Chapter 10  Foreign Investment Interest Offset

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10.1 In General

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a. The Foreign Investment Interest Offset

Revenue and Taxation Code (R&TC) §24344(c) provides that interest expense incurred for purposes of foreign investments may offset dividends deductible under R&TC §24411. The purpose of the foreign investment interest offset is to offset the water's-edge group's R&TC §24411 dividend deduction by interest expense attributable to foreign investments. The underlying theory being one of "matching" income and expense. In other words, interest expense incurred to carry an investment that generates income which is not included in the measure of tax should be "matched" with the nontaxable income, and should be excluded.

Before computing the foreign investment interest offset, compute the R&TC §24411 dividend deduction. If the water's-edge group does not claim an R&TC §24411 dividend deduction, then there would be no foreign investment interest offset.

It is important to note that the foreign investment interest offset is limited to the LESSER of:

1. Interest expense attributable to foreign investments.
2. The water's-edge group's R&TC §24411 dividend deduction.
Total interest expense paid or incurred by the water's-edge group is specifically allocated or assigned by formula between foreign and domestic investments. The total interest expense attributable to foreign investment is subject to the foreign investment interest offset, which is a direct adjustment to net income after state adjustments.

Interest expense, subject to the foreign investment interest offset, is equal to the sum of:
- Interest expense allocated to specific foreign investment; plus
- Unassigned interest expense allocated to foreign investment.

The computation of the foreign investment interest offset is a two-step process:

- First, the taxpayer determines if any interest is specifically assignable to either domestic or foreign investments.

- Second, any remaining interest not specifically assignable is allocated between domestic and foreign investments based on a ratio. (CCR §24344(c) (5).) The ratio is the group's foreign investments to total assets:

\[
\text{Pool of Unassigned Interest Expense} \times \frac{\text{Unassigned Foreign Investment}}{\text{Unassigned Total Assets}} = \text{Interest Expense Assigned to Foreign Investment}
\]

The foreign investment interest offset is the sum of the amount of interest specifically assignable to foreign investments plus the amount allocated to foreign investment by formula. However, the amount of the offset may not exceed the R&TC §24411 dividend deduction.

For taxable years beginning on or after January 1, 1997, the foreign investment interest offset as calculated above is multiplied by the same percentage that was used to determine the dividend deduction under R&TC §24411, usually 75 percent. (R&TC §24344(c)(2).)

**b. Computation on a Combined Basis**

The interest offset is computed on a combined basis, not a separate entity basis. Authority for computing the foreign investment interest offset on a combined basis can be found in the regulatory requirement to eliminate
intercompany accounts of interest and assets from the offset computation. (CCR §24344(c)(2)(B)(3) and CCR §24344(c)(2)(C)(3).) The reason for the eliminations is to avoid double counting that would otherwise occur in a combined offset computation. The fact that the regulation requires these adjustments clearly indicates a requirement to compute the offset on a combined basis. If the offset were required to be computed on a separate entity basis, there would be no reason to make the intercompany account adjustments.

Additional authority can be found in the California Supreme Court's decision in *Pacific Telephone and Telegraph Co. v. Franchise Tax Board* (1972) 102 Cal. Rptr. 782. In that case, the FTB computed the interest offset adjustment (R&TC §24344(b)) on a group basis. The taxpayer argued that the computation should be done on a separate entity basis. The court found that FTB's computation of the offset on a group basis was supported by the statute and rejected the single entity argument made by the taxpayer. The court's reasoning is equally applicable to the foreign investment interest offset provision of CCR §24344(c).

c. Intercompany Adjustments

In preparing a water's-edge combined report, intercompany accounts of assets, liabilities, equities, income, costs and expenses may be required to be eliminated in whole or in part, to properly reflect net income and apportionment factors in a combined report. For partially included entities, intercompany transactions are eliminated only to the extent of the amounts actually included in the water's-edge combined report.

In general, the elimination of intercompany accounts of expense, assets and equities for purposes of R&TC §24344(c) will not increase or decrease the net income that would otherwise be taken into account for any entity, except as provided under R&TC §24344(c), (CCR §25106.5-1.) The purpose of the elimination is to avoid taking into account the subject item more than once in a combined report.

The following example shows that, while a CFC and US entity may have intercompany transactions, the intercompany elimination is limited by the CFC's partial inclusion ratio.

Example 1

P and S are affiliated corporations included in the water's-edge combined report under R&TC §25110(a)(1)(C) and (a)(2)(A)(ii). P has net income of $500. S has net income of $300 and a ratio of Subpart F income to earnings
and profits (E&P) for the taxable year of 1/3. P incurs $30 of interest expense paid to S, of which $10 ($30 x 1/3) is considered an intercompany account. It is determined that $10 of P's interest expense is an intercompany account to be eliminated for purposes of calculating the foreign investment interest offset. (See WEM 14 for a detailed discussion of the proper treatment of intercompany transactions in the water's-edge combined report.)

The combined net income of P and S is determined as follows.

Combined Net Income:

<table>
<thead>
<tr>
<th></th>
<th>Corp P</th>
<th>&amp; S</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$500</td>
<td>$100</td>
</tr>
<tr>
<td>Combined net income before offset</td>
<td>$600</td>
<td></td>
</tr>
</tbody>
</table>

Combined Net Income With Intercompany Adjustment:

<table>
<thead>
<tr>
<th></th>
<th>Corp P</th>
<th>Corp S</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$500</td>
<td>$100</td>
<td>$600</td>
</tr>
<tr>
<td>Intercompany interest adjustment</td>
<td>+ 10</td>
<td>- 10</td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>$510</td>
<td>$ 90</td>
<td>$600</td>
</tr>
</tbody>
</table>

For purposes of determining the interest offset, $10 of P's interest expense is considered to be intercompany and $10 S's interest income is considered to be intercompany. These amounts are eliminated in the computation of interest offset. However, the combined net income is not increased or decreased by intercompany interest expense.

d. Forms

The water's-edge group's foreign investment interest offset appears in the following forms:

- FTB 2424 Water’s-Edge Foreign Investment Interest Offset
- Schedule R Line 1b, Water’s-edge foreign investment interest offset from Form FTB 2424, Lin 17
10.2 Form FTB 2424

a. Form FTB 2424, Line 1 - R&TC §24411 Dividend Deduction
b. Form FTB 2424, Line 2 - Total Interest Expense
c. Form FTB 2424, Lines 3 and 4, Specifically Assigned Interest
d. Form FTB 2424, Line 5 - Unassigned Interest Expense
e. Form FTB 2424, Line 11 - Unassigned Foreign Investment
f. Form FTB 2424, Line 12 – Unassigned Total Assets
g. Form FTB 2424, Lines 13, 14, 15, 16 and 17

a. Form FTB 2424, Line 1 – R&TC §24411 Dividend Deduction

The R&TC §24411 dividend deduction is the amount determined on Schedule H (100W), which flows up to California Form 100W or Form 100S as a state adjustment. If there is no R&TC §24411 dividend deduction claimed or allowed, then there will be no foreign investment interest offset. The foreign investment interest offset is limited to the lesser of interest expense attributable to foreign investments, or the R&TC §24411 dividend deduction allowed. It may not exceed the total R&TC §24411 dividend deduction. (CCR §24344(c)(3)(A).)

b. Form FTB 2424, Line 2 – Total Interest Expense

Total interest expense includes all interest expense incurred or paid within the taxable year by any bank or corporation, to the extent the entity is included in the water's-edge combined report (CCR §24344(c)(2)(B).) Total interest expense should reconcile to the financial statements of the entities included in the combined report and to their books and records. The computation is done on an aggregate basis for the entire water's-edge group.

Total interest includes:

1. All interest expense paid or incurred by entities included 100 percent in the water's-edge combined report, which includes the following entities:

   • US incorporated banks and corporations that are owned more than 50 percent by the same interests.

   • Domestic International Sales Corporations, Foreign Sales Corporation and Export Trade Corporations.
• Any corporation, regardless of where incorporated, whose average property, payroll, and sales in the US are 20 percent or more.

Interest expense can generally be found on California Form 100W, Schedule F, line 18, Federal Form 1120, page 1, line 18, and Federal Form 1118, Schedule H, Part II, Column (b), line 1a.

2. Interest expense included in the combined report that is paid or incurred by partially included entities. Partially included entities may include the following entities:

• Controlled Foreign Corporations (CFCs) with Subpart F Income

A CFC’s total interest expense will be included to the extent of the ratio of its Subpart F income to its current year E&P (CCR §24344(c)(2)(B)(2)(b).) CFCs report interest expense on Federal Form 5471, Sch. C, line 12.

Example 2

Corp F (a CFC) is included in the combined report under R&TC §25110(a)(2)(A)(ii). Corp F's Subpart F income is $1,000 and its current year E&P is $4,000, resulting in a partial inclusion ratio of 1/4. Only 1/4 of Corp F's total interest expense of $400 is included in the water's-edge group foreign investment interest offset computation. ($400 x 1/4 = $100 interest expense included in the combined report.)

• Foreign Corporations with Effectively Connected Income (ECI)

Foreign entities with income attributable to sources within the US will include only that portion of the interest expense reflected on the books of account maintained with respect to the US activities, (i.e., the interest expense that is included in the computation of net income subject to inclusion in the combined report.) (CCR §24344(c)(2)(B)(2)(a).)

Interest expense of a foreign corporation attributable to US activities is generally reported on Federal Form 1120-F, Section II, line 18. In computing net income included in the California combined report, if interest expense was adjusted to eliminate any tax treaty adjustments, such adjustments would also apply in computing total interest for purposes of the foreign investment interest offset.
3. Intercompany interest expense between members of the water's-edge group should be eliminated. Interest expense paid or incurred to members of the water's-edge group is eliminated to the extent that such interest expense and related interest income is included in the combined report.

Elimination of intercompany interest expense is sometimes reported on the elimination column of the combined reporting schedules, supporting interest income, and expense reported on California Form 100W, Schedule F, lines 5 and 18. However, sometimes elimination entries are not reported, since income and expense offset one another in computing net taxable income. For an includible CFC, intercompany interest expense may be found on Federal Form 5471, Schedule M.

c. Form FTB 2424, Lines 3 and 4, Specifically Assigned Interest

For interest expense to be assigned to a specific property (including investments), whether foreign or US, the interest expense must satisfy ALL three of the below listed requirements. (CCR §24344(c)(4)(A).)

1. The interest relates to debt paid or specifically incurred for the purpose of purchasing, maintaining, or improving the specific property;

2. The proceeds of the borrowing were actually applied to the specified purpose; and,

3. The creditor can look only to the specific property (or any lease or other interest therein) as security for payment of the principal and interest of the loan and, thus, has no secured interest in any other property of the borrower or the borrower itself with respect to repayment of the loan.

WEM 10.5 provides examples of documents that you may request as support each of the above three requirements.

If the debt does not meet all three requirements, the interest cannot be specifically assigned to the property and must be included in the pool of unassigned interest subject to allocation by formula. In addition, interest expense will not be considered traced to a specific property when the motive for structuring the transaction had no economic significance.

In computing the federal foreign tax credit (FTC), the IRC has provisions related to the allocation and apportionment of interest expense, including
attributing interest expenses to foreign and domestic sources. There are similarities and differences when comparing the federal FTC provisions with the California foreign investment interest offset provisions. For a comparison between these requirements and the federal rules for direct assignment and allocation of interest expense, including interest from qualified nonrecourse indebtedness (QNI), see WEM 10.3. As provided in WEM10.3, information needed to compute the foreign investment interest offset may be identified in the taxpayer's computation of the FTC (see Federal Form 1118, Schedule H, Part II [Rev. 12-2016]).

d. Form FTB 2424, Lines 5 through 10

1. Form FTB 2424, Line 5 – Unassigned Interest Expense

The total interest expense (FTB 2424, Line 2), less any interest expense specifically assigned to foreign or US investment (FTB 2424, Lines 3 and 4), is the pool of unassigned interest expense. (Unassigned interest expense is allocated to foreign investment based on the ratio of foreign investment to total assets.)

A distinction must be made between interest expense paid on debt incurred before January 1, 1988, and interest expense paid on debt incurred after January 1, 1988. Any interest expense paid on debt incurred after January 1, 1988, that relates to debt proceeds that were deposited into a “restricted account” will be excluded from the pool of unassigned interest expense.

2. Form FTB 2424, Line 6 - Unassigned Interest Expense Paid on Debt Incurred Prior to January 1, 1988

All unassigned interest expense paid on debt incurred prior to January 1, 1988, is included in the pool of unassigned interest expense and is subject to assignment by formula to foreign investment (CCR §24344(c)(5)(B).)

3. Form FTB 2424, Line 7 - Unassigned Interest Expense Paid on Debt Incurred on or After January 1, 1988

This line includes all interest expense paid on debt incurred on or after January 1, 1988, unless the debt meets both the refinancing and restricted account criteria. If both criteria are met, the interest on the debt is excluded from the pool of unassigned interest. If the debt does not meet both criteria, interest on the debt is included in the pool of unassigned interest expense.
**Refinancing Criteria**

If the majority of the debt was not used to refinance debt incurred prior to January 1, 1988, and the debt proceeds were deposited in a “restricted account” (see below), then the interest expense is considered assigned to US investments.

However, if the majority of the debt was used to refinance debt incurred prior to January 1, 1988, or the debt arose pursuant to a line of credit or similar account or arrangement established prior to January 1, 1988, then the debt is treated as debt incurred prior to January 1, 1988 (CCR §24344(c)(5)(C).) Thus, interest on this debt is included in the pool of unassigned interest.

**4. Form FTB 2424, Line 8, Restricted Accounts**

If the debt proceeds were not used to refinance old debt and the debt proceeds were deposited into a “restricted account”, then the interest expense is excluded from the pool of unassigned interest. It is considered assigned to US investment.

A “restricted account” is an account that precludes its use for foreign investment and which has not, in fact, been used for foreign investment. (CCR §24344(c)(5)(C).)

The following will disqualify a taxpayer from the “restricted account” relief provision:

- **Use of Funds (CCR §24344(c)(5)(C)(1))**

  If any of the funds in the restricted account are used for foreign investment, then the restricted account will be viewed as unrestricted and the interest expense will be included in the pool of unassigned interest. This will apply only for the year in which the use occurred. Thus, the unassigned interest expense related to the restricted account will be subject to assignment by formula to foreign investment for that year.

- **Transfer of Funds (CCR §24344(c)(5)(C)(2))**

  The transfer of funds, from a restricted account to or through an unrestricted account or accounts from which proceeds are disbursed for purposes of foreign investment within 60 days of the transfer, will disqualify the restricted account. Thus, that interest would be included in the pool of unassigned interest for that year.
5. Form FTB 2424, Line 9 - Net Unassigned Interest Expense on Debt Incurred After January 1, 1988

Subtract the interest expense related to restricted accounts (Line 8) from the unassigned interest expense paid on debt incurred on or after January 1, 1988 (Line 7). The remaining balance is the net unassigned interest expense paid on debt incurred on or after January 1, 1988.

6. Form FTB 2424, Line 10 - Total Unassigned Interest Expense

The sum of Line 6 (unassigned interest expense paid on debt incurred prior to January 1, 1988) and Line 9 (net unassigned interest expense paid on debt incurred after January 1, 1988) results in the total pool of unassigned interest expense to be apportioned by formula. The pool of unassigned interest expense should now consist of interest expense not specifically assigned to foreign or US assets. The interest expense has not met the restricted account test.

e. Form 2424, Line 11 – Unassigned Foreign Investment

Enter the amount of total unassigned foreign investment. Foreign investment is defined as stock or other equity in foreign entities, excluded from the waters-edge combined report, determined by using the federal basis rules and adjusting for accumulated E&P. None of the foreign investments to which interest expense was specifically assigned is includible here. Make any intercompany eliminations, including equity investments in a partially included CFC based on its inclusion ratio.

Total unassigned foreign investment is computed as follows:

<table>
<thead>
<tr>
<th>Total:</th>
<th>Foreign investment:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less:</td>
<td>Any foreign investment to which interest has been specifically assigned.</td>
</tr>
<tr>
<td>Less:</td>
<td>Intercompany eliminations.</td>
</tr>
<tr>
<td>Equals:</td>
<td>Unassigned foreign investment.</td>
</tr>
</tbody>
</table>

1. Stock and Other Equity Investments Included In Total Foreign Investment:

Total foreign investment is equal to stock or other equity investment, regardless of when it was made, in any:
• Entity whose dividends would qualify for the water's-edge dividend deduction.

• Nonaffiliated corporation that is organized outside the US. (CCR §24344(c)(2)(A).)

The foreign investment includes only that portion of the equity that is included in total assets (as defined below). (CCR §24344(c)(2)(A).)

This calculation becomes especially difficult when there are multiple tiers of CFCs, which are partially included in the combined report. The numerator of the unassigned foreign interest allocation ratio includes the foreign investment in foreign corporations directly owned by the water's-edge group whose dividends, if paid, would qualify for the R&TC §24411 deduction. Per CCR §24344(c)(2)(A)(2), only the portion of the foreign corporation's equity that is included in the denominator will be included in the numerator. Per CCR §24344(c)(2)(C), only the assets of the entities included in the combined report are included in the denominator. If the assets of a partially included CFC are included in the denominator, then its equity must be excluded from the denominator, since it would be considered an intercompany account. Therefore, if a CFC is partially included in the combined report, its assets will be included in the denominator. To the extent the assets are included in the denominator, the equity of that CFC will be excluded from the denominator. To the extent the equity is excluded from the denominator, the equity will be excluded from the numerator.

Example 3

US Corporation owns 100% of CFC1, which owns 100% of CFC2. The inclusion ratio (Subpart F income/current E&P) of CFC1 is 60% and 20% for CFC2. US Corporation's foreign investment (stock basis plus accumulated E&P) in CFC1 is $100,000 and CFC1's foreign investment in CFC2 is $200,000. The amount of foreign investment for CFC1 and CFC2 included in the numerator of the foreign investment interest offset is $136,000.

CFC1 is included in the combined report based on its 60% inclusion ratio. Therefore, the US Corporation's foreign investment included for CFC1 would be $40,000. This is determined by taking the foreign investment of $100,000 and multiplying it by 40%, the percentage that CFC1 is excluded. The foreign investment representing 60% of CFC1 would be eliminated as intercompany.

CFC2 is included in the combined report to the extent of its 20% inclusion ratio. Therefore, CFC1's foreign investment for CFC2 would be $96,000.
This is determined by taking CFC1's $200,000 foreign investment in CFC2 and multiplying it by 80%, the percentage that CFC2 is excluded, then multiplying this number by CFC1's 60% inclusion ratio. ($200,000 \times 80\% \times 60\% = 96,000$.) The foreign investment must be multiplied by CFC1's inclusion ratio since the amount included in the numerator is the foreign investment of the water's-edge group and CFC1 is only included to the extent of 60%.

The above calculation is reflected in the chart below.

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>US</th>
<th>CFC1</th>
<th>CFC2</th>
<th>Total/Combined</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in foreign subsidiaries:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>In CFC1</td>
<td>100,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>In CFC2</td>
<td></td>
<td>200,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>In other FC</td>
<td></td>
<td></td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Inclusion Ratio</td>
<td>100%</td>
<td>60%</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>Includible Foreign Investment (before eliminations)</td>
<td>100,000</td>
<td>120,000</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Less: Intercompany</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>60% of Inv. In CFC1</td>
<td></td>
<td>(60,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20% of Inv. In CFC2 x CFC1 Inclusion ratio of 60%</td>
<td></td>
<td></td>
<td>(24,000)</td>
<td></td>
</tr>
<tr>
<td>Total Foreign Investment</td>
<td>40,000</td>
<td>96,000</td>
<td>0</td>
<td>136,000</td>
</tr>
</tbody>
</table>

2. Average Value of Foreign Investment

The unassigned foreign investment is computed at the beginning and end of the taxable year. Then, it is averaged. If the circumstances warrant it, the FTB can take an average of monthly values. (CCR §24344(c)(6)(C).)

3. Stock or Other Equity Investment Defined

Stock or other equity investment in an affiliated bank or corporation is taken into account at its adjusted federal basis, plus (minus) any increases (deficits) in E&P, but not below zero, accumulated during the period the
stock was owned by an entity that is a member of the group which includes
the taxpayer. (CCR §24344(c)(6)(B).) For these purposes an affiliated bank
or corporation is an entity owned greater than 50 percent. (R&TC
§25110(b)(1).) Stock or other equity investment in an unaffiliated entity,
(i.e., an entity owned 50 percent or less), is taken into account at federal
tax book value, (i.e., federal adjusted basis.)

A. Federal Adjusted Basis

The federal adjusted basis in stock includes:

- Cost - IRC §1012.
- Basis Adjustments - IRC §1016. (Adjustments to stock basis are made
  for the amount of distributions previously made that were tax-free.)

These are the more common federal provisions which define adjusted basis,
but other federal rules may also apply. Therefore, the auditor needs to
analyze the taxpayer's records detailing its adjusted basis in stock
investments. If the auditor is not sure of any adjustment, have the taxpayer
provide the detail of the adjustment amount, the taxable year of the
adjustment, and the applicable federal code section.

For federal purposes, IRC §961 requires the stock basis of a CFC to be
increased by undistributed amounts taxed under Subpart F, and decreased
by later distributions, which are not taxed at the time of distribution because
they were previously taxed.

Do not make this adjustment for state “foreign investment” purposes if the
taxpayer owns more than 50 percent of the CFC. As explained below, for
purposes of determining foreign investment, the stock in an affiliated entity
is increased by the entity's E&P. If the federal stock basis adjustment made
for Subpart F income is included in the foreign investment computation,
there will be double counting since the total E&P (of which Subpart F income
is a part) is also included in the amount of foreign investment.

B. Basis Adjusted For Accumulated E&P

CCR §24344(c)(6)(B)(1) states that the federal adjusted basis for stock in
an affiliated bank or corporation is increased by the amount of E&P
accumulated during the period the stock was owned by a member (including
the taxpayer) of the affiliated group. Any increase in E&P, attributable to
the period the stock was owned by an unaffiliated bank or corporation, is not
considered in the calculation. Thus, no increase to the federal adjusted
basis is made for an entity's E&P accumulated prior to ownership by a member of the affiliated group.

CCR §24344(c)(6)(B)(2) states that the federal adjusted basis for stock in an affiliated bank or corporation will be reduced by any deficits in E&P during the period the stock was owned by any member, including the taxpayer, of the affiliated group. Any deficit, attributable to the period the stock was owned by an unaffiliated bank or corporation, is not considered in the calculation. Thus, no decrease to the federal adjusted basis is made for an entity's E&P deficits that were accumulated prior to ownership by a member of the affiliated group.

If a portion of an entity is included in the water's-edged combined report (because it has Subpart F income or income attributable to US sources), then the same portion of the taxpayer's investment in that entity's stock or other equity investment will be excluded from the computation of the taxpayer's total foreign investment. (CCR §24344(c)(2)(C)(3).)

The information to determine the E&P of a foreign subsidiary can be found in the work-papers supporting the federal Form 1118, Foreign Tax Credit (FTC), or the foreign corporation’s audited financial statements.

4. Examples of Total Foreign Investment

Example 4

Corp A (a domestic corporation) bought all of Corp C's stock (a foreign corporation) from Corp B (an unaffiliated domestic corporation) in 1996 for $600,000. Corp B had owned Corp C since its inception in 1990. There has been no reportable income under Subpart F during Corp A's ownership. Corp C's accumulated E&P at the time of acquisition by Corp A was $500,000; its accumulated E&P is currently $800,000.

Corp A's foreign investment is increased by the amount of positive E&P accumulated since acquisition by Corp A. ($800,000 - $500,000 = $300,000.) Therefore, Corp A's foreign investment in Corp C is $900,000. ($600,000 + $300,000 = $900,000.)

Example 5

Assume the same facts as Example 4 except that Corp A bought all of Corp C's stock from Corp D (a nonunitary affiliated domestic corporation). Since Corp D is an affiliated corporation (unity is not a factor), all of Corp C's E&P is added to Corp A's federal adjusted basis in the stock. Therefore, Corp A's
foreign investment in Corp C is $1,400,000. ($600,000 + $800,000 = $1,400,000.)

Example 6

Assume the same facts as Example 4 except that Corp C's accumulated E&P at the time of acquisition by Corp A was $500,000; its accumulated E&P is currently a negative ($400,000.) Thus, Corp C's E&P accumulated by since acquisition by Corp A is a negative ($900,000.) The deficit adjustment cannot reduce Corp A's basis below zero. Therefore, the deficit adjustment is limited to the federal adjusted basis. Corp A's foreign investment is $0. ($600,000 - $600,000 = $0.)

Example 7

Corp P, a domestic corporation with a calendar year, holds the following equity investments in foreign subsidiaries as of January 1, 2000:

- Corp A (100% owned CFC) $60,000
- Corp B (80% owned CFC) $80,000
- Corp C (10% owned CFC) $90,000

Corp B has Subpart F income of $5,000, and current E&P of $20,000, which results in a partial inclusion ratio of 25%. Corp A and C both have $10,000 of total E&P accumulated since acquisition by Corp P. Assume the current E&P of Corp B equals its total E&P accumulated since acquisition by Corp P.

P's end-of-year foreign investment is as follows:

- Corp A ($60,000 + $10,000) $70,000
- Corp B [$80,000 + ($20,000 x 80%) x 75%] $72,000
- Corp C $90,000
- Total Foreign Investment $232,000

For Corporation B, 25% of its income and assets are included in the water's-edge combined report. Thus, B will include 25% of its assets in the amount of unassigned total assets used in the formula to assign interest to foreign investment of the water's-edge group. Therefore, because 25% of B's
underlying assets are included in total assets of the water's-edge group, 25% of Corporation P's investment in B will be eliminated from the foreign investment computation as an intercompany investment. The remaining 75% of P's investment in B will be included in the amount of foreign investment and total unassigned assets. Also, before determining the intercompany elimination, P's beginning year equity investment balance in B is increased by 80% of B's 2000 E&P, (the amount of E&P attributable to the stock owned by the water's-edge group.)

Total foreign investment also includes the stock of foreign corporations owned less than 50% (Corporation C). However, P's basis in C is not increased by its E&P because the E&P adjustment is made only for affiliated banks or corporations. Subsidiaries that are not owned more than 50% are not an affiliate per CCR §24344(c)(2)(G).

f. Form FTB 2424, Line 12 – Unassigned Total Assets

1. Total Assets

A. Total Assets Includes:

- All assets of the entities included 100 percent in the combined report.
- A portion of the total assets for any foreign bank/corporation included in the combined report, to the extent it has income attributable to US sources. The total assets includible is only that portion attributable to the US activities. (CCR §24344(c)(2)(C)(2)(a).)
- A portion of the total assets for CFCs, based on their inclusion ratios. (CCR §24344(c)(2)(C)(2)(b).)

Intercompany eliminations for stock investment in a member of the water's-edge group are made to the extent the underlying assets are included in the combined report. (CCR §24344(c)(2)(C)(3).) All assets, less intercompany, are included in total assets. No distinction is made between business and nonbusiness assets. (CCR §24344(c)(2)(C)(4).)

B. Computation of Total Assets

Federal tax book value of all assets, other than stock or other equity investment:

<table>
<thead>
<tr>
<th>Plus:</th>
<th>Total unassigned foreign investments.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plus:</td>
<td>Stock or other equity investment in a nonunitary domestic affiliate.</td>
</tr>
</tbody>
</table>
Less: Assets to which interest expense has been specifically assigned.

Less: Intercompany asset accounts between members of the water's-edge group to the extent included in the combined report.

Equals: Total Assets.

2. Asset Values

All assets, other than stock in an affiliated bank or corporation, are taken into account at federal tax book value, which is computed as follows. (CCR §24344(c)(6)(A).)

Original cost for federal tax purposes:

<table>
<thead>
<tr>
<th>Less:</th>
<th>Allowed depreciation, amortization or depletion.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equals:</td>
<td>Federal tax book value. (CCR §24344(c)(6)(A).)</td>
</tr>
</tbody>
</table>

Stock or other equity investment in an affiliated bank or corporation is taken into account at an adjusted federal basis plus/minus any increases/deficits in E&P, but not below zero. (CCR §24344(c)(6)(B).)

The value of assets is computed using an average of the values at the beginning and end of the taxable year. (CCR §24344(c)(6)(C).) The FTB may permit or require the averaging of monthly values during the taxable year to properly reflect the average value of the assets.

3. Intercompany Investment Account Elimination

Intercompany stock investment accounts in banks or corporations included 100 percent in a combined report are eliminated in their entirety. (CCR §25110(e)(4).) Intercompany stock investment accounts in banks or corporations partially included in a combined report are eliminated in the proportion or to the extent that the corresponding account of the affiliated bank or corporation is taken into account in the combined report under R&TC §§25110(a)(2)(A)(i) or 25110(a)(2)(A)(ii). (CCR §25110(e)(5).)

Be careful not to make double eliminations. If the records or financial statements used as the starting point for the computation already have made intercompany eliminations, do not duplicate the elimination.
Example 8

Corporation V (a domestic corporation) holds the following equity investments before intercompany eliminations:

- Corp W (100% owned domestic corporation) $100,000
- Corp X (100% owned domestic corporation) $  70,000
- Corp Y (100% owned CFC) $300,000
- Corp Z (5% ownership in foreign corporation) $200,000
- Total Investment $670,000

Intercompany Elimination:
- Corp W ($100,000)
- Corp X ($  70,000)
- Corp Y (CFC 10% Inclusion; $300,000 x 10% = $30,000 Intercompany) ($ 30,000)
- Total Investment Elimination ($200,000)

Total Investment $670,000
Less Intercompany Elimination $200,000
Total Investment After Elimination $ 470,000

Note: 10% of Y's income and factors is included in the combined report and none of Z's income and factors is included. Therefore, the investment amounts are not eliminated to the extent the entities are not included in the combined report. 10% of Y's assets are included in total assets.

g. Form FTB 2424, Lines 13, 14, 15, 16 and 17

These lines are mathematical computations. Once you have determined the values for Lines 1-12, Lines 13, 14, 15, 16 and 17 can be completed.
10.3 Overview – Federal Law

The purpose of this section is to give a brief overview of the federal sections that involve the allocation and apportionment of interest. California’s foreign investment interest offset rules are patterned after the federal rules used to attribute interest to foreign sources for purposes of the FTC computation. Therefore, some of the information needed to compute the foreign investment interest offset should have been calculated for federal FTC purposes.

For federal purposes, there are detailed rules covering the allocation and apportionment of interest. For domestic corporations the importance of allocating and apportioning deductions is that it affects the FTC limitation. (IRC §904(a) and §904(d).) The FTC amount a US taxpayer can use to offset its US tax liability can be limited. The formula for the limitation is as follows:

\[
\frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}} \times \frac{\text{Pre-Credit US Tax}}{\text{FTC Limitation}} = \text{FTC Limitation}
\]

Taxpayers have long recognized that if expenses are allocated against US source income instead of foreign source income, their FTC limitation will increase. The IRC sets forth the rules on how the final figures are computed. For instance, separate FTC limitations have to be computed for specific sources and categories of income or “baskets of income.” Although the statutory provision for allocating and apportioning interest expense is IRC §864(e), the regulations are numbered Treas. Reg. §1.861-9T through Treas. Reg. §1.861-13T.

The IRS defines any expense that is deductible under IRC §163, including original issue discount, as constituting interest for allocation and apportionment purposes. (Treas. Reg. §1.861-9T(a).) The temporary Treas. Reg. restate the principle that money is fungible. “The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. Exceptions to the fungibility rule are set forth in TR §861-10T. The fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes, and it is reasonable under this
approach to attribute part of the cost of borrowing to such other purposes.” (Treas. Reg. §1.861-9T(a).)

However, in the case of qualified nonrecourse indebtedness (QNI), the deduction for interest is considered directly allocable solely to the gross income generated by property that was acquired, constructed or improved with the proceeds of the indebtedness. (Treas. Reg. §1.861-10T(b).) The California specific assignment requirements were patterned after the federal direct allocation rules that were in Treas. Reg. §1.861-8(e), as it existed prior to 1988. Since that time, the federal QNI rules were modified and moved to Treas. Reg. §1.861-10T. Although the criteria for specific allocation of interest, under CCR §24344(c)(4), are still similar to the federal QNI rules, the rules are not exactly the same.

Federal law contains several requirements that are not applicable for California. If indebtedness qualifies as QNI for federal purposes, then it probably meets the California requirements for specific allocation. However, if interest expense does not qualify as QNI, it does not necessarily mean that it will not meet the California criteria for direct allocation. If interest expense is specifically allocated for California purposes, there should be documentation to substantiate that the California criteria was met.

Indebtedness must possess the following five characteristics to be classified as QNI for federal purposes:

1. The purpose of the QNI must be to purchase, construct or improve identified property that is depreciable real or tangible personal property with a useful life of more than 1 year or amortizable intangible personal property with a useful life of more than 1 year.

2. The proceeds must be actually applied to purchase, construct or improve the property.

3. Creditors can look only to the identified property as security for interest and principal.

4. The cash flow from the property in all years is reasonably expected to cover interest, original issue discount and principal.

5. The loan agreement restricts the disposal or use of the property consistent with #3 and #4, above.

Treas. Reg. §1.861-10T(b)(4) lists the following six exceptions whereby interest expense is not QNI, transactions that:
• Lack economic significance (facts and circumstances test).
• Involve cross collateralization.
• Involve credit enhancement.
• Involve the purchase of inventory.
• Involve the purchase of any financial asset, including stock in a corporation, an interest in a partnership or a trust, or the debt obligation of any obligor.
• Involves interest expense that constitutes qualified residence interest as defined in IRC §163(h)(3).

In computing specifically assigned interest, there are similarities and differences between the California rules for specific assignment of interest and the federal rules for direct allocation on interest from QNI. As of December 2016, the federal Form 1118, Schedule H, Part II, Lines 1b and 1c, provides a breakdown of specifically assigned assets and interest expense. If needed, the work-papers supporting the allocation of interest expense for purposes of the federal Form 1118, can be obtained. The specifically assigned interest, if any, appears on federal Form 1118, Schedule A, column 9(d). Keep in mind that there are differences between the state and federal requirements for specifically assigned interest.

For federal purposes the apportionment of interest expense to foreign sources is accomplished by following formula:

\[
\frac{\text{Asset Values in Given Category-Basket}}{\text{Total Assets in a Given Category-Basket}} \times \frac{\text{Total Interest Expense Affiliated}}{\text{Total Interest Expense}} = \text{Interest Expense Apportioned to Category}
\]

A taxpayer may elect to value assets on the basis of tax book value or fair market value (FMV). (For the California computation, CCR §24344(c)(6) requires that the value of assets be the federal tax book value. Therefore, there could be a federal/state difference in the calculation.) Under the asset method in the temporary regulations, interest expense is apportioned to the various statutory groupings based on the average total value of assets in each grouping for the taxable year.

For purposes of this computation, investment in 10 percent owned corporations not included in the consolidated federal return are stated at adjusted basis, plus (minus) any increases (decreases) in E&P accumulated while the taxpayer held the stock. (This is similar to the California rules for determining the value of stock or other equity investment in affiliated entities used in the formula for assigning interest to foreign investment.)
Domestic corporations must use the asset method to apportion interest expense. CFCs may generally use the asset method or a modified gross income method to apportion interest expense. If, however, for federal purposes, the US affiliates elect to use the FMV method to value their assets, then the CFCs must use the asset method.

An average of values (book or market) will be computed for the taxable year on the basis of values of assets within each grouping at the beginning and end of the year, except where a substantial distortion of asset values would result. (Treas. Reg. §1.861-9T(g).)

Revenue Agent Report adjustments can affect the foreign investment interest offset calculation. Any federal adjustments that apply for California purposes should first be considered before determining the foreign investment interest offset.
10.4 PASS Schedules

a. Introduction
b. Foreign Investment Interest Offset (Form FTB 2424)
c. Averaged Unassigned Foreign Investment
d. Unassigned Total Assets & Unassigned Total Assets for Partially Included CFCs

a. Introduction

The foreign investment interest offset, as reported, and the related audit adjustment is reported on the MSA Principal Schedule titled, "State Adjustments to Income – Ia." PASS also contains a foreign investment interest offset workbook titled, "MSA-Water's Edge-Foreign Investment Interest Offset," to aid auditors in their review and computing the adjusted foreign investment interest offset. The foreign investment interest offset workbook contains the following schedules/worksheets:

1. Computation of Water's-Edge 24344 Foreign Investment Interest Offset As Revised For TYB On Or After 1/1/1997
2. Schedule of Averaged Unassigned Foreign Investment
3. Computation of Unassigned Total Assets
4. Schedule of Averaged Total Unassigned Assets for Partially Included CFCs

b. Foreign Investment Interest Offset (Form FTB 2424)

The worksheet titled, "Computation of Water's-Edge 24344 Foreign Investment Interest Offset As Revised For TYB..." allows you to compute the foreign investment interest offset. This schedule mirrors Form FTB 2424. Line 11, Unassigned Foreign Investment, and Line 12, Unassigned Total Assets, are linked to the respective worksheets, which are further described below.

c. Averaged Unassigned Foreign Investment

The worksheet titled, "Schedule of Average Unassigned Foreign Investment," computes the investor's foreign investment less intercompany; the numerator of the ratio unassigned foreign investment over unassigned total assets. This schedule averages the stock basis and accumulated E&P of the CFC, and then multiplies this calculated number by the percentage that it is excluded (100 percent less its own inclusion ratio) from the California combined report. The accumulated E&P and capital stock basis entered in
this schedule should reflect the shareholder's ownership percentage. If the excluded CFC is owned by a top-tier CFC that is partially included or excluded, then an additional step must be taken. That calculated number must also be multiplied by the top-tier CFC's inclusion ratio. The schedule is set up to perform the additional step.

Example 10

CFC1 owns 100% of the stock in CFC2. In 2000, CFC1 has a partial inclusion ratio of 60% and CFC2 has a partial inclusion ratio of 70%. If the average stock basis and accumulated E&P of CFC2 is $100,000, then the foreign investment in CFC2 in the numerator is $18,000. (The foreign investment amount in CFC1 would also be included in the numerator. However, for purposes of this example, we are only looking at the foreign investment of CFC2.) The $100,000 should be multiplied by 30%, the excluded percentage of CFC2. (100% less 70% = 30%.) Since CFC2 has a partial inclusion ratio of 70%, it is excluded by 30%. Therefore, the $100,000 is multiplied by 30%; the result is $30,000.

The $30,000 must be multiplied by 60%, which is the inclusion ratio of CFC1, which is CFC2's shareholder. The result is $18,000. ($30,000 x 60% = $18,000.)

d. Unassigned Total Assets & Unassigned Total Assets for Partially Included CFCs

The worksheet titled, "Computation of Unassigned Total Assets," computes the average total assets of the members of the water's-edge combined report; the denominator of the ratio unassigned foreign investment over unassigned total assets. The worksheet titled, "Schedule of Averaged Total Unassigned Assets for Partially Included CFCs," computes the average total assets of each includible CFC that are included in the water's-edge combined report (average total assets x inclusion ratio). The average total unassigned assets of the includible CFC's flows up to the schedule titled, "Computation of Unassigned Total Assets," which is then combined with the average total assets of the domestic members.

As reflected on the schedule titled, "Computation of Unassigned Total Assets," the first adjustment relates to the elimination of assets to which interest was specifically assigned. Any adjustments to the foreign investments (numerator) would also be required to the total asset amounts. Additionally, any equity adjustments to investments in nonunitary domestic entities is reflected on this schedule. The schedule provides separate line items for each adjustment.
CCR §24344(c)(6)(B) requires that the foreign investment be included in the denominator, using the same method that was used to determine the unassigned foreign investment amount in the numerator. If the foreign investment account that is reflected in the balance sheet is the same number as the amount calculated for numerator purposes, then no adjustment is required. However, rarely will these numbers be the same. Thus, an adjustment is usually needed.

If the number reflected in the balance sheet is not the same as the amount in the numerator, an adjustment is required. Reverse the amount reflected in the balance sheet and add in the amount calculated for numerator purposes. The schedule provides separate line items for these adjustments.

Example 9

US shareholder owns 100% of the stock in CFC1 and is the only member of the water's-edge combined report. CFC1 has a 0% inclusion ratio. US shareholder's total assets, per the balance sheet, are $100,000. Included in the $100,000 of total assets is an investment account for CFC1 with a $20,000 balance. This is the “per books” amount. Assume that the average unassigned foreign investment included in the numerator is $30,000. Then, the denominator should be $110,000.

Since the foreign investment account included in the denominator is supposed to be the same number as the numerator, an adjustment to the $100,000 of total assets reflected on the balance sheet is required. The foreign investment per books of $20,000 should be reversed and the amount calculated per the numerator, $30,000, should be added to total assets. Adjustments of ($20,000) and $30,000 to the total assets line are required. Or instead, a net $10,000 positive adjustment could be made. The overall result is total assets should equal $110,000. ($100,000 - $20,000 + $30,000 = $110,000)

The last adjustment reflected on the schedule is for the elimination of intercompany asset accounts between members of the water's-edge group.
10.5 Audit Tips

In verifying the foreign investment interest offset, below are suggested audit actions to be performed, although such list is not all-inclusive and such actions are dependent upon materiality.

- Review California Form 2424 and determine basis for foreign investment interest offset as reported by the taxpayer. If basis for foreign investment interest offset is R&TC §24411 foreign dividend deduction, verify R&TC §24411 foreign dividend deduction. Otherwise, consider performing additional steps below.

- Request work-papers supporting foreign investment interest offset, including total interest expense, any assigned interest, foreign investment (numerator) and total assets (denominator).

- For interest expense -
  - Review and reconcile amounts reported on supporting work-papers with interest expense reported on the various California and Federal forms.
    - Verify total interest expense is included from 100 percent and partially included entities
    - Verify that interest expense is not netted with any items of interest income and/or that interest expense
    - Verify that intercompany interest expense has been eliminated
  - For any discrepancies/differences, request explanation from taxpayer and/or request the book/tax work-papers and/or general ledger or trial balances supporting interest expense.

- For interest expense specifically assigned, verify that each of the related debt instruments satisfies ALL three of the requirements listed below. Under each requirement, there are examples of documents that may support each of the requirements/circumstances. In addition, review annual reports for related notes.

  1. The interest was from debt specifically incurred for the purpose of purchasing, maintaining, or improving the specific property;
     - Board minutes describing the incurrence of debt for a specific property
     - Management meeting minutes describing the incurrence of debt for a specific property
• Notes in the annual reports describing the incurrence of debt for a specific property
• Internal Request requesting funds (purchase orders and capital acquisition requests) for specific property
• Internal budgeting reports indicating debt required for specific property
• Third party or regulatory agency requirements for the purchase of specific property

2. The proceeds of the borrowing were actually applied to the specified purpose; and,

• Documents supporting tracing of funds to actual purchase of property (i.e., escrow statements)

3. The creditor can look only to the specific property (or any lease or other interest therein) as security for payment of the principal and interest of the loan and, thus, has no secured interest in any other property of the borrower or the borrower itself with respect to repayment of the loan.

• Loan agreement which provides that a creditor can look only to specific property as security for payment of the principal and interest.
• Uniform Commercial Code-1 (UCC-1) Financial Statement Filing that provides the creditor can look only to the specific property as security. Such a form is often filed with the office of the Secretary of State in the state where the debtor is located.

• For foreign investment, numerator of the unassigned foreign interest allocation ratio -
  o Review work-paper amounts and reconcile to balance sheets. Verify investment amounts represent federal adjusted basis, plus (minus) any increases (deficits) in E&P, but not below zero and accumulated during the period the stock was owned by the water's-edge member. Verify that investments of includible CFCs are included to the extent of the CFCs' inclusion ratio. Verify that intercompany amounts are eliminated (i.e., domestic parent's investment in includible CFC). Verify any foreign investment to which interest has been specifically assigned is removed from the foreign investment total.
• For total assets, the denominator of the unassigned foreign interest allocation ratio -
  o Review work-paper amounts and reconcile to balance sheets. Verify total assets include all members of the water's-edge return. Verify total assets of includible CFCs are included to the extent of the applicable CFC's inclusion ratio. Verify intercompany assets are eliminated. Verify stock and/or other equity investments, including foreign investments, are based upon federal adjusted basis, plus (minus) any increases (deficits) in E&P, but not below zero and accumulated during the period the stock was owned by the water's-edge member. Verify any assets to which interest expense has been specifically assigned are removed from total assets.