Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I International Practice Service Concept Unit

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Unit Name	Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation

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FTC Management	Accessing FSI	Interest Expense Allocation/Apportionment	N/A

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General Overview

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation

The United States taxes a U.S. corporation's income on a worldwide basis. To prevent double taxation, U.S. taxpayers are allowed a credit for foreign income taxes paid. However, the amount of Foreign Tax Credit (FTC) a taxpayer can utilize each year is based upon the ratio of foreign source taxable income (FSTI) to worldwide taxable income. Thus, FTC is limited to the US tax on foreign source taxable income (FSTI). This is commonly known as the IRC 904 FTC Limitation:

$$\frac{\text{FSTI}}{\text{WWTI}} \quad \text{X} \quad \text{U.S. Tax Liability} \quad = \quad \text{IRC 904 FTC Limit}$$

A taxpayer who is in an excess credit position often strategically plan to increase the IRC 904 FTC limitation by maximizing the portion of their worldwide income that is FSTI. One way to maximize net FSTI is by minimizing interest expense allocated/apportioned to FSI. The Regulations provide numerous rules for allocating and apportioning interest expenses. This Concept Building Block will provide an overview of the interest expense allocation and apportionment rules.

The Regulations require that the allocation and apportionment of interest expense be made on the basis of assets (the asset method) and not on gross income. Under the asset method, interest expense is apportioned between (or among) statutory and residual groupings of gross income in proportion to the average total values of assets within each such grouping for the taxable year. For purposes of determining the FTC limitation(s), the statutory groupings are the IRC 904 separate categories of FSI and the residual grouping is U.S. source income. The FTC limitation must be calculated separately for each category of FSI. Examples of IRC 904 separate categories include General Category Income, Passive Category Income, Income resourced by Treaty and Sanctioned Country Income. Assets are assigned to a grouping based on the source and character of the income generated by the specific asset.

General Overview (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation

The FSTI in each separate category is determined by assigning gross income to the proper category and then allocating and apportioning expenses to each category.

The apportionment to the separate categories is done using the following formula:

$$\text{Interest Expense} \times \frac{\text{Assets in separate category}}{\text{Total assets}} = \begin{array}{c}\text{Interest expense}\\ \text{apportioned to FSI}\\ \text{separate category}\end{array}$$

For this purpose, taxpayers may elect to value assets based on their fair market value (FMV), tax book value, or alternative tax book value per Treas. Reg. 1.861-8T(c)(2) and 1.861-9(i).

The three conceptual elements below will be discussed in greater detail in separate units:

- FMV Method
- Asset Categories (planned unit)
- Exceptions to the Asset Method Rule (planned unit)

Detailed Explanation of the Concept

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation		
Analysis	**Resources**	**6103 Protected Resources**
<u>Interest Expense Defined</u> ▪ All interest expense deducted under IRC 163 must be allocated and apportioned. Expenses deductible under IRC 163 include (See Treas. Reg. 1.861-9T(a)&(b)): – Original issue discount – Imputed interest – Bond premium – Cost for use of funds – Interest Equivalents. ▪ Non-deductible interest is not allocated and apportioned, which includes (See Treas. Reg. 1.861-9T(c)): – Interest on tax exempt bonds under IRC 265 – Certain interest accrued to related foreign entities – IRC 263A capitalized interest – IRC163(d) & 469 suspended interest deductions. Interest Netting: ▪ Interest netting is not allowed. Interest income cannot offset interest expense. Gross interest expense must be allocated and apportioned. See Bowater, Inc. and Subsidiaries v. C.I.R. 108 F.3d 12, cert. denied.		

Detailed Explanation of the Concept (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation		
Analysis	**Resources**	**6103 Protected Resources**
<u>Asset Method: The Concept</u> ▪ The FTC limitation would be overstated if a US company had all its debt in the US and used the cash as all equity to its CFCs. This would result in reduced US taxable income and overstated FSI. ▪ Money is fungible – all activities and assets require funds. The fungibility rule per Reg. 1.861-9T(a) states in part: "all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds." The fungibility concept implies that interest expense relates more closely to the amount of capital used or invested in a business rather than to the gross income generated from it. ▪ Under this concept, effectively all borrowings of the US company are deemed to support all the assets owned, both domestic and foreign. Interest deductions generally are attributable to all of a taxpayer's activities and property ▪ Therefore interest deductions are allocated to all gross income, and apportioned on the basis of assets ▪ Interest expense is apportioned according to the average total value of the assets within the statutory (foreign) and residual (domestic) groupings ▪ The asset based apportionment attempts to make sure that FSTI is not overstated for purposes of computing the FTC limitation by apportioning this domestic interest expense against the FSI generated by the foreign assets. ▪ See Treas. Reg. 1-861-9T(g)		

Detailed Explanation of the Concept (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation		
Analysis	**Resources**	**6103 Protected Resources**
Asset Method: Three Step process ▪ Determine average value (tax book or fair market) of assets - "valuation step": Use one of following methods: – Tax book value (adjusted basis for tax purposes) or alternative tax book value (ATBV) – Fair market value (FMV) - elective method ▪ Characterize assets per the source and character of income (statutory – foreign grouping) they generate, have generated, or may be expected to generate – "characterization step" ▪ Apportion interest expense based upon percentage of assets in each grouping - "apportionment step"		

Detailed Explanation of the Concept (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation		
Analysis	**Resources**	**6103 Protected Resources**
<u>Asset Method: Valuation step</u> ▪ Generally, use the average of beginning and end of year values ▪ Where a substantial distortion would result (e.g., major disposition), the taxpayer must use a method that more clearly reflects the average value weighted to reflect the time such assets are held ▪ See Treas. Reg. 1.861-9T(g)(2)(i) ▪ Partnerships – 10% interest or more: A corporate partner whose interest in the partnership is 10 percent or more, apportions its own interest expense as well as its distributive share of the partnership's interest expense by reference to all the partner's assets, including the partner's pro rata share of the assets of the partnership. See Treas. Reg. 1.861-9T(e)(2). – Less than 10% interest: A corporate partner whose interest in the partnership is less than 10% directly allocates its distributive share of the partnership's interest expense against its distributive share of partnership gross income. For purposes of apportioning other interest expense of the partner on an asset basis, the partner's interest in the partnership, and not the partner's pro rata share of the partnership assets, is considered to be the relevant asset. See Treas. Reg. 1.861-9T(e)(4). ▪ Exclusion of Tax-Exempt Assets – IRC 864(e)(3) provides that tax exempt assets are excluded from interest apportionment computations		

Detailed Explanation of the Concept (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation		
Analysis	**Resources**	**6103 Protected Resources**
<u>Tax Book Value Method</u> ▪ Under the tax book value method, assets are valued using the tax basis in those assets ▪ A taxpayer may elect to apply the alternative tax book value method: Includes special rules for tangible property that is depreciated under IRC 168. Treas. Reg. 1.861-9(i). ▪ Basis Bump-up: Basis of stock in non-affiliated 10%-owned corporation (e.g., CFC) must be adjusted for E&P changes – Applicable only if tax book value method is used – The adjusted basis of the stock must be increased or decreased by T/P's pro rata share of E&P accumulated since acquisition of non-affiliated corp. – E&P of a first-tier 10%-owned corporation includes a pro rata share of the earnings and profits (or deficit) of each succeeding lower-tier 10%-owned corporation – Applies to any non-affiliated corp. directly or indirectly 10%-owned by U.S. corporation – Previously Taxed Income (PTI) is excluded from basis of the CFC, but it is added back in the E & P bump-up to stock basis under Treas. Reg. 1.861-12T(c)(2)(i)(B) and so is included in the tax book value of the CFC stock		

Detailed Explanation of the Concept (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation		
Analysis	**Resources**	**6103 Protected Resources**
<u>Fair Market Value Method</u> ▪ Elective ▪ Must establish the FMV to the satisfaction of the Commissioner ▪ Cannot change from FMV method without permission from the Commissioner ▪ See Treas. Reg. 1.861-8T(c)(2) ▪ See Process Practice Unit on FMV Method of Interest Expense and Allocation		
<u>Characterization of Assets: Second step</u> ▪ Assets must be categorized into one of three types (See Treas. Reg. 1.861-9T(g)(3)): – Single category assets: income generated in 1 grouping (e.g., U.S. Treasury bills) – Multiple category assets: income generated in 2 or more groupings (e.g., U.S. plant whose products are sold outside of the U.S.)- attribute based on proportion of gross income generated. – Assets without directly identifiable yield (e.g., assets used in general and administrative functions) – disregarded. ▪ Details of the characterization of assets is discussed in the Process Practice Unit on Asset Characterization.		

Detailed Explanation of the Concept (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation		
Analysis	**Resources**	**6103 Protected Resources**
Characterization of Assets: Second step ▪ Assets must be categorized into one of three types (See Treas. Reg. 1.861-9T(g)(3)): – Single category assets: income generated in 1 grouping (e.g., U.S. Treasury bills) – Multiple category assets: income generated in 2 or more groupings (e.g., U.S. plant whose products are sold outside of the U.S.)- attribute based on proportion of gross income generated. – Assets without directly identifiable yield (e.g., assets used in general and administrative functions) – disregarded. ▪ Details of the characterization of assets is discussed in the Process Practice Unit on Asset Characterization.		

Detailed Explanation of the Concept (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation		
Analysis	**Resources**	**6103 Protected Resources**
Exceptions to the Asset Rule ▪ Exceptions to the asset method rule allow interest expense to be directly allocated to the income generated by certain assets ▪ When an exception is applicable, the assets relating to the loan are removed from the allocation formula used for the remaining interest expense. Exceptions to the asset method rule allow interest expense to be directly allocated to the income generated by certain assets ▪ Three Exceptions per Treas. Reg. 1.861-10T: 1. Nonrecourse debt 2. Integrated Financial Transactions 3. CFC Netting ▪ See Form 1118, Sch. H, part II, line 1b-1c for any direct allocation of interest expense		

Detailed Explanation of the Concept (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation		
Analysis	**Resources**	**6103 Protected Resources**
<u>Other Items</u> ▪ Overall Foreign Loss (OFL) Rules: The asset based apportionment attempts to make sure that FSTI is not overstated for purposes of computing the FTC limitation by apportioning the domestic interest expense against the FSI generated by the foreign assets, regardless of whether dividends are actually paid to the US company by the CFCs (which would be foreign sourced income). Agents should be aware that this apportionment of interest expense annually potentially generates OFLs if the US company defers US tax on the earnings of its CFCs by not repatriating the E&P. Due to the interest expenses allocated to FSI, this may create an OFL. The OFL recapture mechanism insures that the apportionment of interest expense eventually reduces the FTC limitation (since FSI in later years will be re-characterized as domestic sourced for 904 limitation purposes) to prevent over crediting of FTCs. Without the OFL mechanism a US company would "time" its dividends to produce a significant amount of dividend income every few years with only the apportioned interest expense of that year reducing FSI.		

Detailed Explanation of the Concept (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation		
Analysis	**Resources**	**6103 Protected Resources**
Other Items, Cont'd Election to Allocate and Apportion on a Worldwide Basis (For Informational Purposes Only)- Recap of Notice 2008-54 Issued June 30, 2008 Requesting Comments: ▪ IRC 864(f) was added to the Code by the American Jobs Creation Act of 2004, P.L. 108-357, 118 Stat. 1418 (October 22, 2004) ▪ IRC 864(f)(6) permits taxpayers to make a one-time election to allocate and apportion interest expense on a worldwide affiliated group basis. ▪ In general, if the election is made, the domestic members of the worldwide affiliated group determine their foreign source taxable income by allocating and apportioning their interest expense to such income in an amount equal to the excess (if any) of the worldwide affiliated group's total interest expense multiplied by a fraction with a numerator consisting of the worldwide affiliated group's foreign assets and a denominator consisting of the worldwide affiliated group's total assets, over the amount of interest expense of all foreign corporations that are members of the worldwide affiliated group that would have been allocated and apportioned to foreign source income of such foreign members of the worldwide affiliated group if the rules of IRC 864(f) were applied to a group consisting solely of all such foreign members.		

Detailed Explanation of the Concept (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation		
Analysis	**Resources**	**6103 Protected Resources**
Other Items, Cont'd Election to Allocate and Apportion on a Worldwide Basis (For Informational Purposes Only)- Recap of Notice 2008-54 Issued June 30, 2008 Requesting Comments: ▪ IRC 864(f)(5) permits a one-time election to expand the financial institution group of a worldwide affiliated group that has made the election under IRC 864(f) to allocate interest expense on a worldwide affiliated group basis. The elections under IRC 864(f) may be made only for the first taxable year beginning after December 31, 2008, in which the taxpayer is eligible to make the election, and are revocable only with the consent of the Secretary. ▪ The effective date of IRC 864(f) has been continually postponed and is currently set for tax years beginning after December 31, 2020.		

Examples of the Concept

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation

Examples

Asset Method: Basic Example #1

- Domestic Corp (DC) has interest expense of 150.
- Adjusted basis of X's assets - $3,600
  - $3,000 generates U.S. income
  - $600 generates foreign passive income
- DC uses tax book method
- Conclusion:
  - Apportion to U.S. source: 150 x 3000/3600 = 125
  - Apportion to foreign passive: 150 x 600/3600 = 25

Asset Method: Basic Example #2

- Domestic Corp (DC) has interest expense of 150. Total FMV of assets - 4,000
  - 3,200 generates U.S. income
  - 800 generates foreign passive income
- DC uses FMV method
- Conclusion:
  - Apportion to U.S. source: 150 x 3,200/4,000 = 120
  - Apportion to foreign passive: 150 x 800/4,000 = 30

Examples of the Concept (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation

Examples

Tax Book Value Method: Basis bump-up Example #1:

- Taxpayer purchases 10% interest in ABC Corp (foreign) for $100.
- Since acquisition, ABC Corp has E&P of 200. Taxpayer's basis has to be increased by 10% of $200, or $20.
- See Treas. Reg. 1.861-12T(c)(2)(i)

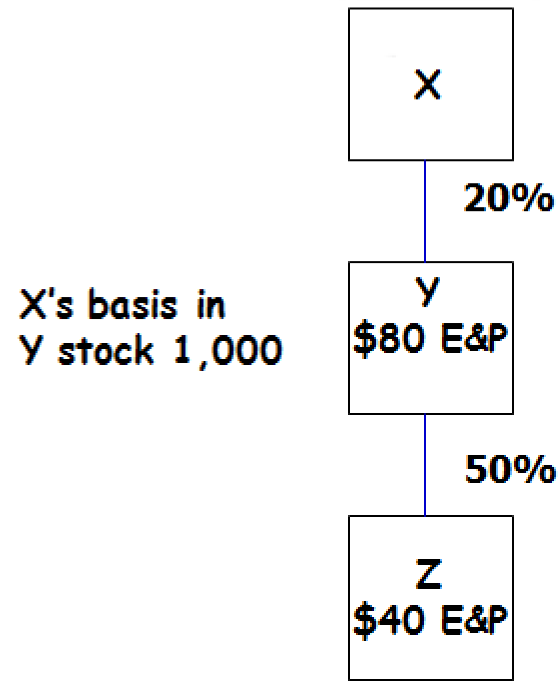
Examples of the Concept (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation

Examples

<u>Tax Book Value Method: Basis bump-up Example 2:</u>

- See Treasury Reg. 1.861-12T(c)(2)(vi)
- Compute X's tax book basis of Y stock
- X uses the tax book value method of apportionment,
- X owns 20 percent of the stock of Y
- Y owns 50 percent of the stock of Z.
- X's basis in the Y stock is $1,000.
- The undistributed earnings and profits of Y and Z at year-end attributable to X's period of ownership are $80 and $40, respectively
- Because Y owns half of the Z stock, X's pro rata share of Z's earnings and profits attributable to X's Y stock is $4.
- X's pro rata share of Y's earnings attributable to X's Y stock is $16.
- For purposes of apportionment, the tax book value of the Y stock is $1,020.



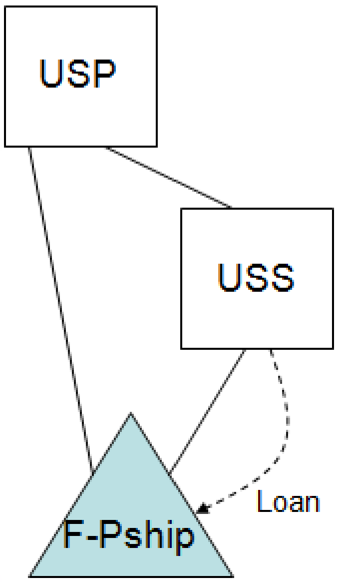
Examples of the Concept (cont'd)

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation

Examples

Issues: Partnership

- Partnerships can be used in a number of ways to increase FSI due to the flexibility of the partnership tax law.
- Example:
  - USP and USS are members of a consolidated group and together own 100% of FPS (shown on diagram as "F-Pship").
  - FPS is engaged in foreign business.
  - USS loans money to FPS.
  - Interest income paid by FPS is 100% foreign source income. IRC 861(a)(1)
  - Interest expense flows up to USP and USS and is apportioned using the consolidated group apportionment fractions. Treas. Reg. 1.861-9T(e).
- The loan to the partnership does not increase worldwide income of the consolidated group, but it affects the proportion of U.S. source and foreign source income. This is because the interest income is 100% foreign source but the offsetting interest expense is deducted against both foreign source and U.S. income according to the apportionment fractions of the consolidated group.
- The impact of this structure on FSI can be multiplied through the use of a series of loans down a chain of tiered foreign partnerships.
- End Result: Assuming proper business purpose, result is supported under the current regulations (as is converse result if borrower is a US partnership).



Training and Additional Resources

Overview – Interest Expense Allocation/Apportionment in Calculation of the FTC Limitation		
Type of Resource	**Description(s) and/or Instructions for Accessing**	**References**
CENTRA sessions	▪ IBC Allocation & Apportionment of Interest Expense Reg 1.861 (KVL608729)	
Podcasts / Videos	▪ FY 2011 International CPE	
Other Training Materials	▪ Training - International Issues Phase II, Module D - Allocation and Apportionment of Deductions	
White Papers / Guidance	▪ IRM 4.61 LMSB International Program Audit Guidelines	

Glossary of Terms and Acronyms

Acronym	Definition
CFC	Controlled Foreign Corporation
ETR	Effective Tax Rate
FMV	Fair Market Value
FSI	Foreign Source Income
FSTI	Foreign Source Taxable Income
FTC	Foreign Tax Credit
OFL	Overall Foreign Loss
PTI	Previously Taxed Income
USP	United States Parent