first realized benefits from such expenditures on August 1. Accordingly, X must report $100,000 in column (a), a temporary difference of ($90,000) [i.e., $100,000 – $10,000] in column (b), and $10,000 [i.e., $120,000/60 months, times 5 months] in column (d).

3. Partnership X is a calendar year taxpayer that files and entirely completes Schedule M-3 for its 2016 tax year. X adopted the current expense method for research and experimental expenditures for U.S. income tax purposes. During 2016, X incurred $50,000 of research and development costs that X recognized as an expense in its financial statements. Also, X undertook to develop a new machine for its business. X expended $30,000 on the project of which $10,000 represents actual costs of material, labor and component cost to construct the machine, and $20,000 represents research costs not attributable to the machine itself. X capitalized all costs of $30,000 related to the machine and recognized $6,000 of depreciation expense in its financial statements. X's depreciation expense on the $10,000 of costs related to the machine itself was $2,000 for U.S. income tax purposes. Accordingly, X must report $50,000 in column (a), $20,000 (research costs which aren't attributable to the machine itself) in column (b), and $70,000 in column (d). X must also report $6,000 in column (a), ($4,000) in column (b) and $2,000 in column (c) on Part III, line 25.

4. Partnership X is a calendar year taxpayer that files and entirely completes Schedule M-3 for its 2016 tax year. During 2016, X incurred $10,000 of research and development costs related to social sciences that it recognized as an expense in its financial statements. X adopted the current expense method for research and experimental expenditures for U.S. income tax purposes. Because such costs aren't allowable costs under section 174, X must report $10,000 in column (a), permanent difference ($10,000) in column (c) and $0 in column (d). If such costs are otherwise deductible for U.S. income tax purposes, X must report this item of expense on Part III, line 30.

5. Partnership X is a calendar year taxpayer that files and entirely completes Schedule M-3 for its 2016 tax year. During 2016, X paid $75,000 to acquire or in-license intangible assets under a collaborative arrangement with another company that X recognized as a research and development expense in its financial statements. X adopted the current expense method for research and experimental expenditures for U.S. income tax purposes. Because payments made to acquire rights to a product or technology are excluded costs from the definition of research and experimental expenditures, X must report $75,000 in column (a), ($75,000) in column (c) and $0 in column (d). X must report any amortization otherwise allowable related to the payments on Part III, line 21.

Line 30. Other Expense/ Deduction Items With Differences

Separately state and adequately disclose on line 30 all items of expense/deduction that aren't otherwise listed on lines 1 through 29.

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) or (c). The entire description completes the tax description for the amount included in column (d) for each item separately stated on this line.

The statement of details attached to the return for line 30 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 partnership'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 isn't 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 five columns. The first column has the description for the next four columns; the second column is column (a), *expense per income statement*; the third column is column (b), *temporary difference*; the fourth column is column (c), *permanent difference*; and the fifth column is column (d), *deduction per tax return*. Every item listed on the attached statement for line 30 must always have columns (a) + (b) + (c) = (d). Each item with amounts in columns (a), (b), (c), and (d) will be totaled and included as one line on line 30 of the face of the schedule.

Comprehensive income. If any "comprehensive income" as defined by SFAS No. 130 is reported on this line, describe the item(s) in detail as, for example, "Foreign currency translation adjustments – comprehensive income" and "Gains and losses on available-for-sale securities – comprehensive income."

Reserves and contingent liabilities. Report on line 30 amounts related to the change in each reserve or contingent liability that isn't required to be reported elsewhere on Schedule M-3. Report on line 30, column (a), expenses included in net income reported on Part I, line 11, that are related to reserves and contingent liabilities. Report on line 30, column (d), 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 items that must be reported on line 30 include warranty reserves, restructuring reserves, reserves for discontinued operations, and reserves for acquisitions and dispositions. Only report on line 30 items that aren't required to be reported elsewhere on Schedule M-3, Parts II and III. For

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example, the expense for a reserve for inventory obsolescence must be reported on Part II, line 15.

Example 22. Partnership Q is a calendar year partnership that files and entirely completes Schedule M-3 for its 2016 tax year. On July 1 of each year, Q has a fixed liability for its annual insurance premiums that provides a 12-month coverage period beginning July 1 through June 30. In addition, Q historically prepays 12 months of advertising expense on July 1. On July 1, 2016, Q prepays its insurance premium of $500,000 and advertising expenses of $800,000. For financial 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 financial statements, Q treats the differences attributable to the financial 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 30, must be separately stated and adequately disclosed as follows:

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Description	Column (a) Expense per Income Statement	Column (b) Temporary Difference	Column (c) Permanent Difference	Column (d) Deduction per Tax Return
Prepaid Insurance premium expenses not capitalized	$250,000	$250,000	-0-	$500,000
Legal Expense Reserve	300,000	(100,000)	-0-	200,000
Total Line 30	$550,000	$150,000	-0-	$700,000

Line 31. Total Expense/ Deduction Items

Enter on Part II, line 24, columns (a) through (d), as applicable, positive amounts from line 31 as negative (in parentheses) and negative amounts as positive. For example, if line 31, column (a), reflects an amount of $1 million, then report on Part II, line 24, column (a), ($1 million). Similarly, if line 31, column (b), reflects an amount of ($50,000), then report on Part II, line 24, column (b), $50,000.