Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Concept Unit
Knowledge Base – Jurisdiction to Tax

Library Level	Number	Title
Shelf		Business Inbound
Book	6	Income Shifting (Inbound)
Chapter	6.1	U.S. Branch Allocations (No-Treaty ECI Determinations)
Section	6.1.2	Determination of Proper Expense Allocation – 1.861-8
Subsection		

Unit Name	General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)	
Primary UIL Code	9422.01-02	Determination of Proper Expense Allocation – 1.861-8

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General Overview

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)

The United States taxes U.S. persons on their worldwide income. However, foreign persons are taxed on a territorial basis. Generally, when a non-U.S. person such as a foreign corporation ("FC") engages in a U.S. trade or business ("USTB") at any time during the taxable year, it is required to file a Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*, to report two types of income:

1. Certain U.S. sourced fixed, determinable, annual, and periodical income ("FDAP") that is not effectively connected with the conduct of an USTB; and
2. Effectively connected income (ECI) from the conduct of an USTB.

In the absence of an applicable treaty, FDAP will be taxed on a gross basis at the rate of 30% per IRC 881. ECI, on the other hand, will be taxed on a net basis using the same graduated tax rate schedule that applies to domestic corporations. In computing the taxable amount of ECI, or net ECI, FC is entitled to claim deductions.

Timely Filed Requirement

To claim deductions, the FC must meet certain procedural and substantive requirements. Procedurally, the FC must timely file a true and accurate Form 1120-F. Whether a Form 1120-F is timely filed is determined by IRC 882(c) and Treas. Reg. 1.882-4, which generally require a Form 1120-F be filed within 18 months of the due date set forth in IRC 6072. Failure to timely file may result in a denial of deductions and credits. See future practice unit: Determining when Form 1120-F is timely filed.

T **TREATY IMPLICATION:** This Practice Unit assumes FC is a resident of a non-treaty jurisdiction. If FC is a resident of a treaty country and entitled to claim treaty benefits, different results may occur depending on the particular treaty. Confer with the Treaties Practice Network or TAIT (Treaty Assistance and Interpretation Team) for assistance on treaty issues.

General Overview (cont'd)

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)

Unit Scope

Whether a particular expense is a deductible business expense is determined by the operative code section governing that expense. The amount of the allowable expense that can be deducted against ECI, however, must be determined in accordance with the allocation and apportionment rules contained in Treas. Reg. 1.861-8 and 1.861-8T.

This unit is intended to provide the general concept in applying the allocation and apportionment rules, and will not cover special rules dealing with the following list of expenses.

Expenses Not Covered in This Unit

1. Interest (Treas. Reg. 1.861-8(e)(2))*
2. Research & Experimental Expenditures (Treas. Reg. 1.861-8(e)(3))*
3. Stewardship and controlled services (Treas. Reg. 1.861-8(e)(4))*
4. Legal and Accounting fees and expenses (Treas. Reg. 1.861-8(e)(5))*
5. Income Taxes (Treas. Reg. 1.861-8(e)(6))
6. Losses on the sale, exchange, or other disposition of property (Treas. Reg. 1.861-8(e)(7))
7. Net operating loss deduction (Treas. Reg. 1.861-8(e)(8))
8. Charitable Contributions (Treas. Reg. 1.861-8(e)(12))

* Refer to the Index of Related Practice Units for issue coverage.

Cost of Goods Sold

Cost of Goods Sold (COGS) is not considered to be a deduction, but a reduction to gross income. In manufacturing, merchandising, and mining businesses, gross income means the total product sales less COGS (see Treas. Reg. 1.61-3(a)).

General Overview (cont’d)

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)

Cost of Goods Sold (cont’d)

FC should generally report COGS on the Form 1120-F under the same tax principles as a domestic entity. This includes, if applicable, complying with the uniform capitalization rules of IRC 263A. FC is also required to attach Form 1125-A, *Cost of Goods Sold,* to the Form 1120-F. This unit will not cover the various issues regarding COGS.

CONSULTATION: For assistance in computing IRC 263A adjustment or any other questions related to COGS, please refer to Issue Snapshots of the Inventory & IRC 263A Practice Network or consider contacting the Practice Network for additional assistance, as needed.

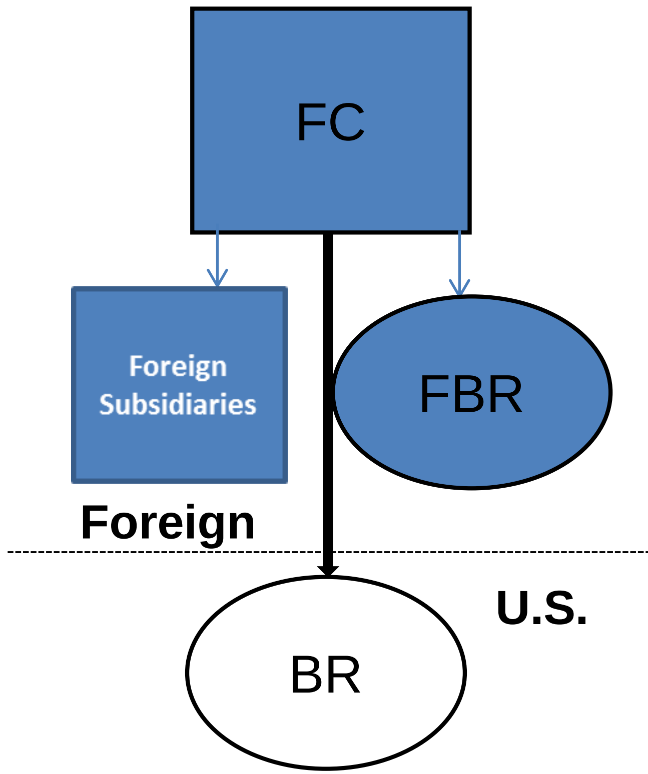
Relevant Key Factors

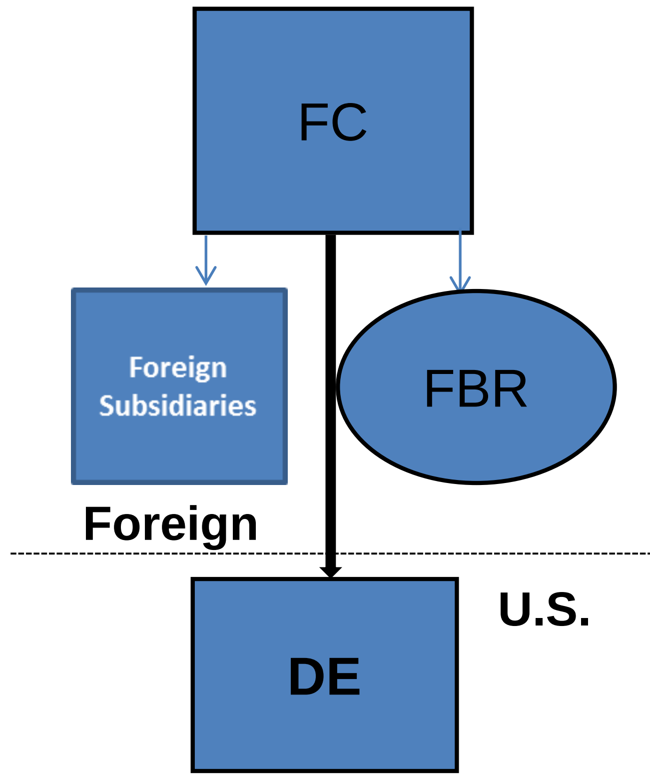
General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)
Key Factors
<u>Does FC Have a U.S. Branch?</u> FC and its U.S. branch are not separate legal entities for U.S. tax purposes. However, for FC's country of residence purposes, FC may treat the U.S. branch as a separate legal entity. This situation may occur when the U.S. branch is a single member limited liability company ("LLC") or a Check-the-Box ("CTB") election has been made to treat a qualifying U.S. entity as a disregarded entity. FC may or may not have a separate set of books and records for the U.S. branch. For U.S. tax purposes, all the income and expenses are incurred by FC but FC is only required to report and pay tax on the net ECI with the U.S. trade or business. <u>Does FC Have Expenses That Would Be Deductible Under General U.S. Tax Law?</u> Any deduction claimed by FC must be deductible under general U.S. tax law. Thus, there must be a legal basis supporting the deductibility of any given expense. This also includes determining whether the dollar amount claimed is correct. <u>What Portion, If Any, of the Otherwise Allowable Expense is Related to FC's U,S. Branch Operation (ECI)?</u> Even if an expense is entirely deductible under general U.S. tax law, FC may or may not be able to deduct the entire amount on Form 1120-F. The allowable amount of FC's deduction depends on the extent such expense relates to the U.S. branch operation. This, in turn, is determined by the allocation and apportionment rules under Treas. Reg. 1.861-8, et.al.

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)

Diagram of Concept

FC is a corporation for U.S. tax purposes.
FC is incorporated in and a tax resident of a non-treaty country.
FC may (or may not) have other foreign subsidiaries or foreign branches.
FC engages in an USTB through a branch ("BR") or a disregarded entity ("DE") for U.S. tax purposes.





Detailed Explanation of the Concept

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)
Allocating and Apportioning Deductions to ECI

Analysis	Resources
After FC has established the deductibility of each specific deduction under the relevant operative IRC section(s) and substantiated the total amount of each deduction, the portion of each deductible item that can be charged against the ECI of the U.S. branch must be determined. All deductions of FC must be so allocated and apportioned between ECI and non-ECI. The allocations and apportionments are made on the basis of the factual relationship of the deduction to ECI and non-ECI. The allocation and apportionment rules under Treas. Reg. 1.861-8 and 8T provide the general rules for how to allocate and apportion the otherwise allowable deduction of FC against ECI. As mentioned in the General Overview of this Practice Unit, certain types of deductions have special allocation and apportionment rules under the regulations which are not covered in this unit. Determining the amount of allowable deductions generally involves a two-step process: 1. FC is required to allocate deductions to a class of gross income, and 2. If necessary, apportion deductions between the "statutory" grouping (or groupings) of gross income and the "residual" grouping (or groupings) of gross income.	▪ Treas. Reg. 1.861-8(a)(2)

Detailed Explanation of the Concept (cont'd)

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)	
Analysis	**Resources**
In determining the taxable income of FC's U.S. branch, the relevant statutory grouping will be ECI and the residual grouping will be non-ECI. Deductions which are not definitely related to a class of gross income are ratably apportioned to all gross income.	
Step 1: Allocation	
FC must first allocate each deduction to a class of gross income to which it is "definitely related." A "class of gross income" refers to the gross income to which a specific deduction is definitely related, and may consist of one or more items (or subdivisions of these items) of gross income listed in IRC 61, for example income derived from business, interest, rents, royalties, etc.	▪ Treas. Reg. 1.861-8(a)(3) & (b)(1)
The process of allocation is premised on the factual relationship between the deduction and a class of gross income. The classes of gross income are not predetermined but must be determined on the basis of the deductions to be allocated.	▪ Treas. Reg. 1.861-8(b)(1)
A deduction is considered definitely related to a class of gross income and therefore allocable to that class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is generated (or could reasonably have been expected to generate).	▪ Treas. Reg. 1.861-8(b)(2)

Detailed Explanation of the Concept (cont'd)

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)	
Analysis	**Resources**
Step 2: Apportionment	
Apportionment produces a mathematical division of the expense or deduction. It divides the allocated expense within the class of gross income between the statutory and residual grouping of gross income. The term "statutory grouping of gross income" or "statutory grouping" means the gross income from a specific source or activity which must first be determined in order to arrive at "taxable income" from such specific source or activity under an operative section. Gross income from other sources or activities is referred to as the "residual grouping of gross income". For purposes of Form 1120-F, the statutory grouping will be ECI and the residual grouping will be non-ECI.	▪ Treas. Reg. 1.861-8(a)(4)
Once a deduction has been properly allocated to a class of income, and that class of income consists of both a statutory grouping of gross income and a residual grouping of gross income, FC must apportion the deduction between the two groupings. Deductions requiring apportionment to different statutory groupings of gross income (ECI) can use different apportionment methods. For purposes of FC filing its Form 1120-F, if FC allocates a deduction to a class of income that includes either only ECI or only non-ECI, no second step apportionment is necessary.	▪ Treas. Reg. 1.861-8(a)(2);1.861-8T(c)(1)

Detailed Explanation of the Concept (cont'd)

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)	
Analysis	**Resources**
Step 2: Apportionment (cont'd) Apportionment must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. # [redacted] # In determining the method of apportionment for a specific deduction, factors that should be considered in the formula approach are ratios or proportions which can include, but are not limited to, one of the following: ▪ Comparison of units sold attributable to the statutory grouping and units sold attributable to the residual grouping, ▪ Comparison of the amount of gross sales or receipts within each grouping, ▪ Comparison of the Cost of Goods Sold by each grouping, ▪ Comparison of the profit contribution by each grouping,	▪ Treas. Reg. 1.861-8T(c)(1)

Detailed Explanation of the Concept (cont'd)

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)	
Analysis	**Resources**
Step 2: Apportionment (cont'd) ▪ 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, − Salaries paid, − Space utilized, − Time spent. ▪ Comparison of the amount of the gross income in the statutory grouping with the amount in the residual grouping. Example: If Gross Sales is the appropriate apportionment method, the computation for apportioning a deduction within a class of income between ECI and non-ECI is as follows: $\text{Deduction to be Apportioned} \times \dfrac{\text{Gross Sales (ECI)}}{\text{Total Gross Sales (ECI + Non-ECI)}} = \text{Amount Deductible on Form 1120F}$	

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Detailed Explanation of the Concept (cont’d)

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)	
Analysis	**Resources**
<u>Step 2: Apportionment (cont’d)</u> **CONSULTATION:** Before proposing any changes to FC’s method of apportionment, we suggest that you seek input from local Counsel and Jurisdiction to Tax Practice Network.	

Detailed Explanation of the Concept (cont'd)

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)	
Analysis	**Resources**
Verification of FC's Allocations and Apportionments Treas. Reg. 1.861-8(f)(5) requires documentation that FC's allocations and apportionments were made on the basis of the factual relationship between deductions and gross income. FC is required to furnish information from which such factual relationships can be determined. In addition to functions with a specific international purpose, consideration should be given to the functions of management, the direction and results of an acquisition program, the functions of operating units and personnel located at the head office, the functions of support units (including but not limited to engineering, legal, budget, accounting, and industrial relations), the functions of selling and advertising units and personnel, the direction and uses of research and development and the direction and uses of services furnished by independent contractors. FC shall make available, upon request, any of its organization charts, manuals, and other writings which relate to the manner in which its gross income arises and to the functions of organizational units, employees, and assets of FC and also arrange for the interview of such of its employees as necessary in order to determine the gross income to which deductions relate. Examination Considerations In order to properly allocate and apportion deductions, it is important to know the types of income generated by FC. In this regard, we need to thoroughly understand the following:	▪ Treas. Reg. 1.861-8(f)(5)

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Examination Considerations (cont'd)</u>

1. FC's business operations both within and without the United States;
− Internet search for FC's Company website
− External internet searches – See SPDER (Servicewide Policy, Directives and Electronic Resources) website for information relating to available electronic research tools.
2. The amount and type of income FC treats as non-ECI.

Keep in mind that no deduction can be taken if that deduction is attributable to tax-exempt income or income that should be taxed on a gross basis (e.g. non-ECI U.S. Sourced FDAP).</td><td></td></tr>
<tr><td>At the request of the Internal Revenue Service, FC is required to furnish information sufficient to establish FC's entitlement to the claimed deductions and credits. The IRS may require, as appropriate, that an English translation be provided for any information in a foreign language. When furnishing information, the taxpayer must do so in a form suitable to permit verification of claimed deductions.</td><td>▪ Treas. Reg. 1.882-4(b)(1) & (2)
▪ Treas. Reg. 1.6001-1(a)</td></tr>
<tr><td>When requesting documentation, the IRS must comply with the relevancy threshold established in U.S. v. Powell - 379 U.S. 48 (1964). This is a relatively low threshold; generally, any information that might throw light on FC's U.S. tax liability will be found to be relevant by the courts. See Practice Units: Using Alternative Means to Obtain Foreign Based Evidence and Issuing a Formal Document Request when a US Taxpayer is Unresponsive to an IDR.</td><td>▪ U.S. v. Powell - 379 U.S. 48 (1964)
▪ Practice Unit - Using Alternative Means to Obtain Foreign Based Evidence
▪ Practice Unit - Issuing a Formal Document Request when a US Taxpayer is Unresponsive to an IDR</td></tr>
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Detailed Explanation of the Concept (cont'd)

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)	
Analysis	**Resources**
Examination Considerations (cont'd) If a foreign corporation fails to furnish sufficient information, the IRS may in its discretion disallow any claimed deductions and credits in full or in part. It is well-established that deductions are a matter of legislative grace and that the taxpayer bears the burden of proving entitlement to the deduction sought.	▪ Treas. Reg. 1.882-4(b)(2) ▪ *New Colonial Ice Co. v. Helvering* - 292 U.S. 435, 440 (1934) ▪ *Commissioner v. Lincoln Sav. & Loan Ass'n* - 403 U.S. 345, 352 (1971) ▪ *INDOPCO, Inc. v. Commissioner* - 503 U.S. 79 (1992) ▪ *LB&I Guidelines for Handling Delinquent Forms 1120-F and Requests for Waiver Pursuant to Treas. Reg. 1.882-4(a)(3)(ii)* (see Training and Additional Resources section)

Examples of the Concept

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)
Examples
Examples of Allocation and Apportionment Expense Solely Attributable to ECI FC operates a branch in the United States selling widgets. FC reported $x of deduction on line 13, Section II of the Form 1120-F for salaries paid to U.S. employees responsible for overseeing the accounts receivable due from FC's U.S. customers. This deduction would be properly allocated to a class of income defined as ECI (Gross Sales Income) generated by FC's U.S. branch operation. Since this class of income consists solely of ECI, no apportionment is necessary and the entire amount is deductible on the Form 1120-F. Expense Solely Attributable to Non-ECI FC operates a branch in Country X selling widgets. FC also operates a branch in the U.S. selling widgets. FC hired USCo, an U.S. company, to provide on-site security for its warehouse located in Country X. This warehouse is used by FC solely to store widgets to be sold in Country X. All matters relating to the work to be performed by USCo were negotiated and overseen by FC's branch in Country X. FC paid USCo's fee out of its U.S. bank account and claimed a deduction for this fee on line 27, section II of the Form 1120-F. In this case, the on-site security fee would be properly allocated to a class of income defined as Non-ECI (Gross Sales Income) from the sales of widgets in FC's Country X branch. Even though FC has ECI from the sale of widgets in the U.S., this deduction is solely allocable to non-ECI class of income. No apportionment is necessary and none of the fee is deductible on the Form 1120-F.

Examples of the Concept (cont'd)

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)
Examples
<u>Examples of Allocation and Apportionment (cont'd)</u> <u>Expense Attributable to Both ECI and Non-ECI</u> Example 1: FC is a global service provider. It conducts its business via various branches throughout the world, including the U.S. FC paid a New York advertising agency $y to run a global campaign for its business. On its Form 1120-F, FC reported only the income earned by the U.S. branch as ECI, but deducted the entire $y on line 27, section II. In this case, the advertising fee would be properly allocated to a class of income defined as service income. Since this class of income consists of both service income earned by the U.S. branch and service income earned by other foreign branches, it must be apportioned between the ECI and the non-ECI using a reasonable method. Only the portion apportioned to ECI can be deducted by FC on Form 1120-F. Example 2: FC incurred $z of legal fees in defending a lawsuit brought by its shareholders alleging that FC had grossly misstated its financial statements. Specifically, the suit alleged that FC had fraudulently misrepresented its world-wide assets and liabilities. FC deducted the entire $z amount on line 27, Section II of the Form 1120-F. Given that this fee related to FC's business operation as a whole, it should be properly allocated to a class of income defined as all FC's gross income. Since the class of income consists of both ECI and non-ECI, this fee must therefore be apportioned between the statutory and residual groupings of FC's ECI and non-ECI using a reasonable apportionment method. Only the portion of the legal expense that is apportioned to ECI can be deducted on the Form 1120-F.

Index of Referenced Resources

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)
IRC 61
IRC 881
IRC 882(c)
IRC 6072
Treas. Reg. 1.61-3(a)
Treas. Reg. 1.861-8
Treas. Reg. 1.861-8T
Treas. Reg. 1.882-4
Treas. Reg. 1.6001-1(a)
Commissioner v. Lincoln Sav. & Loan Ass’n - 403 U.S. 345, 352 (1971)
INDOPCO, Inc. v. Commissioner - 503 U.S. 79 (1992)
New Colonial Ice Co. v. Helvering - 292 U.S. 435, 440 (1934)
U.S. v. Powell - 379 U.S. 48 (1964)

Training and Additional Resources

General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)	
Type of Resource	**Descriptions**
Saba Meeting Sessions	▪ Outer Continental Shelf USTB and PE Issues - IBC Jurisdiction to Tax Network Call - PPT - 2012-11 ▪ *Jurisdiction to Tax/ Form 1120-F* - FY13 CPE - PPT 2012-10
Issue Toolkits	▪ Audit Tool - 1120-F Best Practices From Field Examiners (Jurisdiction to Tax (IBC) SharePoint site)
Podcasts / Videos	▪ Training - Videos (International FY11 CPE) – See video link on Jurisdiction to Tax (IBC) SharePoint site.
Reference Materials	▪ *LB&I Guidelines for Handling Delinquent Forms 1120-F and Requests for Waiver Pursuant to Treas. Reg. 1.882-4(a)(3)(ii)* – Posted on Jurisdiction to Tax SharePoint site under Audit Tools & Reference Resources and Published Guidance.
Other Training Materials	▪ *International Issues Phase II*, Module D - Allocation and Apportionment of Deductions (Student Guide) – See posting on Jurisdiction to Tax (IBC) SharePoint site.

Glossary of Terms and Acronyms

Term/Acronym	Definition
BR	Branch
COGS	Cost of Goods Sold
CTB	Check-the-Box
DE	Disregarded Entity
ECI	Effectively Connected Income
FC	Foreign Corporation
FDAP	Fixed, Determinable, Annual or Periodical Income
FP	Foreign Parent
LLC	Limited Liability Company
PE	Permanent Establishment
SPDER	Servicewide Policy, Directives and Electronic Resources
TAIT	Treaty Assistance and Interpretation Team
USTB	U.S. Trade or Business

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
9460.02	*Issuing a Formal Document Request when a US Taxpayer is Unresponsive to an IDR*	IGA/P/17_02_02-01 (formerly IGA/9460.02_02(2013))
9460.02	*Using Alternative Means to Obtain Foreign Based Evidence*	IGA/T/17_02_01-01 (formerly IGI/9460.02_01(2013))
9422.01-01	*Gross Effectively Connected Income of a Foreign Corporation Non-Treaty*	JTI/T/06_01-01 (formerly ISI/9422.01_01(2013))
9422.01-02	*Interest Expense of U.S. Branch of a Foreign Bank Non-Treaty*	JTI/P/06_01-02 (formerly ISI/9422.01_02(2013))
9422.01-02	*Interest Expense of a Foreign Corporation engaged in a USTB Non Bank Non-Treaty*	JTI/P/06_01-03 (formerly ISI/9422.01_04(2013))
9422.01-02	*Section 861 Home Office and Stewardship Expenses*	JTI/T/06_01_03-01 (formerly ISI/9422.01_05(2013))
9441.02-01	*Effectively Connected Income (ECI)*	USB/C/14_02_01-01 (formerly USB/CU/P_14.2_01(2014))
9441.01	*Identification of a US Trade or Business of a Nonresident Alien*	USB/C/14_01-02 (formerly USB/CU/P_14.1_01(2014))