Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I International Practice Service Concept Unit

IPS Level	Number	Title	UIL Code	Number
Shelf	N/A	Business Outbound	–	–
Book	3	FTC Management	**Level 1 UIL**	9413
Chapter	3.3	Accessing FSI	**Level 2 UIL**	9413.03
Section	3.3.7	Allocation and Apportionment of Deductions	**Level 3 UIL**	9413.03-04
Subsection	N/A	N/A	–	–

Unit Name	Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation

Document Control Number (DCN)	FTM/C/03_03_07-01
Date of Last Update	03/23/2017

Table of Contents

(View this PowerPoint in “Presentation View” to click on the links below)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 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/accrued. 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 (WWTI). Thus, the FTC is limited to the U.S. tax on FSTI. This is commonly known as the IRC 904 FTC Limitation:

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

A taxpayer who is in an excess credit position (i.e. unable to use all their foreign tax credits), or close to the FTC limitation, would like 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 expenses allocated/apportioned to FSTI. The Regulations provide numerous rules for allocating and apportioning expenses. This Concept Unit will provide an overview of the rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively as "deductions") of the taxpayer in calculation of the FTC limitation. Deductions that have specific treatment under the Regulations are not covered in this Practice Unit and may be found in separate completed or forthcoming Practice Units, e.g. *Asset Valuation using the FMV Method for Interest Expense Allocation to calculate FTC Limitation* FTC/9413.03-02_05(2014) and *How to Allocate and Apportion Research and Experimental (R&E) Expenses* FTM/9413.03_04(2014).

Relevant Key Factors

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
Key Factors
Learning the Lingo ▪ The rules related to the allocation and apportionment of deductions are found at Treas. Reg. 1.861-8 *et. seq.* A person reading these Regulations for the first time will be confronted with a number of words that are used repeatedly throughout the Regulations as terms of art. A working knowledge of the Regulations is possible only after a comfort level with this terminology is achieved. To better explain both the Regulations and the general concepts of this Concept Unit, the following terms used in the Regulations will be discussed: − operative sections − statutory grouping − residual grouping − allocation − apportionment

Detailed Explanation of the Concept

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
The allocation and apportionment regulations are used to help calculate foreign source taxable income for the foreign tax credit limitation. These same regulations also are used or “operative” to allocate and apportion deductions for other sections of the Code.

Analysis	Resources
Operative sections. ▪ The Regulations provide that allocation and apportionment rules apply in determining taxable income of the taxpayer from specific sources and activities under many sections of the Code, referred to as “operative sections.” The operative sections include, among others, overall limitation to the foreign tax credit, calculation of effectively connected income, foreign base company income, and domestic production activities income. The Regulations provide that where more than one operative section applies, it may be necessary for the taxpayer to apply the allocation and apportionment rules separately for each applicable operative section. In such a case, the taxpayer is required to use the same method of allocation and the same principles of apportionment for all operative sections. For example, if, in a taxable year, a taxpayer has both a FTC and a IRC 199 manufacturing deduction, the taxpayer will need to allocate and apportion expenses to both FSTI and to domestic production gross receipts. The taxpayer will want to maximize both FSTI and domestic production gross receipts. However, the taxpayer must use the same method of allocation and the same principles of apportionment for purposes of both operative sections.	▪ Treas. Reg. 1.861-8(f)(1) and (2)

Detailed Explanation of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
Deductions on the U.S. return are allocated/apportioned to gross income in the statutory and residual groupings.

Analysis	Resources
Statutory grouping ▪ The statutory grouping relates to the operative sections of the Code and means the gross income from a specific source or activity which must first be determined to arrive at taxable income from such specific source or activity under an operative section. When calculating the IRC 904 FTC Limitation, the statutory grouping will be foreign source taxable income. Residual grouping ▪ The residual grouping is simply what remains after the statutory grouping is taken into account. When calculating the IRC 904 FTC Limitation, the residual grouping will be U.S. source income. To continue with the earlier example of FTC and the IRC 199 domestic production deduction, a taxpayer will have a statutory grouping for each of these operative sections. Not only will the statutory grouping of income for these two operative sections be different, the residual grouping for each of these operative sections will thus also be different—U.S. source income for FTC and non-domestic production deduction income for IRC 199. What about foreign tax credit separate categories of income? ▪ Gross income in each separate category of income under Treas. Reg. 1.904-4(m) will be considered a separate statutory grouping. As a result, a taxpayer with both foreign passive and general category income will have two statutory groupings.	▪ Treas. Reg. 1.861-8(a)(4) ▪ Treas. Reg. 1.861-8T(c)(1) ▪ IRC 904(d) ▪ IRC 954(c) ▪ Treas. Reg. 1.861-8T(c)(1) ▪ Treas. Reg. 1.904-4(m)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
The allocation and apportionment of deductions is a two-step process.

Analysis	Resources
A two-step process ▪ The allocation and apportionment of expenses for foreign tax credit sourcing purposes is a two-step process. A taxpayer first allocates a deduction to a class of gross income and then apportions such expense, if necessary, between the statutory grouping(s) (i.e. foreign general and passive limitation income) and residual grouping (i.e. U.S. source income). An examiner should keep in mind the purpose of such allocation and apportionment is to arrive at the IRC 904 FTC Limitation as found on the Form 1118. Such allocation and apportionment does not change taxpayer's deductions on the Form 1120. There are special rules that exist for allocation and apportionment of interest, R&E, state and local income tax, and stewardship expenses.	▪ Treas. Reg. 1.861-8(a)(2)

Detailed Explanation of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
An introduction to the concept of the allocation of deductions.

Analysis	Resources
Allocation ▪ A taxpayer is required to allocate deductions to a class of gross income and then, if necessary, to make the determination required by the operative section of the Code, to apportion deductions within the class of gross income between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income. All deductions of the taxpayer must be so allocated and apportioned, except for deductions, if any, which are not definitely related to gross income. Deductions which are not definitely related to gross income must be allocated and ratably apportioned to all gross income. As further detailed below, allocations and apportionments are made on the basis of the factual relationship of deductions to gross income.	▪ Treas. Reg. 1.861-8(b)(1) ▪ Treas. Reg. 1.861-8(b)(5)

Detailed Explanation of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
Deductions are allocated when definitely related to a class of gross income.

Analysis	Resources
Allocate deductions that are definitely related to a class of gross income. ▪ A deduction is allocated by first determining, with respect to each deduction, the "class of gross income" to which that deduction is "definitely related" and then allocating (attributing, matching, etc.) the deduction to that class of gross income. The criteria or standard used for determining whether a deduction is definitely related to a class of gross income is the factual relationship between the deduction and a class of gross income. In order to establish the relationship between the deduction and a particular class of gross income, an analysis must be made of the functions underlying the deduction. A deduction is considered definitely related to a class of gross income if one of the following conditions is satisfied: − Incurred as result of, or incident to, an activity, or − Incurred in connection with property from which the class of gross income has been, is, or could reasonably have been expected to be derived.	▪ Treas. Reg. 1.861-8(b)(2)

Detailed Explanation of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
What are "classes" of gross income?

Analysis	Resources
Classes of gross income. The gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items of gross income enumerated in IRC 61, namely: i. Compensation for services, including fees, commissions, and similar items; ii. Gross income derived from business; iii. Gains derived from dealings in property; iv. Interest; v. Rents; vi. Royalties; vii. Dividends; viii. Alimony and separate maintenance payments; ix. Annuities; x. Income from life insurance and endowment contracts; xi. Pensions; xii. Income from discharge of indebtedness; xiii. Distributive share of partnership gross income; xiv. Income in respect of a decedent; xv. Income from an interest in an estate or trust.	▪ Treas. Reg. 1.861-8(a)(3)

Detailed Explanation of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
The allocation of deductions is focused on definitely related deductions . The allocation step is not intended to produce a mathematical division of expenses.

Analysis	Resources
Definitely related deductions ▪ A deduction shall be considered definitely related to a class of gross income whether or not there is any item of income in that class during the taxable year or the amount of deductions exceeds the amount of the gross income in the class. For example, if a company earned no income in its first year of existence, but incurred preliminary marketing expenses, these expenses would be definitely related to the future sales as a class of gross income, even though no income from the activity had yet been received. What allocation is not ▪ The allocation process does not produce a mathematical division of expenses against the various types of income, but merely establishes whether the expense is definitely related to a class of gross income. An important fact is that classes of gross income must be determined on the basis of the deductions to be allocated and not the other way around. In other words, do not look at the classes of gross income and then try and find the deductions related to the income. − For example, overhead related to a company's service department is definitely related, and therefore allocable, to service income. In this example, service department overhead (the deduction) is allocated to service department income (the class of gross income).	▪ Treas. Reg. 1.861-8(b)(2)

Detailed Explanation of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
An allocation cannot be made if a deduction is not definitely related to any gross income.

Analysis	Resources
What if a deduction is not definitely related to a specific class of income? ▪ Although most deductions will be definitely related to some class of a taxpayer's total gross income, some deductions such as certain supportive expenses are related to all gross income, and thus definitely related to all gross income and therefore must be ratably apportioned to all such gross income. In addition, some deductions are treated as not definitely related to any gross income and are also ratably apportioned to all gross income.	▪ Treas. Reg. 1.861-8(b)(5) ▪ Treas. Reg. 1.861-8(c)(3) ▪ Treas. Reg. 1.861-8(e)(9)

Detailed Explanation of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
An introduction of apportionment, the second step in the allocation and apportionment process.

Analysis	Resources
Apportionment ▪ After deductions have been allocated to a class of gross income, the gross income is divided into statutory and residual gross income groupings, and the deductions are then apportioned between the groupings. Apportionment methods ▪ It is the apportionment process that produces a division of expenses between the statutory and residual groupings based upon a mathematical formula. In determining the method of apportionment for a specific deduction, factors which should be considered in the formal approach are ratios or proportions which may include, but are not limited to, one of the following: – Comparison of units sold, – Comparison of the amount of gross sales or receipts, – Comparison of the Cost of Goods Sold, – Comparison of the profit contribution, – Comparison of the following items which are attributable to the activities or properties giving rise to the class of gross income: expenses incurred, assets used (e.g., interest expense per Treas. Reg. 1.861-8T(c)(2)), salaries paid, space utilized, time spent, etc. – Comparison of the amount of the gross income.	▪ Treas. Reg. 1.861-8T(c)(1)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
What is the criteria or standard to evaluate the selection of an apportionment method?

Analysis	Resources
Choosing an apportionment method ▪ The taxpayer may select a method of apportionment. However, the method of apportionment must be one which reflects, to a reasonably close extent, the factual relationship between the deduction and the grouping of gross income. The apportionment rules are applicable with respect to deductions which are definitely related to a class of gross income as well as deductions which are related to all of the gross income. – The burden of maintaining records not otherwise maintained and making computations not otherwise made shall be taken into consideration in determining whether a method of apportionment and its application is sufficiently precise. – A method of apportionment is generally not a method of accounting within the meaning of IRC 446. As a result, a taxpayer does not have a duty of consistency in using a particular apportionment method over consecutive years. However, frequent taxpayer changes in apportionment methods may indicate a potential issue for an examiner to explore in greater depth. For example, a taxpayer that apportions departmental supportive expenses based on units of production in one year, assets in another year, and space utilized in a third year, may have used an apportionment that does not reflect, to a reasonably close extent, the factual relationship between the deduction and the grouping of gross income.	▪ Treas. Reg. 1.861-8T(c)(1)

Detailed Explanation of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
An apportionment is only made if there is more than one grouping of income.

Analysis	Resources
How do I apportion an expense if there is not both a statutory or residual grouping? ▪ For a deduction to be apportioned between the groupings, a class of gross income must contain both statutory and residual groupings of income. If, for example, a deduction for services performed by a CFC relates only to foreign source taxable income, the entire deduction will be expensed against foreign source taxable income for purposes of the IRC 904 FTC Limitation. Apportionment is unnecessary in this example because there the deduction relates only to one grouping of income.	▪ Treas. Reg. 1.861-8T(c)(1)

Detailed Explanation of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
An apportionment must be made not only to the statutory (foreign) grouping, but between the separate categories of income as well.

Analysis	Resources
Apportionment to FTC separate categories ▪ The FTC limitation must be calculated separately for each separate category of income under Treas. Reg. 1.904-4(m). This means that certain deductions may need to be apportioned not only between foreign source and U.S. source categories, but among these separate categories of income. Treas. Reg. 1.904-4(m) separate categories include passive category income, general category income, and additional separate categories, (e.g. income resourced by treaty and sanctioned country income). Passive category income is defined as any income that is received or accrued that would be foreign personal holding company income (defined in IRC 954(c)) if the corporation were a controlled foreign corporation. Examples of passive category income include dividends, interest, royalties, rents and annuities. Passive income does not include any financial services income, any high-taxed income, or any active rents or royalties. General category is income other than passive category income, income resourced by treaty, and sanctioned country income. − Notwithstanding the above, there is a look-through rule for dividends, interest, rents, and royalties received or accrued by a taxpayer from a controlled foreign corporation in which the taxpayer is a U.S. shareholder. While normally passive, these types of income shall be treated as general category income when received from a controlled foreign corporation, unless the income is attributable to the controlled foreign corporation's passive category income.	▪ IRC 904(d) ▪ IRC 954(c) ▪ Treas. Reg. 1.861-8T(c)(1) ▪ Treas. Reg. 1.904-4(m) ▪ Treas. Reg. 1.904-5

Detailed Explanation of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
An apportionment must be made not only to the statutory (foreign) grouping, but between the separate categories of income as well.

Analysis	Resources
Apportionment to FTC separate categories (cont'd) – If a sourcing rule in an applicable income tax treaty treats any U.S. source income as foreign source, and the corporation elects to apply the treaty, the income will be treated as foreign source. The corporation must compute a separate IRC 904 FTC Limitation for any such income for which it claims benefits under a treaty for each amount of re-sourced income from a treaty country. – No credit is allowed for foreign taxes imposed by and paid or accrued to certain sanctioned countries. Moreover, income derived from each such country is subject to a separate IRC 904 FTC Limitation.	▪ IRC 904(h)(10) ▪ Treas. Reg. 1.904-5(m)(7) ▪ IRC 901(j)

Detailed Explanation of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation
How might an agent test and verify the allocations and apportionment of deductions?

Analysis	Resources
Verification of allocations and apportionment ▪ Upon request of an examiner, a taxpayer is required to furnish information to determine the factual relationships it used to make its allocations and apportionments. This could include the functions of management or company support units as well as organizational charts, manuals, and other writings which relate to the manner in which its gross income arises and to the functions of the organization units, employees, and assets of the taxpayer.	▪ Treas. Reg. 1.861-8(f)(5) ▪ Form 1118 Sch. H Part II ▪ Taxpayer 1.861-8 workpapers

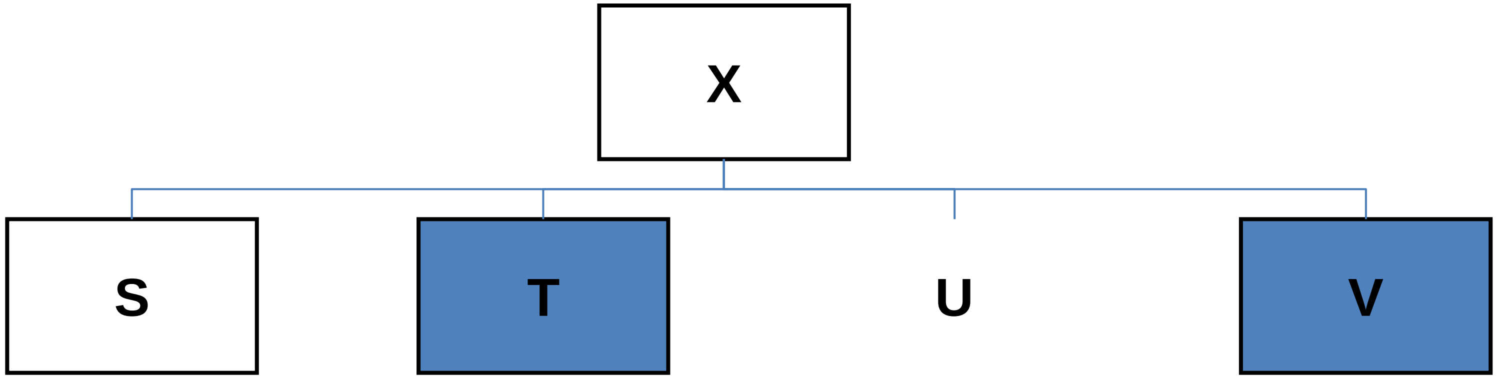
Example of the Concept

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation

Example: Allocation and Apportionment of Expenses

X, a domestic corporation, manufactures and sells products both in the U.S. and foreign countries. X has one domestic subsidiary, S, and three foreign subsidiaries, T, U, and V which perform similar functions in the U.S. and foreign countries T, U, and V, respectively. Each corporation derives substantial net income all of which is general category income described in IRC 904(d)(1). X's gross income for the taxable year consists of the following:

Domestic sales income	$20,000,000	
Foreign sales income	$12,000,000	$32,000,000
Dividends from S (before dividends received deduction)		3,000,000
Dividends from T		2,000,000
Dividends from U		1,000,000
Dividends from V		0
Royalties from T and U		1,000,000
Fees from U for services performed by X in foreign country U		1,000,000
Total gross income		$40,000,000



Back to Table Of Contents

Example of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation

Example: Allocation and Apportionment of Expenses

In addition, X has the following expenses:

Supervision Department Expenses:

1. Services for the direct benefit of U	$900,000

Supportive Expenses:

1. President's salary	800,000
2. Sales Manager's salary	200,000
3. Personnel department expenses	1,400,000
4. Training department expenses	1,000,000
5. General and Administrative expenses	1,600,000
TOTAL SUPPORTIVE EXPENSES	$ 5,000,000

Supervision Department expenses. The allocation of Supervision Department expenses is based on factual relationship to classes of gross income, as follows:

Services rendered to U. The $900,000 for services rendered for the benefit of U is allocated to the $1,000,000 of fees paid by U. No apportionment of $900,000 expense is necessary.

Allocation to class of income:	Residual	Statutory
Fees paid by U		$1,000,000
Expenses rendered (all to statutory)		(900,000)
Foreign source taxable income		$100,000

Example of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation

Example: Allocation and Apportionment of Expenses

Allocation of Supportive Expenses based on factual relationship to classes of gross income, as follows:

President and Manager Salaries: The $1,000,000 of management salaries incurred by X with respect to worldwide activities are definitely related, and therefore allocable to X's gross income from both its foreign and domestic markets. However, X's president devotes only 25 percent of his time to foreign operations and 75 percent of his time to domestic operations. X's sales manager devotes 40 percent of his time to foreign sales and 60 percent of his time to domestic sales. On the basis of additional facts, it is not acceptable to apportion the salaries of the president and sales manager on the basis of gross receipts. It is acceptable to apportion such salaries between the statutory and residual grouping on the basis of time devoted to each sales activity.

Apportionment to statutory grouping (foreign source taxable income):

1. President's salary: $800,000 x 25% = (200,000)
2. Sales manager's salary: $200,000 x 40% = (80,000)

Apportionment to residual grouping (U.S. source taxable income):

1. President's salary: $800,000 x 75% = (600,000)
2. Sales manager's salary: $200,000 x 60% = (120,000)

Remaining Expenses: It is assumed reasonable to allocate and apportion the remaining expenses of $4,000,000 on the basis of gross receipts or gross income. Since gross receipts were not provided in this example, we will use gross income to apportion.

Allocation to class of income:	Residual	Statutory
Foreign sales gross income		$12,000,000
Dividends		3,000,000
Royalties		1,000,000
Service fees		1,000,000
Foreign source gross income		$17,000,000

Example of the Concept (cont'd)

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation

Example: Allocation and Apportionment of Expenses

Allocation to class of income:	Residual	Statutory
U.S. sales gross income	$20,000,000	
Dividends	3,000,000	
U.S. source gross income	$23,000,000	
Apportionment of Remaining expenses:		
$4,000,000 x [$17,000,000/$40,000,000] =		(1,700,000)
$4,000,000 x [$23,000,000/$40,000,000] =	(2,300,000)	

Summary of Allocation and Apportionment:	Residual	Statutory
U.S. source gross income	$23,000,000	
Foreign source gross income	$17,000,000	
Services rendered to U		(900,000)
President's and sales manager's salaries	(720,000)	(280,000)
Remaining supportive expenses	(2,300,000)	(1,700,000)
U.S. source net income (before dividends received deduction)	19,980,000	
Foreign source net income		$14,120,000

Training and Additional Resources

Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation

Type of Resource	Description(s) and/or Instructions for Accessing	References
Other Training Materials	▪ International Examiner Training Phase I	▪ Module A – Allocation and Apportionment of Deductions
	▪ International Examiner Training Phase II	▪ Module D – General Principles for Allocation and Apportionment of Deductions under Treas. Reg. 1.861-8 ▪ Module D – Suggested Guidelines for Examination of Allocation and Apportionment Issues
	▪ International Examiner Training Phase III	▪ Module C – Review of FTC and Allocation and Apportionment
	▪ Sections 199 861 PPT – 2016-09	▪ Sections 199 861 – 2016 CPE Centra (KXL049951)
Databases / Research Tools	Westlaw subscription: BNA	▪ TMFEDPORT No. 906-2nd The Allocation and Apportionment of Deductions

Glossary of Terms and Acronyms

Term/Acronym	Definition
CFC	Controlled Foreign Corporation
FMV	Fair Market Value
FSTI	Foreign Source Taxable Income
FTC	Foreign Tax Credit
IRC	Internal Revenue Code
R&E	Research and Experimental
WWTI	Worldwide Taxable Income

Index of Related Issues

Issue	Associated UIL(s)	References
Interest Expense Concept Unit	▪ 9413.03-02	▪ Overview of Interest Expense Allocation and Apportionment in Calculation of the FTC Limitation ▪ FTC/9413.03-02_06(2014)
Interest allocation using the fair market value method	▪ 9413.03-02	▪ Asset Valuation using the FMV Method for Interest Expense Allocation to calculate FTC Limitation FTC/9413.03-02_05(2014)
Allocation of R&E expenses	▪ 9413.03-03	▪ How to Allocate and Apportion Research and Experimental (R&E) Expenses ▪ FTM/9413.03_04(2014)