

LB&I Transaction Unit

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Issue and Transaction Overview

Section 861 – Home Office and Stewardship Expenses

Note: This Practice Unit was updated to remove references to resources that are no longer current or available and to correct minor typographical or formatting errors. Slide 3 was updated to remove a reference to Form 1120-F, Schedule H, line 40(a) because this line reference was inaccurate. It supersedes the 09/09/2014 Practice Unit of the same title.

Foreign Corporations (FC) may operate in and earn taxable income in multiple jurisdictions including the U.S. In the case of an FC operating in the U.S. through a formal or *de facto* branch, the FC is required to file a Form 1120-F, U.S. Income Tax Return of a Foreign Corporation, and may have a U.S. tax liability.

The FC is required to calculate its taxable income and report the earnings of the U.S. branch (USB) that are effectively connected with the conduct of a Trade or Business within the U.S (Effectively Connected Income, or ECI). As part of this calculation of ECI, the U.S. branch is allowed to deduct expenses associated with the earning of such income. The amount of expenses definitely related to the ECI are generally deductible in the calculation of ECI based on normal domestic principles such as “reasonable” and “ordinary and necessary.” Taxpayers should report total expenses that are definitely related to ECI on line 11, Part I, and line 39(a), Part IV, of Schedule H (Form 1120-F). Indirect expenses, such as those expenses incurred by the foreign headquarters, or a brother-sister branch, *on behalf of the U.S. branch*, and *related to the trade or business of the U.S. branch in earning its ECI*, may also be deductible in part, or possibly, in whole. It is necessary that the FC make an allocation and/or apportionment to the U.S. branch of these types of expenses in order to clearly reflect ECI. The methods and principles of Treas. Reg. Secs.1.861-8 through 1.861-17, 1.861-8T through 1.861-14T, and 1.882-5 (the 861 and 882-5 regulations) as well as the general rules for deductibility as stated above apply. In general, the regulations require that deductions be allocated to gross income based on a reasonably close *factual relationship*. Taxpayers should report total indirect expenses apportioned to ECI on line 16, Part II of Schedule H (Form 1120-F) and line 26, Form 1120-F, Section II. This means that in earning gross income of a particular type or class, certain expenses may be necessary. The deductions resulting from such expenditures are allocated and apportioned to such gross income to the extent that a reasonably close factual relationship exists. As always, the resulting taxable income must be clearly reflected.

Issue and Transaction Overview (cont'd)

Section 861 – Home Office and Stewardship Expenses



CAUTION: The Examiner should be aware that Foreign Corporation (FC) taxpayers with a U.S. branch (USB) may use a variety of different terms *and* accounting practices. For example, Home Office (HO) may refer to the aggregate of non-U.S. activity of FC, or it may refer only to a headquarters branch in the country of incorporation. The Examiner must understand the terminology used by FC. When accounting for the activity of a USB, FC may maintain separate books and records for the USB in the United States, may allocate and apportion activity of FC to the USB, or may use some other method or combination of methods. The Examiner must examine the method or methods FC uses for calculating the ECI of USB. Additionally, the Examiner should remember that the allocation and apportionment used by FC may or may not be acceptable under U.S. tax principles, especially IRC Sections 861 and 882 and the regulations thereunder. Those sections and regulations set forth rules and methods to identify the appropriate expenses that are attributable to ECI whether those expenses are recorded on the HO's books or the USB's books. The expenses recorded on the HO's books are reported on Parts I and II of Schedule H (Form 1120-F), and the expenses recorded on the USB's books are reported on Part IV of that schedule.

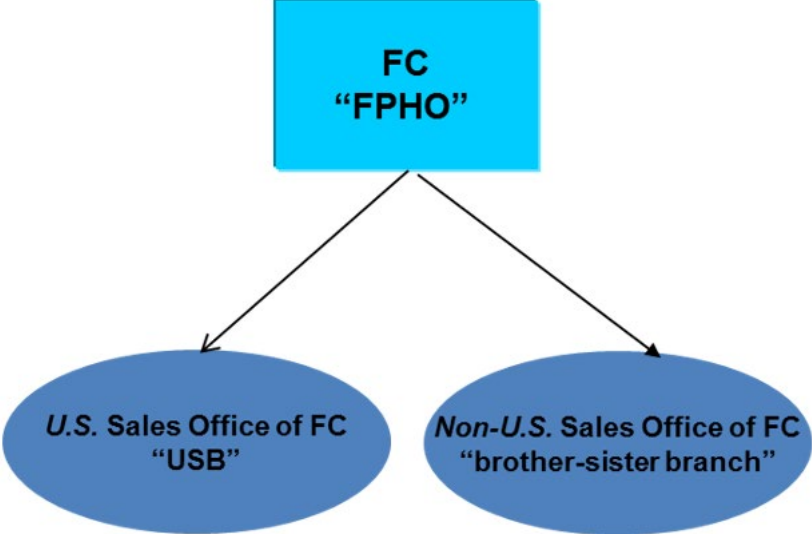
In the interest of clarity, in this unit the term *Foreign Parent Home Office* (FPHO) refers to the aggregate non-USB activities of FC. Thus, if FC is comprised of a U.K. branch (HO), a French branch and a U.S. branch, FPHO would refer to the exclusive combination of the U.K. and the French branches, and not the U.S. branch.

This Practice Unit addresses primarily the deductibility by a U.S. branch (USB) of expenses actually on the books of FPHO. It also identifies the general rules for determining the amount of those expenses deductible by USB in its calculation of ECI. The Examiner must keep in mind that even if the expense is recorded on the books of the USB, the expense may not be deductible for ECI purposes. This Practice Unit does not address any treaty implications which may be present.

The examiner should first determine if the USB deducted any expenses booked on the FPHO books or allocated or apportioned by FC to the ECI of USB. Then the examiner assesses the deductibility of such expenses and then determines if the amount deducted in the calculation of the ECI of USB was proper.

Transaction and Fact Pattern

Section 861 – Home Office and Stewardship Expenses

Diagram of Transaction	Facts
 <pre>graph TD; A[FC "FPHO"] --> B[U.S. Sales Office of FC "USB"]; A --> C[Non-U.S. Sales Office of FC "brother-sister branch"];</pre> The diagram illustrates the organizational structure of a foreign corporation (FC). At the top is a blue rectangle labeled "FC 'FPHO'". Two arrows point downwards from this rectangle to two blue ovals. The left oval is labeled "U.S. Sales Office of FC 'USB'" and the right oval is labeled "Non-U.S. Sales Office of FC 'brother-sister branch'".	▪ FC is a resident of a non-treaty foreign country. ▪ FC is a global manufacturer. ▪ FC has two sales branches, one of which is “engaged in a U.S. trade or business” (USB). The non-U.S. branch is also engaged in a trade or business, but outside the U.S. ▪ In its calculation of ECI, USB deducts \$900 of overhead originally paid for and on the books of either FPHO or the brother-sister branch. (see separate issues) ▪ FC files a Form 1120-F, reporting these expenses as deductions in the calculation of ECI. Note: “Home Office” can refer to the aggregate of Non-U.S. branches, divisions, etc. of the foreign corporation, or it can refer to the headquarters of the foreign corporation.

Summary of Potential Issues

Section 861 – Home Office and Stewardship Expenses

<u>Issue 1</u>	FPHO provides administrative services for its U.S. branch (USB), as well as for other branches. USB deducts a portion of the cost of these services when calculating ECI. How much, if any, is allowable as a deduction by USB?
<u>Issue 2</u>	The sole activity of FC in the US is its US business carried on through its U.S. branch (USB). FPHO provides administrative services for U.S. How much, if any, is allowable as a deduction by USB in its calculation of ECI?
<u>Issue 3</u>	A brother-sister branch (not in the U.S.) provides services for the U.S. branch (USB). How much, if any, is allowable as a deduction by USB in its calculation of ECI?
<u>Issue 4</u>	FPHO pays an expense on behalf of the U.S. branch (USB), but the expense remains on the books of FPHO. The expense relates solely to the trade or business of USB and its ECI. How much, if any, is allowable as a deduction by USB in its calculation of ECI?
<u>Issue 5</u>	FPHO incurs stewardship expenses. How much, if any, of this expense is allowable as a deduction by the U.S. branch (USB) in its calculation of ECI?

All Issues, Step 1: Initial Factual Development

Section 861 – Home Office and Stewardship Expenses

Foreign Corporations (FC) may earn gross income and incur deductible expenses in multiple jurisdictions and through multiple branches or divisions, including through the USB and FPHO. Expenses paid for and booked by the FPHO, may be deductible in whole or in part by USB if the expenses are factually related to ECI of USB under the 861 and 882-5 regulations. This Practice Unit examines several representative fact patterns and discusses the process by which an examiner determines if the subject expenses are properly deductible and, if so, in what amount?

Fact Element	Resources
▪ FC has a branch sales office in the U.S. (USB)	▪ Internet search on FC's website focusing on FC's global lines of business, FC's foreign offices, FC's full or abbreviated financial statements ▪ Prior year Forms 1120-F ▪ Foreign tax returns of FC if available
▪ USB's activities constitute a "trade or business" within the U.S.	▪ Same as above
▪ FC files Form 1120-F for USB and reports ECI related to the U.S. trade or business of USB.	▪ Form 1120-F

All Issues, Step 1: Initial Factual Development (cont'd)

Section 861 – Home Office and Stewardship Expenses

Foreign Corporations (FC) may earn gross income and incur deductible expenses in multiple jurisdictions and through multiple branches or divisions, including through the USB and FPHO. Expenses paid for and booked by the FPHO, may be deductible in whole or in part by USB if the expenses are factually related to ECI of USB under the 861 and 882-5 regulations. This Practice Unit examines several representative fact patterns and discusses the process by which an examiner determines if the subject expenses are properly deductible and, if so, in what amount?

Fact Element	Resources
▪ USB has deducted in its calculation of ECI expenses actually paid and/or booked by FPHO or the brother-sister branch of FC.	Request and/or review: ▪ Detail support for any deductions related to expenses paid and/or originally booked by FPHO or the brother-sister branch of FC ▪ “Functional” organization charts ▪ FC or FC group global financial statements ▪ Any available management reports related to USB ▪ Transfer Pricing studies and Functional analyses, even if for foreign-to-foreign transactions (there may be useful data regarding the organizational structure, etc., in addition to transactional pricing data)

Issue 1, Step 2: Review Potential Issues

Section 861 – Home Office and Stewardship Expenses

Issue 1

FPHO provides administrative services for multiple operating branches, including USB. USB deducts a portion of the cost of these services in calculating ECI. How much, if any, is allowable as a deduction by USB?

Explanation of Issue	Resources
It is common for a foreign corporation to have a business unit or division referred to as the “headquarters branch” and located in the home (foreign) country. The headquarters branch is where general executives and certain administrative personnel are typically located. Such a branch frequently carries on certain activities which support operations of multiple, or all of, the FC’s operating branches, including USB. FPHO should allocate and apportion any expenses it incurs on behalf of another branch to each branch based on the methods and principles of the 861 and 882 regulations. FPHO must take care not to allocate and apportion a disproportionate share of expenses to any branch. Over-allocation or apportionment of an expense to a particular branch would reduce its net income incorrectly and cause a misstatement for tax purposes. It would also have the effect of increasing the net income of FPHO or another branch incorrectly.	▪ IRC 861 ▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5 ▪ Treatises, such as Fundamentals of International Taxation by Bittker and Lokken, generally at paragraph 67.6 ▪ Form 1120-F, Schedule H Instructions

Issue 1, Step 2: Review Potential Issues (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 1

FPHO provides administrative services for multiple operating branches, including USB. USB deducts a portion of the cost of these services in calculating ECI. How much, if any, is allowable as a deduction by USB?

Explanation of Issue	Resources
 CAUTION: In many cases, the foreign corporation/home office may make an actual charge of general and administrative expense to other branches or divisions. The branches receiving these charges generally record an expense and may pay in cash, property, or make an entry in an intercompany account. These charges may be termed in various ways, including “charge outs.” The examiner should be aware that although the amount of these charges may be <i>indicative</i> of the correct amount of expense (for U.S. tax purposes) which should be borne by the receiving branch, they are not <i>determinative</i> . Allocation and apportionment methods which are not appropriate for U.S. tax purposes because they are inconsistent with the 861 and 882-5 regulations may have been used to determine the amount of the charge.	▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5
 CAUTION: Taxpayers with branches in the U.S., a relatively high tax jurisdiction, might be tempted to allocate and apportion too much FPHO expense to those branches in order to reduce their U.S. tax liability. At the FC level, this would result in a lower effective tax rate.	

Issue 1, Step 2: Review Potential Issues (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 1

FPHO provides administrative services for multiple operating branches, including USB. USB deducts a portion of the cost of these services in calculating ECI. How much, if any, is allowable as a deduction by USB?

Explanation of Issue	Resources
 CAUTION: In some situations, certain countries may limit the amount of deductions reported on a foreign corporation's foreign tax return where those expenses were actually incurred by a related entity in another country. Taxpayers may attempt to deduct the maximum amount allowable under foreign law in that foreign jurisdiction and allocate and apportion the remaining portion to the related branches in other jurisdictions. With respect to the United States, taxpayers may attempt to do this by using allocation and apportionment methods and principles that are not consistent with methods and principles of the 861 and 882-5 regulations. The result would obviously be a misstatement of taxable income across multiple jurisdictions.	▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5

Issue 1, Step 3: Additional Factual Development

Section 861 – Home Office and Stewardship Expenses

Issue 1

FPHO provides administrative services for multiple operating branches, including USB. USB deducts a portion of the cost of these services in calculating ECI. How much, if any, is allowable as a deduction by USB?

Fact Element	Resources
▪ USB’s activities constitute a “trade or business” within the U.S. This trade or business requires some level of administrative services.	In addition to the items requested during initial development, consider requesting copies of: ▪ Sales contracts, etc. to confirm that there are administrative functions needed. ▪ Functional analyses or descriptions of administrative activities in USB and FPHO ▪ Management reports which separately state the administrative activities of USB and FPHO, or of different departments

Issue 1, Step 3: Additional Factual Development (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 1

FPHO provides administrative services for multiple operating branches, including USB. USB deducts a portion of the cost of these services in calculating ECI. How much, if any, is allowable as a deduction by USB?

Fact Element	Resources
▪ FPHO provides administrative services for multiple branches of FC, including USB. FPHO charges USB for a portion of the total cost of these administrative services.	In addition to the items requested during initial development, consider requesting copies of: ▪ Invoices or calculations of the expenses of FPHO that were charged to USB. ▪ Management reports and Form 1120-F of USB to ensure that they “tell the same story” with respect to administrative costs ▪ Detail of the methodology used to allocate and apportion expenses among branches

Issue 1, Step 3: Additional Factual Development (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 1

FPHO provides administrative services for multiple operating branches, including USB. USB deducts a portion of the cost of these services in calculating ECI. How much, if any, is allowable as a deduction by USB?

Fact Element	Resources
▪ If only a portion of the expense incurred by the FPHO benefitted USB, the Examiner must carefully examine the methodology used by FC to allocate and apportion the expenses to USB and ensure that the result is consistent with the methods and principles of the 861 and 882-5 regulations.	In addition to the items requested during initial development, consider requesting copies of: ▪ Invoices or calculations of the expenses of FPHO that were charged to USB ▪ Management reports and Form 1120-F of USB to ensure that they “tell the same story” with respect to administrative costs ▪ Detail of the methodology used to allocate and apportion expenses among branches

Issue 1, Step 4: Develop Arguments

Section 861 – Home Office and Stewardship Expenses

Issue 1

FPHO provides administrative services for multiple operating branches, including USB. USB deducts a portion of the cost of these services in calculating ECI. How much, if any, is allowable as a deduction by USB?

Explanation of Adjustment	Resources
 DECISION POINT: If the facts indicate that FPHO incurred general and/or administrative expenses which are factually related to USB's ECI, the Examiner must ensure that the portion of such costs of FPHO which are deducted by USB in its calculation of ECI is consistent with the allocation and apportionment methods and principles of the 861 regulations. These regulations provide generally that an administrative expense may be apportioned on any basis which reflects to a reasonably close extent the factual relationship between the expense and USB's ECI.	▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T

Issue 1, Step 4: Develop Arguments (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 1

FPHO provides administrative services for multiple operating branches, including USB. USB deducts a portion of the cost of these services in calculating ECI. How much, if any, is allowable as a deduction by USB?

Explanation of Adjustment	Resources
Expenses with Direct Benefit - for expenses incurred by FPHO that are factually related to the U.S. trade or business of USB, the Examiner should confirm that the expense provided benefit only to USB and no other branches or subsidiaries. The Examiner should apply the normal requirements for deductibility of expenses and rules and doctrines such as “ordinary and necessary” as they relate to the direct expenses deducted by USB and determine if, under the methods and principles of the 861 and 882-5 regulations, the expense is factually related to USB’s ECI.	▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5

Issue 1, Step 4: Develop Arguments (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 1

FPHO provides administrative services for multiple operating branches, including USB. USB deducts a portion of the cost of these services in calculating ECI. How much, if any, is allowable as a deduction by USB?

Explanation of Adjustment	Resources
Expenses with Indirect Benefit - for expenses incurred by FPHO that have an indirect benefit to the U.S. trade or business of USB, the Examiner should determine if the amount deducted by USB in its calculation of ECI is consistent with the methods and principles of the 861 and 882-5 regulations. Generally, FPHO must allocate and apportion the expense to USB using a method that is based on the factual relationship between the expense and USB's ECI. Although taxpayers have certain leeway in selecting methods, the result <i>must</i> be consistent with the methods and principles of the 861 and 882-5 regulations.	▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5

Issue 2, Step 2: Review Potential Issues

Section 861 – Home Office and Stewardship Expenses

Issue 2

The sole commercial activity of FC in the U.S. is its U.S. business carried on through its U.S. branch (USB). FC maintains a headquarters in the home country which provides administrative services for USB. How much of the expense of FPHO may be deducted by USB in its calculation of ECI?

Explanation of Issue	Resources
It is common for a foreign corporation to have a business unit or division referred to as the “headquarters branch” and located in the home (foreign) country. The headquarters branch is where general executives and certain administrative personnel are typically located. Such a branch frequently carries on certain activities which support operations of multiple, or all of, the FC’s operating branches, including USB. With respect to USB, FPHO should allocate and apportion to USB any expense it incurs on behalf of USB consistent with the methods and principles of the 861 and 882-5 regulations. FPHO must take care not to allocate and apportion a disproportionate share of expenses to USB.	▪ IRC 861 ▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5 ▪ Treatises, such as Fundamentals of International Taxation by Bittker and Lokken, generally at paragraph 67.6

Issue 2, Step 2: Review Potential Issues (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 2

The sole commercial activity of FC in the U.S. is its U.S. business carried on through its U.S. branch (USB). FC maintains a headquarters in the home country which provides administrative services for USB. How much of the expense of FPHO may be deducted by USB in its calculation of ECI?

Explanation of Issue	Resources
Over-allocation or apportionment of an expense to the branch would reduce its net income incorrectly and cause a misstatement for tax purposes. It would also have the effect of incorrectly increasing net income of FPHO. If FPHO has absolutely no activity other than supporting USB, then it may, depending on the facts, be allowable for USB to deduct FPHO general and administrative expenses. However, any expenses incurred by FPHO solely for the purposes of maintaining its foreign headquarters would not be deductible. This would be a highly fact intensive determination, and as stated above, not very common.	▪ IRC 861 ▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5 ▪ Treatises, such as Fundamentals of International Taxation by Bittker and Lokken, generally at paragraph 67.6

Issue 2, Step 2: Review Potential Issues (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 2

The sole commercial activity of FC in the U.S. is its U.S. business carried on through its U.S. branch (USB). FC maintains a headquarters in the home country which provides administrative services for USB. How much of the expense of FPHO may be deducted by USB in its calculation of ECI?

Explanation of Issue	Resources
 CAUTION: Foreign Corporations with branches in relatively high tax jurisdictions, such as the U.S., might be tempted to allocate and apportion too much FPHO expense to the branches in such jurisdictions in order to reduce the total tax expense or tax liability of the foreign corporation. Since the U.S. is a relatively high tax jurisdiction this may be attempted in order to reduce tax expense of USB and thus reduce the effective tax rate of the foreign corporation. For example, assume that foreign corporation FCA is incorporated in Country A which has a 25% tax rate and has profitable operating branches in County A (Branch A) and in Country B (Branch B). If the tax rate in B is 35%, FCA can reduce its total tax expense and effective tax rate by “moving” or “shifting” expenses from Branch A to Branch B. This reduces the income in B, increases income in A, and causes a permanent difference equal to 10% (35% - 25%) of the amount shifted. This may also be attempted in situations wherein there are profitable branches and unprofitable branches with similar results.	▪ IRC 446 ▪ Treas. Reg. 1.446-1, <i>et al</i>

Issue 2, Step 3: Additional Factual Development

Section 861 – Home Office and Stewardship Expenses

Issue 2

The sole commercial activity of FC in the U.S. is its U.S. business carried on through its U.S. branch (USB). FC maintains a headquarters in the home country which provides administrative services for USB. How much of the expense of FPHO may be deducted by USB in its calculation of ECI?

Fact Element	Resources
▪ FC claims that its only commercial activity is that which is carried on by USB, and therefore, generally all expenses of FPHO would be deductible by USB in the calculation of ECI under the methods and principles of the 861 and 882-5 regulations. However, expenses incurred by FC solely to maintain its operation in the foreign country would not be allocated and apportioned to ECI under those regulations. ▪ The Examiner should confirm that the only commercial activity of FC is the trade or business carried on by USB. The Examiner should confirm that only “ordinary and necessary” expenses were incurred by FPHO on behalf of USB. Any other expenses incurred by FPHO would not be deductible by USB. Also, the methods and principles of the 861 and 882-5 regulations must be applied	▪ Annual reports ▪ Published company information ▪ Tax filings in the country of incorporation ▪ Business or commercial filings in the country of incorporation, if available. ▪ Marketing materials ▪ Trade journals ▪ Commercial databases such as those used in ascertaining “comparable data” for transfer pricing purposes

Issue 2, Step 4: Develop Arguments

Section 861 – Home Office and Stewardship Expenses

Issue 2

The sole commercial activity of FC in the U.S. is its U.S. business carried on through its U.S. branch (USB). FC maintains a headquarters in the home country which provides administrative services for USB. How much of the expense of FPHO may be deducted by USB in its calculation of ECI?

Explanation of Adjustment	Resources
▪ Review responses to IDRs which requested information sufficient to confirm that the only commercial activity of FC is the trade or business carried on by USB. Ensure that all documents, etc. “tell the same story.” In other words, does data from websites, etc. indicate that FC has a presence in other jurisdictions? ▪ Review taxpayer’s responses to IDR which requested substantiation that deductions of USB in its calculation of ECI are related to expenses that were “ordinary and necessary”, “reasonable,” etc. Ensure that only expenses that meet the normal criteria for deductibility are included as deductions in the calculation of ECI.	

Issue 2, Step 4: Develop Arguments (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 2

The sole commercial activity of FC in the U.S. is its U.S. business carried on through its U.S. branch (USB). FC maintains a headquarters in the home country which provides administrative services for USB. How much of the expense of FPHO may be deducted by USB in its calculation of ECI?

Explanation of Adjustment	Resources
▪ Even if the expenses meet the normal criteria for deductibility, they may not be taken into account in the calculation of ECI unless allocation and apportionment of those expenses to ECI is consistent with the methods and principles of the 861 and 882-5 regulations.	▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5

Issue 3, Step 2: Review Potential Issues

Section 861 – Home Office and Stewardship Expenses

Issue 3

A brother-sister branch (not in the U.S.) provides services for the USB. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Explanation of Issue	Resources
It is common for a foreign corporation to have multiple branches in multiple countries. Frequently the headquarters branch is the branch where general executives and certain administrative personnel are typically located, and through which they provide general and administrative services and support for the operating branches. However, this is not always the case, and it is not uncommon for an operating branch to provide services for brother-sister branches, including the USB. With respect to the calculation of the ECI of USB, the expenses of any branch providing general and administrative services to USB should be allocated and apportioned to the ECI of USB based on the methods and principles of the 861 regulations. Likewise, if USB incurs general and administrative costs which support the activities of another branch, only the portion related to the support of USB's ECI are deductible in the calculation of ECI. The branch performing the services must take care not to allocate and apportion a disproportionate share of expenses to any branch. Over-allocation or apportionment of an expense to a particular branch would reduce its net income incorrectly and cause a misstatement for tax purposes. It would also have the effect of increasing the net income of at least one other branch.	▪ IRC 861 ▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5 ▪ Treatises, such as Fundamentals of International Taxation by Bittker and Lokken, generally at paragraph 67.6

Issue 3, Step 2: Review Potential Issues (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 3

A brother-sister branch (not in the U.S.) provides services for the USB. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Explanation of Issue	Resources
 CAUTION: In many cases, the foreign corporation/home office or a branch may make an actual charge of general and administrative expense to other branches or divisions. The branches receiving these charges generally record an expense and may pay in cash, property, or make an entry in an intercompany account. These charges may be termed in various ways, including “charge outs.” The examiner should be aware that although the amount of these charges may be <i>indicative</i> of the correct amount of expense (for U.S. tax purposes) which should be borne by the receiving branch, they are not <i>determinative</i> . Allocation and apportionment methods which are not consistent with the methods and principles of the 861 regulations may have been used to determine the amount of the charge.	▪ IRC 861 ▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5 ▪ Treatises, such as Fundamentals of International Taxation by Bittker and Lokken, generally at paragraph 67.6

Issue 3, Step 2: Review Potential Issues (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 3

A brother-sister branch (not in the U.S.) provides services for the USB. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Explanation of Issue	Resources
 CAUTION: Taxpayers with branches in the U.S., a relatively high tax jurisdiction, might be tempted to allocate and apportion too much FPHO expense to USB in order to reduce their U.S. tax liability. At the legal entity FC level, this would result in a lower effective tax rate.	▪ IRC 861 ▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5 ▪ Treatises, such as Fundamentals of International Taxation by Bittker and Lokken, generally at paragraph 67.6
 CAUTION: In some situations, certain countries may limit the deductibility of expenses (on tax returns in their country) charged to a taxpayer in their country when such expenses were incurred by a related entity or branch in another country. Taxpayers may attempt to charge only so much of an expense as is deductible in one of the jurisdictions. With respect to the U.S., taxpayers may attempt to do this by using allocation or apportionment methods that are not consistent with the methods and principles of the 861 and 882-5 regulations. The result would obviously be a misstatement of taxable income across multiple jurisdictions.	

Issue 3, Step 3: Additional Factual Development

Section 861 – Home Office and Stewardship Expenses

Issue 3

A brother-sister branch (not in the U.S.) provides services for the USB. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Fact Element	Resources
▪ The Examiner must ensure that any expenses deducted by USB are supported by valid deductions that meet the general criteria of “ordinary and necessary,” “reasonable.” etc. and that the allocation and apportionment of those expenses is consistent with the methods and principles of the 861 and 882-5 regulations.	In addition to the items requested during initial development, consider requesting copies of: ▪ Invoices or calculations of the expenses (of the branch that provided the services) that were charged to USB. ▪ Management reports and Form 1120-F of USB, to ensure that they “tell the same story” with respect to administrative costs ▪ Sales contracts, etc. to confirm that there are administrative functions needed.

Issue 3, Step 3: Additional Factual Development (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 3

A brother-sister branch (not in the U.S.) provides services for the USB. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Fact Element	Resources
▪ Since FC has multiple operating branches in multiple countries and at least one branch provides general and administrative services for another branch, the Examiner must identify the services provided for, or on behalf of, USB, by a brother-sister branch and whether the expenses would be properly allocated and apportioned to USB's ECI under the methods and principles of the 861 regulations. ▪ If only a portion of the expense incurred benefitted USB, the Examiner must carefully examine the methodology used by FC to allocate and apportion the expense to USB and ensure that allocation and apportionment is consistent with the methods and principles of the 861 regulations.	In addition to the items requested during initial development, consider requesting copies of: ▪ Functional analyses or functional descriptions of administrative activities in USB ▪ Management reports which separately state the administrative activities of all branches ▪ Detail of the methodology used to allocate and apportion expenses among branches

Issue 3, Step 4: Develop Arguments

Section 861 – Home Office and Stewardship Expenses

Issue 3

A brother-sister branch (not in the U.S.) provides services for the USB. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Explanation of Adjustment	Resources
 DECISION POINT: If the facts indicate a brother-sister branch incurred general and/or administrative expenses which directly or indirectly benefited USB, the Examiner must ensure that the amount of those expenses deducted by USB in its calculation of ECI is consistent with the methods and principles of the 861 regulations.	▪ IDR responses ▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T

Issue 3, Step 4: Develop Arguments (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 3

A brother-sister branch (not in the U.S.) provides services for the USB. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Explanation of Adjustment	Resources
Expenses with Direct Benefit - for expenses incurred by a branch other than USB that have a direct benefit to the U.S. trade or business of USB, the Examiner should confirm that the expense provided benefit only to USB and no other branches or subsidiaries. The Examiner should apply the normal requirements for deductibility of expenses and rules and doctrines such as “ordinary and necessary” as they relate to the direct expenses deducted by USB and determine whether they are factually related to USB’s ECI under the methods and principles of the 861 and 882-5 regulations.	▪ IDR responses ▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5

Issue 3, Step 4: Develop Arguments (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 3

A brother-sister branch (not in the U.S.) provides services for the USB. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Explanation of Adjustment	Resources
Expenses with Indirect Benefit - for expenses incurred by a branch other than USB that have an indirect benefit to the U.S. trade or business of USB, the Examiner should determine if the amount deducted by USB in its calculation of ECI is consistent with the methods and principles of the 861 and 882-5 regulations. Generally, any indirect expenses deducted by USB must be determined using a method that is based on the factual relationship between the expenses and USB's ECI. Although taxpayers have certain leeway in selecting methods, the result <i>must</i> be consistent with the methods and principles of the 861 and 882-5 regulations.	▪ IDR responses ▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5

Issue 4, Step 2: Review Potential Issues

Section 861 – Home Office and Stewardship Expenses

Issue 4

FPHO pays an expense on behalf of USB, but the expense remains on the books of FPHO. The expense relates solely to the trade or business of USB and its ECI. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Explanation of Issue	Resources
It is common for a foreign corporation to have a headquarters branch or similar branch in the home (foreign) country. The headquarters branch is the branch where general executives and certain administrative personnel are typically located. Such a branch carries on certain activities which support operations of multiple, or all of, the FC's operating branches, including USB.	▪ IRC 861 ▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5 ▪ Treatises, such as Fundamentals of International Taxation by Bittker and Lokken, generally at paragraph 67.6 ▪ IRC 446, <i>et seq</i>

Issue 4, Step 2: Review Potential Issues (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 4

FPHO pays an expense on behalf of USB, but the expense remains on the books of FPHO. The expense relates solely to the trade or business of USB and its ECI. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Explanation of Issue	Resources
 CAUTION: The Examiner should not assume that the FC used methods of accounting acceptable for U.S. tax purposes and should refer to general domestic rules for specifics on application of methods of accounting and contact the Method of Accounting Practice Network, if necessary, especially as they relate to transactions between related parties. Under the accrual method of accounting, taxpayers are generally allowed to deduct certain expenses before actual payment if certain requirements are met. Accounting entries are <i>indicative (but not determinative)</i> of how a transaction should be treated and are usually <i>prima facie</i> evidence of a taxpayer's intent.	▪ IRC 861 ▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5 ▪ Treatises, such as Fundamentals of International Taxation by Bittker and Lokken, generally at paragraph 67.6 ▪ IRC 446, <i>et seq</i>

Issue 4, Step 3: Additional Factual Development

Section 861 – Home Office and Stewardship Expenses

Issue 4

FPHO pays an expense on behalf of USB, but the expense remains on the books of FPHO. The expense relates solely to the trade or business of USB and its ECI. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Fact Element	Resources
 DECISION POINT: The Examiner should take steps to understand the accounting policies, etc. used by FC and not be misled by accounting entries as they appear in source documents. Determine if USB attempted to deduct an expense related to an interbranch transaction, even though under the Internal Revenue Code, such transactions are disregarded.	▪ IDRs to ascertain USB's method of accounting ▪ Cancelled checks or bank statements indicating payment of the expense ▪ General U.S. tax principles regarding the timing and deductibility of expenses ▪ Source documentation as available or appropriate

Issue 4, Step 4: Develop Arguments

Section 861 – Home Office and Stewardship Expenses

Issue 4

FPHO pays an expense on behalf of USB, but the expense remains on the books of FPHO. The expense relates solely to the trade or business of USB and its ECI. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Explanation of Adjustment	Resources
If the facts indicate that FPHO incurred general and/or administrative expenses which are factually related to USB's ECI, the Examiner must ensure that the portion of such costs of FPHO which are deducted by USB in its calculation of ECI is consistent with the allocation and apportionment methods and principles of the 861 regulations. If FPHO incurred expenses that do <i>not</i> bear a factual relationship to any activity of USB, the Examiner should ensure that those expenses are not deducted in the calculation of ECI. The Examiner should generally propose disallowance of any expenses of FPHO that are related solely to FPHO's activities in its country of incorporation. An example would be registration costs paid to the foreign country for FC to be registered, since these costs would generally not meet the "ordinary and necessary" standard.	▪ IRC 861 ▪ Treas. Reg. 1.861-8 through 1.861-17 ▪ Treas. Reg. 1.861-8T through 1.861-14T ▪ Treas. Reg. 1.882-5 ▪ Treatises, such as Fundamentals of International Taxation by Bittker and Lokken, generally at paragraph 67.6

Issue 5, Step 2: Review Potential Issues

Section 861 – Home Office and Stewardship Expenses

Issue 5

FPHO incurs *stewardship* expenses. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Explanation of Issue	Resources
It is common for a foreign corporation to have a home office “headquarters branch” or similar in the home (foreign) country. This is the branch where general executives and certain administrative personnel are typically located. Such branch frequently carries on certain activities which support operations of multiple, or all of, the FC’s operating branches, including USB. If the FC has subsidiaries, FPHO would typically exercise “stewardship” or “oversight” functions with respect to its subsidiaries. These functions are generally duplicative in nature. An example might be the use of a mirror set of accounting books kept by the parent to ensure proper financial reporting and accounting practices or proper internal controls over the accounting function at the subsidiary, even though the subsidiary already performs its own accounting functions.	▪ IRC 861 ▪ Treas. Reg. 1.861-8 <i>et seq</i>, especially Treas. Reg. 1.861-8(e)(4) ▪ Treatises, such as Fundamentals of International Taxation by Bittker and Lokken, generally at paragraph 67.6

Issue 5, Step 2: Review Potential Issues (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 5

FPHO incurs *stewardship* expenses. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Explanation of Issue	Resources
Stewardship expenses are generally not “ordinary and necessary” for the commercial operation of a trade or business. However, they are common expenses when a corporation has subsidiaries and are related to an owner’s exercise of due diligence and oversight with respect to protecting an investment in the subsidiaries. Because stewardship expenses relate to FC’s investment in its subsidiaries and not to the ECI of USB, none of the stewardship expenses can be allocated and apportioned to the ECI under the 861 regulations.	▪ IRC 861 ▪ Treas. Reg. 1.861-8 <i>et seq</i>, especially Treas. Reg. 1.861-8(e)(4) ▪ Treatises, such as Fundamentals of International Taxation by Bittker and Lokken, generally at paragraph 67.6

Issue 5, Step 2: Review Potential Issues (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 5

FPHO incurs *stewardship* expenses. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Explanation of Issue	Resources
FC has a branch sales office in the U.S. (USB) the activities of which constitute a “trade or business” within the U.S. This trade or business requires some level of administrative services. FC/FPHO also exercises stewardship activities with respect to its subsidiaries. The Examiner must determine which expenses of FC (and USB) are ordinary and necessary for the operation of USB’s trade or business in the U.S. and ensure that none of the stewardship expenses are deducted by USB in determining its ECI.	- IRC 861 - Treas. Reg. 1.861-8 <i>et seq</i>, especially Treas. Reg. 1.861-8(e)(4) - Treatises, such as Fundamentals of International Taxation by Bittker and Lokken, generally at paragraph 67.6

Issue 5, Step 3: Additional Factual Development

Section 861 – Home Office and Stewardship Expenses

Issue 5

FPHO incurs *stewardship* expenses. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Fact Element	Resources
 CAUTION: Taxpayers may be recording <i>stewardship</i> or <i>shareholder oversight</i> expenses on the books of the entity over which the oversight functions are undertaken. In other words, a foreign corporation with a subsidiary would generally exercise some level of stewardship or oversight function with respect to its <i>subsidiary</i> in order to ensure that its investment in the subsidiary is protected. Remember that stewardship or oversight expenses are generally duplicative in nature, and for U.S. tax purposes do not relate to the commercial operation of the subsidiary itself. They relate to the owner's exercise of due diligence, in its capacity as a shareholder or investor, in protecting an investment.	In addition to the items requested during initial development, consider requesting copies of: ▪ Management reports which separately state the administrative and oversight activities of FPHO and USB ▪ Organization charts to determine the existence of subsidiaries. ▪ Functional analyses of activities of both USB and FPHO to identify activities which are duplicative

Issue 5, Step 3: Additional Factual Development (cont'd)

Section 861 – Home Office and Stewardship Expenses

Issue 5

FPHO incurs *stewardship* expenses. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Fact Element	Resources
 CAUTION: Therefore, expenses of stewardship and oversight functions are properly recorded only on the books and records of the shareholder or investor, <i>not</i> on the books and records of the entity over which the stewardship or oversight functions are undertaken.	In addition to the items requested during initial development, consider requesting copies of: ▪ Management reports which separately state the administrative and oversight activities of FPHO and USB ▪ Organization charts to determine the existence of subsidiaries. ▪ Functional analyses of activities of both USB and FPHO to identify activities which are duplicative
 CAUTION: The Examiner should be on guard to ensure that all items of expense (and income) are recorded on the books and records of the appropriate entity.	

Issue 5, Step 4: Develop Arguments

Section 861 – Home Office and Stewardship Expenses

Issue 5

FPHO incurs *stewardship* expenses. How much, if any, is allowable as a deduction by USB in its calculation of ECI?

Explanation of Adjustment	Resources
If the facts indicate that FPHO incurred stewardship or duplicative expenses, the Examiner should generally ensure that no portion of such costs are deducted by USB in its calculation of ECI. Generally, stewardship costs relate to a parent's protection of its investment in a subsidiary and are not deductible by a U.S. branch. The Examiner should rely on an analysis of the actual nature of any such expenses when disallowing them in the calculation of the ECI of USB and distinguish them from deductible expenses.	▪ IRC 861 ▪ Treas. Reg. 1.861-8 <i>et seq</i>, especially Treas. Reg. 1.861-8(e)(4) ▪ Treatises, such as Fundamentals of International Taxation by Bittker and Lokken, generally at paragraph 67.6

Index of Referenced Resources

Section 861 – Home Office and Stewardship Expenses

IRC 446

IRC 861

IRC 882

Treas. Reg. 1.446-1

Treas. Reg. 1.861-8 through 17

Treas. Reg. 1.861-8T through 14T

Treas. Reg. 1.882-5

Form 1120-F, U.S. Income Tax Return of a Foreign Corporation

Form 1120-F, Schedule H Instructions

Additional Resources

Section 861 – Home Office and Stewardship Expenses

Type of Resource	Description(s)
Reference Materials – Treatises	▪ Bittker & Lokken, Fundamentals of International Taxation, Para 67.6

Glossary of Terms and Acronyms

Term/Acronym	Definition
ECI	Effectively Connected Income
FC	Foreign Corporation – the legal entity (including all activities in all branches and divisions wherever located)
FPHO	Foreign Parent Home Office – the aggregate of non-USB activities of FC
USB	Branch of FC engaged in a U. S. trade or business

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9421	Gross Effectively Connected Income (ECI) of a Foreign Corporation (Non-Treaty)
9421	General Deductions of a Foreign Corporation Engaged in U.S. Trade or Business (Non Treaty)
9421	Interest Expense of U.S. Branch of a Foreign Bank (Non-Treaty)
9421	Interest Expense of a Foreign Corporation Engaged in a U.S. Trade/Business (Non-Bank, Non-Treaty)
9424	Non-Services FDAP Income
9460	Using Alternative Means to Obtain Foreign Based Evidence