Internal Revenue Service
DEPARTMENT OF THE TREASURY

# LB&I Process Unit

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| **Unit Name** | Allocation and Apportionment of Deductions | |
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|---|---|
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| **Shelf** | Individual Outbound |
| **Book** | Foreign Tax Credits Individual |
| **Chapter** | Calculation of Amount of Allowable FTC |

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# Process Overview



## Allocation and Apportionment of Deductions

This Practice Unit focuses on the general rules and processes of allocating and apportioning individual taxpayer's most common expenses, losses and other deductions (collectively referred to as deductions), reported on Form 1116, lines 2 through 4, against foreign source gross income (FSGI) in determining the foreign tax credit (FTC) limitation. (Internal Revenue Code (IRC) 904). Capital losses from foreign sources are covered in the Practice Unit, *Qualified Dividends and Capital Gains Rate Differential Adjustments* and in the Form 1116 Instructions for line 5. The limitation is determined by taking the ratio of foreign source taxable income (FSTI) to worldwide taxable income (WWTI) and is applied to U.S. tax on worldwide income, as shown:

$$\frac{\text{FSTI}}{\text{WWTI}} \times \text{U.S. Income Tax Before Credit} = \text{FTC Limitation}$$

The FTC Limitation is computed separately for each separate category of foreign income described in IRC 904(d) and Treas. Reg. 1.904-4(m) (collectively referred to as the separate categories). For information on the separate categories of income, see Practice Unit, *Categorization of Income and Taxes Into Proper Basket.*

# Process Overview (cont'd)



## Allocation and Apportionment of Deductions

The primary factor in the computation of the FTC limitation is FSTI. The computation requires that certain deductions of U.S. taxpayers be allocated and apportioned against the taxpayers' FSGI in each of the separate categories. IRC 861(b) provides that for each item of gross income, "there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income." The numerous rules for the allocation and apportionment of deductions are found in Treas. Reg. 1.861-8 through 1.861-18. In many cases a crucial part of these allocation and apportionment regulations is determining the factual relationship between a deduction and income.

The first step in the process is allocation. The general rule for allocating deductions will separate deductions into three categories:

1. Definitely Related to a Class of Gross Income. This refers to whether a deduction is incurred as a result of, or incident to, an activity or in connection with property from which that income is derived. Treas. Reg. 1.861-8(b)(4).
2. Definitely Related to All Gross Income. This refers to those deductions definitely related and allocable to all gross income. Treas. Reg. 1.861-8(b)(5).
3. Not Definitely Related to Any Gross Income. This refers to deductions that are not definitely related to any gross income and, therefore, are ratably apportioned. Treas. Reg. 1.861-8(e)(9).

! **CAUTION**: Taxpayers should not include deductions related to exempt or excluded income, e.g., foreign earned income exclusion and tax-exempt interest. Nor should taxpayers include any deduction for personal exemptions on any of lines 2 through 5 of Form 1116. Deductions for personal exemptions are not taken into account in allocating and apportioning under this section. Treas. Reg. 1-861-8(e)(11). (The Tax Cuts and Jobs Act (TCJA) reduced the exemption to zero in the case of a taxable year beginning after December 31, 2017, and before January 1, 2026.)

| Allocation and Apportionment of Deductions |
|---|
| **Analysis** |
| The second step in the process is apportionment. Deductions that are definitely related to a class of gross income or that are related to all of the taxpayer's gross income are apportioned, if necessary, between the statutory grouping and the residual grouping within a class of, or within the total, gross income. Treas. Reg. 1.861-8(c)(1). For purposes of determining the FTC limitation the statutory groupings are foreign source income in the separate categories and the residual group is U.S. source income.<br><br>This step produces a mathematical result. Conceivably, a deduction may be apportioned using a method based on units sold, gross receipts, cost of goods sold, time spent, space utilized, etc. The method used must reflect, to a reasonably close extent, the factual relationship between the deduction and the grouping of gross income. The regulations provide specific rules for certain categories of deductions.<br>▪ A deduction must be apportioned where taxpayers elected not to analyze the expense sufficiently to comply with the determination requirements for a direct allocation.<br><br>Deductions that are not definitely related to any gross income are apportioned ratably between the statutory groupings and the residual grouping based on gross income in each grouping. |

# Step 1: Allocate Deductions to Gross Income



| Allocation and Apportionment of Deductions |
|---|
| **Step 1** |
| Allocate deductions to a class of gross income. |

| Considerations | Resources |
|---|---|
| The allocation process begins by first determining the class of gross income to which a deduction is definitely related, then allocating (attributing, matching, etc.) the deduction to that class or classes of gross income. The criteria used for determining whether a deduction is definitely related to a class of gross income is the factual relationship between the deduction and a class of gross income. In order to establish the relationship between the deduction and a particular class of gross income, an analysis must be made of the functions underlying the deduction. A deduction is considered definitely related to a class of gross income if one of the following conditions is satisfied:<br>▪ incurred as result of, or incident to, an activity, or<br>▪ incurred in connection with property from which the class of gross income has been, is, or could reasonably have been expected to be derived.<br><br>! **CAUTION:** Classes of gross income must be determined on the basis of the deductions to be allocated and not the other way around. Do not look at the classes of gross income and then try and find the deductions related to that income. | ▪ Treas. Reg. 1.861-8(b)(2) |

# Step 1: Allocate Deductions to Gross Income (cont'd)



## Allocation and Apportionment of Deductions

Step 1

| Considerations | Resources |
|---|---|
| The gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items of gross income identified in IRC 61. These may include:<br>▪ Compensation for services, including fees, commissions, and similar items;<br>▪ Gross income derived from business;<br>▪ Gains derived from dealings in property;<br>▪ Interest;<br>▪ Rents;<br>▪ Royalties;<br>▪ Dividends;<br>▪ Alimony and separate maintenance payments (repealed by TCJA, generally effective for any divorce or separation instrument executed after December 31, 2018)<br>▪ Annuities;<br>▪ Income from life insurance and endowment contracts;<br>▪ Pensions;<br>▪ Income from discharge of indebtedness;<br>▪ Distributive share of partnership gross income;<br>▪ Income in respect of a decedent;<br>▪ Income from an interest in an estate or trust;<br>▪ Global intangible low-taxed income (GILTI). | ▪ Treas. Reg. 1.861-8(a)(3)<br>▪ Pub. 514 - *Foreign Tax Credit for Individuals* |

# Step 2: Apportion the Deduction

| Allocation and Apportionment of Deductions |
|---|
| **Step 2** |
| Apportion deductions to statutory and residual groupings |

| Considerations | Resources |
|---|---|
| When the deductions have been allocated to a class of gross income, the gross income is divided into statutory and residual gross income groupings. Then, if necessary, the deductions are apportioned between the groupings. The apportionment process computes a division of deductions between the statutory and residual groupings based on a mathematical formula.<br><br>For a deduction to be apportioned between the groupings, a class of gross income must contain both statutory and residual groupings of income. If, for example, a deduction relates only to foreign source income in the separate category for general income, the entire amount will be assigned to the statutory grouping for foreign source general category income. Apportionment is unnecessary in this example because the deduction relates only to one grouping of income.<br><br>A deduction is apportioned by attributing the deduction to gross income within the class to which the deduction has been allocated (one or more statutory groupings) and to gross income within the class (the residual grouping). This attribution 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. | ▪ Treas. Reg. 1.861-8T(c)(1) |

# Step 2: Apportion the Deduction (cont'd)

| Allocation and Apportionment of Deductions |
| --- |
| Step 2 |

| Considerations | Resources |
| --- | --- |
| The regulation provides rules with respect to the allocation (and in some cases apportionment) of certain deductions, as well as those deductions that are ordinarily considered not definitely related to any class of gross income. | ▪ Treas. Reg. 1.861-8(e) |
| Interest Expense<br><br>Individuals generally apportion interest expense according to the type of interest incurred. Taxpayers must use an apportionment method in most cases that is based on assets. Additional interest expense rules can be found in Treas. Reg. 1.861-9 through 11 and Treas. Reg. 1.861-9T through 13T. | |
| ▪ Schedule A<br>− Investment Interest described in Section 163(h)(2)(B) is apportioned on the basis of an individual's investment assets.<br>− Mortgage Interest described in Section 163(h)(2)(D) is apportioned under a gross income method taking into account all income, excluding income exempt under IRC 911. | ▪ Treas. Reg 1.861-9T(d)(1)(ii)<br>▪ Form 1116, line 4b<br>▪ Treas. Reg. 1.861-9T(d)(1)(iv)<br>▪ Form 1116 Instructions |
| ▪ Schedule C<br>− Business Interest described in Section 163(h)(2)(A) is apportioned using an asset method by reference to an individual's business assets. | ▪ Treas. Reg. 1.861-9T(d)(1)(i) |
| An alternative method of apportioning on basis of assets is tax book value method or alternative tax book value. This method is beyond the scope of this Unit and is addressed in other Practice Units. | |

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# Step 2: Apportion the Deduction (cont'd)

| **Allocation and Apportionment of Deductions** |
|---|
| Step 2 |

| Considerations | Resources |
|---|---|
| Interest Expense (cont'd)<br><br>Example<br><br>Jane is a U.S. taxpayer, engaged in the active conduct of a U.S. trade or business as a sole proprietor. Her business generates only domestic source income. She has an investment portfolio with an adjusted basis of $200,000. Forty percent of her investment portfolio ($80,000) generates domestic source income and sixty percent ($120,000) generates foreign source passive income. Jane has a mortgage on her personal residence of $250,000. The interest on the loan is qualified residence interest. She also has a bank loan in the amount of $80,000. The proceeds of her bank loan were divided equally between her business and her investment portfolio. Gross income from her business is $60,000. Her investment portfolio generated $8,000 of domestic source income and $12,000 of foreign source passive income. All her debt obligations bear interest at the rate of 5 percent. | ▪ Treas. Reg. 1.861-9T(d)(1)(v)<br>▪ Treas. Reg. 1.163-8T(c)<br>▪ Pub. 514 - *Foreign Tax Credit for Individuals* |

# Step 2: Apportion the Deduction (cont'd)



## Allocation and Apportionment of Deductions

Step 2

| Considerations | Resources |
|---|---|
| Interest Expense (cont'd)<br><br>Example (cont'd)<br><br>The interest expense for Jane's business is $2,000. It is apportioned on the basis assets. Since all her business income is domestic source, her business assets are deemed domestic assets. This $2,000 is allocable to domestic source income.<br><br>The interest expense for her investments is also $2,000 and is apportioned on the basis of investment assets. $800 ($80,000 divided by $200,000 multiplied by $2,000) is apportioned to domestic source income and $1200 ($120,000 divided by $200,000 multiplied by $2,000) is apportioned to foreign source passive income.<br><br>Jane's home mortgage interest is $12,500 and is apportioned on the basis of her gross income. $68,000 is domestic source income and $12,000 is foreign source passive income. As a result, $10,625 ($68,000 divided by $80,000 multiplied by $12,500) is apportioned to domestic source income and $1,875 ($12,000 divided by $80,000 multiplied by $12,500) is apportioned to foreign source passive income. | ▪ Treas. Reg. 1.861-9T(d)(1)(v)<br>▪ Pub. 514 - *Foreign Tax Credit for Individuals* |
| Legal and Accounting Deductions<br><br>Fees and expenses for these services are generally definitely related and allocable to specific classes of gross income or to all gross income depending on the factual relationship between the deduction and the gross income. | ▪ Treas. Reg. 1.861-8(e)(5). |

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# Step 2: Apportion the Deduction (cont'd)

## Allocation and Apportionment of Deductions

Step 2

| Considerations | Resources |
|---|---|
| State Income Taxes<br><br>State income taxes (and certain taxes measured by taxable income) are definitely related and allocable to the gross income on which the taxes are imposed. If state income tax is imposed in part on foreign source income, the part of the state tax imposed on the foreign source income is definitely related and allocable to foreign source income.<br><br>If the state does not specifically exempt foreign income from tax, the following rules apply.<br>▪ If the total income taxed by the state is greater than the amount of U.S. source income for federal tax purposes, then the state tax is allocable to both U.S. source and foreign source income.<br>▪ If the total income taxed by the state is less than or equal to the U.S. source income for federal tax purposes, none of the state tax is allocable to foreign source income.<br><br>If state law specifically exempts foreign income from tax, the state taxes are allocable to U.S. source income. | ▪ Treas. Reg. 1.861-8(e)(6)<br>▪ Treas. Reg. 1.861-8(g)(25) and (26)<br>▪ Publication 514 - *Foreign Tax Credit for Individuals* |

# Step 2: Apportion the Deduction (cont'd)

## Allocation and Apportionment of Deductions

Step 2

| Considerations | Resources |
|---|---|
| State Income Taxes (cont'd)<br><br>Example<br><br>John's total income for federal tax purposes is $100,000, before deducting state income tax. Of this amount, $25,000 is foreign source and $75,000 is U.S. source. His total income for state tax purposes is $90,000, on which he pays state income tax of $6,000. The state does not specifically exempt foreign source income from tax. The total state income of $90,000 is greater than the U.S. source income for federal tax purposes. Therefore, $6,000 is definitely related and allocable to both U.S. and foreign source income. Assuming $15,000 ($90,000 minus $75,000) is foreign source income taxed by the state, $1,000 of state income tax is apportioned to foreign source income, figured as follows: $15,000 divided by $90,000 multiplied by $6,000 equals $1,000. | ▪ Treas. Reg. 1.861-8(e)(6) |
| Standard Deduction<br><br>The standard deduction is considered a deduction that cannot definitely be allocated to items or classes of gross income. The deduction is apportioned ratably to the statutory and residual groupings based on the relative amounts of U.S. source income. | ▪ IRC 861(b)<br>▪ Form 1116 Instructions<br><br>▪ Treas. Reg. 1.861-8(e)(12) |

# Step 2: Apportion the Deduction (cont'd)

## Allocation and Apportionment of Deductions

Step 2

| Considerations | Resources |
|---|---|
| Charitable Deductions<br><br>Charitable deductions are apportioned solely to the residual group (U.S. source income). If a charitable deduction is not allowed by statute, but is allowed under a treaty, additional rules apply. | ▪ 1.861-8(e)(12) |
| Reduction of Itemized Deductions<br><br>Taxpayers whose adjusted gross income (AGI) exceeds a threshold amount (adjusted annually) are subject to an overall reduction to their itemized deductions. (TCJA removed the limitation for any taxable year beginning after December 31, 2017, and before January 1, 2026.)<br><br>▪ The limitation reduces itemized deductions by the lesser of:<br>– 3 percent of the excess AGI over an applicable amount, or<br>– 80 percent of the amount of their itemized deductions otherwise allowable for the taxable year.<br>▪ Taxpayers must reduce each of the itemized deductions that are subject to the limitation by the percentage of the reduction, unless the entire amount of their itemized deductions is entered on any one of lines 2, 3a, or 4a of Form 1116. In such case, they enter their entire reduced itemized deductions on that line. (See the example on Slide 16) | ▪ IRC 68<br><br>▪ Form 1116 Instructions |

# Step 2: Apportion the Deduction (cont'd)

| **Allocation and Apportionment of Deductions** |
| --- |
| Step 2 |

| Considerations | Resources |
| --- | --- |
| Reduction of Itemized Deductions (cont'd)<br><br>▪ The limitation does not apply to medical expenses (IRC 213), investment interest (IRC 163(d)) or casualty and theft losses (IRC 165), so when figuring the reduction these items should be excluded from the computation.<br>▪ Compute the limitation using the itemized deduction worksheet found in the instructions for Schedule A, or by using the statutory percentages in the previous slide. | ▪ IRC 68<br>▪ Schedule A Instructions |

# Step 2: Apportion the Deduction (cont'd)

## Allocation and Apportionment of Deductions

Step 2

| Considerations | Resources |
|---|---|
| Reduction of Itemized Deductions (cont'd)<br><br>Example<br><br>Jack is single and files Form 1040. His AGI is $288,500 and the threshold amount in 2017 is $261,500. Since his AGI exceeds the threshold amount by $27,000, his itemized deductions of $20,000 must be reduced. Of the $20,000 total, $8,000 is definitely related to his foreign source income on line 1a of Form 1116. The other $12,000 ($20,000 minus $8,000) is for real estate taxes that are not definitely related.<br><br>Analysis<br><br>Three percent of his excess AGI of $27,000 is $810. Eighty percent of his otherwise allowable deductions of $20,000 is $16,000. The lesser of the two is $810, which is the total reduction to itemized deductions. To determine the percentage of reduction, divide the reduction amount of $810 by total itemized deductions of $20,000, or 4 percent. Multiply definitely related deductions of $8,000 by 4 percent to get the reduction amount of $320. Subtract that amount from $8,000 to get $7,680 of definitely related deductions included on line 2 of Form 1116. A similar computation is required for real estate taxes by multiplying $12,000 by 4 percent to get the reduction amount of $480. Subtracting the reduction amount from total real estate taxes equals $11,520, which is included on line 3a of Form 1116. | |

# Step 2: Apportion the Deduction (cont'd)

## Allocation and Apportionment of Deductions

Step 2

| Considerations | Resources |
|---|---|
| Deductions That Are Not Definitely Related<br><br>Deductions that are generally considered not definitely related to any gross income and are ratably apportioned include:<br>▪ The deduction allowed by IRC 163 for non-business interest, which includes qualified residence interest, specified in Treas. Reg. 1.861-9T(d)(1);<br>▪ The deduction allowed by IRC 164 for real estate taxes on a personal residence or for sales tax on the purchase of items for personal use;<br>▪ The deduction for medical expenses allowed by IRC 213, and<br>▪ The deduction for alimony payments allowed by IRC 215. (TCJA repealed section 215 generally effective for any divorce or separation instrument executed after December 31, 2018.) | ▪ Treas. Reg. 1.861-8(e)(9) |
| High-taxed Income<br><br>Deductions that are allocated or apportioned to high-taxed income, should be entered on line 6, rather than lines 2 through 5, on Form 1116 in the high-tax kickout (HTKO) column. The total of these deductions should be entered as a negative amount on the passive category and as a positive amount on the general category Form 1116. | ▪ Form 1116 Instructions |

# Step 3: Verification

| Allocation and Apportionment of Deductions |
|---|
| **Step 3** |
| Verification |

| Considerations | Resources |
|---|---|
| When the deductions have been allocated to a class of gross income, the gross income is divided into statutory and residual gross income groupings. Then, if necessary, the deductions are apportioned between the groupings. The apportionment process computes a division of deductions between the statutory and residual groupings based on a mathematical formula.<br><br>For a deduction to be apportioned between the groupings, a class of gross income must contain both statutory and residual groupings of income. If, for example, a deduction relates only to foreign source income in the separate category for general income, the entire amount will be assigned to the statutory grouping for foreign source general category income. Apportionment is unnecessary in this example because the deduction relates only to one grouping of income.<br><br>A deduction is apportioned by attributing the deduction to gross income within the class to which the deduction has been allocated (one or more statutory groupings) and to gross income within the class (the residual grouping). This attribution 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. | ▪ Treas. Reg. 1.861-8T(c)(1) |

# Other Considerations / Impact to Audit

## Allocation and Apportionment of Deductions

| Considerations | Resources |
|---|---|
| ▪ Confirm line 1a of Form 1116 reflects the Section 911 exclusion and other adjustments. Establish that definitely related deductions were properly allocated and apportioned to a class, or classes, of foreign gross income on line 2 of Form 1116. Establish that the remaining deductions not definitely related to any income and deductions definitely related to all gross income were properly allocated and apportioned on lines 3 through 5. | ▪ Form 1116 Instructions<br>▪ Treas. Reg. 1.861-8 |
| ▪ Self-employed taxpayers that are reporting foreign source self-employment income should include, on line 2 of Form 1116, deductions related to the production of that income as well as the deductible part of self-employment tax. Self-employed taxpayers should also include their foreign source gross receipts as reported on Schedule C, on line 1a of Form 1116. U.S. citizens and residents are also liable for self-employment tax on this income. | ▪ *How to Audit FTC-Form 1116,* Part 2-2015 CPE Saba Meeting |
| ▪ If taxpayers are "in limitation", additional allocation and apportionment of deductions to FSTI will lower the FTC amount allowed. If taxpayers are not "in limitation", a breakeven analysis must be done to determine the threshold amount of deductions to be allocated and apportioned before the limitation has an impact on the allowed FTC. | ▪ IRC 904 |
| ▪ To confirm taxpayers correctly sourced their income and deductions, request a sourcing schedule. Confirm deductions are correctly allocated and apportioned to the correct class, or classes, of gross income. Verify taxpayers correctly allocated and apportioned itemized deductions and other deductions directly related to all gross income. | ▪ Treas. Reg. 1.861-8 |

# Index of Referenced Resources

| Allocation and Apportionment of Deductions |
|---|
| IRC 61 |
| IRC 68 |
| IRC 163 |
| IRC 164 |
| IRC 165 |
| IRC 213 |
| IRC 215 |
| IRC 861(b) |
| IRC 904 |
| IRC 911 |
| IRC 933 |
| IRC 954 |
| Treas. Reg. 1.861-8 through 18 |
| Treas. Reg. 1.861-8T(c) |
| Treas. Reg. 1.861-9 through 11 |
| Treas. Reg. 1.861-9T through 13T |

# Index of Referenced Resources (cont’d)

| Allocation and Apportionment of Deductions |
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| Treas. Reg. 1.904-5 |
| Form 1116 - *Foreign Tax Credit* |
| Form 1116 Instructions |
| Schedule A Instructions |
| Pub. 514 - *Foreign Tax Credit for Individuals* |

# Training and Additional Resources



| Allocation and Apportionment of Deductions | |
|---|---|
| **Type of Resource** | **Description(s)** |
| Saba Meeting Sessions | ▪ *How to audit FTC – Form 1116,* Part 2 - 2015 CPE Saba Meeting |
| Databases / Research Tools | ▪ *BNA Tax Management Portfolio* - Foreign Income Series 6060-1st Sec. IX |
| Reference Materials – Treaties | ▪ *Andersen - Foreign Tax Credits (WG&L)* 9.04 Basic Allocation and Apportionment Rules |

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# Glossary of Terms and Acronyms

| Term/Acronym | Definition |
|---|---|
| AGI | Adjusted Gross Income |
| FSGI | Foreign Source Gross Income |
| FSTI | Foreign Source Taxable Income |
| FTC | Foreign Tax Credit |
| GILTI | Global Intangible low-taxed income |
| HTKO | High-tax Kickout |
| IRC | Internal Revenue Code |
| TCJA | Tax Cuts and Jobs Act |
| WWTI | Worldwide Taxable Income |

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# Index of Related Practice Units

| Associated UIL(s) | Related Practice Unit |
|---|---|
| 9413 | *Overview of Interest Expense Allocation & Apportionment in Calculation of the FTC Limitation* |
| 9413 | *How to Allocate and Apportion Research and Experimental Expenses* |
| 9413 | *Overview - Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation* |
| 9432 | *FTC General Principles* |
| 9432 | *FTC Limitation and Computation* |
| 9432 | *Sourcing of Income* |
| 9432 | *Categorization of Income and Foreign Taxes Into Proper Basket* |
| 9432 | *Qualified Dividends and Capital Gains Rate Differential Adjustments* |
| 9441 | *Allocation & Apportionment of Deductions for Nonresident Alien Individuals* |