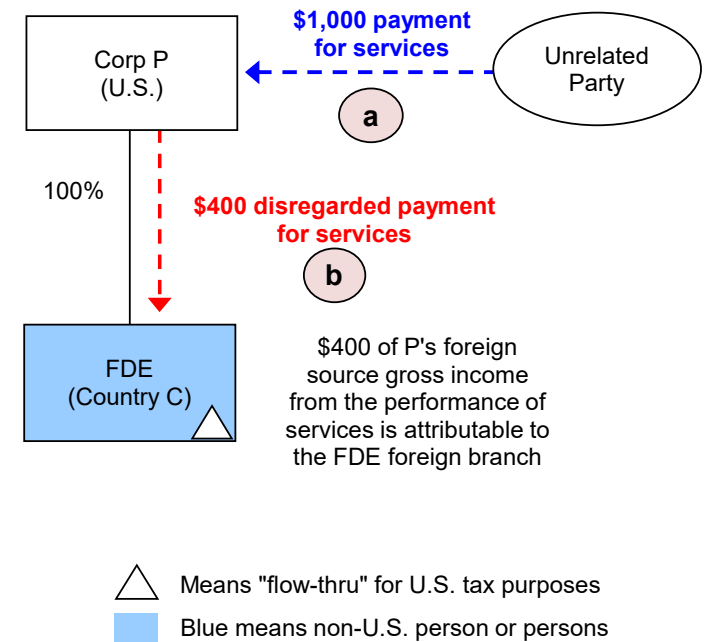


**Reg. 1.904-4(f)(4)(iii),
Example 3**

**Disregarded Payment for Services
From U.S. Owner to FDE**

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P, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch within the meaning of Reg. 1.904-4(f)(3)(vii). FDE's functional currency is the U.S. dollar. In Year 1, P accrues and records on its books and records (and not FDE's books and records) \$1,000x of gross income from the performance of services to unrelated parties that is not passive category income, \$400x of which is foreign source income in respect of services performed outside the United States by employees of FDE and \$600x of which is U.S. source income in respect of services performed in the United States. Absent the application of Reg. 1.904-4(f)(2)(vi), the \$1,000x of gross income earned by P would be general category income that would not be attributable to FDE. FDE provides services in support of P's gross income from services. P compensates FDE for its services with an arm's length payment of \$400x, which is disregarded for Federal income tax purposes. The deduction for the payment of \$400x from P to FDE would be allocated to P's \$1,000x of general category gross services income and apportioned entirely to the \$400x of foreign source services income under §§ 1.861-8 and 1.861-8T principles (treating foreign source general category gross income and U.S. source general category gross income each as a statutory grouping) if the payment were regarded for Federal income tax purposes.



The disregarded payment from P, a United States person, to FDE, its foreign branch, is not recorded on FDE's separate books and records (as adjusted to conform to Federal income tax principles) within the meaning of Reg. 1.904-4(f)(2)(i) because it is disregarded for Federal income tax purposes. However, the disregarded payment is allocable to gross income attributable to P because a deduction for the payment, if it were regarded, would be allocated and apportioned to the \$400x of P's foreign source services income. Accordingly, under Reg. 1.904-4(f)(2)(vi)(A) and (f)(2)(vi)(B)(3), the amount of gross income attributable to the FDE foreign branch (and the gross income attributable to P) is adjusted in Year 1 to take the disregarded payment into account. As such, \$400x of P's foreign source gross income from the performance of services is attributable to the FDE foreign branch. Therefore, \$400x of the foreign source gross income that P earned with respect to its services in Year 1 constitutes gross income that is assigned to the foreign branch category.