2005

Department of the Treasury
Internal Revenue Service

Instructions for Form 1120-FSC

U.S. Income Tax Return of a Foreign Sales Corporation

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

Contents **Page**

What's New

• The foreign personal holding company provisions of sections 551 through 558 have been repealed by the American Jobs Creation Act of 2004 (AJCA). Furthermore, foreign corporations are now exempted from the personal holding company rules by the AJCA. See section 542(c). The form was amended to reflect the repeal of these rules.
• A corporation may elect to deduct qualified cash contributions made after August 27, 2005, and before January 1, 2006, for relief efforts related to Hurricane Katrina, Rita, or Wilma, without regard to the 10% taxable income limit. See Pub. 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma.
• A corporation with a food inventory from a trade or business may deduct charitable contributions of "apparently wholesome food" made after August 27, 2005, and before January 1, 2006. See section 170(e)(3)(C).
• A corporation is allowed a deduction for qualified book contributions made after August 27, 2005, and before January 1, 2006, to certain public schools. See section 170(e)(3)(D).
• The Gulf Opportunity Zone Act of 2005 provided additional tax relief for corporations affected by Hurricanes Katrina, Rita, and Wilma. For details, see Pub. 4492.

Photographs of Missing Children

The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in instructions on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

Unresolved Tax Issues

If the FSC has attempted to deal with an IRS problem unsuccessfully, it should contact the Taxpayer Advocate. The Taxpayer Advocate independently represents the FSC's interests and concerns within the IRS by protecting its rights and resolving problems that have not been fixed through normal channels.

While Taxpayer Advocates may not change the tax law or make a technical tax decision, they may clear up problems that resulted from previous contacts and ensure that the FSC's case is given a complete and impartial review.

The FSC's assigned personal advocate will listen to its point of view and will work with the FSC to address its concerns. The FSC can expect the advocate to provide:
• A "fresh look" at a new or on-going problem,
• Timely acknowledgment,
• The name and phone number of the individual assigned to its case,
• Updates on progress,
• Timeframes for action,
• Speedy resolution, and
• Courteous service.

When contacting the Taxpayer Advocate, the FSC should be prepared to provide the following information.
• The FSC's name, address, and employer identification number.
• The name and telephone number of an authorized contact person and the hours he or she can be reached.
• The type of tax return and year(s) involved.
• A detailed description of the problem.
• Previous attempts to solve the problem and the office that was contacted.
• A description of the hardship the FSC is facing and supporting documentation (if applicable).

The FSC can contact a Taxpayer Advocate as follows.
• Call the Taxpayer Advocate's toll-free number: 1-877-777-4778.
• Call, write, or fax the Taxpayer Advocate office in its area (see Pub. 1546 for addresses and phone numbers).
• TTY/TDD help is available by calling 1-800-829-4059.
• Visit the website at *www.irs.gov/advocate*.

How To Get Forms and Publications

Personal computer. You can access the IRS website 24 hours a day, 7 days a week, at *www.irs.gov* to:
• Download forms, instructions, and publications;
• Order IRS products online;
• Research your tax questions online;
• Search publications online by topic or keyword; and
• Sign up to receive local and national tax news by email.

CD-ROM. You can order Pub. 1796, IRS Tax Products CD-ROM, and obtain:
• A CD that is released twice so you have the latest products. The first release ships in late December and the final release ships in late February;
• Current year forms, instructions, and publications;
• Prior year forms, instructions, and publications;
• Tax Map: an electronic research tool and finding aid;
• Tax law frequently asked questions (FAQs);

• Tax topics from the IRS telephone response system;
• Fill-in, print, and save features for most tax forms;
• Internal Revenue Bulletins; and
• Toll-free and email technical support.

Buy the CD-ROM from the National Technical Information Service (NTIS) at *www.irs.gov/cdorders* for $25 (no handling fee) or call 1-877-CDFORMS (1-877-233-6767) toll free to buy the CD-ROM for $25 (plus a $5 handling fee).

By phone and in person. You can order forms and publications by calling 1-800-TAX-FORM (1-800-829-3676). You can also get most forms and publications at your local IRS office.

General Instructions

Purpose of Form

Use Form 1120-FSC to report the income, gains, losses, deductions, credits, and to figure the income tax liability of a FSC.

FSC Repeal and Extraterritorial Income Exclusion

In general, the FSC Repeal and Extraterritorial Income Exclusion Act of 2000:
• Repealed the FSC rules,
• Provided taxpayers with an exclusion, which is figured on Form 8873, Extraterritorial Income Exclusion, and
• Provided transition rules for existing FSCs (see *Transition Rules for Existing FSCs* below).

Note. The American Jobs Creation Act of 2004 repealed the extraterritorial income exclusion provisions generally for transactions after 2004, subject to a transition rule.

Transition Rules for Existing FSCs

In general, a FSC that was in existence on September 30, 2000, and at all times thereafter, may continue to use the FSC rules for qualifying transactions in the ordinary course of business that are pursuant to a binding contract between the FSC (or a person related to the FSC) and a person other than a related person if that binding contract was in effect on September 30, 2000, and has remained in effect. A binding contract includes a purchase, renewal, or replacement option that is enforceable against a lessor or seller (provided the option is part of a contract that is binding and in effect on September 30, 2000, and has remained in effect).

The mere entering into of a single transaction, such as a lease, would not, in and of itself, prevent the transaction from being in the ordinary course of business.

Election To Apply Exclusion Rules

Taxpayers may elect to apply the extraterritorial income exclusion rules instead of the FSC rules for transactions occurring during the transition period. The election is:
• Made by checking the box on line 2 of Form 8873,
• Made on a transaction-by-transaction basis,
• Effective for the tax year for which it is made and for all subsequent tax years, and
• Revocable only with the consent of the IRS.

Taxpayers use Form 8873 to determine their extraterritorial income exclusion.

Election To Be Treated as a Domestic Corporation

A FSC that was in existence on September 30, 2000, and at all times thereafter, may elect to be treated as a domestic corporation if substantially all of its gross receipts are foreign trading gross receipts.

The election is made by checking the box on line 3 of Form 8873. An electing corporation files Form 1120, U.S. Corporation Income Tax Return, or Form 1120-A, U.S. Corporation Short-Form Income Tax Return. Once made, the election applies to the tax year for which it is made and remains in effect for all subsequent years unless the election is revoked or terminated. If the election is revoked or terminated, the corporation would be a foreign corporation that files Form 1120-F, U.S. Income Tax Return of a Foreign Corporation. Furthermore, the foreign corporation would not be eligible to reelect to be treated as a domestic corporation for 5 tax years beginning with the first tax year for which the original election is not in effect as a result of the revocation or termination.

Effect of election. A FSC that elects to be treated as a domestic corporation ceases to be a FSC for any tax year for which the election applies (and for any subsequent tax year).

FSC Election

No corporation may elect to be a FSC or a small FSC (defined below) after September 30, 2000.

Termination of Inactive FSCs

If a FSC has no foreign trade income (see definition under *Tax Treatment of a FSC* below) for any 5 consecutive tax years beginning after December 31, 2001, the FSC will no longer be treated as a FSC for any tax year beginning after that 5-year period.

Additional Information

For additional information regarding the rules discussed above, see Rev. Proc. 2001-37, 2001-1 C.B. 1327.

Pre-Repeal FSC Rules

Definition of a Foreign Sales Corporation (FSC)

Under section 922(a), a FSC is defined as a corporation that has met all of the following rules.

1. It must be a corporation created or organized under the laws of a qualifying foreign country or any U.S. possession other than Puerto Rico.

Qualifying U.S. possessions include Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands.

A qualifying foreign country is a foreign country that meets the exchange of information rules of section 927(e)(3)(A) or (B). All U.S. possessions other than Puerto Rico are also certified to have met these rules.

The following countries are qualifying foreign countries that have met the exchange of information rules of section 927(e)(3)(A) or 927(e)(3)(B): Australia, Austria, Barbados, Belgium, Bermuda, Canada, Costa Rica, Cyprus, Denmark, Dominica, the Dominican Republic, Egypt, Finland, France, Germany, Grenada, Guyana, Honduras, Iceland, Ireland, Jamaica, Korea, Malta, the Marshall Islands, Mexico, Morocco, the Netherlands, New Zealand, Norway, Pakistan, Peru, the Philippines, St. Lucia, Sweden, and Trinidad and Tobago.

2. It had no more than 25 shareholders at any time during the tax year.

3. It had no preferred stock outstanding at any time during the tax year.

4. During the tax year, the FSC must maintain:
• An office in one of the qualifying foreign countries or U.S. possessions listed above,
• A set of permanent books of account (including invoices) at that office, and
• The books and records required under section 6001 at a U.S. location to sufficiently establish the amount of gross income, deductions, credits, or other matters required to be shown on its tax return.

5. It must have at least one director, at all times during the tax year, who is not a resident of the United States.

6. It must not be a member, at any time during the tax year, of a controlled group of which a DISC is a member.

7. It must have elected to be a FSC or small FSC, and the election must have been in effect for the tax year.

Small FSC. Section 922(b) defines a small FSC as a corporation that:
• Elected small FSC status and has kept the election in effect for the tax year and
• Is not a member, at any time during the tax year, of a controlled group that includes a FSC (unless that other FSC is also a small FSC).

A small FSC is exempt from the foreign management and foreign economic process requirements outlined on page 3.

$5 million limit. Generally, any foreign trading gross receipts of a small FSC for the tax year that exceed $5 million are not to be considered in determining its exempt foreign trade income. The $5 million limit is reduced if the small FSC has a short tax year. It may also be reduced if the small FSC is a member of a controlled group that contains other small FSCs. See Regulations section 1.921-2(b) for more information.

Tax Treatment of a FSC

A FSC is not taxed on its exempt foreign trade income. Section 923 defines foreign trade income as the gross income of a FSC attributable to foreign trading gross receipts (defined on page 3).

The percentage of foreign trade income exempt from tax is figured differently for income determined under the administrative pricing rules (for details, see the instructions for Schedule P (Form 1120-FSC)) and income determined without regard to the administrative pricing rules. These percentages are computed on Schedule E, page 4, Form 1120-FSC, and carried over to lines 9a and 9b of Schedule B, page 3, Form 1120-FSC, to figure taxable income or (loss).

See section 923(a)(4) for a special rule for foreign trade income allocable to a cooperative. See section 923(a)(5) for a special rule for military property.

Tax treaty benefits. A FSC may not claim any benefits under any income tax treaty between the United States and any foreign country.

Foreign Trading Gross Receipts

A FSC is treated as having foreign trading gross receipts (defined in section 924) only if it has met certain foreign management and foreign economic process requirements.

Foreign trading gross receipts do not include:

- Certain excluded receipts (defined in section 924(f)).
- Receipts attributable to property excluded from export property under section 927(a)(2).
- Investment income (defined in section 927(c)).
- Carrying charges (defined in section 927(d)(1)).

Note. Computer software licensed for reproduction abroad is not excluded from export property under section 927(a)(2). Therefore, receipts attributable to the sale, lease, or rental of computer software and services related and subsidiary to such transactions qualify as foreign trading gross receipts.

Foreign Management Rules

A FSC (other than a small FSC) is treated as having foreign trading gross receipts for the tax year only if the management of the FSC during the year takes place outside the United States. These management activities include:

- Meetings of the board of directors and meetings of the shareholders.
- Disbursing cash, dividends, legal and accounting fees, salaries of officers, and salaries or fees of directors from the principal bank account (see below).
- Maintaining the principal bank account at all times during the tax year.

Meetings of directors and meetings of the shareholders. All meetings of the board of directors of the FSC and all meetings of the shareholders of the FSC that take place during the tax year must take place outside the United States.

In addition, all such meetings must comply with the local laws of the foreign country or U.S. possession in which the FSC was created or organized. The local laws determine whether a meeting must be held, when and where it must be held (if it is held at all), who must be present, quorum requirements, use of proxies, etc.

Principal bank accounts. See Regulations section 1.924(c)-1(c) for information regarding principal bank accounts.

Foreign Economic Process Rules

A FSC (other than a small FSC) has foreign trading gross receipts from any transaction only if certain economic processes for the transaction take place outside the United States. Section 924(d) and Regulations section 1.924(d)-1 set forth the rules for determining whether a sufficient amount of the economic processes of a transaction takes place outside the United States.

Generally, a transaction will qualify if the FSC satisfies two requirements:

- Participation outside the United States in the sales portion of the transaction and
- Satisfaction of either the 50% or the 85% foreign direct cost test.

The activities comprising these economic processes may be performed by the FSC or by any other person acting under contract with the FSC.

Participation outside the United States in the sales portion of the transaction. Generally, the requirement of section 924(d)(1)(A) is met for the gross receipts of a FSC derived from any transaction if the FSC has participated outside the United States in the following sales activities relating to the transaction: (1) solicitation (other than advertising), (2) negotiation, and (3) making a contract.

1. Solicitation (other than advertising) is any communication (including, but not limited to, telephone, telegraph, mail, or in person) by the FSC, to a specific, targeted customer or potential customer.
2. Negotiation is any communication by the FSC to a customer or potential customer aimed at an agreement on one or more of the terms of a transaction, including, but not limited to, price, credit terms, quantity, or time or manner of delivery.
3. Making a contract refers to performance by the FSC of any of the elements necessary to complete a sale, such as making or accepting an offer.

Grouping transactions. Generally, the sales activities described above are to be applied on a transaction-by-transaction basis. However, a FSC may make an annual election to apply any of the sales activities on the basis of a group. To make the election, check the applicable box on line 10a, *Additional Information,* on page 2 of Form 1120-FSC. See Regulations section 1.924(d)-1(c)(5) for details.

Satisfaction of either the 50% or 85% foreign direct cost test. To qualify as foreign trading gross receipts, the foreign direct costs incurred by the FSC attributable to the transaction must equal or exceed 50% of the total direct costs incurred by the FSC attributable to the transaction.

Instead of satisfying the 50% foreign direct cost test, the FSC may incur foreign direct costs attributable to activities described in each of two of the section 924(e) categories. The costs must equal or exceed 85% of the total direct costs incurred by the FSC attributable to the activity described in each of the two categories. If no direct costs are incurred by the FSC in a particular category, that category is not taken into account for purposes of determining whether the FSC has met either the 50% or 85% foreign direct cost test.

Direct costs are costs that:

- Are incident to and necessary for the performance of any activity described in section 924(e);
- Include the cost of materials consumed in the performance of the activity and the cost of labor that can be identified or associated directly with the performance of the activity (but only to the extent of wages, salaries, fees for professional services, and other amounts paid for personal services actually rendered, such as bonuses or compensation paid for services on the basis of a percentage of profits); and
- Include the allowable depreciation deduction for equipment or facilities (or the rental cost for its use) that can be specifically identified or associated with the activity, as well as the contract price of an activity performed on behalf of the FSC by a contractor.

Total direct costs means all of the direct costs of any transaction attributable to activities described in any paragraph of section 924(e). For purposes of the 50% test of section 924(d)(1)(B), total direct costs are based on the direct costs of all activities described in all paragraphs of section 924(e). For purposes of the 85% test of section 924(d)(2), however, the total direct costs are determined separately for each paragraph of section 924(e).

Foreign direct costs means the portion of the total direct costs of any transaction attributable to activities performed outside the United States. For purposes of the 50% test, foreign direct costs are based on the direct costs of all activities described in all paragraphs of section 924(e). For purposes of the 85% test, however, foreign direct costs are determined separately for each paragraph of section 924(e).

For more details, see Regulations section 1.924(d)-1(d).

Check the applicable box(es) on line 10b, *Additional Information*, on page 2 of the form, to indicate how the FSC met the foreign direct costs requirement.

Grouping transactions. Generally, the foreign direct cost tests under Regulations section 1.924(d)-1(d) are applied on a transaction-by-transaction basis. However, the FSC may make an annual election (on line 10d, *Additional Information*, on page 2 of the form) to apply the foreign direct cost tests on a customer, contract, or product or product line grouping basis. Any grouping used must be supported by adequate documentation of performance of activities and costs of activities relating to the grouping used. See Regulations section 1.924(d)-1(e) for details.

Exception for foreign military property. The economic process rules do not apply to any activities performed in connection with foreign military sales except those activities described in section 924(e). See Regulations section 1.924(d)-1(f) for details.

Section 925(c) Rule

To use the administrative pricing rules to determine the FSC's (or small FSC's) profit on a transaction or group of transactions, the FSC must perform (or contract with another person to perform) all of the economic process activities relating to the transaction or group of transactions. All of the direct and indirect expenses relating to the performance of those activities must be reflected on the books of the FSC and on Form 1120-FSC.

Under Temporary Regulations section 1.925(a)-1T(b)(2)(ii), an election may be made to include on the FSC's books all expenses, other than cost of goods sold, that are necessary to figure combined taxable income for the transaction or group of transactions. The expenses must be identified on Schedule G on the applicable line.

Who Must File

File Form 1120-FSC if the corporation elected to be treated as a FSC or small FSC, and the election is still in effect.

Note. A FSC that elects to be treated as a domestic corporation under section 943(e)(1) does not file Form 1120-FSC. Instead, it files Form 1120 (or Form 1120-A).

When To File

Generally, a corporation must file Form 1120-FSC by the 15th day of the 3rd month after the end of its tax year. A FSC that has dissolved must generally file by the 15th day of the 3rd month after the date it dissolved.

If the due date falls on a Saturday, Sunday, or legal holiday, the FSC may file on the next business day.

Private delivery services. FSCs may use certain private delivery services designated by the IRS to meet the "timely mailing as timely filing/paying" rule for tax returns and payments. These private delivery services include only the following.

- DHL Express (DHL): DHL Same Day Service, DHL Next Day 10:30 am, DHL Next Day 12:00 pm, DHL Next Day 3:00 pm, and DHL 2nd Day Service.
- Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2Day, FedEx International Priority, and FedEx International First.
- United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express.

The private delivery service can tell you how to get written proof of the mailing date.

CAUTION *Private delivery services cannot deliver items to P.O. boxes. You must use the U.S. Postal Service to mail any item to an IRS P.O. box address.*

Extension of time to file. File Form 7004, Application for Automatic 6-month Extension of Time To File Certain Business Income Tax, Information, and Other Returns, to request a 6-month extension of time to file. Generally, file Form 7004 by the regular due date of the Form 1120-FSC.

Where To File

File Form 1120-FSC with the Internal Revenue Service Center, Philadelphia, PA 19255.

Who Must Sign

The return must be signed and dated by:

- The president, vice president, treasurer, assistant treasurer, chief accounting officer; or
- Any other corporate officer (such as tax officer) authorized to sign.

If a return is filed on behalf of a FSC by a receiver, trustee, or assignee, the fiduciary must sign the return, instead of the corporate officer. Returns and forms signed by a receiver or trustee in bankruptcy on behalf of a FSC must be accompanied by a copy of the order or instructions of the court authorizing signing of the return or form.

If an employee of the FSC completes Form 1120-FSC, the paid preparer's space should remain blank. Anyone who prepares Form 1120-FSC but does not charge the FSC should not complete that section. Generally, anyone who is paid to prepare the return must sign it and fill in the "Paid Preparer's Use Only" area.

The **paid preparer** must complete the required preparer information and:

- Sign the return in the space provided for the preparer's signature.
- Give a copy of the return to the taxpayer.

Note. A preparer may sign original or amended returns by rubber stamp, mechanical device, or computer software programs.

Paid Preparer Authorization

If the FSC wants to allow the IRS to discuss its 2005 tax return with the paid preparer who signed it, check the "Yes" box in the signature area of the return. This authorization applies only to the individual whose signature appears in the "Paid Preparer's Use Only" section of the return. It does not apply to the firm, if any, shown in that section.

If the "Yes" box is checked, the FSC is authorizing the IRS to call the paid preparer to answer any questions that may arise during the processing of its return. The FSC is also authorizing the paid preparer to:

- Give the IRS any information that is missing from the return,
- Call the IRS for information about the processing of the return or the status of any related refund or payment(s), and
- Respond to certain IRS notices about math errors, offsets, and return preparation.

The FSC is not authorizing the paid preparer to receive any refund check, bind the FSC to anything (including any additional tax liability), or otherwise represent the FSC before the IRS.

The authorization will automatically end no later than the due date (excluding extensions) for filing the FSC's 2006 tax return. If the FSC wants to expand the paid preparer's authorization or revoke it before it ends, see Pub. 947, Practice Before the IRS and Power of Attorney.

Other Forms and Statements That May Be Required

Forms

The FSC may have to file some of the forms listed below. See the form for more information.

For a list of additional forms the FSC may need to file (most notably, forms pertaining to the reporting of various types of income, and any related withholding, to U.S. persons, foreign persons, and the IRS), see Pub. 542, Corporations.

- **Form 5471,** Information Return of U.S. Persons With Respect to Certain Foreign Corporations. This form may have to be filed by certain U.S. officers, directors, or shareholders of a FSC to report changes in ownership (see sections 6046 and the related regulations).

If a Form 1120-FSC is filed, Form 5471 is not required to be filed to satisfy the requirements of section 6038 (see Temporary Regulations section 1.921-1T(b)(3)). However, certain U.S. shareholders may be required to file Form 5471 and the applicable schedules to report subpart F income.

See the instructions for Form 5471 for more information.

- **Form 5472,** Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Generally, a FSC that is engaged in a trade or business in the United States that had a reportable transaction with a foreign or domestic related party during the tax year must file Form 5472.
- **Form 5713,** International Boycott Report. FSCs that had operations in, or related to, certain "boycotting" countries file Form 5713.
- **Form 8275,** Disclosure Statement, and **Form 8275-R,** Regulation Disclosure Statement. Disclose items or positions taken on a tax return that are not otherwise adequately disclosed on a tax return or that are contrary to Treasury regulations (to avoid parts of the accuracy-related penalty or certain preparer penalties).
- **Form 8300,** Report of Cash Payments Over $10,000 Received in a Trade or Business. Use this form to report the receipt of more than $10,000 in cash or foreign currency in one transaction or a series of related transactions.
- **Form 8886,** Reportable Transaction Disclosure Statement. Use this form to disclose information for each reportable transaction in which the FSC participated. Form 8886 must be filed for each tax year that the Federal Income tax liability of the FSC is affected by its participation in the transaction. The FSC may have to pay a penalty if it is required to file Form 8886 and does not do so. The following are reportable transactions.

1. Any listed transaction which is a transaction that is the same as or substantially similar to tax avoidance transactions identified by the IRS.
2. Any transaction offered under conditions of confidentiality for which the FSC paid an advisor a fee of at least $250,000.
3. Certain transactions for which the FSC has contractual protection against disallowance of the tax benefits.
4. Certain transactions resulting in a loss of at least $10 million in any single year or $20 million in any combination of years.
5. Certain transactions resulting in a book-tax difference of more than $10 million on a gross basis required to be disclosed on returns with due dates before January 6, 2006. For returns with due dates (including extensions) after January 5, 2006, a

transaction with a significant book-tax difference is no longer a reportable transaction unless it is also a transaction described in one of the five other reportable transaction categories. For more details, see Notice 2006-6, 2006-5 I.R.B. 385.

6. Certain transactions resulting in a tax credit of more than $250,000, if the FSC held the asset generating the credit for 45 days or less.

Penalties. The FSC may have to pay a penalty if it is required to disclose a reportable transaction under section 6011 and fails to properly complete and file Form 8886. The penalty is $50,000 ($200,000 if the reportable transaction is a listed transaction) for each failure to file Form 8886 with its corporate return or for failure to provide a copy of Form 8886 to the Office of Tax Shelter Analysis (OTSA). Other penalties, such as an accuracy-related penalty under section 6662A, may also apply. See the Instructions for Form 8886 for details.

Statements

Election to reduce basis under section 362(e)(2)(C). The transferor and transferee in certain section 351 transactions may make a joint election under section 362(e)(2)(C) to limit the transferor's basis in stock received instead of the transferee's basis in the transferred property. The transferor and transferee may make the election by attaching the statement as provided in Notice 2005-70, 2005-41 I.R.B. 694, to their tax returns filed by the due date (including extensions) for the tax year in which the transaction occurred. Once made, the election is irrevocable. See section 362(e)(2)(C) and Notice 2005-70.

Assembling the Return

To ensure that the FSC's tax return is correctly processed, attach all schedules and other forms after page 6, Form 1120-FSC, and in the following order.

1. Form 4136.
2. Form 4626.
3. Form 851.
4. Additional schedules in alphabetical order.
5. Additional forms in numerical order.

Complete every applicable entry space on Form 1120-FSC. Do not enter "See attached" instead of completing the entry spaces. If more space is needed on the forms or schedules, attach separate sheets using the same size and format as the printed forms. If there are supporting statements and attachments, arrange them in the same order as the schedules or forms they support and attach them last. Show the totals on the printed forms. Enter the FSC's name and EIN on each supporting statement or attachment.

Accounting Methods

Figure taxable income using the method of accounting regularly used in keeping the FSC's books and records. In all cases, the method used must clearly show taxable income. Permissible methods include cash, accrual, or any other method authorized by the Internal Revenue Code.

A member of a controlled group may not use an accounting method that would distort any group member's income, including its own. For example, a FSC acts as a commission agent for property sales by a related corporation that uses the accrual method and pays the FSC its commission more than 2 months after the sale. In this case, the FSC should not use the cash method because that method would materially distort its income.

Generally, the following rules apply.

- A FSC (other than a qualified personal service corporation) must use the accrual method of accounting if its average annual gross receipts exceed $5 million.
- Unless it is a qualifying taxpayer or a qualifying small business taxpayer, a FSC must use the accrual method for sales and purchases of inventory items. See *Schedule A, Cost of Goods Sold Related to Foreign Trading Gross Receipts*, on page 7.

Change in accounting method. To change its method of accounting used to report taxable income (for income as a whole or for the treatment of any material item), the FSC must file Form 3115, Application for Change in Accounting Method. For more information, see Form 3115 and Pub. 538, Accounting Periods and Methods.

Section 481(a) adjustment. The FSC may have to make an adjustment under section 481(a) to prevent amounts of income or expense from being duplicated or omitted. The section 481(a) adjustment period is generally 1 year for a net negative adjustment and 4 years for a net positive adjustment. However, a FSC may elect to use a 1-year adjustment period if the net section 481(a) adjustment for the change is less than $25,000. The FSC must complete the appropriate lines of Form 3115 to make the election.

Accounting Period

A FSC must figure its taxable income on the basis of a tax year. A tax year is the annual accounting period a FSC uses to keep its records and report its income and expenses. Generally, FSCs may use a calendar year or a fiscal year. Personal service corporations, however, must generally use a calendar year.

Note. The tax year of a FSC must be the same as the tax year of the principal shareholder which, at the beginning of the FSC tax year, has the highest percentage of voting power. If two or more shareholders have the highest percentage of voting power, the FSC must have a tax year that conforms to the tax year of any such shareholder. See section 441(h).

Rounding Off To Whole Dollars

The FSC may round off cents to whole dollars on its return and schedules. If the FSC does round to whole dollars, it must round all amounts. To round, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar (for example, $1.39 becomes $1 and $2.50 becomes $3).

If two or more amounts must be added to figure the amount to enter on a line, include cents when adding the amounts and round off only the total.

Recordkeeping

Keep the FSC's records for as long as they may be needed for the administration of any provision of the Internal Revenue Code. Usually, records that support an item of income, deduction, or credit on the return must be kept for 3 years from the date the return is due or filed, whichever is later. Keep records that verify the FSC's basis in property for as long as they are needed to figure the basis of the original or replacement property.

The FSC should keep copies of all filed returns. They help in preparing future and amended returns.

Payment of Tax Due

The FSC must pay the tax due in full no later than the 15th day of the 3rd month after the end of the tax year. The method for payment of the tax due depends upon whether the FSC has an office or place of business in the United States.

1. FSCs that do not maintain an office or place of business in the United States must pay the tax due directly to the IRS (that is, do not use either of the depository methods of tax payment described below). The tax may be paid by check or money order, payable to the "United States Treasury." To help ensure proper crediting, write the FSC's employer identification number (EIN), "Form 1120-FSC," and the tax period to which the payment applies on the check or money order. Enclose the payment when Form 1120-FSC is filed with the Internal Revenue Service Center, Philadelphia, PA 19255.
2. FSCs that maintain an office or place of business in the United States must pay the tax due using a qualified depositary. The two methods of depositing corporate taxes are discussed below.

Depository Methods of Tax Payment

FSCs that maintain an office or place of business in the United States may use either of the two methods of depositing corporate income taxes discussed below.

Electronic Deposit Requirement

The FSC must make electronic deposits of all depository taxes (such as employment tax, excise tax, and corporate income tax) using the Electronic Federal Tax Payment System (EFTPS) in 2006 if:

- The total deposits of such taxes in 2004 were more than $200,000 or
- The FSC was required to use EFTPS in 2005.

If the FSC is required to use EFTPS and fails to do so, it may be subject to a 10% penalty. If the FSC is not required to use EFTPS, it may participate voluntarily. To enroll in or get more information about EFTPS, call 1-800-555-4477. To enroll online, visit *www.eftps.gov*.

Depositing on time. For EFTPS deposits to be made timely, the FSC must initiate the transaction at least 1 business day before the date the deposit is due.

Deposits With Form 8109

If the FSC does not use EFTPS, deposit FSC income tax payments (and estimated tax payments) with Form 8109, Federal Tax Deposit Coupon. If you do not have a preprinted Form 8109, use Form 8109-B to make deposits. You can get this form by calling 1-800-829-4933 or visiting an IRS taxpayer assistance center. Have your EIN ready when you call or visit.

Do not send deposits directly to an IRS office; otherwise, the FSC may have to pay a penalty. Mail or deliver the completed Form 8109 with the payment to an authorized depositary (a commercial bank or other financial institution authorized to accept Federal tax deposits). Make checks or money orders payable to the depositary.

If the FSC prefers, it may mail the coupon and payment to: Financial Agent, Federal Tax Deposit Processing, P.O. Box 970030, St. Louis, MO 63197. Make the check or money order payable to "Financial Agent."

To help ensure proper crediting, write the FSC's EIN, the tax period to which the deposit applies, and "Form 1120-FSC" on the check or money order. Darken the "1120" box under "Type of Tax" and the appropriate "Quarter" box under "Tax Period" on the coupon. Records of these deposits will be sent to the IRS.

For more information on deposits, see the instructions in the coupon booklet (Form 8109) and Pub. 583, Starting a Business and Keeping Records.

CAUTION *If the FSC maintains an office or place of business in the United States and it owes tax when it files Form 1120-FSC, do not include the payment with the tax return. Instead, mail or deliver the payment with Form 8109 to an authorized depositary, or use EFTPS, if applicable.*

Estimated Tax Payments

Generally, the following rules apply to the FSC's payments of estimated tax.

- The FSC must make installment payments of estimated tax if it expects its total tax for the year (less applicable credits) to be $500 or more.
- The installments are due by the 15th day of the 4th, 6th, 9th, and 12th months of the tax year. If any date falls on a Saturday, Sunday, or legal holiday, the installment is due on the next regular business day.
- Use Form 1120-W, Estimated Tax for Corporations, as a worksheet to compute estimated tax.
- If the FSC maintains an office or place of business in the United States and it does not use EFTPS, use the deposit coupons (Forms 8109) to make deposits of estimated tax.
- If the FSC does not maintain an office or place of business in the United States, it must pay the estimated tax due directly to the IRS.
- If the FSC overpaid estimated tax, it may be able to get a quick refund by filing Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax.

For more information on estimated tax payments, including penalties that apply if the FSC fails to make required payments, see *Line 3. Estimated tax penalty,* on page 7.

Interest and Penalties

Interest. Interest is charged on taxes paid late even if an extension of time to file is granted. Interest is also charged on penalties imposed for failure to file, negligence, fraud, substantial valuation misstatements, gross valuation misstatements, substantial understatements of tax, and reportable transaction understatements from the due date (including extensions) to the date of payment. The interest charge is figured at a rate determined under section 6621.

Late filing of return. A FSC that does not file its tax return by the due date, including extensions, may be penalized 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. The minimum penalty for a return that is over 60 days late is the smaller of the tax due or $100. The penalty will not be imposed if the FSC can show that the failure to file on time was due to reasonable cause. FSCs that file late should attach a statement explaining the reasonable cause.

Late payment of tax. A FSC that does not pay the tax when due generally may be penalized ½ of 1% of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25% of the unpaid tax. The penalty will not be imposed if the FSC can show that the failure to pay on time was due to reasonable cause.

Trust fund recovery penalty. This penalty may apply if certain income, social security, and Medicare taxes that must be collected or withheld are not collected or withheld, or these taxes are not paid. These taxes are generally reported on Form 941, Employer's Quarterly Federal Tax Return, or Form 945, Annual Return of Withheld Federal Income Tax.

The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to have been responsible for collecting, accounting for, and paying over these taxes, and who acted willfully in not doing so. The penalty is equal to the unpaid trust fund tax. See Pub. 15 (Circular E), Employer's Tax Guide, for details, including the definition of responsible persons.

Other penalties. Other penalties may be imposed for negligence, substantial understatement of tax, and fraud. See sections 6662, 6662A, and 6663.

A FSC may also be subject to a penalty (under section 6686) of:

- $100 for each failure to supply information, up to $25,000 during the calendar year.
- $1,000 for not filing a return.

These penalties will not apply if the FSC can show that the failure to furnish the required information was due to reasonable cause.

Specific Instructions

Period covered. File the 2005 return for calendar year 2005 and fiscal years that begin in 2005 and end in 2006. For a fiscal year return, fill in the tax year space at the top of the form.

Note. The 2005 Form 1120-FSC may also be used if:
- The FSC has a tax year of less than 12 months that begins and ends in 2006 and
- The 2006 Form 1120-FSC is not available at the time the FSC is required to file its return.

The FSC must show its 2006 tax year on the 2005 Form 1120-FSC and take into account any tax law changes that are effective for tax years beginning after December 31, 2005.

Name. Print or type the FSC's true name (as set forth in the charter or other legal document creating it).

Address. Enter the U.S. address where the FSC maintains the records required under section 6001. Include the suite, room, or other unit number after the street address. If the Post Office does not deliver mail to the street address and the FSC has a P.O. box, show the box number instead.

If the FSC receives its mail in care of a third party (such as an accountant or an attorney), enter on the street address line "C/O" followed by the third party's name and street address or P.O. box.

Item A. Foreign country or U.S. possession of incorporation. See *Definition of a Foreign Sales Corporation (FSC)* on page 2.

Item E. Total assets. Enter the FSC's total assets (as determined by the accounting method regularly used in keeping the FSC's books and records) at the end of the tax year from page 6, Schedule L, column (d), line 15. If there are no assets at the end of the tax year, enter -0-.

Item F. Final return, name change, address change, or amended return.
- If this is the FSC's final return and it will no longer exist, check the "Final return" box.
- If the FSC changed its name since it last filed a return, check the box for "Name change." Generally, a FSC also must have amended its articles of incorporation and filed the amendment with the jurisdiction in which it was incorporated.
- If the FSC has changed its address since it last filed a return (including a change to an "in care of" address), check the box for "Address Change."

Note. If a change of address occurs after the return is filed, use Form 8822, Change of Address, to notify the IRS of the new address.
- If the FSC is amending its return, check the box for "Amended return."

FSC Information

Line 1. Principal shareholder. Complete lines 1a through 1h for the shareholder (individual, corporation, partnership, trust, or estate) that was the principal shareholder at the beginning of the FSC's tax year. See the *Note* on page 5 under Accounting Period.

Foreign address. Enter the information in the following order: city, province or state, and country. Follow the country's practice for entering the postal code. Do not abbreviate the country name.

Line 2. Parent-subsidiary controlled group. If the FSC is a subsidiary in a parent-subsidiary controlled group and the principal shareholder is not the common parent of the group, complete lines 2a through 2g for the common parent. Enter the consolidated total assets on line 2d for a group that files a consolidated return; otherwise, enter only the common parent's total assets.

Note. Check the "Yes" box on line 2 if the FSC is a subsidiary in a parent-subsidiary controlled group. This applies even if the FSC is a subsidiary member of one group and the parent corporation of another.

The term "parent-subsidiary controlled group" means one or more chains of corporations connected through stock ownership (sections 927(d)(4) and 1563(a)(1)). Both of the following requirements must be met.

1. More than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of all classes of stock of each corporation in the group (except the parent) must be owned by one or more of the other corporations in the group.
2. The common parent must own more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of all classes of stock of at least one of the other corporations in the group.

Stock owned directly by other members of the group is not counted when computing the voting power or value.

See sections 927(d)(4) and 1563(d)(1) for the definition of "stock" for purposes of determining stock ownership above.

Tax and Payments

Line 2h. Backup withholding. If the FSC had income tax withheld from any payments it received due to backup withholding, include the amount withheld in the total for line 2h. Show the amount withheld in the blank space in the right-hand column between lines 1 and 2h, and write "backup withholding."

Note. Do not include backup withholding amounts on line 2g. Include on line 2g only amounts withheld under Chapter 3 of the Code.

Line 3. Estimated tax penalty. A FSC that does not make estimated tax payments when due may be subject to an underpayment penalty for the period of underpayment. Generally, a FSC is subject to the penalty if its tax liability is $500 or more and it did not timely pay the smaller of:

- Its tax liability for 2005 or
- Its prior year's tax.

See section 6655 for details and exceptions, including special rules for large corporations.

Use Form 2220, Underpayment of Estimated Tax by Corporations, to see if the FSC owes the penalty and to figure the amount of the penalty. Generally, the FSC does not have to file this form because the IRS can figure the amount of any penalty and bill the FSC for it. However, even if the FSC does not owe the penalty, complete and attach Form 2220 if:

- The annualized income or adjusted seasonal installment method is used or
- The FSC is a large corporation computing its first required installment based on the prior year's tax. (See the Form 2220 instructions for the definition of a large corporation.)

If Form 2220 is attached, check the box on line 3 and enter the amount of any penalty on this line.

Schedule A

Cost of Goods Sold Related To Foreign Trading Gross Receipts

Complete Schedule A only for the cost of goods sold deduction related to foreign trading gross receipts reported on lines 1 through 5 of Schedule B.

Complete column (a) to show the cost of goods sold for inventory acquired in transactions using the administrative pricing rules. Complete column (b) to show the cost of goods sold for inventory acquired in transactions that did not use the administrative pricing rules. For details on the administrative pricing rules, see the Instructions for Schedule P (Form 1120-FSC).

If the FSC acts as another person's commission agent on a sale, do not enter any amount on Schedule A for the sale.

Small FSCs will have to make two separate computations for cost of goods sold if their foreign trading gross receipts exceed the limitation amount on line 6e of Schedule B. In this case, a deduction for cost of goods sold will be figured separately for the income on line 6h of Schedule B, and separately for the income on line 7 of Schedule F.

Generally, inventories are required at the beginning and end of each tax year if the purchase or sale of merchandise is an income-producing factor. See Regulations section 1.471-1.

However, if the FSC is a qualifying taxpayer or a qualifying small business taxpayer, it may adopt or change its accounting method to account for inventoriable items in the same manner as materials and supplies that are not incidental (unless its business is a tax shelter (as defined in section 448(d)(3))).

A qualifying taxpayer is a taxpayer that, for each prior tax year ending after December 16, 1998, has average annual gross receipts of $1 million or less for the 3-tax-year period ending with that prior year.

A qualifying small business taxpayer is a taxpayer (a) that, for each prior tax year ending on or after December 31, 2000, has average annual gross receipts of $10 million or less for the 3-tax-year period ending with that prior tax year and (b) whose principal business activity is not an ineligible activity.

Under this accounting method, inventory costs for merchandise purchased for resale are deductible in the year the merchandise is sold (but not before the year the FSC paid for the merchandise, if it is also using the cash method). For additional guidance on this method of accounting for inventoriable items, see Pub. 538, and the Instructions for Form 3115.

Enter amounts paid for merchandise during the tax year on line 2. The amount the FSC may deduct for the tax year is figured on line 8.

All FSCs not using the cash method of accounting should see *Section 263A uniform capitalization rules* in the instructions for Schedule G on page 10. See those instructions before completing Schedule A.

If the FSC uses intercompany pricing rules (for purchases from a related supplier), use the transfer price figured in Part II of Schedule P (Form 1120-FSC).

Line 1. Inventory at beginning of year. If the FSC is changing its method of accounting for the current tax year, it must refigure last year's closing inventory using its new method of accounting and enter the result on line 1. If there is a difference between last year's closing inventory and the refigured amount, attach an explanation and take it into account when figuring the FSC's section 481(a) adjustment (explained on page 5).

Line 4. Additional section 263A costs. An entry is required on this line only for FSCs that have elected a simplified method of accounting.

For FSCs that have elected the simplified production method, additional section 263A costs are generally those costs, other than interest, that were not capitalized under the FSC's method of accounting immediately prior to the effective date of section 263A but are now required to be capitalized under section 263A. For details, see Regulations section 1.263A-2(b).

For FSCs that have elected the simplified resale method, additional section 263A costs are generally those costs incurred with respect to the following categories.

- Off-site storage or warehousing.
- Purchasing.
- Handling, such as processing, assembling, repackaging, and transporting.
- General and administrative costs (mixed service costs).

For details, see Regulations section 1.263A-3(d).

Enter on line 4 the balance of section 263A costs paid or incurred during the tax year not includible on lines 2, 3, and 5.

Line 5. Other costs. Enter on line 5 any costs paid or incurred during the tax year not entered on lines 2 through 4.

Line 7. Inventory at end of year. See Regulations sections 1.263A-1 through 1.263A-3 for details on figuring the amount of additional section 263A costs to be included in ending inventory. If the FSC accounts for inventoriable items in the same manner as materials and supplies that are not incidental, enter on line 7 the portion of its merchandise purchased for resale that is included on line 6 and was not sold during the year.

Lines 9a through 9f. Inventory valuation methods. Inventories may be valued at:

- Cost;

• Cost or market value (whichever is lower); or
• Any other method approved by the IRS that conforms to the requirements of the applicable regulations cited below.

However, if the FSC is using the cash method of accounting, it is required to use cost.

FSCs that account for inventoriable items in the same manner as materials and supplies that are not incidental may currently deduct expenditures for direct labor and all indirect costs that would otherwise be included in inventory costs.

The average cost (rolling average) method of valuing inventories generally does not conform to the requirements of the regulations. See Rev. Rul. 71-234, 1971-1 C.B. 148.

FSCs that use erroneous valuation methods must change to a method permitted for Federal income tax purposes. To make this change, use Form 3115.

On line 9a, check the method(s) used for valuing inventories. Under lower of cost or market, the term “market” (for normal goods) means the current bid price prevailing on the inventory valuation date for the particular merchandise in the volume usually purchased by the taxpayer. If section 263A applies to the taxpayer, the basic elements of cost must reflect the current bid price of all direct costs and all indirect costs properly allocable to goods on hand at the inventory date.

Inventory may be valued below cost when the merchandise is unsalable at normal prices or unusable in the normal way because the goods are subnormal due to damage, imperfections, shopwear, etc., within the meaning of Regulations section 1.471-2(c). The goods may be valued at the current bona fide selling price, minus direct cost of disposition (but not less than scrap value) if such a price can be established.

If this is the first year the Last-in, First-out (LIFO) inventory method was either adopted or extended to inventory goods not previously valued under the LIFO method provided in section 472, attach Form 970, Application To Use LIFO Inventory Method, or a statement with the information required by Form 970. Also check the LIFO box on line 9c. On line 9d, enter the amount or the percent of total closing inventories covered under section 472. Estimates are acceptable.

If the FSC changed or extended its inventory method to LIFO and had to write up the opening inventory to cost in the year of election, report the effect of the write-up as other income (as appropriate on Schedule F, line 16), proportionately over a 3-year period that begins with the year of the LIFO election (section 472(d)).

For more information on inventory valuation methods, see Pub. 538.

Additional Information

Line 2. Show any **tax-exempt interest** received or accrued. Include any exempt-interest dividends received as a shareholder in a mutual fund or other regulated investment company. Also include this amount on Schedule M-1, line 7a.

Line 5. If the FSC owned at least a 10% interest, directly or indirectly, in any foreign partnership, attach a statement listing the following information for each foreign partnership. For this purpose, a foreign partnership includes an entity treated as a foreign partnership under Regulations section 301.7701-2 or 301.7701-3.

1. Name and EIN (if any) of the foreign partnership;
2. Identify which, if any, of the following forms the foreign partnership filed for its tax year ending with or within the FSC's tax year: Form 1042, 1065 or 1065-B, or 8804;
3. Name of the tax matters partner (if any); and
4. Beginning and ending dates of the foreign partnership's tax year.

Line 6. If the FSC has a net operating loss (NOL) for its 2005 tax year, it may elect to waive the entire carryback period for the NOL and instead carry the NOL forward to future tax years. To do so, check the box on line 6 and file the tax return by its due date, including extensions (do not attach the statement described in Temporary Regulations section 301.9100-12T). Once made, the election is irrevocable. See Pub. 542 and Form 1139, Corporation Application for Tentative Refund, for more details.

Line 7. Enter the amount of the NOL carryover to the tax year from prior years, even if some of the loss is used to offset income on this return. The amount to enter is the total of all NOLs generated in prior years but not used to offset income (either as a carryback or carryover) to a tax year prior to 2005. Do not reduce the amount by any NOL deduction reported on line 19a, Part II of Schedule B.

Lines 8c and 9b(2). See *Definition of a Foreign Sales Corporation (FSC)* on page 2 for definitions of qualifying foreign country and U.S. possession.

Line 9. All FSCs (except small FSCs) must answer these questions. For more information, see *Foreign Management Rules* on page 3.

Line 10. All FSCs (except small FSCs) must answer these questions. On line 10b, indicate how the FSC met the foreign direct costs requirement of section 924(d) for all transactions that generated foreign trading gross receipts reported on lines 1 through 5 of Schedule B. Also, complete line 10a and/or line 10d to make an election to use either of the annual grouping election(s) indicated. See *Foreign Economic Process Rules* on page 3 for details.

Schedule B

Taxable Income or (Loss)

Use Schedule B to compute taxable income from all sources.

Part I

Use Part I to compute net income attributable to nonexempt foreign trade income. Income and expenses on lines 1 through 15 are reported in column (a) if the administrative pricing rules were used in the transaction that produced the income.

Report in column (b) all foreign trade income from all transactions in which the administrative pricing rules were not used. Attach a schedule that shows the computation of the taxable and nontaxable income included on line 15, column (b). Include only the taxable amount on line 16.

Nonaccrual experience method. Accrual method FSCs are not required to accrue certain amounts to be received from the performance of certain services that, on the basis of their experience, will not be collected, if the FSC's average annual gross receipts for the 3 prior tax years does not exceed $5 million.

This provision does not apply to any amount if interest is required to be paid on the amount or if there is any penalty for failure to timely pay the amount. For more information, see section 448(d)(5) and Temporary Regulations section 1.448-2T.

Corporations that qualify to use the nonaccrual experience method should attach a schedule showing total gross receipts, the amount not accrued as a result of the application of section 448(d)(5), and the net amount accrued. Enter the net amount on the applicable line of Schedule B.

Lines 1 through 5. Enter the foreign trading gross receipts requested on lines 1 through 5. See section 924 and *Foreign Trading Gross Receipts* on page 3 of these instructions for receipts that are excluded and other details. Report commission income on line 1 or line 2 based on the sale, lease, or rental of property on which that commission arose.

Line 5. If the 50% gross receipts test of section 924(a)(5) is not met, report the FSC's gross receipts that would have otherwise qualified under that section on line 16, Schedule F, instead of line 5, Schedule B.

Lines 6b through 6h. See section 924(b)(2)(B) for the rules regarding the limitation on the amount of foreign trading gross receipts that a small FSC may take into account in determining its exempt foreign trade income.

Line 6d. Temporary Regulations section 1.921-1T(b)(5) indicates that, in the case of a small FSC having a short tax year, the dollar limitation reported on line 6b or 6c is to be prorated on a daily basis. A small FSC having a short tax year must divide the number of days in its short tax year by the number of days that would have made up a full tax year and enter the resulting fraction on line 6d as a decimal less than 1.00000.

Example. For its 2005 calendar year tax year, a small FSC has a short tax year of 73 days. The FSC enters 0.20 (73/365) on line 6d.

Line 6f. If commission income is reported in the total for line 6a of Schedule B, total receipts for purposes of line 6f are figured as follows:

1. Enter total of columns (a) and (b), line 6a, Schedule B	**1.**	_____
2. Enter total commission income reported on line 1 and line 2, Schedule B	**2.**	_____
3. Subtract line 2 from line 1	**3.**	_____

4. With respect to the commission income reported on line 2 above, enter total gross receipts on the sale, lease, or rental of property on which the commission income arose (section 927(b)(2)) . . . . **4.** ______

5. Add lines 3 and 4. Enter here and on line 6f, Schedule B . . . . **5.** ______

Line 6h. When making the line 6h allocation, allocate only the commission income from the gross receipts on line 4 above. If the small FSC's foreign trading gross receipts for the tax year (line 6f, Schedule B) exceed its allowable limitation (line 6e, Schedule B), the small FSC may select the gross receipts to which the limitation is allocated. In such a case, allocate the amount on line 6g between columns (a) and (b) on line 6h based on whether the administrative pricing rules were used for the gross receipts selected. See Regulations section 1.921-2(b), Q&A-4.

Part II

Line 19a. Net operating loss deduction. A FSC may use the NOL incurred in one tax year to reduce its taxable income in another tax year. Enter on line 19a the total NOL carryovers from other tax years, but do not enter more than the FSC's taxable income (after the dividends-received deduction). Attach a schedule showing the computation of the NOL deduction. Also complete line 7 in *Additional Information* on page 2 of the form.

For details on the NOL deduction, see Pub. 542, section 172, and Form 1139.

Line 19b. Dividends-received deduction. A FSC may be entitled to a deduction for dividends it receives from other corporations. Complete the worksheet on page 10 using the instructions that begin below. Attach the completed worksheet to Form 1120-FSC.

Line 20. Taxable income or (loss). If line 20 is zero or less, the FSC may have an NOL that may be carried back or forward as a deduction to other tax years. Generally, a FSC first carries back an NOL 2 tax years. However, the FSC may elect to waive the carryback period and instead carry the NOL forward to future tax years. To make the election, see the instructions for Additional Information, line 6 on page 8.

See Form 1139 for details, including other elections that may be available, which must be made no later than 6 months after the due date (excluding extensions) of the FSC's tax return.

Schedule E

Exemption Percentages Used in Figuring Exempt Foreign Trade Income

For purposes of the *Note* at the top of Schedule E, a C corporation is a corporation other than an S corporation. Shareholders, other than C corporations, are individuals, partnerships, S corporations, trusts, and estates.

Use lines 2a through 2d to figure the exemption percentage for foreign trade income determined by not using the administrative pricing rules. See section 923(a)(2).

Use lines 3a through 3d to figure the exemption percentage for foreign trade income that was determined by using the administrative pricing rules (see section 923(a)(3)). If a qualified cooperative is a shareholder of the FSC, see section 923(a)(4).

Schedule F

Net Income From Nonexempt Foreign Trade Income and Taxable Nonforeign Trade Income

Part I

Enter net income from nonexempt foreign trade income and related expenses in Part I.

Line 2. Enter FSC income that resulted from the FSC's cooperation with an international boycott. See section 927(e)(2) and Form 5713 and related schedules and instructions.

Line 3. Enter the amount, if any, of illegal payments, bribes, or kickbacks that the FSC paid, directly or indirectly, to government officials, employees, or agents. See section 927(e)(2).

Line 5. See the instructions for Schedule A before completing this line.

Part II

Enter the taxable portion of gross income of the FSC that was not derived from foreign trading gross receipts. This type of income includes:

- Small FSCs only. Amounts specifically excluded from foreign trade income because of the small FSC limitation (the amount by which line 6f of Schedule B exceeds line 6e of Schedule B). (Enter the excess, if any, on line 7 of Schedule F.)
- Investment type income. (Enter on lines 8 through 12 of Schedule F.)
- Income from property that is subsidized, deemed in short supply, or destined for use in the United States. (Enter on lines 13 and 14 of Schedule F.)
- Amounts from transactions that did not meet the foreign economic process requirements. (Enter on line 15 of Schedule F.)
- Other nonforeign trade income. (Enter on line 16 of Schedule F.)

For more details, see sections 924(f) and 927(a)(2) and (3).

Line 9. Complete the worksheet on page 10 to figure the total dividends to report on line 9. Attach the completed worksheet to Form 1120-FSC.

Line 18. Enter the deductions allocated or apportioned to line 17 income. Attach to Form 1120-FSC a schedule listing each type of deduction. Show deductions related to cost of goods sold separately. See the instructions for Schedule A on page 7 before completing this line.

Passive activity limitations. Section 469 generally limits the deduction of passive activity losses for closely held FSCs and FSCs that are personal service corporations. See section 469 and the Instructions for Form 8810 for details.

Instructions for Dividends and Dividends-Received Deduction Worksheet

For purposes of the 20% ownership test on lines 1 through 7, the percentage of stock owned by the FSC is based on voting power and the value of the stock. Preferred stock described in section 1504(a)(4) is not taken into account.

Line 1, Column (a)

Enter dividends (except those received on debt-financed stock acquired after July 18, 1984—see section 246A) that:

- Are received from less-than-20%-owned domestic corporations subject to income tax and
- Qualify for the 70% deduction under section 243(a)(1).

Also include on line 1 dividends (except those received on debt-financed stock acquired after July 18, 1984) from a regulated investment company (RIC). The amount of dividends eligible for the dividends-received deduction under section 243 is limited by section 854(b). The FSC should receive a notice from the RIC specifying the amount of dividends that qualify for the deduction.

Report so-called dividends or earnings received from mutual savings banks, etc., as interest. Do not treat them as dividends.

Line 2, Column (a)

Enter dividends (except those received on debt-financed stock acquired after July 18, 1984) that are received from 20%-or-more-owned domestic corporations subject to income tax and that are subject to the 80% deduction under section 243(c).

Line 3, Column (a)

Enter dividends that are:

- Received on debt-financed stock acquired after July 18, 1984, from domestic and foreign corporations subject to income tax that would otherwise be subject to the dividends-received deduction under section 243(a)(1), 243(c), or 245(a). Generally, debt-financed stock is stock that the FSC acquired by incurring a debt (for example, it borrowed money to buy the stock).
- Received from a RIC on debt-financed stock. The amount of dividends eligible for the dividends-received deduction is limited by section 854(b). The FSC should receive a notice from the RIC specifying the amount of dividends that qualify for the deduction.

Line 3, Columns (b) and (c)

Dividends received on debt-financed stock acquired after July 18, 1984, are not entitled to the full 70% or 80% dividends-received deduction. The 70% or 80% deduction is reduced by a percentage that is related to the amount of debt incurred to acquire the stock. See section 246A. Also, see section 245(a) before making this computation for an additional limitation that applies to dividends received from foreign corporations. Attach a schedule to Form 1120-FSC showing how the amount on line 3, column (c), was figured.

Line 4, Column (a)

Enter dividends received on the preferred stock of a less-than-20%-owned public utility that is subject to income tax and is allowed the deduction provided in section 247 for dividends paid.

Line 5, Column (a)

Enter dividends received on preferred stock of a 20%-or-more-owned public utility that is subject to income tax and is allowed the deduction provided in section 247 for dividends paid.

Line 6, Column (a)

Enter the U.S.-source portion of dividends that:

- Are received from less-than-20%-owned foreign corporations and
- Qualify for the 70% deduction under section 245(a). To qualify for the 70% deduction, the FSC must own at least 10% of the stock of the foreign corporation by vote and value.

Line 7, Column (a)

Enter the U.S.-source portion of dividends that are received from 20%-or-more-owned foreign corporations and that qualify for the 80% deduction under section 245(a).

Line 8, Column (c)

Limitation on dividends-received deduction. Generally, line 8, column (c), may not exceed the amount on line 10 of the worksheet below. However, in a year in which an NOL occurs, this limitation does not apply even if the loss is created by the dividends-received deduction. See sections 172(d) and 246(b).

1. Refigure line 18, Part II, Schedule B (page 3 of Form 1120-FSC) without any adjustment under section 1059 and without any capital loss carryback to the tax year under section 1212(a)(1) . . . **1.** _____
2. Multiply line 1 by 80% . . . . **2.** _____
3. Add lines 2, 5, and 7, column (c), and the part of the deduction on line 3, column (c), that is attributable to dividends from 20%-or-more-owned corporations **3.** _____
4. Enter the smaller of line 2 or 3. If line 3 is greater than line 2, stop here; enter the amount from line 4 on line 8, column (c), and do not complete lines 5-10 below . . . . . **4.** _____
5. Enter the total amount of dividends from 20%-or-more-owned corporations that are included on lines 2, 3, 5, and 7, column (a) . . **5.** _____
6. Subtract line 5 from line 1 . . . . . . **6.** _____
7. Multiply line 6 by 70% . . . . **7.** _____
8. Subtract line 3 above from line 8, column (c) . . . . **8.** _____
9. Enter the smaller of line 7 or line 8 . . . . **9.** _____
10. **Dividends-received deduction after limitation (sec. 246(b)).** Add lines 4 and 9. Enter the result here and on line 8, column (c) . . . . . . **10.** _____

Line 10, Column (a)

If the FSC claims the foreign tax credit, enter the tax that is deemed paid under sections 902 and 960. See sections 78 and 906(b)(4).

Line 11, Column (a)

Include the following:

1. Dividends (other than capital gain distributions reported on Schedule D (Form 1120) and exempt-interest dividends) that are received from RICs and that are not subject to the 70% deduction.

2. Dividends from tax-exempt organizations.

3. Dividends (other than capital gain distributions) received from a real estate investment trust that, for the tax year of the trust in which the dividends are paid, qualifies under sections 856 through 860.

4. Dividends not eligible for a dividends-received deduction, which include the following.

a. Dividends received on any share of stock held for less than 46 days during the 91-day period beginning 45 days before the ex-dividend date. When counting the number of days the FSC held the stock, you may not count certain days during which the FSC's risk of loss was diminished. See section 246(c)(4) and Regulations section 1.246-5 for more details.

b. Dividends attributable to periods totaling more than 366 days that the corporation received on any share of preferred stock held for less than 91 days during the 181-day period that began 90 days before the ex-dividend date. When counting the number of days the FSC held the stock, you may not count certain days during which the FSC's risk of loss was diminished. See section 246(c)(4) and Regulations section 1.246-5 for more details. Preferred dividends attributable to periods totaling less than 367 days are subject to the 46-day holding period rule above.

c. Dividends on any share of stock to the extent the FSC is under an obligation (including a short sale) to make related payments with respect to positions in substantially similar or related property.

5. Any other taxable dividend income not properly reported above (including distributions under section 936(h)(4)).

If patronage dividends or per-unit retain allocations are included on line 11, identify the total of these amounts in a schedule attached to Form 1120-FSC.

Schedule G

Deductions Allocated or Apportioned to Foreign Trade Income Other Than Foreign Trade Income Reported on Schedule F

Limitations on Deductions

Section 263A uniform capitalization rules. The uniform capitalization rules of section 263A generally require FSCs to capitalize, or include in inventory, certain costs incurred in connection with:

Dividends and Dividends-Received Deduction Worksheet (See instructions that begin on page 9)	**(a)** Dividends received	**(b)** %	**(c)** Dividends-received deduction: **(a)** × **(b)**
1 Dividends from less-than-20%-owned domestic corporations that are subject to the 70% deduction (other than debt-financed stock)		70	
2 Dividends from 20%-or-more-owned domestic corporations that are subject to the 80% deduction (other than debt-financed stock)		80	
3 Dividends on debt-financed stock of domestic and foreign corporations (section 246A)		See Inst.	
4 Dividends on certain preferred stock of less-than-20%-owned public utilities .		42	
5 Dividends on certain preferred stock of 20%-or-more-owned public utilities .		48	
6 Dividends from less-than-20%-owned foreign corporations that are subject to the 70% deduction		70	
7 Dividends from 20%-or-more-owned foreign corporations that are subject to the 80% deduction		80	
8 **Total dividends-received deduction.** Add lines 1 through 7. See instructions for limitation. Enter here and on line 19b, Schedule B . . . . ▶			
9 Other dividends from foreign corporations not included on lines 3, 6, or 7 .			
10 Foreign dividend gross up (section 78)			
11 Other dividends			
12 **Total dividends.** Add lines 1 through 11. Enter here and on line 9, Schedule F ▶			

• Personal property (tangible and certain intangible property) acquired for resale.
• The production of real property and tangible personal property by a FSC for use in its trade or business or in an activity engaged in for profit.

Tangible personal property produced by a FSC includes a film, sound recording, videotape, book, or similar property.

FSCs subject to the section 263A uniform capitalization rules are required to capitalize:

1. Direct costs and
2. An allocable part of most indirect costs (including taxes) that (a) benefit the assets produced or acquired for resale or (b) are incurred by reason of the performance of production or resale activities.

For inventory, some of the indirect expenses that must be capitalized are:
• Administration expenses.
• Taxes.
• Depreciation.
• Insurance.
• Compensation paid to officers attributable to services.
• Rework labor.
• Contributions to pension, stock bonus, and certain profit-sharing, annuity, or deferred compensation plans.

Regulations section 1.263A-1(e)(3) specifies other indirect costs that relate to production or resale activities that must be capitalized and those that may be currently deductible.

Interest expense paid or incurred during the production period of designated property must be capitalized and is governed by special rules. For more details, see Regulations sections 1.263A-8 through 1.263A-15.

The costs required to be capitalized under section 263A are not deductible until the property (to which the costs relate) is sold, used, or otherwise disposed of by the FSC.

Exceptions. Section 263A does not apply to:
• Personal property acquired for resale if the FSC's average annual gross receipts for the 3 prior tax years were $10 million or less.
• Inventoriable items accounted for in the same manner as materials and supplies that are not incidental. See *Schedule A* on page 7 for details.

For more details on the uniform capitalization rules, see Regulations sections 1.263A-1 through 1.263A-3.

Transactions between related taxpayers. Generally, an accrual basis taxpayer may only deduct business expenses and interest owed to a related party in the year the payment is included in the income of the related party. See sections 163(e)(3), 163(j), and 267 for limitations on deductions for unpaid interest and expenses.

Golden parachute payments. A portion of the payments made by a FSC to key personnel that exceeds their usual compensation may not be deductible. This occurs when the FSC has an agreement (golden parachute) with these key employees to pay them these excess amounts if control of the FSC changes. See section 280G.

Line 1. Enter only foreign direct costs on lines 1a through 1e. See section 924(e) and Regulations sections 1.924(e)-1(a) through (e) for definitions and rules on direct activity costs related to foreign trade income.

Line 4. Depreciation. Include on line 4 depreciation and the cost of certain property that the FSC elected to expense under section 179. See Form 4562, Depreciation and Amortization, and its instructions.

Line 5. Salaries and wages. Enter the total salaries and wages paid for the tax year. Do not include salaries and wages deductible elsewhere on the return, such as amounts included in cost of goods sold, elective contributions to a section 401(k) cash or deferred arrangement, or amounts contributed under a salary reduction SEP agreement or a SIMPLE IRA plan.

Line 10. Compensation of officers. Enter deductible officers' compensation on line 10. Do not include compensation deductible elsewhere on the return, such as amounts included in cost of goods sold, elective contributions to a section 401(k) cash or deferred arrangement, or amounts contributed under a salary reduction SEP agreement or a SIMPLE IRA plan.

Line 11. Bad debts. Enter the total debts that became worthless in whole or in part during the tax year. A cash basis taxpayer may not claim a bad debt deduction unless the amount was previously included in income.

Line 14. Other deductions. Attach a schedule, listing by type and amount, all allowable deductions that are not deductible elsewhere on Form 1120-FSC. Enter the total on line 14.

Examples of other deductions include:
• Amortization (see Form 4562).
• Insurance premiums.
• Legal and professional fees.
• Supplies used and consumed in the business.
• Utilities.

Also see *Special rules* below for limits on certain other deductions.

Do not deduct:
• Fines or penalties paid to a government for violating any law.
• Any amount that is allocable to a class of exempt income. See section 265(b) for exceptions.

Special rules apply to the following expenses:

Travel, meals, and entertainment. Subject to limitations and restrictions discussed below, the FSC may deduct ordinary and necessary travel, meals, and entertainment expenses paid or incurred in its trade or business. Also, special rules apply to deductions for gifts, skybox rentals, luxury water travel, convention expenses, and entertainment tickets. See section 274 and Pub. 463, Travel, Entertainment, Gift, and Car Expenses, for more details.

Travel. The FSC may not deduct travel expenses of any individual accompanying a corporate officer or employee, including a spouse or dependent of the officer or employee, unless:
• That individual is an employee of the corporation and
• His or her travel is for a bona fide business purpose and would otherwise be deductible by that individual.

Meals and entertainment. Generally, the FSC may deduct only 50% of the amount otherwise allowable for meals and entertainment expenses paid or incurred in its trade or business. In addition (subject to exceptions under section 274(k)(2)):
• Meals must not be lavish or extravagant,
• A bona fide business discussion must occur during, immediately before, or immediately after the meal; and
• An employee of the FSC must be present at the meal.

See section 274(n)(3) for a special rule that applies to expenses for meals consumed by individuals subject to the hours of service limits of the Department of Transportation.

Membership dues. The FSC may deduct amounts paid or incurred for membership dues in civic or public service organizations, professional organizations (such as bar and medical associations), business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards. However, no deduction is allowed if a principal purpose of the organization is to entertain, or provide entertainment facilities for, members or their guests. In addition, FSCs may not deduct membership dues in any club organized for business, pleasure, recreation, or other social purpose. This includes country clubs, golf and athletic clubs, airline and hotel clubs, and clubs operated to provide meals under conditions favorable to business discussion.

Entertainment facilities. The FSC may not deduct an expense paid or incurred for a facility (such as a yacht or hunting lodge) used for an activity usually considered entertainment, amusement, or recreation.

Amounts treated as compensation. Generally, the FSC may be able to deduct otherwise nondeductible entertainment, amusement, or recreation expenses if the amounts are treated as compensation to the recipient and reported on Form W-2 for an employee or on Form 1099-MISC or Form 1042-S for an independent contractor.

However, if the recipient is an officer, director, or beneficial owner (directly or indirectly) of more than 10% of any class of stock, the deductible expense is limited. See section 274(e)(2) and Notice 2005-45, 2005-24 I.R.B. 1228.

Schedule J

Tax Computation

Lines 1 and 2

Members of a controlled group. A member of a controlled group, as defined in section 927(d)(4), must check the box on line 1 and complete lines 2a and 2b of Schedule J, Form 1120-FSC.

Line 2a. Members of a controlled group are entitled to one $50,000, one $25,000, and one $9,925,000 taxable income bracket amount (in that order) on line 2a.

When a controlled group adopts or later amends an apportionment plan, each member must attach to its tax return a copy of its consent to this plan. The copy (or an attached statement) must show the part of the amount in each taxable income bracket apportioned to that member. See Regulations section 1.1561-3(b) for other requirements and for the time and manner of making the consent.

Unequal apportionment plan. Members of a controlled group may elect an unequal apportionment plan and divide the taxable income brackets as they want. There is no need for consistency among taxable income brackets. Any member may be entitled to all, some, or none of the taxable income bracket. However, the total amount for all members may not be more than the total amount in each taxable income bracket.

Equal apportionment plan. If no apportionment plan is adopted, members of a controlled group must divide the amount in each taxable income bracket equally among themselves. For example, Controlled Group AB consists of Corporation A and Corporation B. They do not elect an apportionment plan. Therefore, each corporation is entitled to:

- $25,000 (one-half of $50,000) on line 2a(1),
- $12,500 (one-half of $25,000) on line 2a(2), and
- $4,962,500 (one-half of $9,925,000) on line 2a(3).

Line 2b. Members of a controlled group are treated as one group to figure the applicability of the additional 5% tax and the additional 3% tax. If an additional tax applies, each member will pay that tax based on the part of the amount used in each taxable income bracket to reduce that member's tax. See section 1561(a). If an additional tax applies, attach a schedule showing the taxable income of the entire group and how the FSC figured its share of the additional tax.

Line 2b(1). Enter the FSC's share of the additional 5% tax on line 2b(1).

Line 2b(2). Enter the FSC's share of the additional 3% tax on line 2b(2).

Line 3

Most FSCs should figure their tax using the Tax Rate Schedule below. Exceptions apply to members of a controlled group (see worksheet below) and qualified personal service corporations (see instructions below).

Members of a controlled group must attach to Form 1120-FSC a statement showing the computation of the tax entered on line 3.

Tax Rate Schedule

If taxable income (Schedule B, line 20) is:

Over—	*But not over—*	*Tax is:*	*Of the amount over—*
$0	$50,000	**15%**	$0
50,000	75,000	**$ 7,500 + 25%**	50,000
75,000	100,000	**13,750 + 34%**	75,000
100,000	335,000	**22,250 + 39%**	100,000
335,000	10,000,000	**113,900 + 34%**	335,000
10,000,000	15,000,000	**3,400,000 + 35%**	10,000,000
15,000,000	18,333,333	**5,150,000 + 38%**	15,000,000
18,333,333	- - - - -	**35%**	0

Qualified personal service corporations. A qualified personal service corporation is taxed at a flat rate of 35% on its taxable income. A FSC is a qualified personal service corporation if it meets both of the following tests:

- Substantially all of the FSC's activities involve the performance of services in the fields of engineering, architecture, or management consulting and
- At least 95% of the corporation's stock, by value, is owned, directly or indirectly, by (1) employees performing the services, (2) retired employees who had performed the services listed above, (3) any estate of the employee or retiree described above, or (4) any person who acquired the stock of the FSC as a result of the death of an employee or retiree (but only for the 2-year period beginning on the date of the employee's or retiree's death).

Tax Computation Worksheet for Members of a Controlled Group
(keep for your records)

Note: *Each member of a controlled group (except a qualified personal service corporation) must compute the tax using this worksheet.*

1.	Enter taxable income (Schedule B, line 20)	**1.** ______
2.	Enter line 1 or the FSC's share of the $50,000 taxable income bracket, whichever is less	**2.** ______
3.	Subtract line 2 from line 1	**3.** ______
4.	Enter line 3 or the FSC's share of the $25,000 taxable income bracket, whichever is less	**4.** ______
5.	Subtract line 4 from line 3	**5.** ______
6.	Enter line 5 or the FSC's share of the $9,925,000 taxable income bracket, whichever is less	**6.** ______
7.	Subtract line 6 from line 5	**7.** ______
8.	Multiply line 2 by 15%	**8.** ______
9.	Multiply line 4 by 25%	**9.** ______
10.	Multiply line 6 by 34%	**10.** ______
11.	Multiply line 7 by 35%	**11.** ______
12.	If the taxable income of the controlled group exceeds $100,000, enter this member's share of the smaller of: 5% of the taxable income in excess of $100,000, or $11,750 (see the instructions for Schedule J, line 2b)	**12.** ______
13.	If the taxable income of the controlled group exceeds $15 million, enter this member's share of the smaller of: 3% of the taxable income in excess of $15 million, or $100,000 (see the instructions for Schedule J, line 2b)	**13.** ______
14.	**Total.** Add lines 8 through 13. Enter here and on Schedule J, line 3	**14.** ______

Note. If the FSC meets these tests, check the box on line 3, Schedule J, Form 1120-FSC.

Line 4

Alternative minimum tax (AMT). Unless the FSC is treated as a small corporation exempt from the AMT, it may owe the AMT if it has any of the adjustments and tax preference items listed on Form 4626, Alternative Minimum Tax – Corporations. The FSC must file Form 4626 if its taxable income (or loss) combined with these adjustments and tax preference items is more than the smaller of $40,000 or the FSC's allowable exemption amount (from Form 4626). For this purpose, taxable income does not include the NOL deduction. See Form 4626 for details.

Exception for small corporations. A FSC is treated as a small corporation exempt from the AMT for its tax year beginning in 2005 if:

1. It was treated as a small corporation exempt from the AMT for all prior tax years beginning after 1997 and
2. Its average annual gross receipts for the 3-tax-year period (or portion thereof during which the FSC was in existence) ending before its tax year beginning in 2005 did not exceed $7.5 million.

Line 6

Foreign tax credit. Generally, a FSC may not claim a foreign tax credit. It may, however, claim a foreign tax credit for any foreign taxes imposed on foreign source taxable nonforeign trade income (Schedule F, Part II) that is treated as effectively connected with a U.S. trade or business. See Temporary Regulations section 1.921-3T(d)(2) for more details.

Line 7

Total tax

Interest on tax deferred under the installment method for certain nondealer installment obligations. If an obligation arising from the disposition of property to which section 453A applies is outstanding at the close of the year, the FSC must include the interest due under section 453A(c) in the amount on line 7, Schedule J. On the dotted line to the left of line 7, Schedule J, write "Section 453A(c) interest" and the amount. Attach a schedule showing the computation.

Schedule L

Balance Sheets per Books

The balance sheet should agree with the FSC's books and records. Include certificates of deposit as cash on line 1, Schedule L.

Line 5. Tax-exempt securities. Include on this line:

- State and local government obligations, the interest on which is excludible from gross income under section 103(a) and
- Stock in a mutual fund or other regulated investment company that distributed exempt-interest dividends during the tax year of the FSC.

Line 27. Adjustments to shareholders' equity. Some examples of adjustments to report on this line include:

- Foreign currency translation adjustments.
- The excess of additional pension liability over unrecognized prior service cost.

If the total adjustment to be entered on line 27 is a negative amount, enter the amount in parentheses.

Schedule M-1

Reconciliation of Income (Loss) per Books With Income per Return

Line 5c. Travel and entertainment. Include on line 5c any of the following:

- Meal and entertainment expenses not deductible under section 274(n).
- Expenses for the use of an entertainment facility.
- The part of business gifts over $25.
- Expenses of an individual over $2,000, which are allocable to conventions on cruise ships.
- Employee achievement awards over $400.
- The cost of entertainment tickets over face value (also subject to 50% limit under section 274(n)).
- The cost of skyboxes over the face value of nonluxury box seat tickets.
- The part of luxury water travel expenses not deductible under section 274(m).
- Expenses for travel as a form of education.
- Other nondeductible travel and entertainment expenses.

For more information, see Pub. 542.

Line 7a. Tax-exempt interest. Report any tax-exempt interest received or accrued, including any exempt-interest dividends received as a shareholder in a mutual fund or other regulated investment company. Also report this amount on line 2, *Additional Information,* on page 2 of the form.

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax. Section 6109 requires return preparers to provide their identifying numbers on the return.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form and related schedule will vary depending on individual circumstances. The estimated average times are:

Form	Recordkeeping	Learning about the law or the form	Preparing and sending the form to the IRS
1120-FSC	94 hr., 13 min.	19 hr., 45 min.	38 hr., 56 min.
Sch. P (1120-FSC)	9 hr., 48 min.	1 hr., 29 min.	1 hr., 43 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form and related schedule simpler, we would be happy to hear from you. You may write to Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6406, Washington, DC 20224. Do not send the tax form to this office. Instead, see *Where To File* on page 4.

Forms 1120-FSC

Principal Business Activity Codes

This list of principal business activities and their associated codes is designed to classify an enterprise by the type of activity in which it is engaged to facilitate the administration of the Internal Revenue Code. These principal business activity codes are based on the North American Industry Classification System.

Using the list of activities and codes below, determine from which activity the FSC derives the largest percentage of its “total receipts.” Total receipts is defined as the sum of the foreign trading gross receipts on Form 1120-FSC, page 3, Schedule B, line 6a, and the total income on page 4, Schedule F, lines 4 and 17. If the FSC’s largest percentage of its total receipts is derived from the wholesale trading of durable goods, the FSC must use one of the corresponding codes from the list below (423100-423990).

Once the principal business activity is determined, entries must be made on Form 1120-FSC, page 2, Additional Information, lines 1a, 1b, and 1c. For the business activity code number, enter the six digit code selected from the list below. On line 1b, enter a brief description of the FSC’s business activity. Finally, enter a description of the principal product or service of the FSC on line 1c.

Wholesale Trade

Merchant Wholesalers, Durable Goods

Code	
423100	Motor Vehicle & Motor Vehicle Parts & Supplies
423200	Furniture & Home Furnishings
423300	Lumber & Other Construction Materials
423400	Professional & Commercial Equipment & Supplies
423500	Metal & Mineral (except Petroleum)
423600	Electrical & Electronic Goods
423700	Hardware, & Plumbing & Heating Equipment & Supplies
423800	Machinery, Equipment, & Supplies
423910	Sporting & Recreational Goods & Supplies
423920	Toy & Hobby Goods & Supplies
423930	Recyclable Materials
423940	Jewelry, Watch, Precious Stone, & Precious Metals
423990	Other Miscellaneous Durable Goods

Merchant Wholesalers, Nondurable Goods

Code	
424100	Paper & Paper Products
424210	Drugs & Druggists’ Sundries
424300	Apparel, Piece Goods, & Notions
424400	Grocery & Related Products
424500	Farm Product Raw Materials
424600	Chemical & Allied Products
424700	Petroleum & Petroleum Products
424800	Beer, Wine, & Distilled Alcoholic Beverages
424910	Farm Supplies
424920	Book, Periodical, & Newspapers
424930	Flower, Nursery Stock, & Florists’ Supplies
424940	Tobacco & Tobacco Products
424950	Paint, Varnish, & Supplies
424990	Other Miscellaneous Nondurable Goods

Wholesale Electronic Markets and Agents and Brokers

Code	
425110	Business to Business Electronic Markets
425120	Wholesale Trade Agents & Brokers

Information

Publishing Industries (except Internet)

Code	
511110	Newspaper Publishers
511120	Periodical Publishers
511130	Book Publishers
511140	Directory & Mailing List Publishers
511190	Other Publishers
511210	Software Publishers

Motion Picture and Sound Recording Industries

Code	
512100	Motion Picture & Video Industries (except video rental)
512200	Sound Recording Industries

Broadcasting (except Internet)

Code	
515100	Radio & Television Broadcasting
515210	Cable & Other Subscription Programming

Internet Publishing and Broadcasting

Code	
516110	Internet Publishing & Broadcasting

Telecommunications

Code	
517000	Telecommunications (including paging, cellular, satellite, cable & other program distribution, resellers, & other telecommunications)

Internet Service Providers, Web Search Portals, and Data Processing Services

Code	
518111	Internet Service Providers
518112	Web Search Portals
518210	Data Processing, Hosting, & Related Services

Other Information Services

Code	
519100	Other Information Services (including news syndicates & libraries)

Rental and Leasing

Rental and Leasing Services

Code	
532100	Automotive Equipment Rental & Leasing
532210	Consumer Electronics & Appliances Rental
532220	Formal Wear & Costume Rental
532230	Video Tape & Disc Rental
532290	Other Consumer Goods Rental
532310	General Rental Centers
532400	Commercial & Industrial Machinery & Equipment Rental & Leasing

Professional Services

Architectural, Engineering, and Related Services

Code	
541310	Architectural Services
541320	Landscape Architecture Services
541330	Engineering Services
541340	Drafting Services
541350	Building Inspection Services
541360	Geophysical Surveying & Mapping Services
541370	Surveying & Mapping (except Geophysical) Services
541380	Testing Laboratories

Other Professional Services

Code	
541600	Management Consulting Services