



We are pleased to send you this second issue of Meaden & Moore's International Tax News and hope you find the content useful. We would appreciate your feedback on our efforts to raise awareness of critical international tax issues.

Please send any suggestions or topics you would like us to address to William Harwood at wharwood@meadenmoore.com or call us at (216)-928-5411.

UPCOMING ISSUE

More Tips on Allocation & Apportionment.

- New interest expense election and how it can affect multinational companies far into the future.

Allocation and Apportionment for Companies with Foreign Operations

If you're doing business in foreign countries, each year at tax time you face the sometimes overwhelming task of calculating what's known as Allocation and Apportionment—the official process for assigning your expenses for foreign operations. The only time it's not required is if you have no foreign tax credit to claim, no domestic production to claim, and no foreign losses to claim.

Below is a list of questions and areas to consider in order to properly allocate your expenses:

- Where income and losses occur for tax purposes?
- How much foreign tax credit is available to you?
- How much of a foreign person's income is taxable by IRS?
- What is the tax basis of business units?
- Review certain types of income that are subject to US taxation and in what amount.

Though the rules are clear, calculating A&A isn't as straightforward as it might be. It's easy to get off track and potentially end up filing an incorrect return, or worse, being unable to make full use of available tax benefits.

Your first job is to decide which method to use as your measure, e.g. gross income vs. total revenue. Choosing the measure with care can yield a better result, usually by maximizing the amount of foreign income. Other financial measures for

apportioning income can include by compensation paid or accrued, or one of various other costs. A ratio analysis is an indispensable tool. Below are the steps to follow to correctly and fully complete the allocation part of the process:

1. Establish the source of all income to be reported to IRS. This is relatively straightforward.
2. Determine if there is an alternative sourcing rule available in a tax treaty between the United States and the relevant foreign jurisdiction. Your most efficient search option here is to use one of the major tax library services such as BNA, CCH, Tax Analysts, or RIA. Watch for "terms of art," which are seemingly common expressions that have very specific meanings in tax law. Plan to spend sufficient time in this step.
3. Establish the various sources of income into classes. The basic classes are fairly common knowledge, and if you're very familiar with Allocation and Apportionment, you'll know exactly what your options are here. If not, you may want our experts at Meaden & Moore to help with this step.
4. Segregate expense items that have special sourcing rules. These most usually include interest expense, R&D expenditures, and taxes. It's very important to think about what your goal is when performing this step. After you've performed this information gathering and sorting process, the next steps refer to the apportionment part of the A&A process:

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Continued from page 1

1. Determine, of all expenses (other than those in step 4 above) from all sources (source refers to where something is treated as occurring for tax purposes), which must be matched with particular classes of income, and assign those expenses accordingly. Business managers generally understand how to perform this step.

2. Within each class of income there may be several sub-classifications and a need to appropriately allocate additional directly related expenses. Subclasses can apply because of various business activities. Your decisions should be based on your goals and an understanding of your opportunities, as well as according to the limits of tax law. Choices might include, for example, foreign income vs. domestic income that is effectively connected with a US trade or business, qualified domestic production income, various special income classifications earned by “controlled foreign corporations.” These options are by no means simple. If you are not thoroughly familiar with the benefits of each option, you may want to seek advice from our experts at Meaden & Moore.

3. Establish a reasonable method for apportioning non-allocated expenses to all the various groupings and sub-groupings of income. The trick is to consider the benefits of various method options, eliminate those that would not produce a reasonable result, then pick the best for you.

Executing the A&A portion of your tax returns is a complex process. Sometimes just reading a description of what needs to be done can be daunting. An expert can bring deep knowledge—the kind often missing from the regular tax accountant’s experience—to making decisions in A&A that comply strictly with requirements yet bring the greatest benefit to your organization.

For a complimentary high-level audit of your A&A or other foreign tax issues, call Bill Harwood at 216.928.5411.

Example of a Simple Apportionment

ABC Company has \$100 of gross income from sales, \$50 from rents and \$50 from partnerships. Expenses apportioned to sales = \$60 to rents = \$60 and to partnerships = \$5. All expenses except executive salaries (\$30), and professional fees (\$10) have been accounted for in the allocation process. Using gross income as the apportionment factor, 50% of unallocated expenses (\$20) is applied to sales, 25% (\$10) to rents, and 25% (\$10) to partnerships.

Class	Gross Income	Allocation	Apportionment	Net Income
Sales	100	60	20	20
Rents	50	60	10	-20
Partnerships	50	5	10	35
Total	200	125	40	35

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1100 Superior Avenue
Suite 1100
Cleveland, OH 44114

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