Foreign Tax Credit

FDU, Summer 2010

Foreign Tax Credit

- Credit allowed for foreign income taxes
- Limited to portion of current year tax generated by foreign source taxable income
- Excess credits carried over
  - Back 1 year
  - Forward 10 years

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First a quick review of FTC rules

Credit vs. Deduction

- Choice every year
- Can change your mind for 10 years
  - §6511(d)(3)
- Choice applies to regular tax and AMT
- Coordination of credit carryovers in deduction years

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6511(d)(3) allows changing choice at any time for 10 years after extended due date

This covers the following contingencies:

IRS audit adjustments cause NOLs, etc, changing FTC benefits

Foreign tax authorities change tax

Coordination of carryovers, etc:

If credit carryovers exist in a year deductions are chosen, then must treat as "used" to

extent that the carryovers would have been used. (highly unlikely scenario)

No carryovers generated in year deductions chosen.

Creditable Taxes

- Foreign taxes imposed on
- Net Income or equivalent, under US concepts
- OR Foreign tax in lieu of income tax

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Creditable taxes are only taxes imposed by a foreign country or political subdivision thereof on income or an equivalent measure

What is a Foreign Income Tax?

- **IRS has issued rulings on many taxes**
- **Must be imposed on net income or a reasonable approximation thereof**
- **Excludes capital taxes, stamp taxes, etc.**
  - **Example: Swiss tax has income & capital components**
    - **Income part is creditable**
    - **Capital part is not**
- **Duck test**

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Some of the IRS rulings are surprises, so always check. Some national insurance (social security) is considered to be income tax.

Must be a tax, not a fee. Examples: user fees, royalties, etc don't qualify. Must be compulsory pursuant to authority to levy taxes. Excludes fines & penalties, even tax related penalties. To the extent a taxpayer derives economic benefit from the government as a result of the levy, the levy is not a tax.

Imposed on net income: need not allow all same deductions. May allow deemed or formulary deductions. But must allow something. Tax on gross proceeds is unlikely to be an income tax (but may be in lieu of one). Tax must be likely to reach net gain. Must not be dependent on the availability of US FTC.

Specific rules permit differences in timing of recognition of income and differences in what deductions are allowed. Also, tax on deemed distributions are specifically permitted.

Examples above

Don't read regs thoroughly: Answer is usually obvious. In 18 years, question has come up once for me.

Amount of FTC

- **Amount paid or accrued**
- **Translated to US$ at applicable rate**
- **Adjustment procedure: §905 below**

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Amount paid is cash pmt. Amount accrued is proper accrual under acctg. principles.

Does not include deferred tax. Only amounts fixed & determinable

Timing of accrual: must look to local law. Like property tax accrual: local principals as to when it becomes a fixed liability and when amount can be determined apply. Only time it's really important is when mismatch between foreign tax year & US tax year (with a few weird exceptions like India, and IRS agents won't detect those)

Translate tax from forn cur. to $ on date ***paid*** not date accrued. Then:

Translating Foreign Taxes

- §986(a)

- Average rate for year
  - But use spot rate on payment date if paid before year or after 2nd following year
  - or of using cash basis & no accrual election
- Refunds: rate on initial payment
- Upward adjustment: rate on date paid

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Translate tax from forn cur. to $ on date ***paid*** not date accrued. Thus must translate at multiple rates if estimated tax payments. Example: Canada has monthly. Also, may not know correct rate until after US return filed. Example: UK typically pay 10-11 months after year end. In such case, give best estimate (regs say year end rate, but use rate closest to date of pmt).

Refunds: xlate @ orig pmt rate, basis same. Allocate refund to pmt LIFO

Adjustments to Foreign Tax

  - §905(a), Reg. §§1.905-3T, -4T
- **Taxpayers must notify IRS of adjustment**
  - **File 1040X or 1120X if adjustment results in negative pools or change in direct tax**
    - **Otherwise adjust pools**
  - **By due date of return in which redetermination occurred (for reduction) or 6511(d) period (if increase)**
- **Pay additional US tax on IRS notice & demand**
  - **Interest accrues from original due date till payment**

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Must adjust when paid. Also must adjust if foreign govt. changes. Must notify IRS, but procedure after that is hazy. Depends on whether CEP or not. Reg. 1.905-3T & -4T(revised)

Foreign redeterminations apply to actually paid & deemed paid tax, which changed due to refund, change in forn currency tax or change in exchange rate.

US redetermination req'd if: 1.redeterm of tax actually paid, or 2.redeterm of deemed paid only if remaining pool of tax reduced below zero. Rules for determining pools not covered

Must pay interest on US redeterm. Notification of IRS req'd by due date of return if reduction, within 6511(d)(3)(A) 10 year period if increase

Adjustments to Foreign Tax

- **Applies to changes to foreign tax that affect US tax liability**
  - **Refunds**
  - **Exchange differences**
  - **Accrued vs. paid**
- **Does not apply to adjustments to pools for deemed paid taxes unless change reduces pool below zero**

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Must notify IRS of adjustment to pools on tax return for year in which redetermination occurs

Deemed Paid Foreign Tax Credit

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What's a Dividend

» §301, 316

- Distribution paid with respect to stock (certain exceptions under §302)
- To the extent of current or accumulated E&P
- From most recent E&P first

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Deemed Paid Credits

– §902 & regs

- Credit for taxes paid by 10% or more subsidiary of US corp.
- Credits flow with dividends or Subpart F inclusions
- Income is grossed up for tax
  – Effectively puts corp s/h on pretax basis
- 6 tier limit
- 10% / 5% ownership requirements

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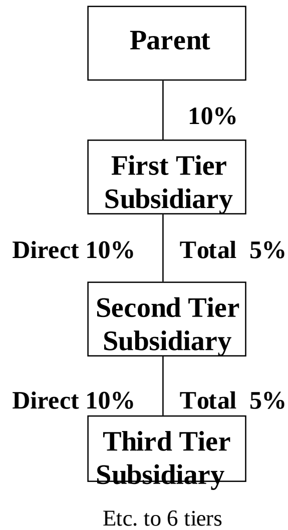
Overview

902: 6 Tier Limit

- **Deemed paid FTC limited to credit for taxes paid by first three tiers**
- **Dividends from lower tier subsidiaries bring tax up chain**
- **6 Tier limit may be avoided by using partnerships or hybrids as intermediaries**
- **Below 3rd tier must be CFC**



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1997 act expanded from 3 to 6 tier limit, effective 1998: give overview above, then:

Time for determination: The determination of ownership is made for **each dividend** separately at the time it is **paid**. Example: D owns F1 which owns F2 on 2/1/08. F2 pays a dividend on that date to F1. F2's taxes are tiered up (see below). On 6/1/08, F1 sells F2 to an unrelated party. D and F1 use a 6/30 fiscal year. On 2/1/09, F1 pays a dividend to D. F1's taxes, including those tiered up from F2, are deemed paid by D.

Note: regulations still reflect 3 tier limit from before 97 act. Also **caution**: older versions of text may refer to 3 tier limit.

Note also, regs changed slightly in Jan 97 to clarify certain more esoteric aspects of deemed paid credits.

Deemed Paid Credit

- **Deemed paid credits determined based on pools of E&P and taxes**
- **Post-86 pool**
  - **Includes only post-acquisition taxes**
- **Pre-87: year by year pool**
  - **Last in first out**

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Deemed paid taxes flow with dividend, Subpart F inclusion, §1248 inclusion, or any other event treated as dividend under §301. Dividend considered received, and taxes flow, when unqualifiedly available to distributee (see regs under §301)

The following pools and relevant earnings apply:

a. Post-86 earnings generally	Post-86 E&P
b. Pre-87 earnings	Year by year (LIFO) accumulated profits
c. Post-86 earnings in a basket	Post-86 E&P in that basket

Note that for subsidiaries acquired after 1986, only post-acquisition earnings are included in the pool

Give a numerical example on board:

Year	E&P	Tax	
85	100	50	Separate pool
86	(20)	5	Separate pool: trapped taxes
87	50	25 \	Pooled together as of 88
88	100	50 /	E&P=150, Tax=75

Deemed Paid Credit

- **Amount of tax deemed paid by shareholder =**

$$\text{Tax in pool} \;\; x \;\; \frac{\text{Part of dividend from pool}}{\text{Total E\&P in pool}}$$

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After telling formula, ask:

Q: what pools? A: post-86, and pre-87 year by year

Pools adjusted for dividends: E&P pool (for §902) reduced by E&P, tax pool by taxes flowing with dividend or deemed inclusion. Reduction happens regardless of whether there are US shareholders, or to what extent dividends are paid to US shareholders.

Example: US person owns 20%, foreign persons own 80%. Post-86 pools are E&P 200, taxes 50. If 80 of dividend is paid proportionately, then pools are reduced by 80/200, becoming 120 and 30. This happens even tho US person gets dividend of 16 and credit of 4, and happens regardless of whether US person claims credits or deductions. This was clarified in 97 regs change.

Gross-up

– §78

- Dividends are "grossed up" for taxes deemed paid
- Puts shareholder on pre-tax basis
- Applies only if foreign tax credit chosen for year
- Applies only to §902 taxes (i.e., foreign corp.)

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Follow slide

Comment on state tax implications: some states exclude. Those that start w/Federal may be taxing you on FT paid by subs even if excluding dividends. Varies by state

902: Trapped Taxes

- **No taxes deemed paid if E&P in pool is zero or deficit**
- **Thus taxes can be "trapped"**
  - **Especially in pre-86**

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No taxes are deemed paid if the denominator is zero or a deficit. Thus, taxes in a pool (e.g., a particular pre-87 year or the entire post-86 pool) in which there is a deficit in E&P are trapped unless and until the deficit is reversed. In Example 2 at Reg. §1.902-1(b)(5), F1 has a deficit in post-86 accumulated E&P at year end, before a dividend and after current year positive E&P. If it pays tax and pays a dividend, the tax is trapped, since there is a net deficit in the pool of E&P. The dividend remains taxable under §316(a). However, if it has later earnings which fully offset the deficit, those trapped taxes will flow with a future dividend.

902: Translation to Dollars

- **Taxes for years after 1997: average rate for year to which they relate: §986(a)**
- **Taxes on post-86, pre-98 E&P: spot rate on date of payment: §986(a) prior to 97 act**
- **Taxes on pre-87 E&P: spot rate on date of distribution of E&P**
  - **Bon Ami, 39 BTA 825 (1939)**

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Rules before 86 act were sketchy: Bon Ami case was only law: translate on date of dividend. Had significant distortive effects in highly inflationary

86 act provided for spot rate on date of payment

97 act provided for average rate for year to which taxes relate, for years beginning after 1997. However, spot rate used if taxes paid later than 2nd year after close of accrual year, or if taxes paid before accrual year, or if hyperinflationary.

902 & 905: Adjustments to Taxes

- **Requires adjustment of pools**
  - **But if adjustment reduces pool below zero, must amend returns reflecting dividends**
- **Translation:**
  - **Payments:**
    - **Up to 2 years after accrual: accrual rate**
    - **Later: spot rate on date of payment**
  - **Refunds: rate used on original tax**

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Note: covered later in more detail under §986. Also covered earlier

Adjustment of taxes (such as due to refund or assessment) adjusts pools only, if there is anything left in pool to adjust. Otherwise, must amend.

Note that translation adjustments on pre-98 years treated same as assessments or refunds

902: Deficits in E&P

- **Carryover & carryback determined at time of dividend**
- **Post-86 current deficits first reduce post-86 pool**
- **Post-86 deficits carried back on LIFO basis**
  - **Carryback limited to pre-87 E&P**
- **Pre-87 deficits in a year carried forward only**

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We’ll talk about E&P later. For now, think of it as ret. earn.

Q: How does E&P accumulate for dividends of US corp? Div is from current and then from most recently accum.

86 act introduced pool concept. Before that, each year stood alone.

New rules finalized in 95: follow notices from 87, 88. Won’t talk about div’s from 87-now; see regs. C/y deficits reduce post-86 pool, even to negative. At time of dividend, determine if deficit in post-86 pool. If so, it reduces pre-87 E&P on LIFO basis & post 86 pool deficit is reduced to extent absorbed in prior years. This can result in trapped taxes if a year is wiped out in which tax was paid. If total pre-87 is less than post 86 deficit at time of div, the deficit is carried forward. (Note: this means the dividend will be in part return of capital)

Deficit triggering example:

Year	E&P	Dividend	Tax	Carryback	Div	902 Tax	
85	10	0	5		(10)	5	Dividend is only 10, balance = cap.
86	15	0	8	(15)	-0-	-0-	8 tax becomes trapped forever
87	(15)	20					

902: Tiering Up

- **Taxes flow up with earnings**
- **No grossup: would result in double counting**
- **Pre-87 E&P and tax counted with post-86 after distribution up chain**

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Taxes paid by lower tier corp. flow to upper tier on dividend. These taxes are tracked separately, no grossup.

After this tiering up, any pre-87 E&P that came up chain is included with distributee's post-86 E&P and tax. Unclear whether separate tracking is required to retain pre-86 character (which matters for basketizing)

Example: put on first write later

FS2 had following:	Year	E&P	Tax	Div	902
	85	80	40	50	25
	86	50	50	50	50
	Post-86	50	40	50	40

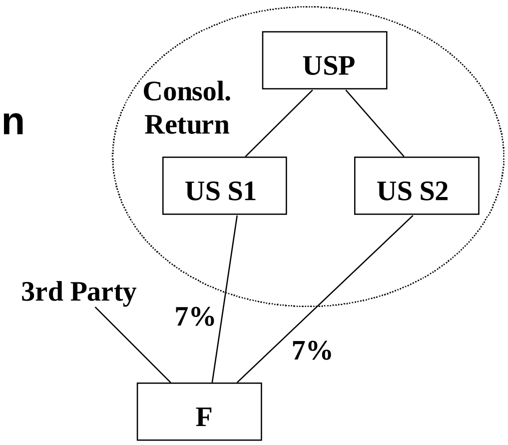
FS2 pays dividend of 150. Tax of 115 comes with it. Ask class how.

FS1 has following:	pre-div			with div	
	85	10	5	10	5
	86	10	5	10	5
	post-86	10	5	160	120

Remember that E&P is AFTER TAX. Thus tracking of E&P and tax is done separately. Will cover E&P more later

902: Direct Ownership

- 10% ownership must be direct, without attribution other than thru partnership
- No 902 credit in example shown:
  - First Chicago, 96 TC 421 (1991)



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New regs add requirement for direct ownership

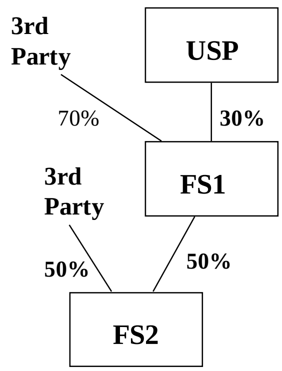
Circuit court in First Chicago said must have direct: as above

Result: over 10% ownership must be in either US1 or US2, even though in consol. return

Contrast result above to Rev.Ruls. 91-5 and 92-86, which held indirect ownership was OK in cross chain sale context under §304. Beyond scope of this course: see F3

902 Exercise

- Tiering up E&P & tax



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Foreign Tax Credit Limitation

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Foreign Tax Credit: Limitation

– §904

- **Credit Limit =**

$$\frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}} \times \text{Current Year Tax before Credits}$$

- **Credit limit computed <u>separately for each basket</u>**

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Foreign taxes are limited to US tax on foreign source income

Separate limitation baskets

Limit formula above

Keys: computing FSTI

Foreign Tax Credit: Baskets

– §904(d): major changes effective after 2006

- Passive income
  - Interest
  - Dividends
  - Rents & royalties
  - Note: high tax & financial services kickouts
- General limitation
- Look through dividends, interest, rents & royalties from CFCs

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Point out "9" baskets

My order dif. from code: easier to keep track of exceptions to passive

Other includes: Shipping, DISC dividends, FSC dividends, FSC FT income

Prior Baskets

The following no longer have applicability on current returns (but may apply to pre-2007 open years):

- High withholding tax interest
- Dividends from noncontrolled 902 corporations
- Shipping income
- FSC income

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High Tax Kickout

- Passive income subject to foreign tax in excess of top US tax rate
- Treated as general basket
- Computed on net FSTI for group of items after allocating & apportioning expenses
- Look thru CFC dividends and QBU income to apply passive & grouping
- Rents & royalties aggregated with expenses

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General grouping rules:

all passive subject to 15% or more withholding = 1 item

all other passive subject to withholding = 1 item

all other passive not subject to withholding = 1 item

CFC and QBU grouping rules:

Apply separately to each CFC or QBU

In country = 1 item

Out of country: apply general grouping rules at CFC level

Coordination with distributions of previously taxed, including effect of reductions of tax on distribution

Passive Income

- Interest
- Dividends
- Rents
- Royalties
- Gains on assets producing passive income
- FX gains as discussed later

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Exception in reg 1.904-4T(b)(2)(iii) for active rents & royalties after 9/20/04: no statutory basis; temp reg expires 12/21/12

General Limitation

- **Everything else**

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Basket Exercise

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Review basic rules first -- 5 minutes

see lead-in on next page before showing next slide

Definition: FPHC Income

- **Foreign Personal Holding Company Income: Subpart F concept: §954(c)**
- **Generally interest, dividends, rents, royalties, gain from passive asset sale, foreign currency gain**
- **Excludes same country related party interest & dividends**
- **Excludes related party rents & royalties from prop. used in same country**
- **Excludes active business rents & royalties**

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The look thru applies only to income that would be FPHC income, a Subpart F term, so will define now.

Follow slide. Will cover in more detail later in SubF

What this means is essentially interest, dividends, rents & royalties, with exceptions

So, how does it work?

Look Thru Rules

– **§904(d)(3), Reg. §1.904-5**

- **Passive income from CFC in which taxpayer is US shareholder treated as general limitation, except as provided**
  - **CFC**
  - **US Shareholder**
- **Applies to Subpart F inclusions also**

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We have talked about passive & 10/50 baskets before, but

What of dividends etc from 100% foreign subsidiary? Why should they be different from branch income? Such would allow lots of manipulation, so look thru (SHOW SLIDE)

CFC & US shareholder are magic words covered later

Look thru applies to all FPHC income from CFC, but rules work differently for different kinds.

Look Thru--Dividends

- Basketize CFC E&P and taxes (see later)
- De minimis (5% or $1 million) amounts (within CFC) not separate basket
- Attribute dividend proportionately to E&P baskets
- Anti-abuse rule for dividend of interest income from related party loans

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Dividends are fully looked thru, as if earned by shareholder

Since dividend is from E&P, must basketize E&P of CFC. Same with SubF income

Note that SubF de minimus rule impacts basketizing: de minimis amounts follow main body of E&P of the sub (usually general limitation)

Attributing dividend to baskets:

$$\frac{\text{Sep. Basket E\&P in pool from which div paid}}{\text{Total pool from which div. paid}} \times \text{dividend}$$

Anti-abuse rule only applies if "the purpose of such loan" (not just a purpose) is to change basket. Thus has very limited application

Denial of Look Thru

- **Pre-acquisition earnings of CFC considered separate 902 basket on distribution: no look thru**
  - **Provisions effective after 2006 are confusing, but result in a deemed separate basket**
- **Complex anti-abuse rule**
- **Earnings of CFC retain character if CFC dropped into holding co.**

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Anti-abuse rule: A distribution from a CFC to a shareholder from earnings after it became a CFC is also treated as a dividend from a noncontrolled §902 corporation if the following conditions are met:

1. The recipient (upper tier corporation or domestic shareholder) owns 90% of the total combined vote, and

2. Neither the recipient nor a member of the same affiliated group (under §1504(a) without regard to the §1504(b)(3) exclusion of foreign corporations) was a U.S. shareholder at the time the earnings were accumulated.

Note: this rule was essentially moved from earlier Prop. Reg. §1.904-4(g)(3)(ii).

Look Thru--Subpart F

- Treat as separate basket to extent in CFC's separate basket
- Rules that kick income out of passive basket apply before this rule
- Exclusions under Subpart F 90% high tax kickout considered general basket
- Subpart F full inclusion rule has no effect on baskets

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Subpart F works differently. For now, believe that Sub F is passive income or sales income involving related parties. It's more, but let's KIS now. Assume further that all sales income is general.

SubF is year by year concept, but with E&P limitation. It is TI, not E&P, so separate computations needed, different from dividends

Sub F has 90% high tax, not the 100% under 904, so for this purpose, get to follow 90%

We'll revisit this later after studying Sub F

Look Thru—Misc.

- Applies to 50% or more owned nonconsolidated domestic corp.
- Look thru partnership
  - Except under 10% corporate GP or any limited partner owning under 10%:
  - Their income is passive
- Gain on sale of partnership interest is passive or high tax kickout
- Tiered look thru
- Ordering rules

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Look thru also applies to US corp. if 50% or more owned. Note that this differs from CFC more than 50% test. Similar rules apply for related person interest, etc. as for CFCs

Look thru gets tiered up. Start computations with lowest tier & work up. Like 902.

Order of computations:

Rent & royalty

Interest

Sub F and partnership inclusions

Dividends

First characterize income received, then characterize income paid.

Rules similar to above apply for determining what part of interest paid to US SH by CFC is from US sources, based on part of CFC's income from US sources. However, if CFC has USSI, you're doing something wrong.

Look Thru Exercise

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Allocating Taxes (non-902)

– **Reg. §1.904-6(a)**

- **Allocate foreign tax to all income subject to that tax**
- **Use foreign rules for determining whether income is taxed**
- **If tax is on multiple baskets, apportion:**

$$\text{Tax} \times \frac{\text{Net income (foreign concept) in basket}}{\text{Net income (foreign concept) subject to tax}}$$

- **Use foreign tax principles for determining net income, or 861 rules if no foreign rules**

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Allocation generally one or two step process:

First allocate to whatever income is covered by the tax under foreign rules

may be specific items (e.g., for w/h tax) or may be all income

Then apportion among baskets, etc., as needed on proportional basis

Foreign tax principles must be used to determine whether an item or group of income is subject to the particular tax being allocated.

However, must look to US rules for doing apportionment

Example for board:

		US income		Foreign income	Tax apport.
Sales inc.	4,000	4,500	inv. timing	1320	
Interest		1,000	1,000		330
Tax on above		1,650			

Now hand out & discuss the example on basketizing income of subsidiary

Associating Deductions with Income

Allocation of Expenses

– §§861(b), 862(b), 863(a), 864(e), (f); Reg. §1.861-8 thru 14

- Foreign tax credit limitation based on <u>net</u> foreign source taxable income
- Must allocate & apportion deductions related to income
- Specific rules for interest, R&D, stewardship

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In computing FTC limit, must alloc & apportion expenses to arrive at FSTI by basket

Good cost acctg, extended to net income level

Really a predecessor to activity based costing

Expense Allocation: Code Rules

- **Reduce specific FSI for:**
  - **Deductions properly allocated or apportioned plus**
  - **Ratable part of deductions not definitely allocated to item or class of gross income**
- **Interest, R&D, stewardship, plus exp. not directly related to some income producing activity allocated & apportioned on consolidated basis**
- **Secretary to prescribe regulations**

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Code takes a very basic approach, leaves to regs.

Follow slide

This is exclusive province of accountants

Key Concepts

- **Gross income**
  - **Sales less cost of sales**
  - **Other income**
- **Deductions**
  - **Includes losses**
- **Item of gross income**
- **Class of gross income**
  - **Determined by reference to deductions**
  - **Different deductions may give rise to different classes**

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Explain above & what they mean

Concentrate on "class of GI"

Examples: Sales of widgets, where there is a widget sales department

Service income if svc. dept.

etc

Statutory vs. Residual groupings

Allocation vs. Apportionment

- **Allocate deductions related to class of gross income**
- **Apportion deductions related to all classes or not related to any class**
- **May require allocation then apportionment**
- **Factual relationships**
- **Expanded cost accounting**

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Allocation means directly attributing an item of expense to an item or class of income. No calculation needed: 1 to 1 corresp.

Apportionment means taking one item of expense and spreading over several classes of income. Requires some sort of calculation

Some expenses must be apportioned.

Use apportionment method that fits facts: square feet for building costs, etc.

However, make sure the req'd data is available.

Alloc & apport based on factual relation of costs to expenses (ABC concepts)

May require multi-tier allocation and apportionment: Example: payroll burden, secretarial support, data processing

Allocating Techniques

- **Multi-tier cost allocations**
  - **Support functions: Reg. §1.861-8T(b)(3)**
  - **See regs. under §263A**
- **Basis for allocating: fact based**
- **Must allocate expense to class even if no income in class for year**

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Concepts similar to 263A

Further examples: alloc DP to order processing & payroll depts. based on run hours. Alloc order proc. to sales. Apportion payroll to all depts except DP based on head count. Apportioned payroll dept that went to executive becomes part of expense to be apportioned.

Can be time consuming for large & complex.

Determining Factual Relationships

- **Ask questions of operations people**
- **Profit/cost center reports**
- **Questionnaires & checklists**
- **Activity Based Costing**

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Since most expenses are allocated based on relationship of expenses to income, must know facts.

Ask questions. On the inside, this is easy; may already have many answers. Outside CPAs have tougher time.

First place to check: profit or cost center reports, management reports, etc

Look for existing allocations that meet needs

May need to do questionnaires

Special Rules

- **Interest**
  - **Consolidated, asset based**
- **Research & experimentation**
  - **Consolidated, based on sales or gross income**
- **Stewardship**
- **Income taxes**
- **Contributions: apportion among all GI**
- **Losses other than stock & inventory: same as gain on such property (with exceptions; not covered)**

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Specific rules for above. Must follow, regardless of other factual relationships

Income Taxes

– **Reg. §1.861-8(e)(6)**

- **Regs may be contrary to Mobil**
- **Allocate taxes, incl. state, among income in tax base**
- **Not consolidated unless combined state return**

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My view is that requiring apportionment of SIT is directly contrary to Supreme Court cases which say states are not permitted to effectively tax income outside their borders. The fact that states use 3 factor & federal uses facts & circumstances leads to distortions. But court has said that these are not systematic distortions but merely quirks of fact.

Won't spend much time on apportionment of SIT. read regs (which are tough) if needed

State Income Taxes

- **Permanent election of one of two optional methods:**

  Both require reducing federal base for income in states with no tax

  - **110% method**
  - **100% method**

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Apportionment of SIT is tricky: cookbook it.

Requires comparison of federal tax base with aggregate state tax bases. If aggregate exceeds federal, there is presumption that states are taxing foreign. There are adjustments (which don't work) for states not taxing due to no nexus.

This can be very time consuming & most agents don't believe or understand the regs. Take any reasonable approach, document it, and leave it.

Stewardship

- **Stewardship = managing investment in subs**
  - **Examples: review of sub's borrowing needs, review of sub's performance**
- **Identify costs, including:**
  - **Officer's compensation & expenses**
  - **Support functions**
- **Directly allocate, or allocate then apportion**

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What is stewardship? Discuss. Ask class for examples & critique

How to identify: survey of relevant people

Allocate first: typically just foreign or just domestic, so no apportionment needed. Can appropriately word questionnaires so that this result happens.

Stewardship vs. Billable

- **PLR 8806002, Young & Rubicam**
- **Costs that directly benefit subs should be billed to subs**
- **Failure to bill will result in reduced FSTI or 482 adjustment**
- **If documented right, can get deduction overseas**
- **482 adjustments may impact allocation of expenses in this regard**

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Differentiating stewardship from expenses that benefit subs: facts & circumstances

Must charge subs if benefit

8806002 and Y&R are cookbooks

Compare foreign rules for management charges:

Canada: must document each charge, and must bill for cost only (no plus)

UK, Germany: can bill at cost plus, and they'll accept approximations if reasonable

Some places will accept a management charge with little documentation

R&D

– **Reg. §1.861-17**

- **Consolidated return basis**
- **Basic concept: allocate part to where performed, apportion balance**
- **Apportioned on 3 digit SIC code groups (with grouping)**
- **R&D expenses defined the same as for §174**

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R&D expenses deducted under 174 must be apportioned on sales or gross income.

Does not apply to R&D capitalized.

Must alloc on consol. return basis for broad product groups.

R&D, Summary

- **Identify 3 digit SIC group (elective grouping)**
- **Summarize costs by such group**
- **Allocate for regulatory requirements**
- **Allocate & Apportion balance**
  - **Sales method: 50% to situs, 50% apportioned**
  - **Gross income method: 25% to situs, 75% apportioned**
- **Use worldwide sales for products benefited**

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First, carve out costs required to meet regulatory requirement

Then allocate 50% to situs (for sales method only) or 25% (GI method)

Then apportion

Sales or GI method is choice each year. Can change on amended return

All members of group must do same

What is sales: for sales method only:

Sales includes sales of uncontrolled parties if:

if uncontrolled party can be reasonably expected to benefit from R&D

Amount: if sales of goods unknown, use reasonable estimate

for licensed & inestimable, use 10 times royalty

Sales includes sales of controlled party if party can reasonably be expected to benefit:

Amount is greater of:

amount that would have been if uncontrolled, or

total sales times percent of vote held

For GI method, just use GI of US consol return group.

R&D, cont.

- Sales of controlled & uncontrolled similar to prior regs.
- Gross income method apportionment to statutory must be at least 50% of sales method
- Binding election of method for 5 year blocks

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Nearly identical rules on what sales count & limits on GI method results

New: binding election. Used to be choice