Chapter 15
Source of Deductions

The source of a deduction is determined by reference to the source of the gross income to which that deduction relates. Thus, the source rules for deductions are matching rules, similar in some respects to the inventory accounting rules that taxpayers use to link the cost of goods sold with their receipts from the sale of goods included in inventory. \(^1\) Whenever possible, deductions are matched with the gross income that they help to generate. When direct matching is considered to be impractical, indirect methods for relating deductions with gross income have been developed.

Foreign persons generally want their allowable deductions to be sourced in the United States. Because foreign persons generally are not taxable on their foreign source income, a deduction attributed to foreign source income would provide them with no tax benefit, whereas a U.S. source deduction generally would reduce the amount of income subject to taxation by the United States.

U.S. persons also want their allowable deductions sourced in the United States, but for a different reason. These taxpayers generally can utilize a deduction in computing their taxable income without reference to its source. The source of a deduction is relevant, however, in determining the limitation on their foreign tax credit. By maximizing their U.S. source deductions, they minimize their foreign source deductions. By so doing, they maximize their foreign source taxable income, thereby maximizing the amount that qualifies for a foreign tax credit under the credit limitation rules.

Section 15.01, below, discusses the general rules that have been developed, largely in Treasury regulation section 1.861-8, for determining the source of deductions. Section 15.02 describes the complex set of rules applicable to the deduction for interest. The special source rules applicable for research and experimental (R&E) costs are addressed in § 15.03.

§ 15.01. General Source of Deduction Rules

Section 15.01.1, below, provides an introduction into the basic methods for determining the source of various allowable deductions. Because the source of a deduction is determined by reference to the source of the gross income that it reduces, the source rules applicable to deductions are primarily matching rules. Section 15.01.2, below, describes the so-called one-taxpayer rule for affiliated companies. The major purpose of the one-taxpayer rule is to prevent an affiliated group of companies from defeating the purpose of the various matching rules by isolating deductions in affiliated companies that earn relatively little foreign source income.

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\(^1\) Gross receipts, for purposes of computing gain from the sale of inventory property, are the amounts received by the seller from the buyer on the sale. Gross income from the sale of inventory property is computed by subtracting the cost of goods sold from gross receipts.

The various provisions of the Code concerned with the source of income generally do not depend for their operation on the source of gross receipts or on the source of the deduction for the cost of goods sold. Thus, there generally is no need for rules that determine the source of those items. It is implicit in the source rules for gross income from the sale of inventory property, nevertheless, that gross receipts from the sale of inventory property and the deduction for costs of inventory property have their source in the country where the gross income from the sale of inventory property is sourced. The source of income from natural resources does depend on the source of gross receipts from the extraction of those natural resources.
The Code and regulations offer many specific rules for determining the source of various deductible amounts. Section 15.01.3, below, addresses issues that arise in linking state and local taxes with particular items of income. The basic point made in that section is that taxes imposed by a local jurisdiction are not necessarily sourced where that jurisdiction is located. Section 15.01.4 deals with the deduction for losses. In general, a loss arising from the sale of an asset has its source in the place where the gross income from the sale would have been sourced if that asset had been sold at a gain. There are important exceptions, however, to this general rule. Section 15.01.5 describes a variety of rules that specify the source of deductions that have no obvious link to income or have a link that is at best ambiguous.

§ 15.01.1. Allocation and Appointment of Deductions

Under Treasury regulation section 1.861-8, the source of deductions is determined by allocating deductions to a class of gross income and then apportioning the deductions so allocated between U.S. and foreign sources. More precisely, deductions are apportioned “between the statutory grouping of gross income . . . and the residual grouping of gross income.” The statutory grouping of gross income is gross income from one or more countries that must be determined under some operative provision of the Code. In the taxation of foreign persons, the statutory grouping is U.S. source income and the residual grouping is foreign source income. In determining the limitation on the foreign tax credit, the statutory grouping is foreign source income and the residual grouping is U.S. source income.

Apportionment of deductions is based upon the factual relationship between the deductions allocated to a class of gross income and the U.S. and foreign source gross income in that class. Guidelines for apportioning income between U.S. and foreign sources are provided in Treasury regulation section 1.861-8. The allocation and apportionment of deductions is illustrated in the following example.

**Example 15.1: Allocation and Apportionment of Deductions**

XCo is a U.S. corporation engaged in the hotel business. It has one hotel located in Canada and another hotel in the United States. Its gross income from the hotel business is $300. According to the gross income source rules, $200 is sourced in Canada and the remaining $100 is sourced in the United States. XCo also has unrelated royalty income of $400, all of which is derived from U.S. sources. It has deductible business expenses of $100 related to its hotel business and deductible expenses of $6 related to the royalty income.

Under these facts, XCo has two relevant classes of gross income — business income and royalty income. The $100 of hotel expenses is allocated to the $300 of gross income generated by the hotel business. The $6 of royalty expenses is allocated to the $400 of royalty income.

The deductions allocated to income from the hotel business are apportioned between U.S. and foreign sources by reference to the factual relationship between those deductions and the gross income.
income in the two countries. If $60 was spent running the Canadian hotel and the remaining $40 was spent running the U.S. hotel, then $60 of deductions would be apportioned to sources in Canada and $40 of deductions would be apportioned to sources in the United States.

If the hotel expenses cannot be definitely related to a specific activity, then they would be apportioned on some reasonable basis. Ratable apportionment on the basis of U.S. and foreign gross receipts from the hotel business might be an acceptable method.

The royalty expenses are attributed to U.S. sources. No apportionment of the royalty expenses between U.S. and foreign sources is required because all of the gross income to which they relate is U.S. source income.

The Code provides that “expenses, losses, and other deductions that cannot definitely be allocated to some item or class or gross income” are to be ratably allocated to all gross income. Under Treasury regulation section 1.861-8, the only deductions that cannot be allocated to some class of gross income are the personal expense deductions. The amount of a deduction ratably allocated to the United States would be determined by multiplying the deduction by a fraction. The numerator of the fraction would be gross income sourced in the United States, and the denominator would be worldwide gross income.

Allocation and apportionment of deductions based on the fraction described above is called the gross-to-gross method of allocation. Prior to the adoption of the section 1.861-8 regulations in 1977, many U.S. taxpayers used the gross-to-gross method for most deductions that had no obvious links with specific items of gross income. That method, for example, was routinely used by U.S. taxpayers to allocate interest expenses and head office expenses.

Treasury officials believed that the gross-to-gross method systematically attributed excessive deductions to U.S. source income, thereby inflating the limitation on the foreign tax credit. The gross-to-gross method gave many U.S. corporations a substantial degree of control over the source of their deductions because of the control they have over the payment by their foreign subsidiaries of dividends, royalties, and similar items of gross income.

Application of the gross-to-gross method to the facts of Example 3.4, above, would produce clearly erroneous results. In that example, U.S. source gross income is $500, foreign source gross income is $200, and worldwide gross income is $700. The total allowable deductions of the company are $106, of which $46 are attributed to U.S. sources under the section 1.861-8 regulations. Under the gross-to-gross method, deductions attributed to the U.S. sources would equal $75.71 ($106 × $500/$700). Foreign source deductions would equal only $30.29 ($106 × $200/$700). The improper result reached under the gross-to-gross method is avoided under the section 1.861-8 regulations by requiring the taxpayer to separate deductions relating to business income from deductions relating to royalty income before making an apportionment between U.S. and foreign sources.

In some circumstances, the gross-to-gross method would produce unacceptable results even if the taxpayer had only one class of gross income. Assume, for example, that P, a U.S. holding company, has a

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6 IRC § 861(b).
7 It is not clear from the facts of the above example whether the business expenses are definitely related to a specific activity. If they are so related, they would not have been apportioned under the gross-to-gross method even prior to the adoption of the section 1.861-8 regulations.
foreign subsidiary, F, and a U.S. subsidiary D. D and F have identical businesses, and each earns $6,000 of taxable income. P has management expenses of $600 that relate to the supervision of F and D. During the taxable year, P received a dividend of $2,000 from F and a dividend of $6,000 from D. It has no other income. Under the gross-to-gross method of allocation, the head office expenses allocated to U.S. source income would be $450, determined by multiplying the amount of the deduction ($600) by the ratio of P’s U.S. source gross income ($6,000) to its worldwide gross income ($8,000).

The result reached above under the gross-to-gross method is inappropriate. It is utterly implausible to contend that P incurred $450 of its management expenses to obtain income from D and only $150 to obtain income from F. Indeed, the gross-to-gross method would allocate none of the management expense to foreign source income if P caused F to make no dividend distribution. No source rule should be so divorced from economic realities or so under the control of the taxpayer.

The section 1.861-8 regulations would require a more reasonable basis for apportioning the management expenses between U.S. and foreign sources. Apportionment according to the earnings and profits of the subsidiaries might be a good method. The appropriate method would depend on the facts and circumstances of each case. Under other circumstances, an appropriate method might be apportionment by gross receipts, unit sales volume, or gross income of the subsidiaries, or by comparisons of time spent by employees weighted to take into account differences in compensation.8

Tax-exempt assets and income from tax-exempt assets generally are not to be taken into account for purposes of allocating or apportioning any deductible expense.9 This rule, added to the Code by the 1986 tax act, is designed principally to prevent U.S. banks and other U.S. taxpayers holding tax-exempt state and local bonds from improperly increasing the amount of their deductions attributed to U.S. sources. The theory of the rule is that expenses incurred to earn taxable income should not be matched for source purposes with tax-exempt income.

§ 15.01.2. One-Taxpayer Rule for Affiliated Companies

Corporations that are members of an affiliated group are treated as if they were one taxpayer in determining the source of deductions that are not directly attributable to a specific income-producing activity.10 Under this one-taxpayer rule, interest, head office expenses, and other unspecific deductions of U.S. corporations included in an affiliated group are consolidated before being allocated and apportioned between U.S. and foreign sources. An affiliated group is composed of a chain of U.S. corporations with a common parent owning (by vote and value) 80 percent or more of the stock of the other members of the group.11 The one-taxpayer rule was adopted to prevent taxpayers from isolating the unspecified deductions of an affiliated group in corporations earning mostly U.S. source income.12

9 IRC § 864(e)(3) and Reg. § 1.861-8T(d)(2) (1999). Note that interest specifically allocable to tax-exempt income is disallowed as a deduction under IRC § 265(a)(2).
10 IRC §§ 864(e)(6) (for expenses other than interest) and 864(e)(1) (for interest). This rule was added to the Code by the 1986 tax act.
11 See IRC § 1504(a).
12 See General Explanation of the Tax Reform Act of 1986 (1987) at 944-945. For special allocation rules applicable to affiliated taxpayers, see Reg. § 1.861-14T (1988). The one-taxpayer rule has caused some taxpayers to want to avoid meeting the consolidation tests with respect to some of their subsidiaries. For discussion, see Lee Sheppard, "Ford Motor Company Avoids Interest Expense Allocation by Deconsolidating Its Financial Operations," 1 Tax Notes Int’l 472 (November 1989).
The tax avoidance schemes blocked by the one-taxpayer rule can be illustrated by the following example. Assume that P, a U.S. corporation, holds all of the stock of D, its domestic subsidiary. P has a U.S. savings account of $1,400 earning annual interest of $100 and has no other assets. It incurs expenses of $100 that are not directly attributable to a specific income-producing activity. D derives $200 of gross income from U.S. sources and $200 of gross income from foreign sources. Under the one-taxpayer rule, the $100 of unspecified expenses incurred by P would be allocated between foreign and U.S. sources as if P and D were a single corporation. But for the one-taxpayer rule, P would be able to contend that the entire $100 should be allocated to U.S. sources on the ground that all of its gross income is sourced in the United States and all of its assets are U.S. assets.

§ 15.01.3. State and Local Taxes

Some taxes, such as a sales tax or a property tax, operate like a cost of doing business in that they must be paid whether or not the operation of the business is successful. Income taxes, in contrast, are not costs of earning income; they are an expense imposed on a company only after the income has been earned. This difference in the nature of state and local taxes justifies some differences in the source rules applicable to those taxes. Section 3/B.1.3.1, below, discusses the rules applicable in determining the source of income taxes. Those rules are complicated by the fact that most states do not use source rules in determining the limitations on their taxing jurisdiction. Section 3/B.1.3.2, below, describes the source rules applicable to property taxes, and section 3/B.1.3.3 describes the rules applicable to sales taxes.

§ 15.01.3.1. Income Taxes

Deductions for state and local income taxes are to be attributed to the gross income with respect to which the taxes were imposed. If a state or local government imposes a tax on foreign source income, as determined under federal concepts of source, then Treasury regulations have long provided that a portion of the federal deduction for those taxes must be attributed to foreign source gross income. Although this rule has attracted some criticism, it is correct in principle.

The practical problem for taxpayers is to determine what portion, if any, of an income tax imposed by a state or local government should be treated as imposed on their foreign source income. The problem is particularly difficult when taxpayers are required to use an apportionment formula, based, for example, on their sales, payroll, and property, to determine the amount of their state taxable income.

The Treasury regulations provide several methods for determining the source of deductions for state and local taxes, depending on the tax laws of the jurisdiction imposing the tax. The least favorable method applies when a state uses a formulary apportionment method and does not specify in its tax laws that foreign source income is exempt from tax. In such circumstances, a taxpayer, at least initially, must treat the portion of its income subject to taxation by the state that exceeds the amount of its U.S. source income, as computed

\[13\] Reg. § 1.861-8(e)(6) (1999). Regulations specifying the source of deductions for state and local taxes were issued in temporary form in 1988 and reissued in final form in March, 1991. The temporary regulations were controversial, and rightly so. The final regulations give taxpayers many more opportunities to demonstrate that the taxes they paid to state and local governments were imposed with respect to U.S. source income.
for federal income tax purposes but without the deduction for state taxes, as foreign source income. The taxes paid to the state are then attributed ratably to foreign source and U.S. source income.14

Assume, for example, that T, a U.S. taxpayer, has taxable income, determined without a deduction for state income taxes, of $1 million, of which $800,000 is U.S. source income and $200,000 is foreign source income under federal tax concepts. The states collectively impose tax under their apportionment formulas on income of $950,000. Under these facts, the regulations initially presume that the states have taxed $150,000 of foreign source income.

Taxpayers can avoid the harsh result illustrated in the example above by showing that the states did not in fact impose a tax on foreign source income. For example, they might demonstrate that the difference between the amount subject to tax by the states and the amount of their U.S. source income for federal purposes was due to the allowance by the states of less generous deductions for depreciation.15

If a state explicitly exempts all foreign source income from taxation, then all taxes paid to that state are allocated to U.S. source income. In the example above, the entire amount of the taxes paid to the states would be allocated to U.S. source income if the laws of each of the states prohibited the taxation of foreign source income. If only one of the states had such a prohibition in its laws, then its taxes would be allocated solely to domestic source income and the taxes of the other states would be allocated in part to foreign source income.16

Some states impose a tax on the foreign source dividends received by their taxpayers but otherwise exempt foreign source income from taxation under their tax laws. In such circumstances, the amount of taxes imposed with respect to the foreign dividends will be allocated to foreign source income and the remaining taxes will be allocated to domestic source income.17 Two safe-harbor rules are provided in the regulations to assist the taxpayer in determining the amount of taxes properly allocable to foreign source dividends.18

The validity of the section 1.861-8(e)(6)(i) regulations, as applied to a California taxpayer, were upheld in Chevron.19 At the time of the case, California determined the net income of a corporate group operating a unitary business within its borders by applying a three-factor formula to the total worldwide net income (“preapportionment income” in state tax terminology) of that group. Dividends received from members of the corporate group are excluded from the group’s total income, but dividends received from other corporations are included in total worldwide income. Chevron was engaged in a unitary business (extraction, refining, and sale of petroleum products) in California and received very substantial dividends from Aramco, a Saudi Arabian corporation not included in Chevron’s corporate group. The basic position of the Internal Revenue Service was that the California income tax should be allocated to foreign source gross income to the extent that the tax was imposed on foreign source income. That position was upheld by the Tax Court.

Treasury regulation section 1.861-8(e)(6)(i) specifically provides that a state income tax that is imposed on foreign source dividends received by a unitary business will be apportioned directly to those dividends if the state is using a formulary apportionment method of taxation and does not include the factors of the

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distributing corporation in the apportionment formula. In the language of the regulations, the specially taxed foreign dividends constitute a separate class of gross income. Chevron's dividends from Aramco fell within this regulatory rule. In accordance with the regulatory rule, which was upheld by the Tax Court, the Service allocated the portion of the California income tax attributable to the Aramco dividends to foreign source gross income.

Chevron had allocated nearly all of the California tax to U.S. source gross income, using methods that were not sanctioned by the regulations. In upholding the regulations, the Tax Court rejected Chevron's allocation methods. As a fallback position, Chevron contended that it should be permitted to use the allocation and apportionment method suggested by Example 25 of the regulations. The Tax Court agreed, rejecting the claim of the Service that Chevron had failed to make a timely election to use the method of Example 25.

Example 25 exemplifies what may be called the “America First” method. Under America First, a state unitary income tax generally is treated as attributable to U.S. source net income to the extent that the net income taxable by the state (after certain adjustments) does not exceed the taxpayer’s net U.S. source income. Assume, for example, that the taxpayer’s California pre-apportionment net income is $1,000, of which $500 is U.S. source net income. California imposes tax of $40 on net income of $400. All of that tax will be considered under America First to be attributable to U.S. source income. A pro rata method, advocated by the Service in Chevron, would attribute one half of the tax ($500/$1,000 × $40 = $20) to foreign source net income. If California had imposed a tax of $60 on net income of $600, then $50 of the tax would be attributed to U.S. source income under America First, and the remaining $10 would be attributed to foreign source income.

§ 15.01.3.2. Property Taxes

The section 1.861-8 regulations do not deal specifically with the allocation and apportionment of state and local taxes other than income taxes. Under the matching principle embodied therein, however, all state and local taxes should be attributed to the gross income they help produce. Thus, state property taxes imposed on a taxpayer’s manufacturing facility should be allocated to the class of gross income derived from the manufacture and sale of the goods produced at that facility. A U.S. manufacturer typically would determine the source of income derived from the manufacture and sale of goods under the two-factor allocation formula set forth in the regulations under Code section 863(b). Taxpayers using the 50/50 formula generally must apportion their deductible expenses ratably between their U.S. source gross income and their foreign source gross income.

A state or local property tax imposed on equipment used by the taxpayer to earn international communications income would be allocated to that class of gross income. For a U.S. person, gross income from the transmission of communications or data between the United States and a foreign country is apportioned on a 50-50 basis between U.S. sources and foreign sources. Property tax deductions relating to that gross income should be apportioned by the same formula.

A state or local property tax imposed on equipment held for rent should be allocated to the gross income derived from the rental of that property. The source rule for income derived from the rental of property is the place of use. Thus, a property tax imposed by a U.S. state on rental property used within that

state would be allocated and apportioned entirely to U.S. source income. If the rental property is used outside the United States, however, the section 1.861-8 regulations require the taxpayer to apportion the taxes between the domestic and foreign sources on some reasonable basis. For example, if a U.S. person is running a car rental business and some of the cars are rented for use in Canada, then the taxpayer must apportion some of the property taxes imposed on those cars to the rental income derived from the use of the cars in Canada.

Some weak authority is provided by Missouri Pacific Railroad for allocating to the United States the entire amount of state property taxes imposed on rental property used in interstate and international commerce. The case predates the section 1.861-8 regulations and is badly reasoned in any event. In support of its holding, the court stated that “[p]ayment of the property taxes to the several states in no way affected the right of the taxpayer to operate in Mexico or enhanced its ability to earn income in that nation.” That observation, although undoubtedly correct, is irrelevant under the section 1.861-8 regulations. The correct issue for the court under the regulations would have been whether the property taxes were paid with respect to property used to earn income in Mexico. If the answer was yes, then some portion of the deductions for property taxes should be allocated to foreign source income.

Missouri Pacific Railroad is good authority for the proposition that a state property tax on railway cars or other rolling stock should be attributed to gross rental income derived within that state from the rolling stock if the tax is reasonably apportioned by the state to apply only to the use of the rolling stock within that state. The case is not good authority for the more general proposition that a property tax imposed on property used to earn foreign source income can be apportioned entirely to the state where the property is located. That latter proposition is illogical and is directly contrary to the principles of Treasury regulation section 1.861-8.

§ 15.01.3.3. Sales Taxes

Sales taxes imposed by a state or local government should be allocated and apportioned according to the matching principal of Treasury regulation section 1.861-8. Sales taxes imposed on goods used in the production of inventory property might best be treated as an inventory cost, with the allocation and apportionment then made under the inventory accounting rules. Sales taxes imposed on office supplies might be allocated and apportioned according to the methodology used to allocate and apportion head office expenses. A taxpayer who purchases an automobile for use in his business should allocate the sales tax imposed on that purchase to his business income. Whatever method is used to attribute state and local taxes to a grouping of gross income, it “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.”

21 Missouri Pacific Railroad Company v. U.S., 411 F.2d 327 (8th Cir. 1969), cert. denied, 396 U.S. 1037 (involving state property taxes imposed on railroad cars used to generate rental income in the United States and Mexico).

22 In addition, the court apparently was under the mistaken opinion that an allocation of some portion of the state taxes to Mexican source income would impugn the constitutionality of the state property taxes.

23 For property used predominantly for earning either U.S. source income or foreign source income, a de minimis rule should be provided by regulation that would allocate the entire state tax to U.S. source or to foreign source gross income, as the case may be. See IRC § 865(c)(3)(B) (providing such a de minimis rule for determining the source of gain derived from the sale of depreciable property).

§ 15.01.4. Losses

The source of a deduction for a loss resulting from the sale or other disposition of personal property described in Code section 865 ("section 865 property") is generally the place where gain from the sale of that property would have its source. For example, a loss recognized by a United States resident on the sale of a bond generally is allocated to reduce United States source income because gain on that sale would be U.S. source income under the residence-of-the-seller rule. Similarly, a loss on the sale of stock by a U.S. resident would reduce U.S. source income. The residence of the seller is determined under the special residency rules of Code section 865(g). A partner's share of a loss recognized by a partnership is treated as if the partner had recognized the loss.

A taxpayer who suffers a net operating loss from engaging in a business activity generally is allowed to deduct that loss under Code section 172. The source of the loss carryover is the place where the deductions giving rise to the loss carryover were located.

The general rule produces results that are favorable for most U.S. persons and unfavorable for foreign persons and U.S. persons treated as foreign persons under the special residency rules of Code section 865(g). Exceptions to the general rule and several anti-avoidance rules reduce the benefits otherwise obtainable under the general rule.

There are some important exceptions to the general rule described above for locating the source of a loss on the disposition of section 865 property in order to prevent abuses of the general rule. Different exceptions apply to losses on stock and losses on other categories of personal property. The following exceptions to and clarifications of the general rule apply to dispositions of personal property other than stock:

(1) Foreign Office. A loss on the disposition of personal property incurred by a U.S. resident that is attributable to a foreign office is sourced in the country where the office is located if a gain would have been attributed to that office.

(2) Foreign Tax Home. With certain exceptions, a loss recognized by a U.S. citizen or resident alien having a foreign tax home will be foreign source income.

25 Reg. §§ 1.865-1T(a)(1) (1998) and 1.865-2(a)(1) (1998). The current general rule was adopted by regulation in 1998. Under prior regulations, the general rule was that losses on a sale of personal property constituting a capital asset were sourced where the income from that property was generated (or were expected to be generated). Reg. § 1.861-8(e)(7)(i) (1999). See Black & Decker Corp. v. Comm’r, TC Memo 1991-557 (applying prior general rule to hold that loss on deemed disposition of stock of Japan affiliate is a foreign source loss despite failure of affiliate to pay dividends).

26 Id. (providing this example). See IRC § 865(a)(1) (stating the residence-of-seller rule).

27 Reg. § 1.865-2(a)(1) (1998) (providing this example). This result was reached in Int'l Multifoods Corp. v. Comm’r, 108 T.C. 579 (1997). For an early discussion of making the source of losses on the sale of stock the place where the gain on such stock would be sourced, see Gail W. Taylor, "Determining the Source and Category of Losses on Dispositions of Stock," 3 Tax Notes Int’l 205 (February 1991).

28 See Reg. § 1.861-2(d)(4) (giving cross reference to IRC § 865(g)). No similar cross reference is provided in Reg. § 1.861-1T (1998). For discussion of the section 865 residency rules, see section 3/A.2.2.7, above.


(3) **Inventory.** Losses attributable to inventory property described in Code section 1221(a)(1) are not governed by the regulations under section 865.\(^{33}\) Whether the location of a loss on the sale of inventory property is determined under the passage-of-title test is unsettled. Taxpayers electing a method for apportioning gains from the production and sale of inventory property presumably must use that method in determining the source of losses.\(^{34}\)

(4) **Depreciation Recapture.** To maintain parallel treatment of gains and losses, a loss on the disposition of depreciable property subject to recapture is located in the country where the property was predominantly used.\(^{35}\)

(5) **Interest and Interest Substitutes.** Losses attributable to assets that generate amounts taxable as interest or interest substitutes generally are allocated and apportioned under the rules applicable to deductions for interest.\(^{36}\)

(6) **Currency and Certain Financial Instruments.** Currency losses and loss recognized with respect to options contracts or derivative financial instruments are not governed by the regulations under section 865.\(^{37}\)

Some of the above exceptions also apply to losses on the disposition of stock, and some additional exceptions also apply. In general, the following exceptions to and clarifications of the general rule apply to dispositions of stock:

(1) **Common Exceptions.** The foreign office exception,\(^{38}\) the foreign tax home exception,\(^{39}\) and the inventory exception,\(^{40}\) described in items 1-3 above, also apply to dispositions of stock.

(2) **Real Property Interest.** A loss recognized by a nonresident alien individual or a foreign corporation with respect to stock that constitutes a United States real property interest is sourced in the United States.\(^{41}\)

(3) **Stock of an S Corp.** A loss recognized with respect to stock in an S corporation (as defined in Code section 1361) is not treated as a loss on section 865 property.\(^{42}\)

(4) **Dividend Recapture.** Subject to some exceptions, a loss on the disposition of stock has its source where the dividends received on that stock within the prior two years had their source, up to the amount of those dividends.\(^{43}\) Assume, for example, that PCo, a U.S. corporation, received dividends of $400 from FCo, its foreign subsidiary, during year 1 and year 2. At the end of year 2, PCo sells the FCo stock at a loss of

\(^{33}\) Reg. § 1.861-1T(c)(2) (1998).

\(^{34}\) See Reg. § 1.863-3(e)(1) (requiring taxpayer to obtain permission of tax authorities to change its apportionment method).


\(^{36}\) Reg. §§ 1.861-1T(b)(2) (1998) and 1.861-1T(c)(3)–(5) (1998)


$1,000. Assuming no exceptions or special rules apply, PCo would have a foreign loss of $400 and a U.S. loss of $600.

In addition to the exceptions to the general rules described above, the following three anti-abuse rules apply to losses arising from the disposition of section 865 property. For these rules to apply, the circumstances must indicate that the taxpayer was attempting to manipulate the source of its loss to avoid taxes.

(1) Built-in Losses. If a taxpayer holds an asset that would generate a foreign loss on its disposition, the loss will continue to be a foreign loss under the built-in loss rule even if the taxpayer transfers the asset to a related person or otherwise engages in a transaction that would cause the built-in loss to become a U.S. loss under the general rule. For example, assume that FCo, a foreign affiliate of PCo, holds assets valued at $100 with a tax basis of $200. A sale of that asset by FCo would produce a foreign loss. To change the source of the loss, FCo transfers that asset to PCo as part of a tax-free exchange, and PCo disposes of it. The loss is a foreign loss under the built-in loss rule.

(2) Offsetting Positions. Under the offsetting positions rule, a taxpayer must treat a loss as a foreign loss if it disposes of personal property that would constitute a U.S. loss under the general rule and it, or a related person, holds an offsetting position with respect to that property that has produced or will produce an equivalent amount of foreign source gain. For purposes of this rule, two positions are offsetting if the risk of loss of holding the first position is substantially diminished by holding the second position. Assume, for example, that PCo, a U.S. corporation, purchases for $200 a contractual right to purchase 1,000 bushels of corn on the last day of year 1 for $4,000. FCo, its foreign affiliate, holds a contractual right to sell 1,002 bushels of corn on the third day of year 2 for $4,001. These positions in corn are offsetting. As a result, if PCo disposes of its contract right for a loss of $50, the loss will be a foreign loss.

(3) Matching Rule. Subject to certain exceptions, a taxpayer must recognize a foreign loss under the matching rule if it engages in a transaction generating foreign source income that results in the creation of a corresponding loss that would constitute a U.S. loss under the general rule. Assume, for example, the PCo establishes FCo, a foreign corporation. In year 1, PCo contributes $1,000 to the capital of FCo in exchange for one share of so-called fast-pay preferred stock. The preferred share is entitled to a dividend in year 1 and year 2 of $400 per year and is redeemable at the end of year 3 for $210. PCo received preferred dividends of $400 in years 1 and 2. At the start of year 3, it sells the preferred stock to NCo, an unrelated purchaser, for $200, recognizing a loss of $800. Because PCo recognized foreign source income for tax purposes that resulted in the creation of a corresponding loss with respect to the FCo preferred stock, the $800 loss is characterized as a foreign loss under the matching rule.

Making the rules determining the source of losses reciprocal to the source rules for gains is unsound, in theory and practice. The practical objections are evident from the many exceptions and complex anti-avoidance rules that are required to prevent major abuses. It is unsound in theory because it is not fully consistent with the justification for allowing a deduction for business losses.

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The basic fairness rationale for allowing a deduction for business losses is that a government that treats itself as a silent partner of the taxpayer in collecting revenue on income ought to treat itself as a silent partner in sharing losses. With respect to investment made in a foreign country, there are two silent partners, the government exercising residence jurisdiction and the government exercising source jurisdiction. When the U.S. government makes itself a silent partner with a U.S. person investing in a foreign country for purposes of collecting taxes on income, it is the junior partner (the residual tax collector) and the government of the foreign country is the senior partner (the primary tax collector). The U.S. government should remain the junior partner when the income does not materialize and the taxpayer suffers a loss. That result is achieved by characterizing the loss as a foreign loss. As a foreign loss, it reduces income that the United States taxes only on a residual basis and does not reduce U.S. source income, over which the United States exercises primary jurisdiction.

When a U.S. person makes a foreign investment that is expected to generate unrealized capital appreciation, the reciprocal approach often produces an appropriate result. A foreign government cannot reasonably expect to obtain income tax revenue from unrealized appreciation or from the sale by a U.S. person of stock or certain other categories of intangible property. It should not be required, therefore, to share the loss. When the U.S. person invested in a foreign country with an expectation that it would generate foreign source dividends, interest, royalties, or other income subject to tax by the government of that country, however, then the foreign government should be required to act as the senior partner in sharing any resulting loss.

The proper tax policy result would be achieved in most cases by linking the source of a loss on an investment in personal property to the source of the income that the investment was expected to generate when it was made. That rule is superior to the current rule in theory and would be less complex to administer.

§ 15.01.5. Miscellaneous Other Deductions

Specific guidance is provided in the section 1.861-8 regulations for determining the source of a variety of deductions that are not linked clearly with any particular item of income. Sections 3/B.1.5.1 through 3/B.1.5.5, below, discuss the source rules applicable to those deduction.

§ 15.01.5.1. Supportive Functions

Deductions for overhead costs, supervisory expenses, general administration, and the like may be difficult to link with specific classes of gross income. The section 1.861-8 regulations offer two alternatives to making such linkage for supportive functions other than stewardship expenses. First, if the taxpayer can establish that those supportive expenses relate to other deductions that are more easily allocated to gross income, it may allocate them according to the methodology used to allocate those other deductions. For example, if the taxpayer hires an outside accountant for which accurate time allocation records are kept, and the accounting services relate closely to the taxpayer’s supervisory activities, then the allocation and apportionment method used for the accounting charges also might be used for the supervisory activities.

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Second, the taxpayer may allocate the supportive expenses directly to all gross income or to another broad class of gross income and apportion the expenses in some appropriate manner. For example, the taxpayer might allocate supervisory expenses to gross income from sales of its products and then apportion the expenses between U.S. sources and foreign sources by reference to gross receipts from U.S. and foreign sale of its products. If the supervisory deductions relate to all classes of income, the taxpayer might allocate and apportion them using the asset method, which is used primarily to allocate and apportion interest deductions.

§ 15.01.5.2. Stewardship Expenses

A stewardship expense, as defined in the section 1.861-8 regulations, is a cost incurred by a corporation to oversee its investments in its affiliated companies. In a refined accounting system, such expenditures might be considered capital in nature. In most circumstances, nevertheless, they appear to be deductible in the year the expense was paid. These expenditures are considered to be definitely related and allocable to dividends received, or to be received, from the affiliated companies.

Assume, for example, that P, a U.S. holding company, has two subsidiaries, F and D. F is organized in Country X and earns only foreign source income. D is a domestic company and earns only U.S. source income. P spends $1,000 in supervising F and $500 in supervising D. P’s only income is a dividend of $10,000 from D. Under these conditions, the $1,000 spent on supervising F is allocated to foreign source gross income, with the result that P has a loss of $1,000 from sources without the United States. The $500 of supervisory expenses relating to D is allocated to U.S. source income, producing net taxable income from U.S. sources of $9,500.

§ 15.01.5.3. Legal and Accounting Fees

Fees for legal or accounting services generally should be allocable to the specific class or classes of gross income to which they relate or to all classes of gross income, depending on the nature of the services rendered. For example, accounting fees paid for the preparation of a study on the costs of manufacturing a product in the United States for sale in Country A would be allocated to gross income derived from the manufacture and sale of that product and apportioned between those two countries, presumably under the two-factor formula provided in the regulations under Code section 863(b). An allocation to one or more classes of gross income must be made even if the provider of the legal or accounting services fails to provide an itemized bill.

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51 Id.
53 Reg. § 1.861-8T(b)(3) (1999). See also Reg. § 1.861-8T(c)(2) (1999) (allowing taxpayers to use the asset method to apportion deductions other than interest in appropriate cases). For description of the asset method, see section 3/B.2.1, below.
55 The example is drawn from Reg. § 1.861-8(g)(Ex. 17) (1999).
57 Id.
§ 15.01.5.4. Charitable Contributions

The general rule is that charitable deductions are allocated pro rata to the taxpayer’s worldwide gross income.59 This venerable rule is a model of simplicity, is consistent with the treatment of other personal deductions, conforms with the statutory language, and is supported by case law.60

A proposed regulation issued in 1991 would modify the general rule.61 It provides that a deduction for a charitable contribution generally would be allocated solely to U.S. source gross income if the taxpayer has designated the contribution for use in the United States and has reason to believe that the contribution will be so used.62 Thus, a gift to an American university for minority scholarships typically would have a U.S. source. A donation by a substantial contributor to a private foundation would be eligible for this exception only if the contributor has required the foundation to set up a restricted account and to keep full records of the use of the funds in that account.63

A deduction would be allocated solely to foreign source gross income under the proposed regulation if the taxpayer designated the gift for use outside the United States or has reason to believe that the gift could be used only outside the United States.64 Thus, a gift of blocked currency that could be used only in a particular foreign country would result in a foreign source deduction. Similarly, a gift of medication with an expired or expiring date should result in a foreign source deduction if sale of that medication within the United States would be contrary to federal regulations.

In all other circumstances, the proposed regulations would ratably apportion a charitable deduction to the taxpayer’s gross income.65 Assume, for example, that P, a U.S. corporation, makes an untied gift of $100 to an organization benefitting persons afflicted with cancer. P has gross income from U.S. sources of $5,000 and gross income from foreign sources of $20,000. Under these facts, the deduction does not relate solely for use either within or without the United States because cancer victims are found both within and without the United States. Thus, the deduction would be apportioned ratably to P’s gross income under the proposed regulations. P would apportion $20 (\$100 \times \$5,000/\$25,000) of the gift to U.S. sources and the remaining $80 (\$100 \times \$20,000/\$25,000) to foreign sources.66

The result reached under the proposed regulation for gifts designated for use in a particular country is curious, to say the least. A company making what it designates as a charitable contribution may actually be making the contribution for business reasons, without any charitable impulse. In that event, deductions for such contributions should be treated as business expenses and allocated to the class of income they help

60  See Grunebaum v. Comm’r, 50 T.C. 710 (1968), aff’d, 420 F.2d 332 (2d Cir. 1970).
66  Prop. Reg. § 1.861-8(g)(Ex. 34) (1991). The proposed rule raises serious problems of interpretation. Is an unrestricted gift to an American university that conducts research with international implications to be attributed exclusively to the United States or allocated pro rata? How are gifts to a U.S. public radio station that occasionally broadcasts outside the United States to be allocated? Because the proposed regulation is not based on any discernible principle, it offers little or no guidance in answering such questions.
generate. The country of use of the deduction by the charity would be irrelevant unless, by happenstance, the particular use by the charity resulted in a business advantage to the donor.67

Congress generally has viewed the deduction for charitable contributions as an incentive for charitable giving. To achieve the maximum incentive for charitable giving, Congress might provide that all charitable deductions are allocated to U.S. source income. Or it might do what the proposed regulations do — provide an incentive for charities that provide exclusive benefits within the United States and a disincentive for charities operating abroad. That choice, however, is for Congress to make. The regulation writers should not be making spending choices for Congress under the guise of interpreting the Code.68

§ 15.01.5.5. Personal Expenses

Deductions for personal expenses and losses are apportioned ratably to gross income. Under this rule, pro rata apportionment applies to deductions for (1) property taxes on a personal residence; (2) medical expenses; (3) alimony payments; and (4) personal interest.69 As discussed in section 3/B.1.5.4, above, it also applies under the current regulations to charitable deductions. The personal exemptions for the taxpayer and dependents are allowed without allocation or apportionment.70

§ 15.02. Interest Payments

Two separate methods are used for allocating and apportioning interest payments. The general rule, discussed in section 3/B.2.1, below, is provided in Treasury regulation section 1.861-8 and Code section 864(e)(2). In general, it allocates interest deductions to all classes of gross income and apportions those deductions by reference to the location of the taxpayer’s assets.

A special rule, contained in Treasury regulation section 1.882-5, is applicable only for the purpose of determining the income of foreign corporations that is effectively connected with a U.S. trade or business. This special rule is described below in section 3/B.2.2. It is a hybrid of an asset method of apportionment and a tracing of liabilities method. This rule does not apply to nonresident alien individuals.

§ 15.02.1. The Section 1.861-8 Interest Source Rule

In many circumstances, interest payments are capital in nature. That is, they are costs incurred to earn income in some future period. The Code, nevertheless, allows a deduction against current gross income for such expenditures in many circumstances. The congressional purpose in providing a special status for

67 See Reg. § 1.170A-1(c)(5) (1996) (“[t]ransfers of property to an organization described in section 170(c) which bear a direct relationship to the taxpayer’s trade or business and which are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses rather than as charitable contributions”). Most business advantages obtained from a charitable gift constitute goodwill, the cost of which does not qualify for a current deduction.

68 By failing to revoke the proposed regulation, the U.S. tax authorities are encouraging taxpayers who would benefit from it to file their tax returns in accordance with it, whereas taxpayers who do not benefit from it are filing in accordance with current law. In effect, the tax authorities have placed the U.S. government in a whipsaw position.


interest payments is unclear. It may be due, at least in part, to the lack of a scholarly consensus as to the proper tax treatment of those payments.\textsuperscript{71} Over the past several years, Congress has required taxpayers to capitalize many types of interest payments, although payments made in the ordinary course of business generally can be deducted in the year paid or accrued.\textsuperscript{72}

To the extent that interest deductions do not relate to gross income earned in the current period, the matching principal of Treasury regulation section 1.861-8 is not useful for relating those deductions to particular items of current income. That is, deductions that help earn income accruing in future periods are not related, under the matching principle, with income accruing in the current period. Some rules must be employed, nevertheless, to determine the country of source of those deductions. The rules provided are above average in complexity.

As a simplification measure, a U.S. citizen or resident having an interest expense of no more than $5,000 is allowed to apportion the entire interest expense to U.S. sources without reference to the principles of Treasury regulation section 1.861-8.\textsuperscript{73} This \textit{de minimis} rule also applies to U.S. estates and certain trusts.\textsuperscript{74} If the $5,000 threshold is exceeded, then business interest, investment interest, and passive interest of a U.S. individual are apportioned under a modified asset method. Deductible interest paid with respect to a qualified residence and other deductible personal interest are apportioned according to a gross income method.\textsuperscript{75}

A nonresident alien individual can deduct interest only to the extent that it is attributable to income that is effectively connected with a U.S. trade or business. Interest expense is not considered to be related to effectively connected income unless it is incurred (1) with respect to liabilities that are entered on the books and records of the U.S. trade or business or (2) with respect to liabilities that are secured by assets that generate effectively connected income.\textsuperscript{76} Nonresident aliens cannot deduct interest that is paid or accrued with respect to liabilities that exceed 80 percent of the gross assets of the U.S. trade or business.\textsuperscript{77} In addition, interest on debts that are secured by property other than the assets of the nonresident’s U.S. trade or business are not deductible.\textsuperscript{78}

Section 15.02.1.1, below, describes in appropriate detail the operation of the asset method that taxpayers other than foreign corporations generally must use to determine the source of their interest deductions. Exceptions to the asset method, other than the \textit{de minimis} exception described above, are addressed in section 15.02.1.2, below. The policies underlying the asset method are analyzed in § 15.02.1.3.


\textsuperscript{73} Reg. § 1.861-9T(d)(1) (2009).

\textsuperscript{74} Id.

\textsuperscript{75} Reg. § 1.861-9T(d)(1)(i)-(iv) (2009).

\textsuperscript{76} Reg. § 1.861-9T(d)(2)(i) (2009).


\textsuperscript{78} Reg. § 1.861-9T(d)(2)(ii)(B) (2009).
§ 15.02.1.1. Operation of Asset Method

Under the general interest source rule of Treasury regulation section 1.861-8, each interest payment is allocated ratably to the assets of the taxpayer, generally in proportion to the tax book value of those assets. The interest payment is then apportioned between U.S. and foreign sources. The amount apportioned to U.S. sources is determined by multiplying the interest payment by a fraction. The numerator of the fraction generally is the tax book value of those assets expected to generate taxable gross income sourced in the United States, and the denominator is the tax book value of the taxpayer’s worldwide assets expected to generate taxable gross income. This method of determining the source of interest deductions is referred to in the section 1.861-8 regulations as the “asset method” of apportionment. The following example illustrates its operation.

Example 15.2: Asset Method of Apportionment

P is a U.S. corporation conducting business in the United States and in Country A. During the taxable year, P makes a deductible interest payment of $100. It owns a valuable patent right that has a tax book value of $600. One-third of the income derived from that patent is U.S. source gross income and the remaining two-thirds is foreign source gross income. P has assets with a tax book value of $800 used in connection with its business operations in the United States. The U.S. assets include inventory, working capital, trade receivables, depreciable equipment, plant, and patent rights used to earn income within the United States.

P’s assets relating to its business in Country A have a tax book value of $2,600. Those assets include inventory, working capital, trade receivables, depreciable equipment, patent rights, and plant used to earn income within Country A.

To compute its foreign tax credit limitation, P must determine the amount of its foreign source taxable income. For that purpose, it must apportion its interest deduction between the statutory grouping, foreign source gross income, and the residual grouping, U.S. source gross income. The amount of the interest deduction apportioned to foreign source income is $75 and the amount apportioned to U.S. sources is $25, computed as follows:

1. Total interest payments ............................................................... $100
2. Tax book value of assets related to earning taxable U.S. income ($200 + $800) ........ $1,000
3. Tax book value of assets related to earning taxable income in Country A ($400 + $2,600) . . $3,000
4. Total tax book value of worldwide assets used to earn taxable income ...................... $4,000
5. Interest apportioned to foreign sources (line (1) × line (3)/line (4)) ........................... $75
6. Interest apportioned to U.S. sources (line (1) × line (2)/line (4)) .............................. $25

79 The tax book value of assets is typically determined by averaging the tax book value of assets held at the beginning and at the end of the taxable year.
80 Reg. § 1.861-9T(g)(1) and (2) (2009). Apportionment on the basis of assets is specifically authorized in IRC § 864(e)(2), as amended by the 1986 tax act. Proposed revisions of the regulations relating to interest were published by the Treasury Department in 1984 and then withdrawn in 1987. New temporary regulations were issued to reflect the changes in the interest source rules and the interest deduction rules enacted as part of the 1986 tax act. See Reg. §§ 1.861-9T to -13T.
The world of Treasury regulation section 1.861-8 is substantially more complex than the example above suggests. In computing the limitation on the credit, it is not enough for a U.S. person to determine interest apportioned to foreign source gross income. It must also determine the amount of interest apportioned to each of the applicable credit limitation baskets established by Code section 904(d). For example, if P, the above example, has some passive foreign source income and also some foreign business income, it must determine the amount of interest apportioned to the “passive income basket” and the “general limitation basket.”

The method for apportioning the interest deduction among the separate limitation baskets is simply an extension of the method illustrated above. To employ that method, the taxpayer must determine the value (generally tax book value) of its assets used to produce foreign source gross income in each of the limitation baskets. It then must apportion the interest deduction to each basket by multiplying the deduction by the ratio of assets related to that basket over total worldwide assets. In the above example, if P used assets with a tax book value of $400 to produce foreign source passive gross income, then the interest deduction apportioned to its passive income basket would be $10 ($100 × $400/$4,000).

To apply the apportionment formula mandated by the asset method, taxpayers must divide their assets into two categories — those likely to generate income in the statutory grouping and those likely to generate income in the residual grouping.81 The actual physical location of the assets is not important.82 For example, if a taxpayer holds inventory located in the United States and the inventory is expected to be sold outside the United States, then the inventory is as an asset held for production of foreign source income.83 Taxpayers may elect to sort their assets based on their fair market value or their tax book value.84

Problems can arise in determining the proper division of assets between those likely to generate income in the statutory grouping and those likely to generate income in the residual grouping. The regulations provide some detailed guidance in solving those problems.85 The basic approach is to classify assets into three types. Type I assets are labeled “single category assets.” These assets are ones that are likely to generate income exclusively within a single statutory grouping or the residual grouping.86 In the above example, the inventory, working capital, trade receivables, depreciable equipment, plant, and patent rights used to earn income within the United States would all be Type I assets. Type I assets are attributable either to the statutory or to the residual grouping, as the case may be.

Type II assets are called “multiple category assets,” and, as the name suggests, they are assets that are likely to produce income within more than one statutory or residual grouping.87 The patent right in the above example is a Type II asset. A Type II asset is obviously attributable partly to the statutory grouping and partly to the residual grouping. The attribution to the statutory grouping is made by multiplying the value of the asset (typically tax book value) by a fraction. The numerator is the amount of income actually

82 Reg. § 1.861-9T(g)(3) (2009).
83 Reg. § 1.861-12T(b) (1988).
generated in the statutory grouping by that asset during the taxable year, and the denominator is the total income actually generated by the asset during the taxable year.\textsuperscript{88}

The remaining division, Type III assets, are called "assets without directly identifiable yield."\textsuperscript{89} These assets fall into a hard-to-classify category either because they do not produce an obvious income stream or because they support the production of all income. A corporate headquarters is the example given in the regulations of a Type III asset.\textsuperscript{90} A piece of art work in the president's office might be another example. Type III assets are simply ignored in applying the asset method. In effect, their value is apportioned pro rata between assets in the statutory grouping and the residual grouping, based upon the value of the Type I and Type II assets attributable to those groupings.

Interest expenses of affiliated corporations are apportioned under the asset method using the one-taxpayer rule. That is, the interest expenses of all members of an affiliated group are aggregated and then apportioned as if the family of corporations were a single corporation.\textsuperscript{91} The one-taxpayer rule applies primarily for purposes of computing limitations on the foreign tax credit.\textsuperscript{92} It does not apply in computing the income of controlled foreign corporations subject to taxation under subpart F or for the computation of the effectively connected income of foreign corporations.\textsuperscript{93} In applying the asset method under the one-taxpayer rule, stock of corporations within the affiliated group is ignored.\textsuperscript{94} A special rule treats financial corporations that are part of an affiliated group as a separate taxpayer for purposes of the one-taxpayer rule.\textsuperscript{95}

In theory, the asset method should apportion interest expenses on the basis of the fair market value of assets held by the taxpayer. In practice, however, the apportionment is generally based on the tax book value of assets. Tax book value is the taxpayer's adjusted tax basis in its assets, as determined under Code section 1011, with the adjustments required by regulation for application of the tax-book-value method.\textsuperscript{96} Taxpayers may elect to use fair market value for apportionment purposes if they establish the market value of their assets to the satisfaction of the tax authorities.\textsuperscript{97}

The tax book value of assets would produce appropriate results in the apportionment formula employed in the asset method only if the tax book value is systematically proportionate to market value. Unfortunately, many taxpayers hold assets that have a basis that bears no systematic relationship to market value. Common examples of assets that typically have a market value substantially in excess of their book value are stock in related corporations, intangible property developed by the taxpayer, and property with respect to which depreciation has been taken using an accelerated cost recovery method.

\textsuperscript{88} Reg. §§ 1.861-9T(g)(3) (2009) and 1.861-12T(j) (Ex. 1) (1988). It is inconsistent with the theory of the asset method to have the apportionment depend on actual income for the taxable year. According to the theory, the apportionment of interest should depend upon the income expected to be generated by assets in the past, present, and future. Using current income obviously is more simple and more certain than indulging in speculation about future income.

\textsuperscript{89} Reg. § 1.861-9T(g)(ii) (2009).

\textsuperscript{90} See Reg. § 1.861-12T(j)(Ex. 1) (1988).

\textsuperscript{91} IRC § 164(a)(1) and Reg. § 1.861-11T(c) (1988). For discussion of the one-taxpayer rule, see section 3/B.1.2, above.

\textsuperscript{92} Reg. § 1.861-11T(b)(1)(1988).

\textsuperscript{93} Reg. § 1.861-11T(b)(2)(1988).

\textsuperscript{94} Reg. § 1.861-11T(c)(1988).

\textsuperscript{95} Reg. § 1.861-11T(d)(4)(1988).

\textsuperscript{96} The term "tax book value" is not defined in the regulations, although its meaning is clear. A definition of tax book value was included in the regulations when they were first issued in 1977.

\textsuperscript{97} Reg. § 1.861-9T(g)(1)(ii) and (h) (2009)
A refined asset method of apportionment would make some adjustments for cases in which a systemic discordance between book value and market value has been identified. The only adjustment actually required under the asset method because of discordance between book and market values, however, is for stock in certain related corporations.

In most cases, the tax book value of stock of a related corporation equals the amount of capital originally contributed to it. The market value of the stock, however, depends in substantial part on the amount of the retained earnings of the corporation. The Code provides that a taxpayer owning 10 percent or more of the stock of a corporation (domestic or foreign) must increase the tax book value of the stock by the amount of the corporation’s undistributed profits for purposes of applying the asset method.98 The important consequence of this rule is to increase the tax book value that U.S. corporations must use in allocating interest deductions to the stock of their foreign affiliates.

In applying either the tax-book-value method or the fair-market-value method, the value used is the average values of assets for the taxable year. Those average values are computed by taking the mean of the opening values and the closing values for each asset.99

Some additional adjustments to tax book value are required under the regulations. For example, a reduction in basis is required for the amount of a debt instrument if the interest on that debt is directly allocated to assets under one of the exceptions to the asset method.100 Similarly, a reduction in basis is required for the amount of a debt if interest paid on that debt is capitalized, deferred, or disallowed under any provision of the Code.101

§ 15.02.1.2. Exceptions to Asset Method

The section 1.861-8 regulations provide the following three exceptions to the use of the asset method for apportioning interest deductions. These exceptions require direct attribution of interest to particular assets. Section 15.02.1.2.1, below, describes the so-called “CFC netting rule.” That rule, which has major revenue implications, prevents taxpayers from exploiting the averaging built into the asset method to borrow money, lend it to a foreign affiliate, and get a substantial portion of the interest paid on the loan apportioned to U.S. source income. Section 15.02.1.2.2, below, describes the direct allocation of interest relating to certain purchase-money nonrecourse loans. Section 15.02.1.2.3 describes a direct allocation rule applicable to certain integrated financial transactions.

§ 15.02.1.2.1. CFC Netting Rule

The CFC netting rule provides that certain interest expenses incurred by the U.S. parent of a controlled foreign corporation (CFC) will be directly allocated to interest income received from that CFC under certain circumstances. This rule can have important consequences for many U.S. parent corporations. Its typical effect is to increase the amount of the U.S. parent’s interest expense that it must attribute to one or more

100 Reg. § 1.861-9T(g)(2)(iii) (2009).
categories of foreign source income, thereby reducing, in many cases, the amount of its allowable foreign tax credit.

The CFC netting rule is above average in complexity.\(^{102}\) It applies when a U.S. affiliated group is considered to have increased its borrowings from unrelated third parties and then re-lent the borrowed money to its related CFCs for tax-motivated reasons. Regulations provide that the CFC netting rule generally will not apply if the pattern of third-party borrowing and lending to a related CFC in the current year is consistent with the U.S. affiliated group’s pattern over the prior five years.\(^{103}\) Safe harbor rules are also provided.

The amount of interest expense of a U.S. affiliated group that must be directly allocated to its interest income received from its CFCs is determined by a three-step procedure under the regulations. In step one, the taxpayer determines the amount of its lending to related CFCs that is considered to be incurred for tax-avoidance reasons (its "excess related group indebtedness"). Step two determines the amount of the borrowings of the U.S. affiliated group that is treated as having been incurred to finance loans to its related CFCs (its "excess U.S. shareholder indebtedness"). A taxpayer having both excess related group indebtedness and excess U.S. shareholder indebtedness is considered to have engaged in tax-motivated borrowing and lending, and a portion of its interest expense must be directly allocated to its interest income from its CFCs. That direct allocation is accomplished in step three. The operation of the CFC netting rule, in highly simplified form, is illustrated in the following example.

**Example 15.3: CFC Netting Rule**

\(P\) is a U.S. parent corporation, and \(F\) is its wholly owned CFC. For all years prior to the current year, \(P\) had U.S. assets with a tax book value of \(\$40,000\) and foreign assets with a tax book value of \(\$10,000\). Over that same period, \(F\) had assets with a tax book value of \(\$100,000\). During the current year, \(P\) has earned taxable income from U.S. sources, computed before any deduction for interest, of \(\$40,000\). \(F\) has earned taxable income, before any deduction for interest, of \(\$20,000\). All of \(F\)'s income was derived from its business operations and is properly characterized as general limitation income. At the start of the current year, \(F\) needed additional capital of \(\$100,000\) to finance the purchase of a business asset. It could have obtained that amount by borrowing from an unrelated bank at an annual interest charge of \(\$10,000\).

Instead, \(P\) borrowed the money from the unrelated bank and incurred an annual interest expense of \(\$10,000\). It re-lent the \(\$100,000\) to \(F\), charging annual interest of \(\$10,000\). The note from \(F\) increased the tax book value of \(P\)'s assets by \(\$100,000\). After paying the interest to \(P\), \(F\) had taxable income of \(\$10,000\) (\(\$20,000\) minus \(\$10,000\)) and paid a foreign income tax of \(\$5,000\). It distributed the remaining \(\$5,000\) to \(P\) as a dividend.

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\(^{102}\) The U.S. Supreme Court made reference to the CFC netting rule in *Hunt-Wesson, Inc. v. Franchise Tax Board of California*, 120 S. Ct. 1022, 528 U.S. 458 (2000). In that case, the Court, after misstating the CFC netting rule, held that California’s similar direct allocation rule violated the Commerce Clause and the Due Process Clause of the U.S. Constitution. For discussion, see Michael J. McIntyre, “Constitutional Limitations on State Power to Combat Tax Arbitrage: An Evaluation of the Hunt-Wesson Case,” 86 Tax Notes 1907 (March 27, 2000); Michael J. McIntyre, “Hunt-Wesson and the Continuing Problem of Tax Arbitrage,” 6 The State and Local Tax Lawyer 57-87 (2001).

Under these rather special conditions, all of the debt of F to P is characterized as “excess related group indebtedness,” and all of the amount borrowed from the unrelated bank is characterized as “excess U.S. shareholder indebtedness.” P is required to allocate all of its interest deduction on its bank loan directly to the interest income received from F. Its gross foreign source income will be $20,000 ($5,000 dividend from F plus the gross-up amount of $5,000 plus interest income of $10,000), and its net foreign source income will be $10,000 ($20,000 minus the directly allocable interest deduction of $10,000). The limitation on the foreign tax credit will be $3,500 (35 percent of $10,000), with the result that $1,500 of the foreign taxes deemed paid by P will not be creditable.

If P had been allowed to use the asset method under the facts above, it would have been required to allocate only $7,333 ($10,000 interest × $110,000 of foreign assets/$150,000 of worldwide assets) of its interest deduction to foreign source income. Thus, its net foreign source income would have been $12,667, and the limitation on the foreign tax credit would go up to $4,433 (35 percent of $12,667).

The U.S. tax consequences that a U.S. parent corporation would receive under the CFC netting rule from re-lending the proceeds of a third-party loan to its CFC are occasionally identical and generally similar to those that would result from a direct third-party borrowing by a related CFC. Assume, in the above example, that F had borrowed $100,000 directly from a commercial bank instead of borrowing the money from P. In that event, F would have paid interest of $10,000 to the unrelated bank (rather than to P) and would have had net income of $10,000. It would have paid a foreign tax of $5,000 and distributed $5,000 as a dividend to P. On receipt of that dividend, P would have had net foreign source income of $10,000 ($5,000 dividend plus gross-up amount of $5,000), and it would have been entitled to a foreign tax credit of $3,500 (35 percent of $10,000). This is the result reached under the CFC netting rule in the example above.

§ 15.02.1.2.2. Qualified Nonrecourse Indebtedness

Another exception to the asset method is made in the case of interest paid with respect to certain purchase money mortgages, referred to in the regulations as “qualified nonrecourse indebtedness.”104 This exception is narrowly drawn, with extensive anti-avoidance rules for debts lacking in economic substance. This exception does not apply if the creditor can look to property other than the property acquired with the loan proceeds as security for payment, and the taxpayer must show that the property generates sufficient cash flow to service the debt in the first year of ownership and in all subsequent years.

If this exception applies, the deduction for interest on the purchase-money loan is matched against the income generated by the property acquired with the loan proceeds. Assume, for example, that T, a U.S. citizen and resident, purchases an office building in Houston, Texas, for $1.1 million, paying $100,000 in cash and paying the remaining $1 million through a 20-year purchase-money loan. Annual interest is due on the loan of $80,000. T is not personally liable on the loan. She rents out the building under a 20-year net lease arrangement for a guaranteed annual payment of $90,000. The loan qualifies as “qualified nonrecourse indebtedness.” T also earns $1 million of royalty income from foreign sources, on which a foreign income tax of $350,000 is imposed. T is not required to allocate any of the interest on the loan used to acquire the Houston office building to foreign source income. As a result, T can claim a credit for the full amount of the foreign taxes paid on her foreign source income.

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104 Reg. § 1.861-10T(b) (1988).
§ 15.02.1.2.3. Integrated Financial Transactions

A third exception to the asset method applies to loans used to finance an identified term investment that produces interest income or income equivalent to interest. To qualify for this exception, the taxpayer must identify on its books of account, within a 10-business-day grace period, that it has incurred indebtedness to make an investment intended to qualify as an integrated financial transaction. The investment cannot be part of the operation of the taxpayer’s business. The expected return on the term investment must be sufficient to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payments of principal and interest. In addition, the debt and the investment must mature within ten business days of each other.

If the tests for application of this exception are met, then the interest on a loan is directly allocated to the income generated by the related investment. Assume, for example, that PCo, a U.S. corporation, earns $20,000 of foreign source income, on which it pays a foreign income tax of $7,000. It borrows $100 for six months at an annual interest rate of 10 percent and properly identifies the loan as part of an integrated financial transaction. Three days later, PCo uses the proceeds to purchase a portfolio of U.S. stock that approximates the composition of the Standard & Poor’s 500 Index. On that day, PCo also enters into a forward sale contract that requires it to sell the stock six months later for $110. PCo also identifies on its books that the portfolio stock purchases and the forward sale contract constitute part of the integrated financial transaction with respect to which the identified borrowing was incurred.

Under these conditions, the interest on the borrowing by PCo is directly allocated to the gain from its portfolio stock investment. As a result, none of the interest expense is allocated to foreign source income, and PCo is not prevented by the limitation on the credit from claiming a foreign tax credit for the $7,000 it paid in foreign income taxes.

§ 15.02.1.3. Policy Evaluation of Asset Method

The main alternative to the asset method of the section 1.861-8 regulations, which the drafters of the regulations rejected, would be to match interest payments on a loan with the gross income generated by the loan proceeds, using some type of presumptive tracing rules. Tracing is the method of choice in relating cost of goods sold with gross receipts from sales, and it is the method generally applicable for determining the source of most deductions under Treasury regulation section 1.861-8. An advantage of using tracing rules for linking deductions with gross income is that a taxpayer cannot overstate the amount of its deductions allocated to U.S. sources without also overstating the amount of its U.S. source gross income.

The authors of the section 1.861-8 regulations rejected any tracing method for interest deductions because of the commonly held opinion that the fungibility of money prevents meaningful allocation of

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105 Reg. § 1.861-10T(c)(1) and (2)(ii)(1988).
interest to particular uses of the loan proceeds.\textsuperscript{111} They contended that the interest expenses of a taxpayer should be allocated "to all the gross income which the income producing activities and properties of the taxpayer generate, have generated, or could reasonably have been expected to generate."\textsuperscript{112} Interest so allocated would then be apportioned between U.S. and foreign sources in accordance with the value of the assets of the taxpayer.\textsuperscript{113}

Determining the past, present, and future gross income generated by the activities and property of the taxpayer would be difficult, perhaps impossible. \textit{A fortiori}, it would be difficult to determine the source of such gross income. The section 1.861-8 regulations sidestep such difficulties by adopting the asset method of apportionment. The implicit premise underlying the asset method is that the best available proxy for the source of the past, present, and future gross income generated by an interest deduction is the source of the income likely to be generated by the assets of the taxpayer.\textsuperscript{114}

As a matter of tax theory, the attempt to match interest payments with all past, present, and future gross income of the taxpayer is misguided. Under the matching principle generally followed in the section 1.861-8 regulations, deductions should be linked with the income they help generate. If an interest payment made in the current period helped generate income in some other period, then the interest payment should be deductible in that period. The probability that a taxpayer would incur an interest payment to earn income he had already earned in a prior period seems quite small. Thus, it is unlikely that any interest payments are properly traceable to prior taxable periods. Interest payments are commonly incurred, however, to generate income in a future period. An example would be interest on a loan used to finance the purchase of a capital asset. Such payments should not be deductible in the current period. They would be capitalized in a properly designed income tax.

Despite the weakness in the underlying theory, the asset method is superior to the old gross-to-gross method that it replaced.\textsuperscript{115} The gross-to-gross method gives most U.S. corporate taxpayers substantial control over the source of their deductions because most of their foreign source income is derived from dividends and other largely discretionary receipts from their foreign subsidiaries. More fundamentally, the gross-to-gross method is unacceptable because income generated through the use of borrowed money does not relate in any systematic way to the gross income generated by the taxpayer's income-producing activities.

The asset method may be superior to a tracing method, given the current provisions of the Code governing the deduction of interest. Tracing methods work well only if the taxpayer is required to match expenses with income in order to claim a deduction for those expenses. Current law requires some matching of interest expenses with certain classes of gross income, largely to avoid the tax shelter problems created by


\textsuperscript{112} Reg. § 1.861-8(e)(2)(ii) (1999).

\textsuperscript{113} To be consistent with their theory, the drafters of the regulations should also have prohibited tracing for rental payments because a taxpayer's decision to rent property rather than purchase frees up capital for other uses. Thus, a rental payment for tangible property relates to all past, present, and future income in much the same way that a rental payment for the use of someone else's money so relates.

\textsuperscript{114} Reg. § 1.861-8(e)(2)(v) (1999).

\textsuperscript{115} The section 1.861-8 regulations retained an optional gross-to-gross method, applicable in some circumstances. See Reg. § 1.861-8(e)(2)(v) (1999). The use of the gross-to-gross method for apportionment of interest payments is now prohibited under IRC § 864(e)(2), as amended by the 1986 tax act.
the unrestricted interest deduction of prior law. There is, however, no general matching requirement for claiming an interest deduction. Consequently, a source rule for interest deductions based on the matching principle would be difficult, perhaps impossible, to administer.

Although the asset method is grounded on an anti-tracing theory, it does employ an implicit tracing rule for linking interest payments with assets. Under the implicit tracing rule, taxpayers are presumed to finance their assets by drawing in equal proportions from their pools of equity and debt capital. For example, if a taxpayer has $100,000 of equity capital and $400,000 of debt capital, then one-fifth of each of its assets will be presumed to be financed by equity and the remaining four-fifths by borrowing.

Also incorporated into the asset method is an implicit average cost convention — similar to the average cost convention sometimes used in inventory accounting for determining the cost of goods sold — in order to determine the interest rate for capital expended from the taxpayer’s pool of borrowed funds. Consider, for example, X, a U.S. corporation that borrows $10,000 at a 10-percent annual rate and borrows another $10,000 at a 12-percent rate. X has a pool of borrowed money of $20,000 ($10,000 + $10,000), and it pays annual interest of $2,200 ($1,000 + $1,200). The presumed interest rate for capital drawn from the pool of borrowed funds would be 11 percent ($2,200/$20,000).

The asset method of apportionment satisfies one of the criteria for good source rules — it prevents taxpayers from exploiting the fungibility of money to control the source of their deductions. Consider, for example, a newly organized U.S. corporation that borrows $2 million — $1 million at a 6-percent annual interest rate and the other $1 million at an 8-percent rate. The corporation raises another $2 million from the issuance of its own stock. It uses the $4 million to finance construction of two identical hotels, one located in the United States and the other located in Country A. The funds from the loans are commingled with the equity funds, so that physically tracing the loan proceeds to particular expenditures is impractical.

Under the asset method, half of the expenditures made for each hotel will be presumed to come from the pool of equity funds and the other half of those expenditures will be presumed to come from borrowed money. The dollars drawn from the pool of borrowed money will be presumed to bear an interest rate of 7 percent — the average of the two actual interest rates paid by the taxpayer.

The result reached by the asset method in the example above is appealing because the taxpayer was prevented from controlling the source of its interest deduction through economically insignificant choices between the use of borrowed funds and equity capital. Other techniques could be employed, however, to prevent taxpayers from controlling the source of their deductions. For example, a tracing rule that presumed that money borrowed during the taxable year is used to acquire foreign assets, to the extent that foreign assets were acquired during that year, would prevent taxpayers from controlling the source of their deductions. Indeed, any system of presumptive tracing would have that effect.

The asset method produces somewhat less appealing results when the taxpayer is not drawing from uncommitted pools of equity and debt capital. Consider, for example, a taxpayer that has built in year 1 a $2 million hotel in Country A, which is financed entirely with equity capital. In year 2, the taxpayer decides to

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116 See IRC § 163(d) and (h) (limiting the deduction for interest on loans used to finance investments and denying the deduction for consumer credit).

117 If the taxpayer were required to trace in order to claim an interest deduction, then a source rule based on the matching principle would not be difficult to administer, although the tracing rules may themselves present administrative problems. For example, the inventory accounting rules for determining the cost of goods sold present some serious problems of administration. Matching gross receipts from the sale of inventory goods with the cost of goods sold, however, is a relatively simple task, once the problems of determining the cost of goods sold have been resolved.
build an identical hotel in the United States. The construction of the U.S. hotel is financed by a $2 million loan. Under the asset method, only half of the interest expense would be allocated to the U.S. hotel. The remaining half would be treated as a cost of continuing to hold the hotel located in Country A. That is, the tracing formula would treat the taxpayer as having financed one-half of the U.S. hotel with the equity capital already invested in the hotel located in Country A.

The rationale for the result reached in the example above is that the taxpayer, at least in theory, could have sold the Country A hotel for $2 million and borrowed an additional $2 million, thereby creating a capital pool of $4 million. Then it would have financed the construction of the U.S. hotel and a repurchase of the Country A hotel by drawing from its capital pool of $4 million. That rationale is strained; obviously many taxpayers are not in a position to draw down their equity capital to make new investments without incurring unacceptable damage to their existing business.\(^{118}\) They might also incur tax liability from conversion of operating assets into cash. Because the rationale for attributing interest expenses pro rata to equity capital and debt capital is unconvincing, it should be no surprise that apportionment of interest based on that rationale has limited intuitive appeal in some instances.

Another weakness of the asset method is that it fails to take into account the different functions of loans in a business. Consider, for example, PCo, a U.S. automobile manufacturer. Its wholly owned subsidiary, FCo, is organized in Country F and manufactures cars in that country for the local market. PCo earns income from the manufacture of cars in the United States. It also earns income from financing the sale of its cars to U.S. customers. To finance those sales, PCo has borrowed money from a local bank. It has also borrowed money that it used, in conjunction with its equity capital, to finance its manufacturing plant in the United States and FCo’s manufacturing plant in Country F.

Under the asset method, a portion of the interest on the capital-investment loan and the consumer-credit loan is apportioned to foreign source income. This result is proper with respect to the capital-investment loan because the proceeds of that loan were used, directly or indirectly, to finance the manufacturing plant in Country F. The result reached under the asset method is improper, however, with respect to the loan used to finance PCo’s consumer credit loans. In that case, the loans are not properly considered part of the pool of capital from which PCo drew to finance the manufacturing plants.

The chief justification for the asset method is that it allegedly takes control over the source of the interest deduction out of the hands of the taxpayer. The premise is that the situs of business assets is determined largely by business needs. That premise cannot be supported in practice. Many taxpayers have considerable control over the situs of intangible assets, such as intercompany loans. Even tangible assets may be shifted around for tax purposes through the use of intercompany leasing transactions. To protect the integrity of the asset method, therefore, the Treasury Department must develop regulations that establish the situs of assets by reference to objective indicia outside the control of most taxpayers.\(^{119}\)

\(^{118}\) Consider, for example, goodwill. An ongoing business generally cannot sell its goodwill unless it is prepared to terminate its business. The asset method generally ignores goodwill in making allocations because goodwill typically has a zero tax book value. That result is another of the many deficiencies of the asset method.

\(^{119}\) For the attempted solution to the problems created under subpart F by taxpayer control over the situs of assets, see Reg. § 1.954-2(b)(4)(vi) (1999).
§ 15.02.2. The Section 1.882-5 Interest Source Rule

A foreign corporation engaged in business in the United States is not subject to the asset method set forth in the section 1.861-8 regulations in determining the amount of interest that is deductible from the gross income effectively connected with its U.S. business. Instead, the allocation and apportionment of interest paid by a foreign corporation is determined under Treasury regulation section 1.882-5. That regulation was adopted in 1980 and revised significantly in 1996.

The section 1.882-5 regulations were developed largely in response to problems created for foreign banks by the asset method of the section 1.861-8 regulations. Under the asset method, the interest expenses of a bank are spread ratably to all of its domestic and foreign loans, without reference to the actual interest costs incurred in obtaining funds for a particular loan. Banks, however, typically do not have uniform interest costs for obtaining loanable funds.

First of all, the loanable funds obtained by a bank in its home country generally come in substantial part from demand deposits on which the bank pays little or no interest, whereas foreign loans typically are financed with money borrowed at a market interest rate. In addition, the interest rate on a loan depends in part on the expected inflation or deflation of the currency in which the loan is to be repaid. If the loan must be repaid in a strong currency—that is a currency that is appreciating relative to other currencies—the nominal interest rate will understate the real interest rate. In contrast, the real interest rate will be lower than the nominal interest rate if the lender is able to repay its loan in a depreciating currency.

For U.S. banks, the asset method was advantageous because it caused the high interest rates paid to acquire funds for foreign loans to be apportioned in part to U.S. sources. Foreign banks, particularly banks resident in Japan and Germany, felt that they were being treated unfairly by the asset method. Under the asset method, the high interest rates paid on loans traceable to their branch operations in the United States were being averaged with the low or zero rates paid on demand deposits in their home country. In addition, because the German mark and Japanese yen were strong relative to the U.S. dollar throughout the 1970s, the German and Japanese banks faced the prospect of having the relatively high interest rates paid on their loans denominated in U.S. dollars averaged with the relatively low interest rates on loans denominated in their home currency.

Treasury officials during the Carter administration believed that the complaints made by the German and Japanese banks had some merit. These officials also were concerned that the foreign banks might be able to establish by litigation a special treaty rule for apportioning interest expenses that was at odds with the section 1.861-8 rule. They believed that a hybrid of a treaty and Code rule imposed by the courts would present serious technical and administrative difficulties and might complicate the treaty process. In addition, Treasury realized that the asset method was providing an unwarranted benefit to foreign corporations that made loans in a currency that was weaker than the U.S. dollar. The high interest rates paid on those loans

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121 Under inflationary conditions, the nominal interest rate paid by the borrower has two real components: a rental fee for the use of someone else's money and a prepayment of principal to compensate the lender for the decline in the real value of the principal amount due under the loan agreement. Under deflationary conditions, the nominal interest rate is lower than the real interest rate because the lender expects to be repaid in currency worth more than the amount lent. U.S. tax law, however, allows a deduction for nominal interest, without any adjustment for inflation or deflation.
were being averaged under the asset method with the relatively low rates on loans incurred to fund the U.S. operations of those corporations.122

Treasury concerns about a treaty rule for interest deductions proved to be well founded. In the NatWest case,123 decided in 1999 by the Court of Federal Claims, the court concluded that a U.S. branch of a U.K. bank is entitled, under the tax treaty between the United States and the United Kingdom, to deduct as interest the accounting entries representing imputed interest between the bank and its U.S. branch.124 How the U.S. tax authorities and Congress will respond to this ill-considered opinion is yet to be seen. Some response is required because the court-created treaty rule is unworkable and inconsistent with U.S. tax policy.

The section 1.882-5 rule is a hybrid of a tracing rule and the pro rata apportionment rule implicit in the asset method. Leaving aside its many special features, the basic idea of the rule is to allocate the taxpayer’s liabilities pro rata to its assets and to allow an interest deduction with respect to that fraction of the liabilities that are allocated to U.S. assets. For example, assume that FCo, a foreign corporation, has a branch, B, in the United States. B has U.S. assets of $1,000 and the total assets of FCo are $5,000. FCo has total liabilities of $3,000. Under these highly stylized facts, the section 1.882-5 regulations would allocate liabilities of $600 ($3,000 × $1,000/$5000) to B. Assuming the interest rate on the U.S.-connected liabilities is 10 percent, B would be allowed a deduction of $60 in computing its taxable income effectively connected with a U.S. trade or business.

The example above illustrates the pro rata apportionment aspect of the section 1.882-5 regulations that corresponds to the asset method of the section 1.861-8 regulations. A tracing aspect, not illustrated in that example, allows the foreign corporation to deduct interest payments attributed to liabilities shown on the books of its U.S. branch as long as the amount of the liabilities does not exceed the amount determined under the pro rata allocation described above. If the liabilities do exceed that amount, they are reduced under a pro rata rule to the acceptable level. In general, interest is determined in U.S. currency or in the functional currency of the foreign corporation. An election is available, however, that allows the U.S. branch to compute its interest deduction in the currencies in which the interest was actually paid.

The regulations establish a three-step procedure for computing the amount of interest that a foreign corporation is allowed to deduct in computing its effectively connected income. In step one, the taxpayer computes the amount of its U.S. assets — that is, the amount of the assets it used to produce U.S. effectively connected income. In step two, the taxpayer determines the amount of its U.S.-connected liabilities. That amount is calculated by determining the ratio of worldwide liabilities to worldwide assets and multiplying that ratio by the amount for U.S. assets computed in step one.

In step three, the taxpayer calculates the amount of interest attributable to its U.S.-connected liabilities. In computing the interest deduction attributable to U.S.-connected liabilities, the taxpayer may elect to use an average interest rate determined in U.S. dollars, or it may use the average rates for the various currencies in which it actually paid interest. If the taxpayer make the latter election, the three-step procedure, modified

122 The statements in the text regarding the motives of Treasury officials are drawn from H. David Rosenbloom, "The Source of Interest Payments Made by Nonresidents," 30 Wayne Law Review 1023, 1028-1030 (1984). Mr. Rosenbloom was International Tax Counsel at Treasury when the section 1.882-5 regulations were drafted.
124 Reg. § 1.882-5(a)(2) specifically provides that no special treaty rule is available. The 1980 regulations at issue in NatWest contained a similar provision.
in certain respects, is referred to as the “separate currency pools method.”125 If the former election is made, the method is called the “adjusted U.S. booked liabilities method.”126

U.S. assets, as determined under step one, generally are the assets of the foreign corporation that are held to produce U.S. effectively connected income.127 The section 1.882-5 regulations incorporate by reference the detailed rules for determining whether an asset is a U.S. asset that were developed in the branch profits tax regulations.128 In effect, the regulations require a foreign corporation to treat the income derived from an asset as producing effectively connected income in order to treat the asset as a U.S. asset in computing the amount of its U.S. interest deduction.129

For tax avoidance reasons, a foreign corporation would like to increase the amount of its U.S. assets, thereby increasing its U.S. interest deduction, if it could do so without causing its U.S. effectively connected income to increase by enough to offset the tax benefits of the larger interest deduction. To prevent perceived abuses, the regulations provide that an asset will not be treated as a U.S. asset if it was acquired or used to artificially inflate the amount of U.S. assets.130

A foreign corporation determines the value of its U.S. assets according to their U.S. tax book value unless it has made an election to use their fair market value.131 The U.S. tax book value is the adjusted basis of the assets, as determined under Code section 1011.132 An election to use fair market value must be used for all purposes under the section 1.882-5 regulations and cannot be changed without the consent of the tax authorities.133 The value of assets must be determined at intervals — monthly for large banks, semiannually for other foreign corporations — and the average values used in calculating the taxpayer’s U.S. assets for the year.134

In the second step, the foreign corporation determines the amount of its U.S.-connected liabilities. Two alternative methods are provided. Under the first method, referred to as the “actual ratio method,” the taxpayer multiplies the value of its U.S. assets by the ratio of its worldwide liabilities to its worldwide assets.135 For example, if the foreign corporation has worldwide liabilities of $700 and worldwide assets of $800, its actual ratio would be 87.5 percent, and its U.S.-connected liabilities would be 87.5 percent of its U.S. assets. The taxpayer must employ a consistent method that substantially complies with U.S. tax principles in computing its worldwide liabilities and worldwide assets.136 The amounts must be expressed in U.S. dollars or in the functional currency of the foreign corporation’s home office.137

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129 For exceptions to the general rules defining U.S. assets, see Reg. § 1.882-5(b)(1)(ii) and (iii) (1996).
139 Reg. § 1.882-5(c)(2)(iii) and (iv) (1996).
Under the second method, referred to as the “fixed ratio method,” the taxpayer multiplies the value of its U.S. assets by a fixed percentage. That percentage is 93 percent in the case of a foreign corporation engaged in the banking business in the United States.\(^{138}\) It is 50 percent in the case of any other foreign corporation.\(^{139}\)

In step three, the foreign corporation determines the amount of its interest expense allowable as a deduction against U.S. effectively connected income. That amount is the interest expense of the taxpayer that was paid or deemed paid with respect to its U.S.-connected liabilities. As noted above, the taxpayer has a choice of using the “adjusted U.S. booked liabilities method” or the “separate currency pools method.” The taxpayer may not elect the separate currency pools method if the value of a taxpayer’s U.S. assets valued in a hyperinflationary currency exceeds 10 percent of its U.S. assets.\(^{140}\) Once the taxpayer has elected one of these methods, it generally cannot change methods for at least five years without the permission of the U.S. tax authorities.\(^{141}\)

Under the adjusted U.S.-booked liabilities method, the foreign corporation first determines whether the amount of its U.S.-connected liabilities, determined in step two, equals or exceeds the average amount of the liabilities shown on the books of its U.S. branch (its “U.S.-booked liabilities”).\(^{142}\) If the U.S.-booked liabilities equal the U.S.-connected liabilities, then the foreign corporation is allowed to deduct the amount of the interest shown on the books of the U.S. branch.\(^{143}\)

If U.S.-connected liabilities exceed the U.S.-booked liabilities, then the allowable interest deduction is the sum of (1) the actual interest expense shown on the U.S. books and (2) the interest deemed paid with respect to U.S.-connected liabilities in excess of the U.S.-booked liabilities.\(^{144}\) The interest deemed paid with respect to the excess liabilities is generally the amount of the excess liabilities multiplied by the taxpayer’s average interest rate paid on its foreign liabilities.\(^{145}\)

A foreign corporation is allowed to deduct only a portion of the interest shown on its U.S. books if its U.S.-booked liabilities exceed its U.S.-connected liabilities, as determined in step two. The interest deduction allowed is the amount shown on the U.S. books, scaled back to eliminate the interest paid with respect to the excess U.S.-booked liabilities.\(^{146}\) For example, assume that FC, a foreign corporation, has U.S.-booked liabilities of $1,000, U.S.-connected liabilities of $800, and an interest payment on its U.S. books of $100. The interest deduction will be scaled back to $80 ($100 × $800/$1,000). The operation of the adjusted U.S.-booked liabilities method is illustrated in the example below.\(^{147}\)

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\(^{139}\) Id. A taxpayer cannot use the fixed ratio method to deduct more interest from its U.S. effectively connected income than it actually paid. Reg. § 1.882-5(a)(3) (1996).


Example 15.4 is based on the examples in Reg. § 1.882-5(d)(6) (1996).
Example 15.4: Interest Deduction Under Section 1.882-5

FCo is a foreign corporation organized in Country F with a U.S. branch office. For the taxable year, FCo has assets used to generate U.S. effectively connected income with a tax book value of $300. The average total amount of FCo’s worldwide liabilities is $2,700 and the average value of its worldwide assets is $3,000. FCo has elected in a prior year to use the actual ratio rather than the fixed ratio in determining its U.S.-connected liabilities. It has also elected to use the adjusted U.S.-booked liabilities method. Its U.S.-connected liabilities equal $270, determined as follows:

1. U.S. assets ................................................................. $300
2. Worldwide liabilities .................................................. $2,700
3. Worldwide assets (at tax book value) ........................ $3,000
4. Actual ratio (line 2/line 3) ........................................... 90%
5. U.S.-connected liabilities (line 1 x line 4) ............... $270

On the books of its U.S. branch, FCo has average liabilities of $200 (U.S.-booked liabilities). That amount is less than the U.S.-connected liabilities in line (5). The interest expense shown on the books of the U.S. branch of FCo is $20. The average interest rate paid by FCo on its loans not connected with its U.S. business is 10 percent.

If F elects to use the adjusted U.S.-booked liabilities method, its interest deduction for the year against the effectively connected income of its U.S. branch will be the sum of the interest shown on its U.S. books and the interest deemed paid on its U.S.-connected liabilities in excess of the liabilities shown on its U.S. books. That amount is $27, computed as follows:

6. Average U.S.-booked liabilities ..................................... $200
7. Interest expense shown on U.S. books .......................... $20
8. Excess of U.S.-connected liabilities over U.S.-booked liabilities (line 5 minus line 6) .......... $70
9. Average interest rate on foreign loans .......................... 10%
10. Interest expense on U.S.-connected liabilities in excess of liabilities on U.S. books (line 8 x line 9) ................................................................. $7
11. Interest deduction allowable under adjusted U.S.-booked liabilities method (line 7 + line 10) ................................................... $27

Foreign corporations electing the separate currency pools method determine their allowable interest deduction separately for each currency in which they have borrowed money.\textsuperscript{148} A three-step process is followed that parallels the three-step procedure used under the adjusted U.S.-booked liabilities method. In step one, the taxpayer determines its U.S. assets in each currency pool.\textsuperscript{149} In step two, it determines the U.S.-


connected liabilities in each currency pool. In step three, it determines the amount of interest expense attributable to each currency pool by multiplying its U.S.-connected liabilities in that pool by the average interest rate paid in the currency of that pool.

Assume, for example, that ZCo, a foreign bank, is engaged in the banking business in the United States. It has U.S. assets held in U.S. dollars with an average value of $20,000, and U.S. assets denominated in Country Z francs of ZF30,000. The exchange rate is US $1 equals ZF2. ZCo’s actual ratio of worldwide liabilities to worldwide assets is 96 percent. The average interest rate on its U.S. dollar denominated liabilities is 9 percent, and the average rate on its liabilities denominated in Country Z francs is 20 percent.

Under these facts, ZCo has U.S.-connected liabilities denominated in U.S. dollars of $19,200 (96% of $20,000) and U.S.-connected liabilities denominated in Country Z francs of $28,800 (96% of $30,000). Its deductible interest expense in the U.S. dollar pool is $1,728 (9% of $19,200). Its interest expense in the Country Z franc pool is ZF5,760 (20% of $28,800), which, converted into U.S. dollars, equals $2,880. Thus, ZCo’s total interest deduction against U.S. effectively connected income is $4,608 ($1,728 + $2,880).

A foreign corporation may elect to directly allocate its interest deduction to U.S. assets without pro rata apportionment under exceptions comparable to the exceptions to the asset method for qualified nonrecourse indebtedness and integrated financial transactions. In computing its remaining interest expense, the taxpayer must reduce its worldwide liabilities and amount of interest paid by the amount of the liabilities and interest subject to direct allocation.

Any provision of the Code that disallows, defers, or capitalizes an interest expense is applied after the interest apportioned to U.S. effectively connected income has been determined. For example, assume that FCo, a foreign corporation, has interest of $1,000 attributed to U.S. assets under the section 1.882-5 regulations. One quarter of its U.S. assets are held to produce income that is exempt from U.S. tax under a U.S. tax treaty. The interest on a loan used to finance the acquisition or holding of such assets is disallowed under Code section 265(b). Under these circumstances, $250 (25% of $1,000) of FCo’s interest expense attributed to U.S. assets is disallowed as a deduction under section 265(b).

§ 15.03. Research and Experimental (R&E) Costs

Research and experimental (R&E) expenditures typically are capital in nature because the typical objective of the taxpayer in making them is to increase earnings in future years by developing new products or improving existing products. The Code allows a current deduction, nevertheless, for most R&E expenditures. The resulting mismatch of deductions with the income they help generate creates a problem for the taxpayer and the tax authorizes in determining the source of R&E deductions.

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152 This example is based on Reg. § 1.882-5(e)(5)(Ex. 1) (1996).
158 IRC § 174.
The colorful history leading to the current rules is recounted briefly in § 15.03.1, below. The basic operative rules are described in § 15.03.2. Section 15.03.3 describes the sales method — a method used to allocate and apportion R&E expenditures to the place where sales are expected to be made of products improved or developed as a result of those expenditures. Section 15.03.4 describes two gross-to-gross methods that taxpayers may elect as a substitute for the sales method. Policy notes are provided in § 15.03.5.

§ 15.03.1. Background

The method to be used for allocating and apportioning deductions for research and experimental (R&E) expenditures has been controversial since the late 1960s. The section 1.861-8 regulations, which were initially published in 1977 after a decade of political wrangling, contain detailed rules governing the source of deductions for R&E expenditures. These rules were in effect from 1977 to 1981. They were scheduled to go back into effect many times over the next decade and have done so for very brief periods. Before they went into effect, or before they remained in effect for very long, Congress would provide a temporary moratorium on their application, sometimes retroactively.

During the various legally sanctioned moratorium periods, Congress provided a temporary alternative to the section 1.861-8 rules that was more favorable to U.S. taxpayers than the 1977 regulations. The temporary nature of these measures was dictated by the high costs in forgone revenue of adopting permanent rules. The moratoriums were created by various amendments to Code section 864(f). During a moratorium period ending in 1992, that section provided, inter alia, that 64 percent of R&E costs could be allocated to the place where the expenditures were made. Tax specialists referred to this rule as “the 64-percent solution,” playing on the title of the Sherlock Holmes pastiche, “The Seven-Per-Cent Solution,” by Nicholas Meyer. That particular moratorium ran out without congressional action, due to the unwillingness of the Bush administration to raise taxes enough to pay for the multi-billion dollar cost of an additional moratorium.

Notwithstanding the absence of congressional action, the Bush administration extended the moratorium period for 18 months by issuing Rev. Proc. 92-56.159 Many commentators from the public and private sector criticized this action as cynical, unprincipled, and lawless. The revenue procedure also called for a study by the Treasury Department to determine whether some liberalization of the R&E rules was required under the principles of Treasury regulation section 1.861-8. The study, completed by the Treasury Department early in the Clinton administration, found that the 30-percent solution contained in the 1977 regulations already provided excessive benefits to U.S. based multinationals in a significant majority of cases.160

In 1993, Congress amended and extended Code section 864(f) to provide the 50-percent solution by statute. That subsection terminated, however, in 1995. As a practical matter, nevertheless, the moratorium game ended in 1995 when the Treasury Department adopted new regulations that include the 50-percent solution without any specified termination date.

§ 15.03.2. General Rules

R&E expenditures made solely to meet certain legal requirements are allocated to gross income derived in the country that imposed those requirements.\(^{161}\) This legal-requirement rule applies if it is reasonable to assume that the entire benefits of a particular R&E expenditure, beyond \textit{de minimis} amounts, will be derived in a particular country. For example, a requirement for product testing imposed by the U.S. Food and Drug Administration would be allocated solely to U.S. source gross income if the testing was required for making sales in the United States and would not affect foreign sales materially. If the exception applies, then the entire deduction for that R&E expenditure is allocated to gross income arising in the country where the benefit is expected to be derived before allocations are made under any other rules.

Whether the legal-requirement rule is important or relatively insignificant depends on how it is enforced. If it is enforced strictly, the rule has modest importance because most government mandated testing of a product is likely to produce substantial benefits that could affect profits derived from foreign sales. For example, the testing might lead to improvements to the product, to an enhanced reputation of the produce for safety or reliability, or to a better understanding of side effects that might reduce risks of injury to customers. Only mindless regulatory requirements or requirements narrowly focused on local matters are likely to have exclusively local effects.

A key feature of the regulations revised in 1995 is the attribution of at least 50 percent of the otherwise unallocated R&E expenses to U.S. source income if more than 50 percent of the expenditures are attributable to activities performed within the United States.\(^{162}\) A mirror-image rule attributes 50 percent of expenditures to foreign source income if the activities were performed outside the United States.\(^{163}\)

The taxpayer may allocate more than 50 percent of its unallocated R&E expenditures to the place of performance of its R&E activities if it establishes to the satisfaction of the tax authorities that the research and experimentation expenditures are reasonably expected to have very limited or long delayed application outside the geographic location where the activities associated with those expenditures were performed.\(^{164}\) In determining whether future sales outside the place where the R&E activities were performed is likely, the taxpayer’s past experience with research and experimental expenditures may be considered.\(^{165}\)

The general rule for allocating and apportioning the remaining unallocated portion of R&E expenditures is the sales method.\(^{166}\) The sales method requires the taxpayer to allocate its various R&E expenditures to the product categories to which they best relate. The deductions allocated to each product category are then apportioned ratably between U.S. source gross income and foreign source gross income by reference to gross receipts from U.S. sales in the product category and gross receipts from foreign sales in that category. A taxpayer may elect to use a gross-to-gross method instead of the sales method. A taxpayer making that election, however, must apportion to foreign source gross income at least 50 percent of the


\(^{163}\) Id. The mirror-image rule fails to specify how R&E expenditures relating to activities conducted outside the United States are to be apportioned to various classes of foreign source income for purposes of determining the separate basket limitations on the foreign tax credit. Those limitation rules are important only for U.S. persons, however, and most U.S. persons will not be governed by the mirror-image rule.


\(^{165}\) Id.

\(^{166}\) Reg. §1.861-17(c)(1) (1995).
amounts that would have been apportioned to foreign source income under the sales method.\textsuperscript{167} Most U.S. taxpayers are likely to elect to use one of the alternative gross-to-gross methods.

In general, the one-taxpayer rule applies for allocating R&E expenditures.\textsuperscript{168} A special exception to the one-taxpayer rule applied to sales derived from products produced in a U.S. possession by an electing possessions corporations.\textsuperscript{169}

§ 15.03.3. Sales Method

Under the sales method, unallocated R&E deductions are allocated to gross income derived from the business activities to which they relate.\textsuperscript{170} Business activities are classified according to a list of product categories incorporated by reference into the regulations.\textsuperscript{171} These product categories define the relevant classes of gross income for purposes of allocating the R&E deductions. The deductions are then apportioned between U.S. source gross income and foreign source gross income by reference to the gross receipts from U.S. sales and foreign sales.\textsuperscript{172} The sales method is sometimes referred to as the gross receipts method because the apportionment is made with respect to gross receipts.

The product categories incorporated by reference into the regulations are the three-digit classifications contained in the Standard Industrial Classification Manual (SIC code) used by the U.S. government in preparing statistical summaries of business operations.\textsuperscript{173} There are many SIC product categories on that list. The classification scheme has one-digit divisions, two-digit major groups, three-digit industry groups, and then four-digit subgroups. Within the subgroups, there often are unnumbered lists. The following table is an edited sample from the SIC code list, with the three-digit categories in italics.

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\textsuperscript{167} Reg. § 1.861-17(d)(2) and (3) (1995).
\textsuperscript{170} Reg. § 1.861-17(c)(1) (1995).
\textsuperscript{172} Amounts received from the lease of equipment are treated as sales receipts. Reg. § 1.861-17(c)(1)(ii) (1995).
### Excerpts from Standard Industrial Classification Manual (SIC code)

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<tr>
<th>A</th>
<th>Agriculture, forestry, and fisheries</th>
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<tr>
<td>01: Agricultural Production Crops</td>
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<td>011: Cash Grains</td>
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<td>111 Wheat</td>
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<td>112 Rice</td>
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<td>0115 Corn</td>
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<td>0115: Field Crops, Except Cash Grains</td>
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<tr>
<td>013: Field Crops, Except Cash Grains</td>
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<tr>
<td>0131 Cotton</td>
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<td>0132 Tobacco</td>
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<td>017: Fruits And Tree Nuts</td>
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<th>D</th>
<th>Manufacturing</th>
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<td>20: Food And Kindred Products</td>
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<td>28: Chemicals And Allied Products</td>
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<tr>
<td>30: Rubber And Miscellaneous Plastics Products</td>
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<tr>
<td>301: Tires And Inner Tubes</td>
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<tr>
<td>35: Industrial And Commercial Machinery And Computer Equipment</td>
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<td>352: Farm And Garden Machinery And Equipment</td>
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<td>3524 Lawn and Garden Tractors and Home Lawn and Garden Equipment</td>
<td></td>
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<tr>
<td>356: General Industrial Machinery And Equipment</td>
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<tr>
<td>357: Computer And Office Equipment</td>
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<td>3571 Electronic Computers</td>
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<td>3572 Computer Storage Devices</td>
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<td>3575 Computer Terminals</td>
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<tr>
<td>3577 Computer Peripheral Equipment, Not Elsewhere Classified</td>
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</table>

The general apportionment rule is that R&E deductions allocated to a class of gross income should be apportioned between U.S. and foreign sources with respect to gross receipts from sales of products in that class.174 For example, gross income derived from “computer and office equipment” would be a class of gross income. R&E expenditures relating to that class would be apportioned between U.S. source gross income and foreign source gross income in accordance with the taxpayer’s U.S. and foreign sales during the taxable year of products in that class.

The apportionment formula can be represented as follows:

\[
R&E_{US} = R&E_{ww} \times \frac{U.S. \text{ Sales}}{WW \text{ Sales}}
\]

where

- \( R&E_{US} \) is the R&E deduction apportioned to the United States in a SIC product category;
- \( R&E_{ww} \) is the total worldwide R&E deduction in that product category;
- \( U.S. \text{ Sales} \) is the gross receipts from U.S. sales in that product category; and
- \( WW \text{ Sales} \) is the worldwide gross receipts from sales in that product category.

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For an illustration of the operation of the sales method, consider PCo, a U.S. corporation that manufactures various products, including tires, for sale within and without the United States. PCo spends $1,200 on R&E relating to tires that is deductible in the current year. During the year, it sells $30,000 worth of tires, which are classified under the SIC list as "SIC code 301: Tires and Inner Tubes." Sales of $10,000 were made within the United States. Under these circumstances, $400 ($1,200 × $10,000/$30,000) of PCo’s R&E deduction would be apportioned to U.S. source gross income derived from the sale of “tires and inner tubes.” The remaining $800 would be apportioned to foreign source gross income.

For a more complex example, assume that PCo, the U.S. corporation in the example above, has two other businesses — the manufacture and sale of inner tubes and the production and sale of wheat. In addition to the $1,200 R&E deduction relating to tires, PCo has an R&E deduction of $300 relating to inner tubes and an R&E deduction of $500 relating to wheat. The worldwide inner tube sales are $10,000, of which $4,000 are made in the United States. All of the sales of wheat are made in the United States.

Because tires and inner tubes are in the same SIC category, the R&E deductions of $1,500 ($1,200 + $300) for tires and for inner tubes are apportioned with respect to the $40,000 of total sales of tires and inner tubes ($30,000 + $10,000). The amount apportioned to the U.S. source gross income of $14,000 ($10,000 + $4,000) is $525 ($1,500 × $14,000/ $40,000). No apportionment is required within a SIC category. The $500 deduction relating to wheat is allocated to gross income in the SIC category 011, “cash grains” and apportioned to U.S. source gross income.

In the examples above, the taxpayer allocated R&E deductions to a three-digit category. The taxpayer may elect to combine categories for purposes of making its allocations.175 The taxpayer may not subdivide the three-digit categories.176 For example, a taxpayer could elect to combine the category for computers (SIC 357) and the category for general industry machinery (SIC 356) and allocate and apportion its R&E deductions to that broader category. It cannot, however, break down the category for computers into subcategories for computer storage devices (SIC 3572) and computer terminals (SIC 3575) and allocate and apportion its R&E deductions with respect to those subcategories. A taxpayer cannot change its product categories from year to year unless it establishes to the satisfaction of the Commissioner that a change is appropriate due to a change in relevant facts.177

Some taxpayers exploit technology that they have developed from R&E activities by licensing or selling that technology to other persons. A taxpayer so exploiting the fruits of its R&E expenditures must take into account the sales made by a licensee or purchaser in applying the sales method if the licensee or purchaser can reasonably be expected to benefit, directly or indirectly, from the taxpayer’s R&E expenditures.178 A person is expected to benefit from a taxpayer’s R&E expenditure if the taxpayer can reasonably be expected to make any resulting technology available, by sale or otherwise, to that person.179 In effect, the taxpayer claiming the R&E deduction is treated, for the purpose of applying the sales method, as if it had made all of the sales of products produced from the technology that its R&E expenditure is deemed to have created.

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175  Reg. § 1.861-17(a)(2)(i) (1995). Under the 1977 regulations, the taxpayer was required to use two-digit SIC categories. The 1995 regulations, in effect, allow the taxpayer to subdivide the two-digit categories at its election.
176  Id. Restrictions apply in using the two-digit categories “Wholesale Trade” and “Retail Trade.” Reg. § 1.861-17(a)(2)(iv) and (v) (1995).
178  Reg. §§ 1.861-17(c)(2) (1995) (relating to license arrangements, etc., with uncontrolled parties) and 1.861-17(c)(3) (1995) (relating to license arrangements, etc., with controlled parties).
179  Id.
Consider, for example, a U.S. corporation, XCo, that manufactures lawn mowers. During the taxable year, XCo has an allowable R&E deduction of $1,000 relating to the SIC category 3524 (Lawn and Garden Tractors and Home Lawn and Garden Equipment) for lawn mowers. It licenses its small motor technology used to make the engines for lawn mowers to an unrelated foreign corporation, YCo, in exchange for a royalty on YCo’s sales of mowers. As part of the licensing arrangement, XCo agrees to license to YCo all future motor technology that it develops.

During the year, XCo sells $10,000 worth of mowers in the United States, and YCo sells $40,000 worth of mowers in Country B, for total worldwide sales of $50,000. XCo receives a royalty from YCo of $5,000. In applying the sales method for apportioning the deduction between its U.S. source sales income and its foreign source royalty income, XCo must take into account the $10,000 of gross receipts from its own sales of motors. It also must take into account the gross receipts of $40,000 from YCo’s sales of mowers in Country B. Of the $1,000 R&E deduction, $200 ($1,000 × $10,000/$50,000) is apportioned to U.S. gross income, and $800 ($1,000 × $40,000) would be apportioned to foreign source gross income.

In some circumstances, the taxpayer claiming an R&E deduction cannot be expected to know the amount of the sales of products produced from technology it has sold or licensed to an unrelated person. In such circumstances, the taxpayer must make a reasonable estimate of the amount of the gross receipts from sales of those products.\(^{180}\)

§ 15.03.4. Optional Gross-to-Gross Methods

The R&E regulations permit a taxpayer to apportion R&E deductions using a gross-to-gross apportionment method instead of using the sales method. Two gross-to-gross methods are provided. An election to use an optional gross-to-gross method rather than the sales method is binding on the taxpayer for the current year and for four succeeding years.\(^{181}\) The taxpayer may elect to use the first of the two methods only if it meets certain conditions. The second method is the residual method. These methods are used to apportion R&E deductions after those deductions have been allocated to a product category under the rules applicable under the sales method.

Under both gross-to-gross methods, 25 percent, rather than 50 percent, of the taxpayer’s R&E deduction, after application of the legal-requirement test, is allocated to the country where the R&E activities were performed.\(^{182}\) The election to use the gross-to-gross method must be made with respect to the taxpayer’s entire R&E deduction. The taxpayer cannot use the sales method for R&E deductions allocated to one product category and the gross-to-gross method for R&E deductions allocated to another product category.\(^{183}\)

The first gross-to-gross method permits a taxpayer to apportion its R&E deduction in each product category ratably to its U.S. source gross income and the foreign source gross income derived in that product category. Assume, for example, that PCo has foreign source gross income from sale of wheat of $500 and U.S. source gross income from sale of wheat of $1,500. Its previously unallocated R&E deduction relating to

wheat is $400. The activities relating to that deduction were performed in the United States. No part of the R&E deduction is allocated under the legal-requirement test.

Before applying the gross-to-gross method, PCo allocates 25 percent, or $100, of its $400 R&E deduction to the United States. Under the gross-to-gross method, it apportions $75 ($300 × $500/$2,000) of this deduction to foreign source gross income and the remaining $225 to U.S. source gross income. Thus, the total amount of the $400 R&E deduction apportioned to the U.S. source income is $325.

To qualify for this gross-to-gross option, the taxpayer must meet two conditions. First, the amount apportioned to the statutory grouping (foreign source income in the case of a U.S. person computing the limitation on its foreign tax credit) must be at least 50 percent of the amount that would be apportioned to the statutory grouping under the sales method.184 Second, the amount apportioned to the residual grouping (foreign source income in the case of a foreign person computing its U.S. effectively connected income) must be at least 50 percent of the amount that would be apportioned to the residual grouping under the sales method.

Assume, for example, that PCo in the above example has gross receipts from the sale of wheat of $20,000 in the United States and the same amount in foreign markets. Under the sales method, PCo would apportion 50 percent of the $400 deduction to U.S. source gross income. The remaining $200 R&E deduction that would be apportioned under the sales method to U.S. source gross income would be $100 ($200 × $20,000/$40,000). Thus, the total amount apportioned to U.S. source gross income (the residual grouping) under the sales method would be $300 ($200 + $100). The amount allocated to foreign source gross income (the statutory grouping) under the sales method would be $100 ($400 – $300).

PCo apportions $75 to foreign source gross income (the statutory grouping) under the gross-to-gross method. That amount is more than 50 percent of the $100 that would be apportioned to foreign source gross income under the sales method. As a result, the first condition is met. The second condition is also met because the $325 apportioned to U.S. source income (the residual grouping) is more than 50 percent of the $300 apportioned to U.S. source income under the sales method. Indeed, U.S. taxpayers would never consider electing the gross-to-gross method if this second condition were not met. Its function is to prevent foreign persons from apportioning an excessive amount of R&E deductions to U.S. source income under the gross-to-gross method.

A taxpayer that fails one of the two conditions for electing the first alternative gross-to-gross method may elect to use the second gross-to-gross method. Under that method, a U.S. person may allocate to foreign source gross income (statutory grouping) only 50 percent of the amount that would have been allocated to foreign source gross income under the sales method. Assume, for example, that DCo, a U.S. corporation, has an R&E deduction of $20,000. Assume also that it would apportion $5,000 of its R&E deduction to foreign source gross income under the sales method and only $1,000 to foreign source income under the first gross-to-gross method. As a result, it would not be able to elect the first gross-to-gross method.

Under the second method, DCo would be permitted to apportion $2,500 (50% of $5,000) to foreign source income and the remaining $17,500 to U.S. source income. Thus, it should elect to use the second gross-to-gross method rather than the sales method. A comparable result would be achieved if DCo were a foreign corporation.

§ 15.03.5. Policy Notes

The allocation and apportionment of R&E expenditures has been controversial for more than three decades. The normatively correct rule is the sales method, modified to allow direct allocations to a particular country when the R&E is likely to provide disproportionate benefits in that country. The safe-harbor rule allowing some portion of R&E expenditures to be allocated directly to the country where the R&E activities are performed is correct in theory. The tax policy issue for discussion is the size of that direct allocation.

The various gross-to-gross methods have never been justified. Indeed, no one seems prepared to even offer a justification. They were introduced into the 1977 regulations to soften the expected angry response of U.S. multinationals to those regulations. They did not serve that purpose very well then, and they do not serve any discernable public purpose now.

On the contrary, the gross-to-gross rules cut against important U.S. tax and trade policies. By making low foreign source gross income the key to high U.S. R&E deductions, the gross-to-gross rules encourage U.S.-based multinationals to license their technology abroad. In that way, the gross income they receive has been reduced by almost all of the major costs of earning that income. At best, this incentive will cause U.S.-based companies to make formal changes in the way they deal with their foreign affiliates. At worst, it will encourage those companies to manufacture their products abroad rather than in the United States. When the best that can be said for a rule is that it encourages international tax avoidance, the rule is indefensible on public policy grounds.

Allocation and apportionment of R&E expenditures is complicated by the fact that the expenditures are deductible currently, notwithstanding the fact that most of those expenditures are made to earn future income. If the expenditures were capitalized, then matching the deductions with U.S. source income and foreign source income would be simplified greatly and the quality of the matching would be improved.

Analysts have attempted to justify the current deduction for R&E expenses on tax expenditure grounds. They claim that R&E activities are good for society over and above the return they provide to investors because of certain external benefits that the investors are unable to capture for themselves. The analogy is sometimes made to the external benefits created in the nineteenth century by the building of railway lines in the western states. To encourage railway construction, the federal government gave away large blocks of public lands to the railway companies. Analysts suggest that a similar subsidy for R&E makes good economic sense.

The theory supporting a subsidy for R&E is plausible, but the factual basis for its premises have not been established. Obviously many kinds of research generate external benefits. The federal government subsidizes academic research for exactly that reason. The question is whether the multinational companies generate enough external benefits from their research activities to justify the cost in forgone revenue of an R&E subsidy. Much of the research undertaken by multinationals is not shared with the public, resulting in fairly limited external benefits. In addition, much of the research is directed at differentiating products in the marketplace. There are unlikely to be external benefits from such research, and there may be some social detriment if the research promotes monopoly pricing.

The R&E regulations were written to give benefits to U.S.-based multinationals. In accordance with U.S. treaty obligations, however, they do not discriminate against foreign-based multinationals. Indeed, in some respects, they are more favorable to foreign companies than to U.S. companies. For example, foreign companies are not subject in any meaningful way to the one-taxpayer rule because foreign companies are not permitted under U.S. tax law to file consolidated returns. In addition, the ability of the U.S. tax authorities
to monitor the legal-requirement test, as it applies to foreign companies, is minimal. This neutrality is good tax policy but bad spending policy. It is highly unlikely that a spending program designed to promote research would award large, unmonitored benefits to foreign-based multinational corporations.

For good or for bad, the Code currently provides a tax subsidy for R&E expenditures by allowing a current deduction. Tough rules applicable to the allocation and apportionment of R&E expenditures would weaken that subsidy. The current R&E allocation and apportionment rules may be understood as a crude compromise between the dictates of tax policy and the dictates of spending policy. For the most part, spending policy has prevailed over tax policy.

Supporters of special allocation rules for R&E expenditures contend that some U.S.-based multinational companies have encountered great difficulties in obtaining a deduction in foreign countries for R&E activities conducted within the United States. In principle, double taxation problems of this type should be resolved through the competent authority mechanism of U.S. tax treaties. Unilateral action by the United States to solve those problems for U.S.-based multinationals results in an unwarranted subsidy to foreign governments.