LB&I Concept Unit

Unit Name: Allocation and Apportionment of Deductions for Nonresident Alien Individuals

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General Overview

Note: This practice unit was updated to edit information related to resources, to remove a reference that is no longer available, and for editorial changes and supersedes the October 12, 2016 practice unit with the same title.

Internal Revenue Code (IRC) 871(b) provides that a nonresident alien (NRA) individual is generally subject to United States (U.S.) income taxes at graduated rates on taxable income which is effectively connected income (ECI) with the conduct of a U.S. trade or business (USTB).

The determination of “taxable income” starts with gross income which is effectively connected with the conduct of the USTB. A USTB is only partially defined in the IRC; therefore, case law is relevant in determining what activities constitute a USTB. Relevant court cases provide that continuous business contacts and activities with the United States are usually required in order for an NRA to be engaged in a USTB. Generally, in order to be engaged in a trade or business, the activities by the taxpayer, directly or through agents, have to be regular, substantial and continuous. See Lewenhaupt v. Commissioner, 20 T.C. 151 (1953); De Amodio v. Commissioner, 34 T.C. 894 (1960); Pinchot v. Commissioner, 113 F.2d 718 (2d Cir. 1940); United States v. Balanovski, 236 F.2d 298 (2d Cir. 1956).

IRC 861(b) and section 862(b) provide 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.” See also IRC 863(b).

IRC 873 provides that an NRA can deduct all deductible items connected with ECI, plus casualty and theft losses attributable to property located in the U.S., charitable contributions, and personal exemptions. Under IRC 874(a), deductions can only be claimed if the NRA files a timely return.

Allocation and apportionment of deductions is required whenever a section of the IRC such as IRC 872(a), calls for a determination of taxable income from specific sources, activities, lines of business, etc. An example of an operative provision that can apply to International Individual Compliance (IIC) is effectively connected taxable income (Treas. Reg. 1.861-8(f)(1)(iv)).

The allocation and apportionment rules for NRAs function to determine the amount of net effectively connected taxable income taxed at regular graduated rates. NRAs who have ECI must allocate and if necessary, apportion their deductions to their ECI. The process of allocating and apportioning deductions associates a deduction to the activity which produces the ECI.

IRC 861(b) and the related regulations prescribe the rules for the allocation and apportionment of deductions to gross income from specific sources and activities for the purpose of determining the taxable income from those sources and activities.

Treaty Implication: This unit assumes the NRA is a resident of a non-treaty jurisdiction. Other Practice Units will address situations where the NRA is a resident of a jurisdiction having an income tax treaty with the U.S.and may be able to use the Business Profits Article (Article 7 of the U.S. Model Treaty) or Non-Discrimination Article (Article 24 of the U.S. Model Treaty) of the treaty to override domestic tax provisions discussed in this unit.

Relevant Key Factors

There are a number of key factors that must be present for the allocation and apportionment of deduction rules for NRAs to apply. First, the individual must be an NRA. Second, the NRA must be required to file Form 1040-NR. Third, the NRA must file a timely Form 1040-NR. Fourth, the NRA must be engaged in a USTB and must have income effectively connected with that USTB. Finally, the NRA must have expenses and other deductions that are connected with the ECI.

As previously provided, an NRA must file a timely income tax return to allocate and apportion allowable deductions related to ECI. IRC 874(a) states that deductions can only be claimed if the NRA individual timely files an income tax return. Under Treas. Reg. 1.874-1, an NRA individual shall receive the benefit of deductions and credits only if the NRA timely files a return of the income which is effectively connected with the conduct of a USTB. For an individual, timeliness of a return, (for purposes of Treas. Reg. 1.874-1), is generally 16 months after its due date (without extension) as set forth in IRC 6072. This rule is especially important because IIC frequently deals with many NRA nonfiler cases. An NRA may, however, request a waiver of the filing deadline under Treas. Reg. 1.874-1(b)(2), based on factors set forth in the regulation, including any other mitigating or exacerbating circumstances. Note that Espinosa v. Commissioner, 107 T.C. 146 (1996), was decided under prior regulations, when the waiver standard was under “rare and unusual circumstances.”

Under IRC 873(b), there are 3 classes of deductions for NRAs that are available whether or not they are connected with income effectively connected with a USTB:

- Casualty or theft losses under IRC 165(c), as long as the property is located in the United States at the time of the loss.
- Charitable contributions under IRC 170.
- One personal exemption under IRC 151 (additional exemptions are allowed for residents of Canada and Mexico, and under the terms of a very limited number of tax treaties).[1] Note that the allowable deduction amount for tax years 2018 through 2025 is $0 due to the Tax Cuts and Job Acts of 2017.[2]

Except for the three identified types of deductions just mentioned, NRAs are allowed to deduct expenses against income effectively connected with a USTB only if and to the extent they meet the following criteria:

- The expenses are deductible under a section of the IRC.
- The amount of the expense claimed as a deduction is an amount which is properly allocated and apportioned to income effectively connected with a USTB.

IRC 873(a) and the related treasury regulations provide that, in determining deductions that are effectively connected with the conduct of a USTB, deductions may be allocated and apportioned in accordance with Treas. Reg. 1.861-8.

Under Treas. Reg. 1.861-8(a)(2), the steps in which a taxpayer applies its deductions to its ECI are:

- Identify classes of gross income.
- Allocate deductions to the various classes of gross income.
- If necessary, apportion the deductions within the class of gross income between the statutory grouping and the residual grouping of gross income.

Detailed Explanation of the Concept

Class of Income

Taxpayers are required to allocate deductions to a class of gross income, and then, if necessary, apportion the deductions within the class of gross income between the statutory and residual grouping of the income.[3]

The gross income to which a deduction is definitely related is referred to as a class of gross income and may consist of one or more items of gross income. Some examples include:

- Compensation for personal services
- Gross income derived from a business
- Interest, dividends, rents, and royalties.[4,5]

Statutory grouping consists of gross income that, reduced by deductions, is relevant under particular operative provisions. For example, when calculating ECI, all gross income meeting the effectively connected standard is the statutory grouping, but FDAP income is not. FDAP income is the residual grouping (see next bullet point).[6]

Residual grouping includes all gross income other than gross income in the statutory grouping. For example, if the operative code section is IRC 904 for the FTC calculation, foreign source income is the statutory grouping because it is the determinant of the IRC 904 limitation, and U.S. source income is the residual grouping.[7]

Allocation

Allocation is the first step of the two-step process and is the identification of a deduction with a specific class of gross income. It is made on the basis of the factual relationship of deductions to gross income.[8]

The classes of gross income are not predetermined, but must be determined on the basis of the deductions to be allocated.

Allocation is accomplished by determining the class of gross income to which each deduction is definitely related and then allocating the deduction to that class of gross income.

A deduction is definitely related to a class of gross income and allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived.[9]

If a deduction does not bear a definite relationship to a class of gross income, it will ordinarily be treated as definitely related and allocable to all gross income.[10]

Deductions that are not definitely related to a particular class of Real estate taxes on a personal residence:

- Medical expenses
- Alimony payments.[11,12]

Supportive deductions (such as overhead, general and administrative, and supervisory expenses) may be identified with other deductions rather than with an activity or property and may be allocated and apportioned along with the deductions to which they relate.[13]

Apportionment

If statutory and residual groupings exist within a class of gross income in which an allocation of a deduction was made, the deduction must then be apportioned between the statutory and residual groupings of gross income.[14]

The deduction must be apportioned based on the factual relationship between the deductions and the groupings of gross income.

If a class of gross income is included in more than one statutory grouping, the deduction must be apportioned among the statutory groupings and if necessary, the residual grouping.

The Regulations suggest the following factors that may be used to apportion expenses:

- Comparison of units sold
- Comparison of the amount of gross sales or receipts

- Comparison of cost of goods sold
- Comparison of profit contribution
- Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent in generating the income
- Comparison of the amount of gross income [15]

Specific Rules

The regulations also provide specific rules for allocation and apportionment of certain deductions, some of which are specific to NRAs:

- Interest Expense [IRC 864(e)(2) and Treas. Reg. 1.861-9T(d)(2) and (e)(7)] (for NRAs who are partners in partnerships)
- Research and Experimental Expenditures [Treas. Reg. 1.861-17]
- Legal and Accounting Fees [Treas. Reg. 1.861-8(e)(5)]
- State Income Taxes [Treas. Reg. 1.861-8(e)(6)]
- Losses on Disposition of Property [Treas. Reg. 1.861-8(e)(7)]
- NOLs [Treas. Reg. 1.861-8(e)(8)]
- Personal Exemptions [Treas. Reg. 1.861-8(e)(11)]
- Certain Charitable Contributions [Treas. Reg. 1.861-8(e)(12)][16,17,18]

Examples of the Concept

Taxpayer A is an NRA and a resident of Country X. In the current tax year, Taxpayer A was paid $7,000 for providing landscaping services in the United States, $9,000 from his photography business located in Country X, and $10,000 from his Business Y, which has branches that generate income from both Country X and the United States. In addition, Taxpayer A has also incurred costs of $1,200 directly related to the landscaping business, $5,000 directly related to the photography business, and $2,000 directly related to Business Y.

First, the classes of income are identified as follows:

- $7,000 from the landscaping business in the United States.
- $9,000 from the photography business in Country X.
- $10,000 from Business Y.

Second, deductions are to be allocated to a class of income:

- $1,200 allocated to the landscaping business.
- $5,000 allocated to the photography business.
- $2,000 allocated to Business Y.

The operative sections of the Code in this example are those relating to the determination and taxation of ECI described in Treas. Reg. 1.861-8(f)(1)(iv).

Regarding the landscaping business - All of the income from the landscaping business is U.S. source and is considered ECI in this example, so there is no residual grouping. Therefore, apportionment of deductions related to this business is not necessary. Taxable ECI from the landscaping business is $5,800 ($7,000 income less $1,200 expenses).

Regarding the photography business - Since the photography business is located in Country X and all of its income is foreign source, there is no taxable ECI. Therefore, there is no statutory or residual grouping. Apportionment related to this business is also not necessary.

Regarding Business Y- For Business Y, statutory and residual groupings exist within this income class because there is both ECI and non-ECI. In this case, Taxpayer A would apportion the deductions of $2,000 based on the amount of gross sales in the United States, which generate ECI, and the sales in Country X, which generates foreign source income. Of the $10,000 of income generated by this business, suppose $3,000 was from U.S. sources, which generate ECI, and $7,000 was from foreign sources.

Since 30% of the income is from U.S. sources ($3,000/$10,000), which generates ECI, only $600 of deductions (30% times $2,000 of total deductions) can be used to offset the U.S. source income to arrive at taxable ECI for Business Y. Taxable ECI is therefore $2,400 ($3,000 U.S. source income less $600 of deductions).

Taxpayer A would report a total of $8,200 ($5,800 from landscaping business plus $2,400 from Business Y) of taxable ECI on Line 13 of his Form 1040-NR and attach the respective Schedules C for the two business.

Glossary of Terms and Acronyms

Term/Acronym	Definition
ECI	Effectively Connected Income
FDAP	Fixed Determinable Annual and Periodic Income
IIC	International Individual Compliance
IRC	Internal Revenue Code
NRA	Nonresident Alien
PE	Permanent Establishment
USTB	U.S. Trade or Business

Related Practice Units

- Determining Tax Residency Status of Lawful Permanent Residents
- Effectively Connected Income
- Overview of FDAP

Training and Additional Resources

Training

- N/A

Additional Resources

- Available in Westlaw
  - BNA Tax Management Int'l Portfolio 906-2nd. The Allocation and Apportionment of Deductions
  - Bitter & Lokken Fed. Tan'n Inc, Estates and Gifts – Chapter 73.10

References

[1] Treas. Reg. 1.873-1.

[2] IRC 151(d)(5)

[3] Treas. Reg. 1.861-8(a)(2).

[4] IRC 861

[5] Treas. Reg. 1.861-8(a)(3)

[6] Treas. Reg. 1.861-8(a)(4)

[7] Treas. Reg. 1.861-8(a)(4)

[8] Treas. Reg. 1.861-8(b)(1)

[9] Treas. Reg. 1.861-8(b)(2)

[10] Treas. Reg. 1.861-8(b)(5).

[11] Treas. Reg. 1.861-8(e)(9)

[12] Treas. Reg. 1.861-9T(d)(2)

[13] Treas. Reg. 1.861-8(b)(3)

[14] Treas. Reg. 1.861-8T(c)(1)

[15] Treas. Reg. 1.861-8T(c)(1)

[16] Treas. Reg. 1.861-8(e)

[17] Treas. Reg. 1.861-9T

[18] IRC 864(e)(2)