DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1, 501, 504, 505, 506, 507, 511, 512, 518, 519, and 602

[INTL-952-86]

Allocation and Apportionment of Interest Expense and Certain Other Expenses

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking including cross-reference to temporary regulations.

SUMMARY: This document provides proposed Income Tax Regulations relating to the allocation and apportionment of interest expense and certain other expenses for purposes of the foreign tax credit rules and certain other international tax provisions. In the rules and regulations portion of this Federal Register, the Internal Revenue Service is issuing temporary regulations relating to these matters. The text of those temporary regulations also serves as the comment document for this notice of proposed rulemaking. Certain additional regulations are also proposed by this document. This document also withdraws the notice of proposed rulemaking relating to the same subject that appeared in the Federal Register on September 11, 1987 (52 FR 34580).

DATES: These regulations are proposed to be effective for taxable years beginning after December 31, 1986. In general, these regulations would be applicable to the allocation and apportionment of interest expense and certain other expenses for taxable years beginning after December 31, 1986. Comments and requests for a public hearing must be delivered or mailed before December 13, 1988.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue (Attention: CC:LR:T, INTL-952-86), Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: David Merrick, regarding the allocation and apportionment of interest expense, and Carl Cooper, regarding the allocation and apportionment of other expenses, both of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224 (Attention: CC:LR:T (INTL-952-86)) (David Merrick 202-566-6276, Carl Cooper 202-634-5406, not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)). Comments on the collection of information should be sent to the Office of Information and Regulatory Affairs, Office of Management and Budget, Washington, DC 20503, Attention: Desk Officer for Internal Revenue Service, with copies to the Internal Revenue Service at the address previously specified.

The affirmative elections in this regulation are in § 1.861-9T(g)(1)(ii), which requires taxpayers affirmatively to elect either the gross income or the asset method of apportionment in the case of a controlled foreign corporation, and in § 1.861-12T(c)(4)(ii), which permits taxpayers to elect under certain circumstances to reallocate interest expense that is allocated to a noncontrolled section 902 corporation. This information will be used in audits of taxpayers. The likely respondents are businesses and other for-profit institutions.

Estimated total annual reporting burden: 2,500 hours.

Estimated annual burden per respondent: 10 minutes.

Estimated number of respondents: 15,000.

Estimated annual frequency of responses: On occasion.

This estimate is an approximation of the average time expected to be necessary to make the affirmative elections. It is based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

Background

The temporary regulations published in the rules and regulations portion of this issue of the Federal Register add new temporary regulations §§ 1.861-8T through 1.861-14T. For the text of the temporary regulations, see FR Doc. 88-20838 (T.D. 8228) published in the rules and regulations portion of this issue of the Federal Register. Certain additional regulations are also proposed by this document.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. Although this document is a notice of proposed rulemaking that solicits public comments, the notice and public procedure requirements of 5 U.S.C. 553 do not apply because it has been determined that these proposed regulations are interpretative. Therefore, an initial Regulatory Flexibility Analysis is not required by the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and seven copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request by any person who submits written comments on the proposed rules. Notice of the time and place for the hearing will be published in the Federal Register.

Drafting Information

The principal author of the proposed regulations relating to the allocation and apportionment of interest expense is David Merrick, and the principal author of the proposed regulations relating to the allocation and apportionment of other expenses is Carl Cooper, both of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. Other personnel from offices of the Internal Revenue Service and Treasury Department participated in developing these regulations.

List of Subjects

26 CFR 1.861-1 through 1.997-1

Income taxes, Aliens, Exports, DISCs, Foreign investment in U.S., Foreign tax credit, FSC, Source of income, U.S. nvestments abroad.

:6 CFR Part 602

Reporting and recordkeeping equirements.

Proposed Amendments to the Regulations

The temporary regulations, FR Doc. 88-20838 [T.D. 8228], published in the rules and regulations portion in this issue of the Federal Register, are hereby also proposed as final regulations under sections 861 and 864 of the Internal Revenue Code of 1986. In addition, the regulations set forth below are also proposed as amendments to the Income Tax Regulations (26 CFR Part 1).

The proposed amendments to 26 CFR Part 1 relating to this same subject and published on September 11, 1987 (52 FR 34580) are hereby withdrawn.

Income Tax Regulations

PART 1—[AMENDED]

Paragraph 1. The authority for Part 1 s amended by adding the following citations:

Authority: 26 U.S.C. 7805. * * * Section 1.861-10 is also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i) and 26 U.S.C. 7701(f).

Par. 2. Section 1.861-10 is added at the appropriate place to read as follows:

1.861-10 Special allocations of interest expense.

(a) through (b)(3)(iii) [Reserved]

(v) *Analysis of operating costs.* For taxable years beginning after December 31, 1988, if operating costs other than interest with respect to the property exceed 15 percent of the total income derived from the property in the taxable year (for example, rents or royalties), then a significant portion of revenue shall be considered to be derived from sales, labor, services, or the use of other property. For this purpose, the term "operating costs" shall include only expenses that are deductible solely under section 162.

(b)(3)(v) through (4)(vi) [Reserved]

(vii) The term "qualified nonrecourse indebtedness" shall not include any transaction that involves excess collateralization within the meaning of paragraph (b)(12) of this section.

(b)(5) through (11) [Reserved]

(12) *Excess collateralization.* For taxable years beginning after December 31, 1989, a loan will be deemed to involve excess collateralization if the principal amount of the loan is less than 60 percent of the value of identified property at the time of its purchase (or construction cost in the case of self-constructed assets). If the principal amount of the loan is greater than 80 percent of such value, then the loan will be deemed not to involve excess collateralization. If the principal amount of the loan is within the range of 60 to 80 percent of such value, the determination of whether the loan involves excess collateralization shall be based on facts and circumstances, taking into account factors such as the ratios of loan-to-value in comparable nonrecourse borrowings within the relevant industry or geographic market.

(c) through (e) [Reserved]

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

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will only occur in circumstances in which the aggregate debt-to-asset ratio of all related controlled foreign corporations is less than 80 percent of the debt-to-asset ratio of the related United States shareholder. The value of the related United States shareholder's total assets within each separate limitation category shall then be reduced by the principal amount of such shareholder's third party indebtedness the interest on which is directly allocated to such limitation category. If there is insufficient related person indebtedness to attain the required debt-to-asset ratio, certain stock in controlled foreign corporations will be treated as indebtedness for purposes of this section. Moreover, in certain cases involving disproportionate concentrations of passive assets in related controlled foreign corporations, the Commissioner may choose not to apply the rules of § 1.861-10(e) to a taxpayer.

Affiliated Group Apportionment of Interest Expense

Section 1.861-11T describes the operation of section 864(e)(1) and (5), which requires the affiliated group apportionment of interest expense. Section 1.861-11T(b) indicates that section 864(e)(1) and (5) applies to the computation of foreign source taxable income for purposes of section 904 (relating to various limitations on the foreign tax credit), the computation of the combined taxable income of the related supplier and a foreign sales corporation (FSC) (under sections 921 through 927) or a domestic international sales corporation (DISC) (under sections 991 through 997), and in the application of section 907 for purposes of determining reductions in the amount allowed as a foreign tax credit under section 901. Section 864(e)(1) and (5) does not apply to the computation of subpart F income of controlled foreign corporations (under sections 951 through 964), the computation of combined taxable income of a possessions corporation and its affiliates (under section 963), or the computation of effectively connected taxable income of foreign corporations. With regard to section 936 corporations, the apportionment of the affiliated group's interest expense for purposes of determining the amount of allowable credit under section 936 is governed by section 936. Any rules that are adopted under section 936(h) could result in adjustments to the allocation and apportionment of interest expense pursuant to these rules.

Section 1.861-11T(c) indicates that, except as otherwise provided, the taxable income of each member of an affiliated group from sources outside the United States shall be determined by allocating and apportioning the interest expense of each member according to apportionment fractions which are computed as if all members of such group were a single corporation. Stock in affiliated corporations is not taken into account in determining apportionment fractions under the asset method described in § 1.861-9T(g). In the case of an affiliated group that files a consolidated return, consolidated foreign tax credit limitations are computed for the group in accordance with the rules of § 1.1502-4.

Section 1.861-11T(d) defines the term "affiliated group" to have the same meaning as is given that term by section 1504, except that section 1504(b)(4) is inapplicable. Because section 1504(b)(4) is inapplicable, section 936 corporations are included within the affiliated group for purposes of computing the apportionment fractions applicable to interest expense of other members of the group. The regulations indicate that insurance companies subject to taxation under section 801 shall only be considered to be members of the affiliated group if the parent so elects under section 1504(c)(2)(A) of the Code. Any members of an affiliated group that constitute financial corporations (as defined in the regulations) shall be treated as a separate affiliated group. In addition, a bank holding company that is regulated under the Bank Holding Company Act of 1956 is subject to special rules for purposes of segregating and apportioning its interest expense and certain of its assets between the financial and nonfinancial groups.

Under authority granted by section 7701(f), § 1.861-11T(d) further provides that certain unaffiliated corporations will be considered to constitute affiliated corporations. These corporations include any includible corporation and certain foreign corporations with effectively connected income if 80 percent of either the vote or value of all outstanding shares of such corporations are owned directly or indirectly by members of the same affiliated group.

Section 1.861-11T(e) indicates that, in the case of loans between members of an affiliated group, the indebtedness of the member borrower is not considered as an asset of the member lender. In general, a member lender shall include related person interest income in the same class of gross income as the class of gross income from which the member borrower deducts the related person interest payment. Special rules apply in the case of loans between affiliated corporations that are financial and nonfinancial corporations (as determined under § 1.861-11T(d)), loans between affiliated corporations that generate high withholding tax interest, and certain back-to-back loans.

Section 1.861-11T(f) provides that, in the computation of the combined taxable income of any FSC or DISC and its related supplier which is a member of an affiliated group under the pricing rules of section 925 or 994, the combined taxable income of such FSC or DISC and its related supplier shall be reduced by the portion of the total interest expense of the affiliated group that is apportioned under the asset method to combined gross income from export sales involving that FSC or DISC.

Section 1.861-11T(g) addresses the problem of losses created through affiliated group apportionment in the case of an affiliated group that could, but does not, file a consolidated return or in cases where certain unaffiliated corporations are treated as members of the affiliated group under the rules of § 1.861-11T(d). Generally, section 1.1502-4 of the regulations provides for consolidated determinations of foreign tax credit limitations in the case of an affiliated group filing a consolidated return. In the case of an affiliated group that does not file a consolidated return, or a group that includes an unaffiliated corporation treated as affiliated under § 1.861-11T(d), the amount of foreign tax credits allowed in any separate limitation category cannot exceed the credits computed under paragraph (g). The adjustments that may be required under paragraph (g) eliminate losses in a limitation category created within a given group member through the apportionment of interest expense and reduce income of other group members that have income in the same limitation category.

Characterization Rules and Adjustments for Certain Assets

Section 1.861-12T provides rules that apply in apportioning expenses under an asset apportionment method, including interest expenses that is required by section 864(e)(2) to be apportioned under an asset method.

Section 1.861-12T(b) provides that inventory must be characterized by reference to the source of sales income from the inventory for the year.

Section 1.861-12T(c) concerns the treatment of stock. In general, taxpayers using the tax book value must adjust the adjusted basis of stock in a 10 percent owned corporation by the amount of certain earnings and profits or any deficit therein. This adjustment is to be made annually and is noncumulative. Subject to consistency rules, foreign corporations are permitted to use financial earnings in lieu of earnings and profits for certain pre-effective date years.

Section 1.861-12T(c) also provides rules for characterizing stock of controlled foreign corporations. Stock in a controlled foreign corporation is characterized in the hands of the United States shareholder either by reference to the assets or gross income of the controlled foreign corporation, depending on which method such corporation uses in the allocation and apportionment of its own expenses.

Section 1.861-12T(c) also provides rules concerning the treatment of stock in a noncontrolled section 902 corporation. Although the dividends from each such corporation constitute a separate limitation category, the regulations provide a special rule permitting the reallocation of interest expense that gives rise to a separate limitation loss in a noncontrolled section 902 corporation limitation category to any separate limitation category that is in excess credit, provided that such reallocation does not cause a loss in such other category. This reallocation is irrevocable and cannot be revoked by an amended return.

Section 1.861-12T(d) concerns the treatment of notes and other receivables. Notes and other receivables of affiliated corporations are not taken into account, as provided in § 1.861-9T(g). Notes of any person other than a related controlled foreign corporation are characterized by reference to the source of the interest income received. Notes of a related controlled foreign corporation are characterized according to the treatment of the interest income received, as determined under the look-through rules of section 904(d)(3)(C).

Section 1.861-12T(e) indicates that certain holders of portfolio securities that generate foreign source dividends or interest may take into account the source of gain on the disposition of such securities. These holders include holders in whose hands the securities constitute inventory and holders 80 percent of whose gross income from such securities consists of gains.

Section 1.861-12T(f) provides that, in the case of any asset in connection with which interest expense is capitalized, deferred, or disallowed under any provision, the adjusted basis or fair market value (depending on the taxpayer's choice of apportionment methods) of such an asset shall be reduced.

Section 1.861-12T(g) provides rules concerning the treatment of stock in a foreign sales corporation and the characterization assets that generate foreign trade income. Stock of a foreign sales corporation ("FSC") is generally not taken into account in apportionment of interest for foreign tax credit purposes. Because the assets of a FSC are taken into account fully in apportioning for purposes of computing FSC benefits, the Service believes there should be no secondary apportionment to FSC stock for foreign tax credit purposes.

Section 1.861-12T(j) provides rules concerning the treatment of stock in a domestic international sales corporation and the characterization of assets that generate qualified export receipts.

Section 1.861-13T (relating to transition rules) has been reserved due to the fact the transition rules for interest allocation contained in the technical corrections bill (H.R. 4333) has not yet been enacted. The Service anticipates that upon enactment of these transition rules, § 1.861-13T will be issued in a form that is substantially similar to Prop. Reg. § 1.861-11 (52 FR 34600). The primary anticipated changes in those regulations concern:

(1) The addition of a rule to clarify that, in computing the various transition amounts under Prop. Reg. §§ 1.861-11(b) and (c), any indebtedness the interest on which is directly allocated to identified property under § 1.861-8(e)(2)(iv) shall not be taken into account,

(2) The incorporation of a rule regarding the averaging of end-of-month debt levels in Prop. Reg. § 1.861-11(c)(7) for the purpose of computing the amount of a paydown,

(3) The modification of the rule of Prop. Reg. § 1.861-11(g) to provide for the proration of transition attributes between a transferor and a transferee in the year of transfer, and

(4) The revision of Prop. Reg. § 1.861-11(g)(3) to provide that, when a transferee acquires stock of a corporation and the transferee or any member of its affiliated group assumes the transition qualified indebtedness of an acquired corporation, such indebtedness will continue to be transition qualified until such time as the transferee disposes of the acquired corporation, but shall thereafter cease to be transition qualified.

The regulations also amend § 1.863-3(b), *Example* 2. That example formerly provided that, in cases in which a taxpayer appropriately uses it for the computation of income from certain sales of personal property derived partly from within and partly from without the United States, taxable income shall first be computed by deducting from the gross income derived from the sale of personal property the expenses, losses, or other deductions properly allocated and apportioned thereto in accordance with the rules set forth in § 1.861-8. The amount of taxable income is then split between domestic and foreign sources based on fractions described in paragraph (ii) of that example. Changes to this section indicate that, while the fractions are unchanged, the income derived from such sales and assets generating such income are to be split prior to the allocation and apportionment of expenses to gross income in order to avoid complication in the apportionment of interest and other expenses definitely related to all income. No other change to the provisions of this example is intended. Thus, for purposes of *Example 2*, expenses that are allocable to the generation of section 863(b) income cannot be directly allocated to either the foreign or domestic portion thereof but remain equally allocable to both.

Affiliated Group Allocation and Apportionment of Expenses Other Than Interest

Section 1.861-14T describes the operation of section 864(e)(6), which requires the affiliated group allocation and apportionment of expenses, other than interest, which are not directly allocable and apportionable to any specific income producing activity or property. Section 1.861-14T(a) outlines the contents of § 1.861-14T and provides that § 1.861-14T applies in general to taxable years beginning after December 31, 1986. Section 1.864-14T(b) describes the operative sections to which section 864(e)(6) applies. These are the computation of foreign source taxable income for purposes of section 904 (relating to various limitations on the foreign tax credit), the computation of the combined taxable income of the related supplier and a foreign sales corporation (FSC) (under sections 921 through 927) or a domestic international sales corporation (DISC) (under sections 991 through 997), and the application of section 907 for purposes of determining reductions in the amount allowed as a foreign tax credit under section 901. Section 864(e)(6) does not apply to the computation of subpart F income of controlled foreign corporations (under sections 951 through 964) or the computation of effectively connected taxable income of foreign corporations. The application of section 864(e)(5) in connection with section 936 corporations is reserved.

Section 1.861-14T(c) states that the taxable income of each member of an affiliated group shall be determined by allocating and apportioning the expenses described in § 1.861-14T(e) of each member according to apportionment fractions which are computed as if all members of such group were a single corporation. For this purpose, interaffiliate transactions are eliminated. In cases in which an asset method of apportionment is used, stock in affiliated corporations is not taken into account and loans between members of the affiliated group are treated in accordance with § 1.861-11T(e). In the case of an affiliated group that files a consolidated return, consolidated foreign tax credit limitations are computed for the group in accordance with the rules of § 1.1502-4. A special rule is provided in the case of expenses incurred by one member of an affiliated group that relate to the gross income of some, but not all, other members of the affiliated group. Such expenses are to be apportioned only on the basis of apportionment factors derived from the member incurring such expenses and from those other members to which the expense relates. In other words, only such members (and not all members) are treated as a single taxpayer for purposes of apportionment of such expense. In addition, paragraph (c) makes clear that if section 482 is applied, adjustment of income and expense among members of the group pursuant to section 482 is to be made prior to the allocation and apportionment of expenses under the rule of paragraph (c).

Section 1.861-14T(d) defines the term "affiliated group" to have the same meaning as is given that term by section 1504, except that section 1504(b)(4) is inapplicable. Because section 1504(b)(4) is inapplicable, section 936 corporations are included within the affiliated group for purposes of computing the apportionment fractions applicable to expenses of other members of the group. In addition, financial corporations, which are treated as a separate affiliated group for purposes of the allocation and apportionment of interest expense under section 864(e)(5) and § 1.861-11T(d), are included within the affiliated group for purposes of the allocation and apportionment of expenses other than interest. Life insurance companies taxable under section 801 are included in an affiliated group consisting in part of other companies only if an election is made under section 1504(c)(2)(A).

Section 1.861-14T(e) describes the expenses that are subject to allocation and apportionment under the rules of paragraph (c). In general, the expenses to which paragraph (c) relates do not include interest expense or any other expense which is directly allocable to specific income producing activities or property of the member of the affiliated group that incurred the expense. An expense is considered to be directly allocable to specific income producing activities or property of the member incurring the expense if, taking into account the income of all members of the affiliated group, the expense is considered definitely related within the meaning of § 1.861-8(b)(2) solely to gross income derived by the member incurring the expense. Thus, the rules of paragraph (c) apply to the expenses of supportive functions, such as general and administrative expenses, to certain research and experimental expenses (not subject to allocation to U.S. sources under the statutory moratorium), to certain stewardship expenses, and to certain generalized legal and accounting expenses. Proposed legislation currently under consideration by Congress may affect the treatment of research and experimental expenses under this proposed regulation. This proposed regulation will be changed, if necessary, to conform to that legislation upon its enactment.

Section 1.861-14T(f) provides that the combined taxable income of a FSC or DISC and its related supplier shall be reduced by the portion of the expenses of the affiliated group described in paragraph (e) that is incurred in connection with export sales involving that FSC or DISC. Under this rule, expenses of other group members may be attributed to the combined taxable income of a FSC or DISC and its related supplier without affecting the amount of expenses otherwise deductible (other than any commission payable by the related supplier to the FSC or DISC) by the FSC, DISC, related supplier, and other members of the affiliated group. The FSC or DISC is entitled to its statutory portion of the combined taxable income, after reduction by any apportioned group expense, for purposes of determining the transfer price of export property sold by the related supplier to a buy-sell FSC or DISC or the commission paid by the related supplier to a commission FSC or DISC.

Section 1.861-14T(g), by incorporating by cross-reference the rules of proposed § 1.861-11T(g), addresses the problem of losses created through affiliated group apportionment in the case of an affiliated group that could, but does not, file a consolidated return. Generally, § 1.1502-4 of the regulations provides for consolidated determinations of foreign tax credit limitations in the case of an affiliated group filing a consolidated return. In the case of an affiliated group that does not file a consolidated return, the amount of foreign tax credits allowed in any separate limitation category cannot exceed the credits computed as required by paragraph (g). In general, paragraph (g) requires adjustments to eliminate losses in a limitation category created through the apportionment of expense and correspondingly reduces income of other group members that have income in the same limitation category.

Section 1.861-14T(h) provides special rules concerning the allocation of reserve expenses of a life insurance company.

Section 1.861-14T(j) provides examples illustrating the application of the rules of this section.

Special Analyses

It has been determined that these rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. § 553 for temporary regulations. Therefore, these rules do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6) and a Regulatory Flexibility Analysis is not required.

Drafting Information

The principal author of the regulations relating to the allocation and apportionment of interest expense is David Merrick, and the principal author of the regulations relating to the allocation and apportionment of certain expenses other than interest is Carl Cooper, both of the Office of the Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. However, other personnel from offices of the Internal Revenue Service and the Treasury Department participated in developing the regulations.

List of Subjects

26 CFR 1.861-1 to 1.997-1

Income taxes, Aliens, Exports, DISC, Foreign investment in U.S., Foreign tax credit, FSC, Source of income, United States investments abroad.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Parts 1, 602, and Subchapter G is amended as follows:

Income Tax Regulations

Paragraph 1. The authority for Part 1 is amended by adding the following citations:

Authority: 26 U.S.C. 7805. * * * Sections 1.861-8T through 1.861-14T also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i) and 26 U.S.C. 7701(f).

Par. 2. Section 1.861-8 is amended as follows:

1. By removing the last sentence of § 1.861-8(a)(2).
2. By revising paragraph (b)(3).
3. By redesignating existing paragraph (c)(2) as paragraph (c)(3) and adding a new paragraph (c)(2).
4. By revising paragraphs (c)(1), (d)(2), and (f)(1)(iii).
5. By removing *Examples* (1) and (2) of paragraph (g) and reserving those examples, and
6. By revising *Example* (24) of paragraph (g).

§ 1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(b) *Allocation.*

* * * * *

(3) *Supportive functions.* [Reserved] For guidance, see § 1.861-8T(b)(3).

* * * * *

(c) *Apportionment of deductions*—(1) *Deductions definitely related to a class of gross income.* [Reserved] For guidance, see § 1.861-8T(c)(1).

(2) *Apportionment based on assets.* [Reserved] For guidance, see § 1.861-8T(c)(2).

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(d) *Excess of deductions and excluded and eliminated income.*

* * * * *

(2) *Allocation and apportionment to exempt, excluded, or eliminated income.* [Reserved] For guidance, see § 1.861-8T(d)(2).

(e) *Allocation and apportionment of certain deductions.*

* * * * *

(2) *Interest.* [Reserved] For guidance, see § 1.861-8T(e)(2).

* * * * *

(f) *Miscellaneous matters*—(1) *Operative sections.*

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(iii) *DISC taxable income.* [Reserved] For guidance, see § 1.861-8T(f)(1)(iii).

* * * * *

(g) *General examples.*

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Examle (1). [Reserved]
Examle (2). [Reserved]

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Example (24). [Reserved] For guidance, see § 1.861-8T(g) *Example* 24.

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Par. 3. A new § 1.861-8T is added immediately after § 1.861-8 to read as follows:

§ 1.861-8T Computation of taxable income from sources within the United States and from other sources and activities. (Temporary).

(a) *In general.*

(1) [Reserved]

(2) *Allocation and apportionment of deductions in general.* If an affiliated group of corporations joins in filing a consolidated return under section 1501, the provisions of this section are to be applied separately to each member in that affiliated group for purposes of determining such member's taxable income, except to the extent that expenses, losses, and other deductions are allocated and apportioned as if all domestic members of an affiliated group were a single corporation under section 864(e) and the regulations thereunder. See § 1.861-9T through § 1.861-11T for rules regarding the affiliated group allocation and apportionment of interest expense, and § 1.861-14T for rules regarding the affiliated group allocation and apportionment of expenses other than interest.

(3) through (5) [Reserved]

(b) *Allocation.*

(1) and (2) [Reserved]

(3) *Supportive functions.* Deductions which are supportive in nature (such as overhead, general and administrative, and supervisory expenses) may relate to other deductions which can more readily be allocated to gross income. In such instance, such supportive deductions may be allocated and apportioned along with the deductions to which they relate. On the other hand, it would be equally acceptable to attribute supportive deductions on some reasonable basis directly to activities or property which generate, have generated, or could be reasonably expected to generate gross income. This would ordinarily be accomplished by allocating the supportive expenses to all gross income or to another broad class of gross income and apportioning the expenses in accordance with paragraph (c)(1) of this section. For this purpose, reasonable departmental overhead rates may be utilized. For examples of the application of the principles of this paragraph (b)(3) other than to expenses attributable to stewardship activities, see examples (19) through (21) of paragraph (g) of this section. See paragraph (e)(4) of this section for the allocation and apportionment of deductions attributable to stewardship activities. However, supportive deductions that are described in § 1.861-14T(e)(3) shall be allocated and apportioned in accordance with the rules of § 1.1861-14T and shall not be allocated and apportioned by reference only to the gross income of a single member of an affiliated group of corporations as defined in § 1.861-14T(d).

(4) and (5) [Reserved]

(c) *Apportionment of deductions*—(1) *Deductions definitely related to a class of gross income.* Where a deduction has been allocated in accordance with paragraph (b) of this section to a class of gross income which is included in one statutory grouping and the residual grouping, the deduction must be apportioned between the statutory grouping and the residual grouping. Where a deduction has been allocated to a class of gross income which is included in more than one statutory grouping, such deduction must be apportioned among the statutory groupings and, where necessary, the residual grouping. Thus, in determining the separate limitations on the foreign tax credit imposed by section 904(d)(1) or by section 907, the income within a separate limitation category constitutes a statutory grouping of income and all other income not within that separate limitation category (whether domestic or within a different separate limitation category) constitutes the residual grouping. In this regard, the same method of apportionment must be used in apportioning a deduction to each separate limitation category. Also, see paragraph (f)(1)(iii) of this section with respect to the apportionment of deductions among the statutory groupings designated in section 904(d)(1). If the class of gross income to which a deduction has been allocated consists entirely of a single statutory grouping or the residual grouping, there is no need to apportion that deduction. If a deduction is not definitely related to any gross income, it must be apportioned ratably as provided in paragraph (c)(3) of this section. A deduction is apportioned by attributing the deduction to gross income (within the class to which the deduction has been allocated) which is in one or more statutory groupings and to gross income (within the class) which is in the residual grouping. Such attribution must be accomplished in a manner which reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. In apportioning deductions, it may be that for the taxable year there is no gross income in the statutory grouping or that deductions will exceed the amount of gross income in the statutory grouping. See paragraph (d)(1) of this section with respect to cases in which deductions exceed gross income. In determining the method of apportionment for a specific deduction, examples of bases and factors which should be considered include, but are not limited to—

(i) Comparison of units sold,

(ii) Comparison of the amount of gross sales or receipts,

(iii) Comparison of costs of goods sold,

(iv) Comparison of profit contribution,

(v) Comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to the activities or properties giving rise to the class of gross income, and

(iv) Comparison of the amount of gross income.

Paragraph (e) (2) through (8) of this section provides the applicable rules for allocation and apportionment of deductions for interest, research and development expenses, and certain other deductions. The effects on tax liability of the apportionment of deductions and the burden of maintaining records not otherwise maintained and making computations not otherwise made shall be taken into consideration in determining whether a method of apportionment and its application are sufficiently precise. A method of apportionment described in this paragraph (c)(1) may not be used when it does not reflect, to a reasonably close extent, the factual relationship between the deduction and the groupings of income. Furthermore, certain methods of apportionment described in this paragraph (c)(1) may not be used in connection with any deduction for which another method is prescribed. The principles set forth above are applicable in apportioning both deductions definitely related to a class which constitutes less than all of the taxpayer's gross income and to deductions related to all of the taxpayer's gross income. If a deduction is not related to any class of gross income, it must be apportioned ratably as provided in paragraph (c)(3) of this section.

(2) *Apportionment based on assets.* Certain taxpayers are required by paragraph (e)(2) of this section and § 1.861–9T to apportion interest expense on the basis of assets. A taxpayer may apportion other deductions based on the comparative value of assets that generate income within each grouping, provided that such method reflects the factual relationship between the deduction and the groupings of income and is applied in accordance with the rules of § 1.861–9T(g). In general, such apportionments must be made either on the basis of the tax book value of those assets or on their fair market value. However, once the taxpayer uses fair market value, the taxpayer and all related persons must continue to use such method unless expressly authorized by the Commissioner to change methods. For purposes of this paragraph (c)(2) the term "related persons" means two or more persons in a relationship described in section 267(b). In determining whether two or more corporations are members of same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned by the application of section 267(c). In determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3). In the case of any corporate taxpayer that—

(i) Uses tax book value, and

(ii) Owns directly or indirectly (within the meaning of § 1.861–11T(b)(2)(ii)) 10 percent or more of the total combined voting power of all classes of stock entitled to vote in any other corporation (domestic or foreign) that is not a member of the affiliated group (as defined in section 864(e)(5)), such taxpayer shall adjust its basis in that stock in the manner described in § 1.861–11T(b).

(3) [Reserved]

(d) *Excess of deductions and excluded and eliminated items of income.*

(1) [Reserved]

(2) *Allocation and apportionment to exempt, excluded or eliminated income*—(i) *In general.* In the case of taxable years beginning after December 31, 1986, except to the extent otherwise permitted by § 1.861–13T, the following rules shall apply to take account of income that is exempt of excluded, or assets generating such income, with respect to allocation and apportionment of deductions.

(A) *Allocation of deductions.* In allocating deductions that are definitely related to one or more classes of gross income, exempt income (as defined in paragraph (d)(2)(ii) of this section) shall be taken into account.

(B) *Apportionment of deductions.* In apportioning deductions that are definitely related either to a class of gross income consisting of multiple groupings of income (whether statutory or residual) or to all gross income, exempt income and exempt assets (as defined in paragraph (d)(2)(ii) of this section) shall not be taken into account.

For purposes of apportioning deductions which are not taken into account under § 1.1502–13(c)(2) in determining gain or loss from deferred intercompany transactions, as defined in § 1.1502–13(a)(2), income from such transactions shall be taken into account in the year such income is ultimately included in gross income.

(ii) *Exempt income and exempt assest defined*—(A) *In general.* For purposes of this section, the term "exempt income" means any income that is, in whole or in part, exempt, excluded, or eliminated for federal income tax purposes. The term "exempt asset" means any asset the income from which is, in whole or in part, exempt, excluded, or eliminated for federal tax purposes.

(B) *Certain stock and dividends.* The term "exempt income" includes the portion of the dividends that are deductible under—

(*1*) Section 243(a) (1) or (2) (relating to the dividends received deduction),

(*2*) Section 245(a) (relating to the dividends received deduction for dividends from certain foreign corporations).

Thus, for purposes of apportioning deductions using a gross income method, gross income would not include a dividend to the extent that it gives rise to a dividend received deduction under either section 243(a)(1), section 243(a)(2), or section 245(a). In the case of a life insurance company taxable under section 801, the amount of such stock that is treated as tax exempt shall not be reduced because a portion of the dividends received deduction is disallowed as attributable to the policyholder's share of such dividends. See § 1.861–14T(h) for a special rule concerning the allocation of reserve expenses of a life insurance company. In addition, for purposes of apportioning deductions using an asset method, assets would not include that portion of stock equal to the portion of dividends paid thereon that would be deductible under either section 243(a)(1), section 243(a)(2), or section 245(a). In the case of stock which generates, has generated, or can reasonably be expected to generate qualifying dividends deductible under section 243(a)(3), such stock shall not constitute a tax exempt asset. Such stock and the dividends thereon will, however, be eliminated from consideration in the apportionment of interest expense under the consolidation rule set forth in § 1.861-10T(c), and in the apportionment of other expenses under the consolidation rules set forth in § 1.861-14T.

(iii) *Income that is not considered tax exempt.* The following items are not considered to be exempt, eliminated, or excluded income and, thus, may have expenses, losses, or other deductions allocated and apportioned to them:

(A) In the case of a foreign taxpayer (including a foreign sales corporation (FSC)) computing its effectively connected income, gross income (whether domestic or foreign source) which is not effectively connected to the conduct of a United States trade or business;

(B) In computing the combined taxable income of a DISC or FSC and its related supplier, the gross income of a DICS or a FSC;

(C) For all purposes under subchapter N of the Code, including the computation of combined taxable income of a possessions corporation and its affiliates under section 936(h), the gross income of a possessions corporation for which a credit is allowed under section 936(a); and

(D) Foreign earned income as defined in section 911 and the regulations thereunder (however, the rules of § 1.911-6 do not require the allocation and apportionment of certain deductions, including home mortgage interest, to foreign earned income for purposes of determining the deductions disallowed under section 911(d)(6)).

(iv) *Prior years.* For expense allocation and apportionment rules applicable to taxable years beginning before January 1, 1987, and for later years to the extent permitted by § 1.861-13T, see § 1.861-8(d)(2) (Revised as of April 1, 1986).

(e) *Allocation and apportionment of certain deductions.*

(1) [Reserved]

(2) *Interest.* The rules concerning the allocation and apportionment of interest expense and certain interest equivalents are set forth in §§ 1.861-9T through 1.861-13T.

(3) through (11) [Reserved]

(f) *Miscellaneous matters*—(1) *Operative sections.*

(1) through (1)(ii) [Reserved]

(iii) *Separate limitations to the foreign tax credit.* Section 904(d)(1) requires that the foreign tax credit limitation be determined separately in the case of the types of income specified therein. Accordingly, the income within each separate limitation category constitutes a statutory grouping of income and all other income not within that separate limitation category (whether domestic or within a different separate limitation category) constitutes the residual groups.

(f) (1)(iv) through (5) [Reserved]

(g) *General examples.*

Examples *(1) through (23).* [Reserved]

Example (24)—Exempt, excluded, or eliminated income—(i) *Income method*—(A) *Facts.* X, a domestic corporation organized on January 1, 1987, is engaged in a number of businesses worldwide. X owns a 25-percent voting interest in each of five corporations engaged in the business A, two of which are domestic and three of which are foreign. X incurs stewardship expenses in connection with these five stock investments in the amount of $100. X apportions its stewardship expenses using a gross income method. Each of the five companies pays a dividend in the amount of $100. X is entitled to claim the 80-percent dividends received deduction on dividends paid by the two domestic companies. Because tax exempt income is considered in the allocation of deductions, X's $100 stewardship expense is allocated to the class of income consisting of dividends from business A companies. However, because tax exempt income is not considered in the apportionment of deductions within a class of gross income, the gross income of the two domestic companies must be reduced to reflect the availability of the dividends received deduction. Thus, for purposes of apportionment, the gross income paid by the three foreign companies is considered to be $100 each, while the gross income paid by the domestic companies is considered to be $20 each. Accordingly, X has total gross income from business A companies, for purposes of apportionment, of $340. As a result, $29.41 of X's stewardship expense is apportioned to each of the foreign companies and $5.88 of X's stewardship expense is apportioned to each of the domestic companies.

(ii) *Asset method*—(A) *Facts.* X, a domestic corporation organized on January 1, 1987, carries on a trade or business in the United States. X has deductible interest expense incurred in 1987 of $60,000. X owns all the stock of Y, a foreign corporation. X also owns 49 percent of the voting stock of Z, a domestic corporation. Neither Y nor Z has retained earnings and profits at the end of 1987. X apportions its interest expense on the basis of the fair market value of its assets. X has assets worth $1,500,000 that generate domestic source income, among which are tax exempt municipal bonds worth $100,000, and the stock of Z, which has a value of $500,000. The Y stock owned by X has a fair market value of $2,000,000 and generates solely foreign source general limitation income.

(B) *Allocation.* No portion of X's interest expense is directly allocable solely to identified property within the meaning of § 1.861-10T. Thus, X's deduction for interest is definitely related to all its gross income as a class.

(C) *Apportionment.* For purposes of apportioning expenses, assets that generate exempt, eliminated, or excluded income are not taken into account. Because X's municipal bonds are tax exempt, they are not taken into account in apportioning interest expense. Since X is entitled to claim under section 243 to 80-percent dividends received deduction with respect to the dividend it received from Z, 80 percent of the value of that stock is not taken into account as an asset for purposes of apportionment under the asset method. X apportions its interest deduction between the statutory grouping of foreign source general limitation income and the residual grouping of domestic source income as follows:

To foreign source general limitation income:

$$\text{Interest expense} \times \frac{\text{General limitation assets that are not tax exempt}}{\text{Worldwide assets that are not tax exempt}}$$

$$\frac{\text{Nonexempt foreign assets}}{\text{20 percent of Z stock value} + \text{Nonexempt domestic assets} + \text{Nonexempt foreign assets}}$$

$$= \$60{,}000 \times \frac{\$2{,}000{,}000}{(\$100{,}000 + \$900{,}000 + \$2{,}000{,}000)} = \$40{,}000$$

To domestic source income:

$$\text{Interest expense} \times \frac{\text{Domestic assets that are not tax exempt}}{\text{Worldwide assets that are not tax exempt}}$$

$$\$60{,}000 \times \frac{\$100{,}000+\$900{,}000}{(\$100{,}000+\$900{,}000+\$2{,}000{,}000)} = \$20{,}000$$

$$\frac{\text{20 percent of Z stock value} + \text{nonexempt domestic assets}}{\begin{array}{c}\text{20 percent}\\\text{of Z stock}\\\text{value}\end{array} + \begin{array}{c}\text{Nonexempt}\\\text{domestic}\\\text{assets}\end{array} + \begin{array}{c}\text{Nonexempt}\\\text{foreign}\\\text{assets}\end{array}}$$

Example (25) and (26). [Reserved]

(h) *Effective dates.* In general, the rules of this section, as well as the rules of §§ 1.861–9T, 1.861–10T, 1.861–11T, 1.861–12T, and 1.861–14T shall apply for taxable years beginning after December 31, 1986. In the case of corporate taxpayers, transition rules set forth in § 1.861–13T provide for the gradual phase-in of certain the provisions of this and the foregoing sections. However, the following rules are effective for taxable years commencing after December 31, 1988:

(1) Section 1.861–9T(b)(2) (concerning the treatment of certain foreign currency borrowings),

(2) Section 1.861–9T(d)(2) (concerning the treatment of interest incurred by nonresident aliens),

(3) Section 1.861–10T(b)(3)(ii) (providing an operating costs test for purposes of the nonrecourse indebtedness exception), and

(4) Section 1.861–10T(b)(6) (concerning excess collaterilization of nonrecourse borrowings).

In addition, § 1.861–10T(e) (concerning the treatment of related controlled foreign corporation indebtedness) is effective for taxable years commencing after December 31, 1987. For rules for taxable years beginning before January 1, 1987, and for later years to the extent permitted by § 1.861–13T, see § 1.861–8 (Revised as of April 1, 1986).

§§ 1.861–9 and 1.861–9A [Redesignated as §§ 1.861–15 and 1.861–16 respectively]

Par. 4. Sections 1.861–9 and 1.861–9A are redesignated as §§ 1.861–15 and 1.861–16, respectively.

Par. 5. The following new §§ 1.861–9T, 1.861–10T, 1.861–11T, 1.861–12T and 1.861–14T are added immediately after § 1.861–8T and § 1.861–13T is added and reserved to read as follows:

§ 1.861–9T Allocation and apportionment of interest expense (Temporary regulations).

(a) *In general.* Any expense that is deductible under section 163 (including original issue discount) constitutes interest expense for purposes of this section, as well as for purposes of §§ 1.861–10T, 1.861–11T, 1.861–12T, and 1.861–13T. The term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year. 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 § 1.861–10T. 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 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. Consistent with the principles of fungibility, except as otherwise provided, the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate, have generated, or could reasonably have been expected to generate. In the case of the interest expense of members of an affiliated group, interest expense shall be considered to be allocable to all gross income of the members of the group under § 1.861–11T. That section requires the members of an affiliated group to allocate and apportion the interest expense of each member of the group as if all members of such group were a single corporation. For the method of determining the interest deduction allowed to foreign corporations under section 882(c), see § 1.882–5.

(b) *Interest equivalents*—(1) *Certain expenses and losses.* Any expense or loss (to the extent deductible) incurred in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period shall be subject to allocation and apportionment under the rules of this section if such expense or loss is substantially incurred in consideration of the time value of money. However, the allocation and apportionment of a loss under this paragraph (b) shall not affect the characterization of such loss as capital or ordinary for other purposes of the Code and the regulations therunder. The rule of this paragraph (b)(1) may be illustrated by the following example.

Example. W, a domestic corporation, borrows from X two ounces of gold at a time when the spot price for gold is $500 per ounce. W agrees to return the two ounces of gold in six months. W sells the two ounces of gold to Y for $1000. W then enters into a contract with Z to purchase two ounces of gold six months in the future for $1,050. In exchange for the use of $1,000 in cash, W has sustained a loss of $50 on related transactions. This loss is subject to allocation and apportionment under the rules of this section in the same manner as interest expense.

(2) *Certain foreign currency borrowings*—(i) *Rule.* If a taxpayer borrows in a nonfunctional currency at a rate of interest that is less than the applicable federal rate (or its equivalent in functional currency if the functional currency is not the dollar), any swap, forward, future, option, or similar financial arrangement (or any combination thereof) entered into by the taxpayer or by a related person (as defined in § 1.861–8T(c)(2)) that exists during the term of the borrowing and that substantially diminishes currency risk with respect to the borrowing or interest expense thereon will be presumed to constitute a hedge of such borrowing, unless the taxpayer can demonstrate on the basis of facts and circumstances that the two transactions are in fact unrelated. Under this presumption, the currency loss incurred on the borrowing during taxable years beginning after December 31, 1988, in connection with hedged nonfunctional currency borrowings, reduced or increased by the gain or loss on the hedge, will be apportioned in the same manner as interest expense. This presumption can be rebutted by a showing that the financial arrangement was entered into in connection with hedging currency exposure arising in the ordinary course of a trade or business (other than with respect to the borrowing).

(ii) *Examples.* The principles of this paragraph (b)(2) may be illustrated by the following examples.

Example (1). Taxpayer has a dollar functional currency and does not have any qualified business units with a functional currency other than the dollar. On January 1, 1989, when the unit of foreign currency is worth $1, taxpayer borrows 100 units of foreign currency for a three-year period bearing interest at the annual rate of 3 percent and immediately converts the proceeds of the borrowing into dollars for use in its business. In the ordinary course of its business, taxpayer has no foreign currency exposure in this currency. In March 1989, taxpayer enters into a three-year swap agreement that covers most, but not all, of the payment of interest and principal. Because the swap substantially diminishes currency risk with respect to the borrowing, it is presumed to hedge the loan. Since taxpayer cannot demonstrate that it was hedging currency exposure arising in the ordinary course of its business (other than currency exposure with respect to the borrowing), the net currency loss on the borrowing adjusted for any gain or loss on the swap must be apportioned in the same manner as interest expense.

Example (2). Assume the same facts as in Example 1, except that the taxpayer borrows in two separate foreign currencies on terms described in Example 1 and enters into a swap agreement in a single currency that substantially diminishes the taxpayer's aggregate foreign currency risk. The net currency loss on the borrowings adjusted for any gain or loss on the swap must be apportioned in the same manner as interest expense.

(3) *Losses on sale of certain receivables*—(i) *General rule.* Any loss on the sale of a trade receivable (as defined in § 1.954–2(h)) shall be allocated and apportioned, solely for purposes of this section and §§ 1.861–10T, 1.861–11T, 1.861–12T, and 1.861–13T, in the same manner as interest expense, unless at the time of sale of the receivable, it bears interest at a rate which is at least 120 percent of the short term applicable federal rate (as determined under section 1274(d) of the Code), or its equivalent in foreign currency in the case of receivables denominated in foreign currency, determined at the time the receivable arises. This treatment shall not affect the characterization of such expense as interest for other purposes of the Internal Revenue Code.

(ii) *Exceptions.* To the extent that a loss on the sale of a trade receivable exceeds the discount on the receivable that would be computed applying to the amount received on the sale of the receivable 120 percent of the applicable federal rate (or its equivalent in foreign currency in the case of receivables denominated in foreign currency) for the period commencing with the date on which the receivable is sold and ending with the earlier of the date on which the receivable begins to bear interest at such rate or the anticipated payment date of the receivable, such excess shall not be allocated and apportioned in the same manner as interest expense but rather shall be allocated and apportioned to the gross income generated by the receivable. In cases of transfers of receivables to a domestic international sales corporation described § 1.994–1(c)(6)(v), the rule of this paragraph (b)(3) shall not apply for purposes of computing combined taxable income. In computing the combined taxable income of a foreign sales corporation and its related supplier, loss on the sale of receivables to a third party incurred either by the foreign sales corporation or its related supplier shall offset combined taxable income, notwithstanding the provisions of this paragraph (b)(3). See § 1.924(a)–1T(g)(7).

Example. On October 1, X sells a widget to Y for $100 payable in 30 days, after which the receivable will bear stated interest at 13 percent. On October 4, X sells Y's obligation to Z for $98. Assume that the applicable federal rate for the month of October is 10 percent. Applying 120 percent of the applicable federal rate to the $98 received on the sale of the receivable, the obligation is discounted at a 12 percent rate for a period of 27 days. At this discount rate, the obligation would have sold for $99.22. Thus, 88 cents of the $2 loss on the sale is apportioned in the same manner as interest expense, and $1.22 of the $2 loss on the sale is directly allocated to the income generated on the widget sale.

(4) *Rent in certain leasing transactions.* [Reserved.]

(5) *Treatment of bond premium*—(i) *Treatment by the issuer.* If a bond or other debt obligation is issued at a premium, an amount of interest expense incurred by the issuer on that bond or other debt obligation equal to the amortized portion of that premium that is included in gross income for the year shall be allocated and apportioned solely to the amortized portion of premium derived by the issuer for the year.

(ii) *Treatment by the holder.* If a bond or debt obligation is purchased at a premium, the portion of that premium amortized during the year by the holder under section 171 and the regulations thereunder shall be allocated and apportioned solely to interest income derived from the bond by the holder for the year.

(c) *Allowable deductions.* In order for an interest expense to be allocated and apportioned, it must first be determined that the interest expense is currently deductible. A number of provisions in the Code disallow or suspend deductions of interest expense or require the capitalization thereof.

(1) *Disallowed deductions.* A taxpayer does not allocate and apportion interest expense under this section that is permanently disallowed as a deduction by operation of section 163(h), section 265, or any other provision or rule that permanently disallows the deduction of interest expense.

(2) *Section 263A.* Section 263A requires the capitalization of interest expense that is allocable to designated types of property. Any interest expense that is capitalized under section 263A does not constitute deductible interest expense for purposes of this section. Furthermore, interest expense capitalized in inventory or depreciable property is not separately allocated and apportioned when the inventory is sold or depreciation is allowed. Capitalized interest expense is effectively allocated and apportioned as part of, and in the same manner as, the cost of goods sold, amortization, or depreciation deduction.

(3) *Section 163(d).* Section 163(d) suspends the deduction for interest expense to the extent that it exceeds net investment income. In the year that suspended investment interest expense becomes allowable under the rules of section 163(d), that interest expense is apportioned under rules set forth in paragraph (d)(1) of this section as though it were incurred in the taxable year in which the expense is deducted.

(4) *Section 469*—(i) *General rule.* Section 469 suspends the deduction of passive activity losses to the extent that they exceed passive activity income for the year. Passive activity losses may consist in part of interest expense properly allocable to passive activity. In the year that suspended interest expense becomes allowable as a deduction under the rules of section 469, that interest expense is apportioned under rules set forth in paragraph (d)(1) of this section as though it were incurred in the taxable year in which the expense is deducted.

(ii) *Identification of the interest component of a suspended passive loss.* A suspended passive loss may consist of a variety of items of expense other than interest expense. Suspended interest expense for any taxable year is computed by multiplying the total suspended passive loss for the year by a fraction, the numerator of which is passive interest expense for the year (determined under regulations issued under section 163) and the denominator of which is total passive expenses for the year. The amount of the suspended interest expense that is considered to be deductible in a subsequent taxable year is computed by multiplying the amount of any cumulative suspended interest expense (reduced by suspended interest expense allowed as a deduction in prior taxable years) times a fraction, the numerator of which is the portion of cumulative suspended passive losses that become deductible in the taxable year and the denominator of which is the cumulative suspended passive losses for prior taxable years (reduced by suspended passive losses allowed as deductions in prior taxable years).

(iii) *Example.* The rules of this paragraph (c)(4) may be illustrated by the following example.

Example. On January 1, 1987, A, a United States citizen, invested in a passive activity. In 1987, the passive activity generated no passive income and $100 in passive losses, all of which were suspended by operation of section 469. The suspended loss included $10 of suspended interest expense. In 1988, the passive activity generated $50 in passive income and $150 in passive expenses which included $30 of interest expense. The entire $100 passive loss was suspended in 1988 and included $20 of interest expense ($100 suspended passive loss × $30 passive interest expense/$150 total passive expenses). Thus, at the end of 1988, A had total suspended passive losses of $200, including $30 of suspended interest expense. In 1989, the passive activity generated $100 in passive income and no passive expenses. Thus, $100 of A's cumulative suspended passive loss was therefore allowed in 1989. The $100 of deductible passive loss includes $15 of suspended interest expense ($30 cumulative suspended interest expense × $100 of cumulative suspended passive losses allowable in 1989/$200 of total cumulative suspended passive losses). The $15 of interest expense is apportioned under the rules of paragraph (d) of this section as though it were incurred in 1989.

(d) *Apportionment rules for individuals, estates, and certain trusts*—(1) *United States individuals.* In the case of taxable years beginning after December 31, 1986, individuals generally shall apportion interest expense under different rules according to the type of interest expense incurred. The interest expense of individuals shall be characterized under the regulations issued under section 163. However, in the case of an individual whose foreign source income (including income that is excluded under section 911) does not exceed a gross amount of $5,000, the apportionment of interest expense under this section is not required. Such an individual's interest expense may be allocated entirely to domestic source income.

(i) *Interest incurred in the conduct of a trade or business.* An individual who incurs business interest described in section 163(h)(2)(A) shall apportion such interest expense using an asset method by reference to the individual's business assets.

(ii) *Investment interest.* An individual who incurs investment interest described in section 163(h)(2)(B) shall apportion that interest expense on the basis of the individual's investment assets.

(iii) *Interest incurred in a passive activity.* An individual who incurs passive activity interest described in section 163(h)(2)(C) shall apportion that interest expense on the basis of the individual's passive activity assets. Individuals who receive a distributive share of interest expense incurred in a partnership are subject to special rules set forth in paragraph (e) of this section.

(iv) *Qualified residence and deductible personal interest.* Individuals who incur qualified residence interest described in section 163(h)(2)(D) shall apportion that interest expense under a gross income method, taking into account all income (including business, passive activity, and investment income) but excluding income that is exempt under section 911. For purposes of this section, any qualified residence that is rented shall be considered to be a business asset for the period in which it is rented, with the result that the interest on such a residence is not apportioned under this subdivision (iv) but instead under subdivisions (i) or (iii) of this paragraph (d)(1). To the extent that personal interest described in section 163(h)(2) remains deductible under transitional rules, individuals shall apportion such interest expense in the same manner as qualified residence interest.

(v) *Example.* The following example illustrates the principles of this section.

Example—(i) *Facts.* A is a resident individual taxpayer engaged in the active conduct of a trade or business, which A operates as a sole proprietor. A's business generates only domestic source income. A's investment portfolio consists of several less than 10 percent stock investments. Certain stocks in which A's adjusted basis is $40,000 generate domestic source income and other stocks in which A's adjusted basis is $60,000 generate foreign source passive income. In addition, A owns his personal residence, which is subject to a mortgage in the amount of $100,000. All interest expense incurred with respect to A's mortgage is qualified residence interest for purposes of section 163(h)(2)(D). A's other indebtedness consists of a bank loan in the amount of $40,000. Under the regulations issued under section 163(h), it is determined that the proceeds of the $40,000 loan were divided equally between A's business and his investment portfolio. In 1987, the gross income of A's business, before the apportionment of interest expense, was $50,000. A's investment portfolio generated $4,000 in domestic source income and $6,000 in foreign source passive income. All of A's debt obligations bear interest at the annual rate of 10 percent.

(ii) *Analysis of business interest.* Under section 163(h) of the Code, $2,000 of A's interest expense is attributable to his business. Under the rules of paragraph (d)(1)(i), such interest must be apportioned on the basis of the business assets. Applying the asset method described in paragraph (g) of this section, it is determined that all of A's business assets generate domestic income and, therefore, constitute domestic assets. Thus, the $2,000 in interest expense on the business loan is allocable to domestic source income.

(iii) *Analysis of investment interest.* Under section 163(h) of the Code, $2,000 of A's interest expense is investment interest. Under the rules of paragraph (d)(1)(ii) of this section, such interest must be apportioned on the basis of investment assets. Applying the asset method, A's investment assets consist of stock generating domestic source income with an adjusted basis of $40,000 and stock generating foreign source passive income with an adjusted basis of $60,000. Thus, 40 percent ($800) of A's investment interest is apportioned to domestic source income and 60 percent ($1,200) of A's investment interest is apportioned to foreign source passive income for purposes of section 904.

(iv) *Analysis of qualified residence interest.* The $10,000 of qualified residence interest expense is apportioned under the rules of paragraph (d)(1)(iv) of this section on the basis of all of A's gross income. A's gross income consists of $60,000, $54,000 of which is domestic source and $6,000 of which is foreign source passive income. Thus, $9,000 of A's qualified residence interest is apportioned to domestic source income and $1,000 of A's qualified residence interest is apportioned to foreign source passive income.

(2) *Nonresident aliens*—(i) *General rule.* For taxable years beginning on or after January 1, 1988, interest expense incurred by a nonresident alien shall be considered to be connected with income effectively connected with a United States trade or business only to the extent that interest expense is incurred with respect to liabilities that—

(A) Are entered on the books and records of the United States trade or business when incurred, or

(B) Are secured by assets that generate such effectively connected income.

(ii) *Limitations*—(A) *Maximum debt capitalization.* Interest expense incurred by a nonresident alien is not considered to be connected with effectively connected income to the extent that it is incurred with respect to liabilities that exceed 80 percent of the gross assets of the United States trade or business.

(B) *Collateralization by other assets.* Interest expense on indebtedness that is secured by specific assets (not including the general credit of the nonresident alien) other than the assets of the United States trade or business shall not be considered to be connected with effectively connected income.

(3) *Estates and trusts.* Estates shall be treated in the same manner as individuals. In the case of a trust that is beneficially owned by individuals and is a complex trust, the trust shall be treated in the same manner as individuals under the rules of paragraph

(d) of this section, except that no de minimis amount shall apply. In the case of a trust that is beneficially owned by one or more corporations, the trust shall be treated either as a partnership or as a corporation depending on how the trust is characterized under the rules of section 7701 and the regulations thereunder.

(e) *Partnerships*—(1) *In general—aggregate rule.* A partner's distributive share of the interest expense of a partnership that is directly allocable under § 1.861-10T to income from specific partnership property shall be treated as directly allocable to the income generated by such partnership property. Subject to the exceptions set forth in paragraph (e)(4), a partner's distributive share of the interest expense of a partnership that is not directly allocable under § 1.861-10T generally is considered related to all income producing activities and assets of the partner and shall be subject to apportionment under the rules described in this paragraph. For purposes of this section, a partner's percentage interest in a partnership shall be determined by reference to the partner's interest in partnership income for the year. Similarly, a partner's pro rata share of partnership assets shall be determined by reference to the partner's interest in partnership income for the year.

(2) *Corporate partners whose interest in the partnership is 10 percent or more.* A corporate partner shall apportion its distributive share of partnership interest expense by reference to the partner's assets, including the partner's pro rata share of partnership assets, under the rules of paragraph (f) of this section if the corporate partner's direct and indirect interest in the partnership (as determined under the attribution rules of section 318) is 10 percent or more. A corporation using the tax book value method of apportionment shall use the partnership's inside basis in its assets, adjusted to the extent required under § 1.861-10T(d)(2). A corporation using the fair market value method of apportionment shall use the fair market value of the partnership's assets, adjusted to the extent required under § 1.861-10T(d)(2).

(3) *Individual partners who are general partners or who are limited partners with an interest in the partnership of 10 percent or more.* An individual partner is subject to the rules of this paragraph (e)(3) if either the individual is a general partner or the individual's direct and indirect interest (as determined under the attribution rules of section 318) in the partnership is 10 percent or more. The individual shall first classify his or her distributive share of partnership interest expense as interest incurred in the active conduct of a trade or business, as passive activity interest, or as investment interest under regulations issued under sections 163 and 469. The individual must then apportion his or her interest expense (including the partner's distributive share of partnership interest expense) under the rules of paragraph (d) of this section. Each such individual partner shall take into account his or her distributive share of partnership gross income or pro rata share of the partnership assets in applying such rules. An individual using the tax book value method of apportionment shall use the partnership's inside basis in its assets, adjusted to the extent required under § 1.861-10T(d)(2). An individual using the fair market value method of apportionment shall use the fair market value of the partnership's assets, adjusted to the extent required under § 1.861-10T(d)(2).

(4) *Less than 10 percent limited partners and less than 10 percent corporate general partners—entity rule*—(i) *Partnership interest expense.* A limited partner (whether individual or corporate) or corporate general partner whose direct and indirect interest (as determined under the attribution rules of section 318) in the partnership is less than 10 percent shall directly allocate its distributive share of partnership interest expense to its distributive share of partnership gross income. Under § 1.904-7(i)(2) of the regulations, such a partner's distributive share of foreign source income of the partnership is treated as passive income (subject to the high taxed income exception of section 904(d)(2)(F)), except in the case of high withholding tax interest or income from a partnership interest held in the ordinary course of the partner's active trade or business, as defined in § 1.904-7(i)(2). A partner's distributive share of partnership interest expense (other than partnership interest expense that is directly allocated to identified property under § 1.861-10T) shall be apportioned in accordance with the partner's relative distributive share of gross foreign source income in each limitation category and of domestic source income from the partnership. To the extent that partnership interest expense is directly allocated under § 1.861-10T, a comparable portion of the income to which such interest expense is allocated shall be disregarded in determining the partner's relative distributive share of gross foreign source income in each limitation category and domestic source income. The partner's distributive share of the interest expense of the partnership that is directly allocable under § 1.861-10T shall be allocated according to the treatment, after application of § 1.904-7(i)(2), of the partner's distributive share of the income to which the expense is allocated.

(ii) *Other interest expense of the partner.* For purposes of apportioning other interest expense of the partner on an asset basis, the partner's interest in the partnership, and not the partner's pro rata share of partnership assets, is considered to be the relevant asset. The value of this asset for apportionment purposes is either the tax book value or fair market value of the partner's partnership interest, depending on the method of apportionment used by the taxpayer. This amount of a partner's interest in the partnership is allocated among various limitation categories in the same manner as partnership interest expense (that is not directly allocable under § 1.861-10T) is apportioned in subdivision (i) of this paragraph (e)(4). If the partner uses the tax book value method of apportionment, the partner's interest in the partnership must be reduced, for this purpose, to the extent that the partner's basis consists of liabilities that are taken into account under section 752. Under either the tax book value or fair market value method of apportionment, for purposes of this section only, the value of the partner's interest in the partnership must be reduced by the principal amount of any indebtedness of the partner the interest on which is directly allocated to its partnership interest under § 1.861-10T.

(5) *Tiered partnerships.* If a partnership is a partner in another partnership, the distributive share of interest expense of a lower-tier partnership that is subject to the rules of paragraph (e)(4) shall not be reapportioned in the hands of any higher-tier partner. However, the distributive share of interest expense of lower-tier partnership that is subject to the rules of paragraph (e) (2) or (3) shall be apportioned by the partner of the higher-tier partnership or by any higher-tier partnership to which the rules of paragraph (e)(4) apply, taking into account the partner's indirect pro rata share of the lower-tier partnership's income or assets.

(6) *Example*—(i) *Facts.* A, B, and C are partners in a limited partnership. A is a corporate general partner, owns a 5 percent interest in the partnership, and has an adjusted basis in its partnership interest, determined without regard to section 752 of the Code, of $5. A's investment in the partnership is not held in the ordinary course

of the taxpayer's active trade or business, as defined in § 1.904–7(i)(2). B, a corporate limited partner, owns a 70 percent interest in the partnership, and has an adjusted basis in its partnership interest, determined without regard to section 752 of the Code, of $70. C is an individual limited partner, owns a 25 percent interest in the partnership, and has an adjusted basis in the partnership interest, determined without regard to section 752 of the Code, of $25. The partners' interests in the profits and losses of the partnership conform to their respective interests. None of the interest expense incurred directly by any of the partners is directly allocable to their partnership interest under § 1.861–10T. The ABC partnership's sole assets are two apartment buildings, one domestic and the other foreign. The domestic building has an adjusted inside basis of $800 and the foreign building has an adjusted inside basis of $500. Each of the buildings is subject to a nonrecourse liability in the amount of $500. The ABC partnership's total interest expense for the taxable year is $120, both nonrecourse liabilities bearing interest at the rate of 12 percent. The indebtedness on the domestic building qualifies for direct allocation under the rules of § 1.861–10T. The indebtedness on the foreign building does not so qualify. The partnership incurred no foreign taxes. The partnership's gross income for the taxable year is $360, consisting of $100 in foreign source income and $260 in domestic source income. Under § 1.752–1(e), the nonrecourse liabilities of the partnership are allocated among the partners according to their share of the partnership profits. Accordingly, the adjusted basis of A, B, and C in their respective partnership interests (for other than apportionment purposes) is, respectively, $55, $770, and $275.

(ii) *Determination of the amount of partnership interest expense that is subject to allocation and apportionment.* Interest on the nonrecourse loan on the domestic building is, under § 1.861–10T, directly allocable to income from that investment. The interest expense is therefore directly allocable to domestic income. Interest on the nonrecourse loan on the foreign building is not directly allocable. The interest expense is therefore subject to allocation and apportionment. Thus, $60 of interest expense is directly allocable to domestic income and $60 of interest expense is subject to allocation and apportionment.

(iii) *Analysis for Partner A.* A's distributive share of the partnership's gross income is $18, which consists of $5 in foreign source income and $13 in domestic source income. A's distributive share of the ABC interest expense is $6, $3 of which is directly allocable to domestic income and $3 of which is subject to apportionment. After direct allocation of qualifying interest expense, A's distributive share of the partnership's gross income consists of $5 in foreign source income and $10 in domestic source income. Because A is a less than 10 percent corporate partner, A's distributive share of any foreign source partnership income is considered to be passive income. Accordingly, in apportioning the $3 of partnership interest expense that is subject to apportionment on a gross income method, one-third ($1) is apportioned to foreign source passive income and two-thirds ($2) is apportioned to domestic source income. In apportioning its other interest expense, A uses the tax book value method. A's adjusted basis in A's partnership interest ($55) includes A's share of the partnership's liabilities ($50), which are included in basis under section 752. For purposes of apportioning other interest expense, A's adjusted basis in the partnership must be reduced to the extent of such liabilities. Thus, A's adjusted basis in the partnership, for purposes of apportionment, is $5. For the purpose of apportioning A's other interest expense, this $5 in basis is characterized one-third as a foreign passive asset and two-thirds as a domestic asset, which is the ratio determined in paragraph (e)(4)(i).

(iv) *Analysis for Partner B.* B's distributive share of the ABC interest expense is $84, $42 of which is directly allocable to domestic income and $42 of which is subject to apportionment. As a corporate limited partner whose interest in the partnership is 10 percent or more, B is subject to the rules of paragraph (e)(2) and paragraph (f) of this section. These rules require that a corporate partner apportion its distributive share of partnership interest expense at the partner level on the asset method described in paragraph (g) of this section by reference to its corporate assets, which include, for this purpose, 70 percent of the partnership's assets, adjusted in the manner described in § 1.861–10T(e) to reflect directly allocable interest expense.

(v) *Analysis for Partner C.* C's distributive share of the ABC interest expense is $30, $15 of which is directly allocable to domestic income and $15 of which is subject to apportionment. As an individual limited partner whose interest in the partnership is 10 percent or more, C is subject to the rules of paragraph (e)(3) of this section. These rules require that an individual's share of partnership interest expense be classified under regulations issued under section 163(h) and then apportioned under the rules applicable to individuals, which are set forth in paragraph (d) of this section.

(7) *Foreign partners*—(i) *Foreign corporations.* The rules of this paragraph (e) shall apply to foreign corporations that are partners in partnerships. Any partnership interest expense that is deemed to be incurred directly by such a partner, any partnership liabilities that are deemed to be incurred directly by such a partner, and any partnership assets that are deemed to be held directly by such a partner under the rules of paragraph (e)(1) and (2) of this section (the aggregate approach) or after the application of paragraph (e)(5) shall be taken into account by such partner in the application of the rules of § 1.882–5, and the value of the partnership interest itself shall be disregarded. Any other partnership interest expense described in paragraph (e)(4) (entity rule) shall be apportioned between effectively connected income and noneffectively connected income of the partnership by applying the rules of § 1.882–5 as if the partnership were a foreign corporation. In apportioning under § 1.882–5 interest expense that is deemed incurred directly by the partner under paragraph (e)(1) and (2) of this section, any partnership interest described in paragraph (e)(4) shall not be considered to be an asset that generates income effectively connected with a United States trade or business.

Example. A is a foreign corporation that is a 50 percent partner in a partnership the only asset of which is an office building in the United States. The partnership's basis in the building is $1,000, half of which is deemed to be held directly by A under paragraph (e)(1) and (2) of this section. A's distributive share of interest expense of $100 is deemed to be incurred directly by A under the rules of this paragraph. In applying the rules of § 1.882–5, A shall take account of its share of the partnership liability and shall take account of its share of the partnership's asset.

(ii) *Nonresident aliens.* The distributive share of partnership interest expense of a nonresident alien who is a partner in a partnership shall be considered to be connected with effectively connected income based on the percentage of the assets of the partnership that generate effectively connected income. No interest expense directly incurred by the partner may be allocated and apportioned to effectively connected income derived by the partnership.

(f) *Corporations*—(1) *Domestic corporations.* Domestic corporations shall apportion interest expense using the asset method described in paragraph (g) of this section and the applicable rules of §§ 1.861–10T through 1.861–13T.

(2) *Foreign branches of domestic corporations.* In the application of the asset method described in paragraph (g) of this section, a domestic corporation shall—

(i) Take into account the assets of any foreign branch, translated according to the rules set forth in paragraph (g) of this section, and

(ii) Combine with its own interest expense any deductible interest expense incurred by a branch, translated according to the rules of section 987 and the regulations thereunder.

For purposes of computing currency gain or loss on any remittance from a branch or other qualified business unit (as defined in § 1.989(a)–1T) under section 987, the rules of this paragraph (f) shall not apply. The branch shall compute its currency gain or loss on remittances by taking into account only its separate expenses and its separate income.

Example—(i) *Facts.* X is a domestic corporation which operates B, a branch doing business in a foreign country. In 1988, without regard to branch B, X has gross domestic source income of $1,000 and gross foreign source general limitation income of $500 and incurs $200 of interest expense. Using the tax book value method of apportionment, X, without regard to branch B, determines the value of its assets that generate domestic source income to be $6,000 and the value of its assets that generate foreign source general limitation income to be $1,000. B constitutes a qualified business unit within the meaning of section 989 with a functional currency other than the U.S. dollar and uses the profit and loss method prescribed by section 987. Applying the translation rules of section 987, B earned $500 of gross foreign general limitation income and incurred $100 of interest expense. B incurred no other expenses. For 1988, the average functional currency book value of B's assets that generate foreign general limitation income translated at the year-end rate for 1988 is $3,000.

(ii) *Computation of net income.* The combined assets of X and B for 1988 (averaged under the rules of § 1.861–9T(g)(3)) consist 60 percent of assets generating domestic source income and 40 percent of assets generating foreign source general limitation income. The combined interest expense of both X and B is $300. Thus, $180 of the combined interest expense is apportioned to domestic source income and $120 is apportioned to the foreign source income, yielding net domestic source income of $820 and net foreign source general limitation income of $880.

(iii) *Computation of currency gain or loss.* For purposes of computing currency gain or loss on branch remittances, B takes into account only its gross income and its separate expenses. In 1988, B therefore has a net amount of income in foreign currency units equal in value to $400. Gain or loss on remittances shall be computed by reference to this amount.

(3) *Controlled foreign corporations*—(i) *In general.* For purposes of computing subpart F income and computing earnings and profits for all other federal tax purposes, the interest expense of a controlled foreign corporation may be apportioned either using the asset method described in paragraph (g) of this section or using the modified gross income method described in paragraph (j) of this section, subject to the rules of subdivisions (ii) and (iii) of this paragraph (f)(2). However, the gross income method described in paragraph (j) of this section is not available to any controlled foreign corporation if a United States shareholder and the members of its affiliated group (as defined in § 1.861–11T(d)) constitute controlling shareholders of such controlled foreign corporation and such affiliated group elects the fair market value method of approtionment under paragraph (g) of this section.

(ii) *Manner of election.* The election to use the asset method described in paragraph (g) of this section or the modified gross income method described in paragraph (j) of this section may be made either by the controlled foreign corporation or by the controlling United States shareholders on behalf of the controlled foreign corporation. The term "controlling United States shareholders" means those United States shareholders (as defined in section 951(b)) who, in aggregate, own (within the meaning of section 958(a)) greater than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote. In the case of a controlled foreign corporation in which the United States shareholders own stock representing more than 50 percent of the value of the stock in such corporation, but less than 50 percent of the combined voting power of all classes of stock in such corporation, the term "controlling United States shareholders" means all the United States shareholders (as defined in section 951(b)) who own (within the meaning of section 958(a)) stock of the controlled foreign corporation. All United States shareholders are bound by the election of either the controlled foreign corporation or the controlling United States shareholders. The election shall be made by filing a written statement described in § 1.964–1(c)(3)(ii) at the time and in the manner described therein and providing a written notice described in § 1.964–1(c)(3)(iii), except that no such written statement or notice is required to be filed or sent before March 13, 1989.

(iii) *Consistency requirement.* The same method of apportionment must be employed by all controlled foreign corporations in which a United States taxpayer and the members of its affiliated group (as defined in § 1.861–11T(d)) constitute controlling United States shareholders. A controlled foreign corporation that is required by this paragraph (f)(3)(iii) to utilize a particular method of apportionment must do so with respect to all United States shareholders.

(iv) *Stock characterization.* Pursuant to § 1.861–12T(c)(2), the stock of a controlled foreign corporation shall be characterized in the hands of any United States shareholder using the same method that the controlled foreign corporation uses to apportion its interest expense.

(4) *Other relevant provisions.* Affiliated groups of corporations are subject to special rules set forth in § 1.861–11T. Section 1.861–12T sets forth rules relating to basis adjustments for stock in nonaffiliated 10 percent owned corporations, special rules relating to the consideration and characterization of certain assets in the apportionment of interest expense, and to other special rules pertaining to the apportionment of interest expense. Section 1.861–13T contains transition rules limiting the application of the rules of §§ 1.861–8T through 1.861–12T, which are otherwise applicable to taxable years beginning after 1986. In the case of an affiliated group of corporations as defined in § 1.861–11T(d), any reference in §§ 1.861–8T through 1.861–13T to the "taxpayer" with respect to the allocation and apportionment of interest expense generally denotes the entire affiliated group of corporations and not the separate members thereof, unless the context otherwise requires.

(g) *Asset method*—(1) *In general.* (i) Under the asset method, the taxpayer apportions interest expense to the various statutory groupings based on the average total value of assets within each such grouping for the taxable year, as determined under the asset valuation rules of this paragraph (g)(1) and paragraph (g)(2) of this section and the asset characterization rules of paragraph (g)(3) of this section and § 1.861–12T. Except to the extent otherwise provided (*see, e.g.*, paragraph (d)(1)(iv) of this section), taxpayers must apportion interest expense only on the basis of asset values and may not apportion any interest deduction on the basis of gross income.

(ii) A taxpayer may elect to determine the value of its assets on the basis of either the tax book value or the fair market value of its assets. For rules concerning the application of the fair market value method, see paragraph (h) of this section. In the case of an affiliated group—

(A) The parent of which used the fair market value method prior to 1987, or

(B) A substantial portion of which used the fair market value method prior to 1987,

such a taxpayer may use either the fair market value method or the tax book value method for its tax year commencing in 1987 and may use either such method in its tax year commencing in 1988 without regard to which method was used in its tax year commencing in 1987 and without securing the Commissioner's consent. The use of the fair market value method in 1988, however, shall operate as a binding election as described in § 1.861–8T(c)(2). For rules requiring consistency in the use of the tax book value or fair market value method, see § 1.861–8T(c)(2).

(iii) A taxpayer electing to apportion its interest expense on the basis of the fair market value of its assets must establish the fair market value to the satisfaction of the Commissioner. If a taxpayer fails to establish the fair market value of an asset to the satisfaction of the Commissioner, the Commissioner may determine the appropriate asset value. If a taxpayer fails to establish the value of a substantial portion of its assets to the satisfaction of the Commissioner, the Commissioner may require the taxpayer to use the tax book value method of apportionment.

(iv) For rules relating to earnings and profits adjustments by taxpayers using the tax book value method for the stock in certain nonaffiliated 10 percent owned corporations, see § 1.861-12T(b).

(v) The provisions of this paragraph (g)(1) may be illustrated by the following examples.

Example (1)—(i) *Facts.* X, a domestic corporation organized on January 1, 1987, has deductible interest expense in 1987 in the amount of $150,000. X apportions its expenses according to the tax book value method. The adjusted basis of X's assets is $3,600,000, $3,000,000 of which generate domestic source income and $600,000 of which generate foreign source general limitation income.

(ii) *Allocation.* No portion of the $150,000 deduction is directly allocable solely to identified property within the meaning of § 1.861-10T. Thus, X's deduction for interest is related to all its activities and assets.

(iii) *Apportionment.* X apportions its interest expense as follows:

To foreign source general limitation income:

$$\$150,000 \times \frac{\$600,000}{\$3,600,000} \cdots\cdots \$25,000$$

To domestic source income:

$$\$150,000 \times \frac{\$3,000,000}{\$3,600,000} \cdots\cdots \$125,000$$

Example (2)—(i) *Facts.* Assume the same facts as in Example (1), except that X apportions its interest expense on the basis of the fair market value of its assets. X's total assets have a fair market value of $4,000,000, $3,200,000 of which generate domestic source income and $800,000 of which generate foreign source general limitation income.

(ii) *Allocation.* No portion of the $150,000 deduction is directly allocable solely to identified property within the meaning of § 1.861-10T. Thus, X's deduction for interest is related to all its activities and properties.

(iii) *Apportionment.* If it establishes the fair market value of its assets to the satisfaction of the Commissioner, X may apportion its interest expense as follows:

To foreign source general limitation income:

$$\$150,000 \times \frac{\$800,000}{\$4,000,000} \cdots\cdots \$30,000$$

To domestic source income:

$$\$150,000 \times \frac{\$3,200,000}{\$4,000,000} \cdots\cdots \$120,000$$

(2) *Asset values*—(i) *General rule.* For purposes of determining the value of assets under this section, an average of values (book or market) within each statutory grouping and the residual grouping shall be computed for the year on the basis of values of assets at the beginning and end of the year. For the first taxable year beginning after 1986, a taxpayer may choose to determine asset values solely by reference to the year-end value of its assets, provided that all the members of an affiliated group as defined in § 1.861-11T(d) make the same choice. Thus, no averaging is required for the first taxable year beginning after 1986. Where a substantial distortion of asset values would result from averaging beginning-of-year and year-end values, as might be the case in the event of a major corporate acquisition or disposition, the taxpayer must use a different method of asset valuation that more clearly reflects the average value of assets weighted to reflect the time such assets are held by the taxpayer during the taxable year.

(ii) *Special rule for qualified business units of domestic corporations with functional currency other than the U.S. dollar*—(A) *Tax book value method.* In the case of taxpayers using the tax book value method of apportionment, the following rules shall apply to determine the value of the assets of a qualified business unit (as defined in section 989(a)) of a domestic corporation with a functional currency other than the dollar.

(*1*) *Profit and loss branch.* In the case of a branch for which an election is not effective under § 1.985-2T to use the dollar approximate separate transactions method of computing currency gain or loss, the tax book value shall be determined by applying the rules of paragraph (g)(2)(i) and (3) of this section with respect to beginning-of-year and end-of-year tax book value in units of functional currency that are translated into dollars at the end-of-year exchange rate between the functional currency and the U.S. dollar.

Example. At the end of 1987, a profit and loss branch has assets that generate foreign source general limitation income with a tax book value in units of functional currency of 100. At the end of 1987, the unit is worth $1. At the end of 1988, the branch has assets that generate foreign source general limitation income with a tax book value in units of functional currency of 80. At the end of 1988, the unit is worth $2. The average value of foreign source general limitation assets for 1988 is 90 units, which is worth $180.

(*2*) *Approximate separate transactions method.* In the case of a branch for which an election is effective under § 1.985-2T to use the dollar approximate separate transactions method to compute currency gain or loss, the beginning-of-year dollar amount of the assets shall be determined by reference to the end-of-year balance sheet of the branch for the immediately preceding taxable year, adjusted for United States generally accepted accounting principles and United States tax accounting principles, and translated into U.S. dollars as provided in § 1.985-3T. The year-end dollar amount of the assets of the branch shall be determined in the same manner by reference to the end-of-year balance sheet for the current taxable year. The beginning-of-year and end-of-year dollar tax book value of assets, as so determined, within each grouping must then be averaged as provided in paragraph (g)(2)(i) of this section.

(B) *Fair market value method.* In the case of taxpayers using the fair market value method of apportionment, the beginning-of-year and end-of-year fair market values of branch assets within each grouping shall be computed in dollars and averaged as provided in this paragraph (g)(2).

(iii) *Adjustment for directly allocated interest.* Prior to averaging, the year-end value of any asset to which interest expense is directly allocated during the current taxable year under the rules of § 1.861-10T (b) or (c) shall be reduced (but not below zero) by the percentage of the principal amount of indebtedness outstanding at year-end equal to the percentage of all interest on the debt for the taxable year that is directly allocated.

(iv) *Assets in deferred intercompany transactions.* In the application of the asset method described in this paragraph (g), the tax book value of assets transferred between affiliated corporations in deferred intercompany transactions shall be determined without regard to the gain or loss that is deferred under the regulations issued under section 1502.

(v) *Example.* X is a domestic corporation that uses the fair market value method of apportionment. X is a calendar year taxpayer. X owns 25 percent of the stock of A, a noncontrolled section 902 corporation. At the end of 1987, the fair market value of X's assets by income grouping are as follows:

Domestic	$1,000,000
Foreign general limitation	500,000
Foreign passive	500,000
Noncontrolled section 902 corporation	50,000

For its 1987 tax year, X apportions its interest expense by reference to the 1987 year-end values. In July of 1988, X sells a portion of its investment in A and in an asset acquisition purchases a shipping business, the assets of which generate exclusively foreign shipping income. At the end of 1988, the fair market values of X's assets by income grouping are as follows:

Domestic	$800,000
Foreign general limitation	900,000
Foreign passive	300,000
Noncontrolled section 902 corporation	40,000
Foreign shipping	100,000

For its 1988 tax year, X shall apportion its interest expense by reference to the average of the 1988 beginning-of-year values (the 1987 year-end values) and the 1988 year-end values, assuming that the averaging of beginning-of-year and end-of-year values does not cause a substantial distortion of asset values. These averages are as follows:

Domestic	$900,000
Foreign general limitation	700,000
Foreign passive	400,000
Foreign shipping	50,000
Noncontrolled section 902 corporation	45,000

(3) *Characterization of assets.* Assets are charactrized for purposes of this section according to the source and type of the income that they generate, have generated, or may reasonably be expected to generate. The physical location of assets is not relevant to this determination. Subject to the special rules of paragraph (h) concerning the application of the fair market value method of apportionment, the value of assets within each statutory grouping and the residual grouping at the beginning and end of each year shall be determined by dividing the taxpayer's assets into three types—

(i) *Single category assets.* Assets that generate income that is exclusively within a single statutory grouping or the residual grouping;

(ii) *Multiple category assets.* Assets that generate income within more than one grouping of income (statutory or residual); and

(iii) *Assets without directly identifiable yield.* Assets that produce no directly identifiable income yield or that contribute equally to the generation of all the income of the taxpayer (such as assets used in general and administrative functions).

Single category assets are directly attributable to the relevant statutory or residual grouping of income. In order to attribute multiple category assets to the relevant groupings of income, the income yield of each such asset for the taxable year must be analyzed to determine the proportion of gross income generated by it within each relevant grouping. The value of each asset is then prorated among the relevant groupings of income according to their respective proportions of gross income. The value of each asset without directly identifiable income yield must be identified. However, because prorating the value of such assets cannot alter the ratio of assets within the various groupings of income (as determined by reference to the single and multiple category assets), they are not taken into account in determining that ratio. Special asset characterization rules that are set forth in § 1.861–12T. An example demonstrating the application of the asset method is set forth in § 1.861–12T(d).

(h) *The fair market value method.* An affiliated group (as defined in § 1.861–11T(d)) or other taxpayer (the "taxpayer") that elects to use the fair market value method of apportionment shall value its assets according to the following methodology.

(1) *Determination of values*—(i) *Valuation of group assets.* The taxpayer shall first determine the aggregate value of the assets of the taxpayer on the last day of its taxable year without excluding the value of stock in foreign subsidiaries or any other asset. In the case of a publicly traded corporation, this determination shall be equal to the aggregate trading value of the taxpayer's stock traded on established securities markets at year-end increased by the taxpayer's year-end liabilities to unrelated persons and its pro rata share of year-end liabilities of all related persons owed to unrelated persons. In determining whether persons are related, § 1.861–8T(c)(2) shall apply. In the case of a corporation that is not publicly traded, this determination shall be made by reference to the capitalization of corporate earnings, in accordance with the rules of Rev. Rul. 68–609. In either case, control premium shall not be taken into account.

(ii) *Valuation of tangible assets.* The taxpayer shall determine the value of all assets held by the taxpayer and its pro rata share of assets held by other related persons on the last day of its taxable year, excluding stock or indebtedness in such persons, any intangible property as defined in section 936(h)(3)(B), or goodwill or going concern value intangibles. Such valuations shall be made using generally accepted valuation techniques. For this purpose, assets may be combined into reasonable groupings. Statistical methods of valuation may only be used in connection with fungible property, such as commodities. The value of stock in any corporation that is not a related person shall be determined under the rules of paragraph (h)(1)(i) of this section, except that no liabilities shall be taken into account.

(iii) *Computation of intangible asset value.* The value of the intangible assets of the taxpayer and of intangible assets of all related persons attributable to the taxpayer's ownership in related persons is equal to the amount obtained by subtracting the amount determined under paragraph (h)(1)(ii) of this section from the amount determined under paragraph (h)(1)(i) of this section.

(2) *Apportionment of intangible asset value.* The value of the intangible assets determined under paragraph (h)(1)(iii) of this section is apportioned among the taxpayer and all related persons in proportion to the net income before interest expense of the taxpayer and the taxpayer's pro rata share of the net income before interest expense of each ralated person held by the taxpayer, excluding income that is passive under § 1.904–4(b). For this purpose, net income is determined before reduction for income taxes. Net income of the taxpayer and of related persons shall be computed without regard to dividends or interest received from any person that is related to the taxpayer.

(3) *Characterization of affiliated group's portion of intangible asset value.* The protion of the value of intagible assets of the taxpayer and related persons that is apportioned to the taxpayer under paragraph (h)(2) of this section is characterized on the basis of net income before interest expense, as determined under paragraph (h)(2) of this section, of the taxpayer within each statutory or residual grouping of income.

(4) *Valuing stock in related persons held by the taxpayer.* The value of stock in a related person held by the taxpayer equals the sum of the following amounts reduced by the taxpayer's pro rata share of liabilities of such related person:

(i) The portion of the value of intangible assets of the taxpayer and related persons that is apportioned to such related person under paragraph (h)(2) of this section;

(ii) The taxpayer's pro rata share of tangible assets held by the related person (as determined under paragraph (h)(1)(ii) of this section); and

(iii) The total value of stock in all related person held by the related person as determined under this paragraph (h)(4).

(5) *Characterizing stock in related persons.* Stock in a related person held by the taxpayer or by another related person shall be characterized on the basis of the fair market value of the taxpayer's pro rata share of assets held by the related person attributed to each statutory grouping and the residual grouping under the stock characterization rules of § 1.861–12T(c)(3)(ii), except that the portion of the value of intangible assets of the taxpayer and related persons that is apportioned to the related person under

paragraph (h)(2) of this section shall be characterized on the basis of the net income before interest expense of the related person within each statutory grouping or residual grouping (excluding income that is passive under § 1.904-4(b)).

(6) *Adjustments for apportioning related person expenses.* For purposes of apportioning expenses of a related person, the value of stock in a second related person as otherwise determined under paragraph (h)(4) of this section (which is determined on the basis of the taxpayer's percentage ownership interest in the second related person) shall be increased to reflect the first related person's percentage ownership interest in the second related person to the extent it is larger.

Example. Assume that a taxpayer owns 80 percent of CFC1, which owns 100 percent of CFC2. The value of CFC1 is determined generally under paragraph (h)(4) on the basis of the taxpayer's 80 percent indirect interest in CFC2. For purposes of apportioning expenses of CFC1, 100 percent of the stock of CFC1 must be taken into account. Therefore, the value of CFC2 stock in the hands of CFC1 shall equal the value of CFC2 stock in the hands of CFC1 as determined under paragraph (h)(4) of this section, increased by 25 percent of such amount to reflect the fact that CFC1 owns 100 percent and not 80 percent of CFC2.

(i) [Reserved.]

(j) *Modified gross income method.* Subject to rules set forth in paragraph (f)(3) of this section, the interest expense of a controlled foreign corporation may be allocated according to the following rules.

(1) *Single-tier controlled foreign corporation.* In the case of a controlled foreign corporation that does not hold stock in any lower-tier controlled foreign corporation, the interest expense of the controlled foreign corporation shall be apportioned based on its gross income.

(2) *Multiple vertically owned controlled foreign corporations.* In the case of a controlled foreign corporation that holds stock in any lower-tier controlled foreign corporation, the interest expense of that controlled foreign corporation and such upper-tier controlled foreign corporation shall be apportioned based on the following methodology:

(i) *Step 1.* Commencing with the lowest-tier controlled foreign corporation in the chain, allocate and apportion its interest expense based on its gross income as provided in paragraph (j)(1) of this section, yielding gross income in each grouping net of interest expense.

(ii) *Step 2.* Moving to the next higher-tier controlled foreign corporation, combine the gross income of such corporation within each grouping with its pro rata share of the gross income net of interest expense of all lower-tier controlled foreign corporations held by such higher-tier corporation within the same grouping adjusted as follows:

(A) Exclude from the gross income of the upper-tier corporation any dividends or other payments received from the lower-tier corporation other than interest subject to look-through under section 904(d)(3); and

(B) Exclude from the gross income net of interest expense of any lower-tier corporation any subpart F income (net of interest expense apportioned to such income).

Then apportion the interest expense of the higher-tier controlled foreign corporation based on the adjusted combined gross income amounts. Repeat this step 2 for each next higher-tier controlled foreign corporation in the chain. For purposes of this paragraph (j)(2)(ii), pro rata share shall be determined under principles similar to section 951(a)(2).

§ 1.861-10T Special allocations of interest expense (Temporary regulations).

(a) *In general.* This section applies to all taxpayers and provides three exceptions to the rules of § 1.861-9T that require the allocation and apportionment of interest expense on the basis of all assets of all members of the affiliated group. Paragraph (b) of this section describes the direct allocation of interest expense to the income generated by certain assets that are subject to qualified nonrecourse indebtedness. Paragraph (c) of this section describes the direct allocation of interest expense to income generated by certain assets that are acquired in integrated financial transaction. Paragraph (d) of this section provides special rules that are applicable to all transactions described in paragraphs (b) and (c) of this section. Paragraph (e) of this section requires the direct allocation of third party interest of an affiliated group to such group's investment in related controlled foreign corporations in cases involving excess related person indebtedness (as defined therein). See also § 1.861-9T(b)(5), which requires direct allocation of amortizable bond premium.

(b) *Qualified nonrecourse indebtedness*—(1) *In general.* In the case of qualified nonrecourse indebtedness (as defined in paragraph (b)(2) of this section), the deduction for interest shall be considered directly allocable solely to the gross income which the property acquired, constructed, or improved with the proceeds of the indebtedness generates, has generated, or could reasonably be expected to generate.

(2) *Qualified nonrecourse indebtedness defined.* The term "qualified nonrecourse indebtedness" means any borrowing that is not excluded by paragraph (b)(4) of this section if:

(i) The borrowing is specifically incurred for the purpose of purchasing, constructing, or improving identified property that is either depreciable tangible personal property or real property with a useful life of more than one year or for the purpose of purchasing amortizable intangible personal property with a useful life of more than one year;

(ii) The proceeds are actually applied to purchase, construct, or improve the identified property;

(iii) Except as provided in paragraph (b)(7)(ii) (relating to certain third party guarantees in leveraged lease transactions), the creditor can look only to the identified property (or any lease or other interest therein) as security for payment of the principal and interest on the loan and, thus, cannot look to any other property, the borrower, or any third party with respect to repayment of principal or interest on the loan;

(iv) The cash flow from the property, as defined in paragraph (b)(3) of this section, is reasonably expected to be sufficient in the first year of ownership as well as in each subsequent year of ownership to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payments of interest and original issue discount and periodic payments of principal in each such year; and

(v) There are restrictions in the loan agreement on the disposal or use of the property consistent with the assumptions described in subdivisions (iii) and (iv) of this paragraph (b)(2).

(3) *Cash flow defined*—(i) *In general.* The term "cash flow from the property" as used in paragraph (b)(2)(iv) of this section means a stream of revenue (as computed under paragraph (b)(3)(ii) of this section) substantially all of which derives directly from the property. The phrase "cash flow from the property" does not include revenue if a significant portion thereof is derived from activities such as sales, labor, services, or the use of other property. Thus, revenue derived from the sale or lease of inventory or of similar property does not constitute cash flow from the property, including plant or equipment used in the manufacture and sale or lease, or purchase and sale or lease, of such inventory or similar

property. In addition, revenue derived in part from the performance of services that are not ancillary and subsidiary to the use of property does not constitute cash flow from the property.

(ii) *Self-constructed assets.* The activities associated with self-construction of assets shall be considered to constitute labor or services for purposes of paragraph (b)(3)(i) only if the self-constructed asset—

(A) Is constructed for the purpose of resale, or

(B) Without regard to purpose, is sold to an unrelated person within one year from the date that the property is placed in service for purposes of section 167.

(iii) *Computation of cash flow.* Cash flow is computed by subtracting cash disbursements excluding debt service from cash receipts.

(iv) *Analysis of operating costs.* [Reserved]

(v) *Examples.* The principles of this paragraph may be demonstrated by the following examples.

Example (1). In 1987, X borrows $100,000 in order to purchase an apartment building, which X then purchases. The loan is secured only by the building and the leases thereon. Annual debt service on the loan is $12,000. Annual gross rents from the building are $20,000. Annual taxes on the building are $2,000. Other expenses deductible under section 162 are $2,000. Rents are reasonably expected to remain stable or increase in subsequent years, and taxes and expenses are reasonably expected to remain proportional to gross rents in subsequent years. X provides security, maintenance, and utilities to the tenants of the building. Based on facts and circumstances, it is determined that, although services are provided to tenants, these services are ancillary and subsidiary to the occupancy of the apartments. Accordingly, the case flow of $16,000 is considered to constitute a return from the property. Furthermore, such cash flow is sufficient to fulfill the terms and conditions of the loan agreement as required by paragraph (b)(2)(iii).

Example (2). In 1987, X borrows funds in order to purchase a hotel, which X then purchases and operates. The loan is secured only by the hotel. Based on facts and circumstances, it is determined that the operation of the hotel involves services the value of which is significant in relation to amounts paid to occupy the rooms. Thus, a significant portion of the cash flow is derived from the performance of services incidental to the occupancy of hotel rooms. Accordingly, the cash flow from the hotel is considered not to constitute a return on or from the property.

Example (3). In 1987, X borrows funds in order to build a factory, which X then builds and operates. The loan is secured only by the factory and the equipment therein. Based on the facts and circumstances, it is determined that the operation of the factory involves significant expenditures for labor and raw materials. Thus, a significant portion of the cash flow is derived from labor and the processing of raw materials. Accordingly, the cash flow from the factory is considered not to constitute a return on or from the property.

(4) *Exclusions.* The term "qualified nonrecourse indebtedness' shall not include any transaction that—

(i) Lacks economic significance within the meaning of paragraph (b)(5) of this section;

(ii) Involves cross collateralization within the meaning of paragraph (b)(6) of this section;

(iii) Except in the case of a leveraged lease described in paragraph (b)(7)(ii) of this section, involves credit enhancement within the meaning of paragraph (b)(7) of this section or, with respect to loans made on or after October 14, 1988, does not under the terms of the loan documents, prohibit the acquisition by the holder of bond insurance or similar forms of credit enhancement;

(iv) Involves the purchase of inventory;

(v) Involves 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 (although interest incurred in order to purchase certain financial instruments may qualify for direct allocation under paragraph (c) of this section);

(vi) Involves interest expense that constitutes qualified residence interest as defined in section 163(h)(3); or

(vii) [Reserved].

(5) *Economic significance.* Indebtedness that otherwise qualifies under paragraph (b)(2) shall nonetheless be subject to apportionment under § 1.861-9T if, taking into account all the facts and circumstances, the transaction (including the security arrangement) lacks economic significance.

(6) *Cross collateralization.* The term "cross collateralization" refers to the pledge as security for a loan of—

(i) Any asset of the borrower other than the identified property described in paragraph (b)(2) of this section, or

(ii) Any asset belonging to any related person, as defined in § 1.861-8T(c)(2).

(7) *Credit enhancement*—(i) *In general.* Except as provided in paragraph (b)(7)(ii) of this section, the term "credit enhancement" refers to any device, including a contract, letter of credit, or guaranty, that expands the creditor's rights, directly or indirectly, beyond the identified property purchased, constructed, or improved with the funds advanced and, thus, effectively provides as security for a loan the assets of any person other than the borrower. The acquisition of bond insurance or any other contract of suretyship by an initial or subsequent holder of an obligation shall constitute credit enhancement.

(ii) *Special rule for leveraged leases.* For purposes of this paragraph (b), the term "credit enhancement" shall not include any device under which any person that is not a related person within the meaning of § 1.861-8T(c)(2) agrees to guarantee, without recourse to the lessor or any person related to the lessor, a lessor's payment of principal and interest on indebtedness that was incurred in order to purchase or improve an asset that is depreciable tangible personal property or depreciable tangible real property (and the land on which such real property is situated) that is leased to a lessee that is not a related person in a transaction that constitutes a lease for federal income tax purposes.

(iii) *Syndication of credit risk and sale of loan participations.* The term "syndication of credit risk" refers to an arrangement in which one primary lender secures the promise of a secondary lender to bear a portion of the primary lender's credit risk on a loan. The term "sale of loan participations" refers to an arrangement in which one primary lender divides a loan into several portions, sells and assigns all rights with respect to one or more portions to participating secondary lenders, and does not remain at risk in any manner with respect to the portion assigned. For purposes of this paragraph (b), the syndication of credit risk shall constitute credit enhancement because the primary lender can look to secondary lenders for payment of the loan, notwithstanding limitations on the amount of the secondary lender's liability. Conversely, the sale of loan participations does not constitute credit enhancement, because the holder of each portion of the loan can look solely to the asset securing the loan and not to the credit or other assets of any person.

(8) *Other arrangements that do not constitute cross collateralization or credit enhancement.* For purposes of paragraphs (b) (6) and (7) of this section, the following arrangements do not constitute cross collateralization or credit enhancement:

(i) *Integrated projects.* A taxpayer's pledge of multiple assets of an integrated project, provided that the integrated project. An integrated project consists of functionally related and geographically contiguous assets that, as to the taxpayer, are used in the same trade or business.

(ii) Insurance. A taxpayer's purchase of third-party casualty and liability insurance on the collateral or, by contract, bearing the risk of loss associated with destruction of the collateral or with respect to the attachment of third party liability claims.

(iii) *After-acquired property.* Extension of a creditor's security interest to improvements made to the collateral, provided that the extension does not constitute excess collateralization under paragraph (b)(6), determined by taking into account the value of improvements at the time the improvements are made and the value of the original property at the time the loan was made.

(iv) *Warranties of completion and maintenance.* A taxpayer's warranty to a creditor that it will complete construction or manufacture of the collateral or that it will maintain the collateral in good condition.

(v) *Substitution of collateral.* A taxpayer's right to substitute collateral under any loan contract. However, after the right is exercised, the loan shall no longer constitute qualified nonrecourse indebtedness.

(9) *Refinancings.* If a taxpayer refinances qualified nonrecourse indebtedness (as defined in paragraph (b)(2) of this section) with new indebtedness, such new indebtedness shall continue to qualify only if—

(i) The principal amount of the new indebtedness does not exceed by more than five percent the remaining principal amount of the original indebtedness,

(ii) The term of the new indebtedness does not exceed by more than six months the remaining term of the original indebtedness, and

(iii) The requirements of this paragraph (other than those of paragraph (b)(2) (i) and (ii) of this section) are satisfied at the time of the refinancing, and the exclusions contained in this paragraph (b)(4) do not apply.

(10) *Post-construction permanent financing.* Financing that is obtained after the completion of constructed property will be deemed to satisfy the requirements of paragraph (b)(2) (i) and (ii) of this section if—

(i) The financing is obtained within one year after the constructed property or substantially all of a constructed integrated project (as defined in paragraph (b)(9)(i) of this section) is placed in service for purposes of section 167; and

(ii) The financing does not exceed the cost of construction (including construction period interest).

(11) *Assumptions of pre-existing qualified nonrecourse indebtedness.* If a transferee of property that is subject to qualified nonrecourse indebtedness assumes such indebtedness, the indebtedness shall continue to constitute qualified nonrecourse indebtedness, provided that the assumption in no way alters the qualified status of the debt.

(12) *Excess collateralization.* [Reserved]

(c) *Direct allocations in the case of certain integrated financial transactions*—(1) *General rule.* Interest expense incurred on funds borrowed in connection with an integrated financial transaction (as defined in paragraph (c)(2) of this section) shall be directly allocated to the income generated by the investment funded with the borrowed amounts.

(2) *Definition.* The term "integrated financial transaction" refers to any transaction in which—

(i) The taxpayer—

(A) Incurs indebtedness for the purpose of making an identified term investment,

(B) Identifies the indebtedness as incurred for such purpose at the time the indebtedness is incurred, and

(C) Makes the identified term investment within ten business days after incurring the indebtedness;

(ii) The return on the investment is reasonably expected to be sufficient throughout the term of the investment to fulfill the terms and conditions of the loan agreement with respect to the amount and timing of payments of principal and interest or original issue discount;

(iii) The income constitutes interest or original issue discount or would constitute income equivalent to interest if earned by a controlled foreign corporation (as described in § 1.954-2T(h));

(iv) The debt incurred and the investment mature within ten business days of each other;

(v) The investment does not relate in any way to the operation of, and is not made in the normal course of, the trade or business of the taxpayer or any related person, including the financing of the sale of goods or the performance of services by the taxpayer or any related person, or the compensation of the taxpayer's employees (including any contribution or loan to an employee stock ownership plan (as defined in section 4975(e)(7)) or other plan that is qualified under section 401(a)); and

(vi) The borrower does not constitute a financial services entity (as defined in section 904 and the regulations thereunder).

(3) *Rollovers.* In the event that a taxpayer sells of otherwise liquidates an investment described in paragraph (c)(2) of this section, the interest expense incurred on the borrowing shall, subsequent to that liquidation, no longer qualify for direct allocation under this paragraph (c).

(4) *Examples.* The principles of this paragraph (c) may be demonstrated by the following examples.

Example (1). X is a manufacturer and does not constitute a financial services entity as defined in the regulations under section 904. On January 1, 1988, X borrows $100 for 6 months at an annual interest rate of 10 percent. X identifies on its books and records by the close of that day that the indebtedness is being incurred for the purpose of making an investment that is intended to qualify as an integrated financial transaction. On January 5, 1988, X uses the proceeds to purchase a portfolio of stock that approximates the composition of the Standard & Poor's 500 Index. On that day, X also enters into a forward sale contract that requires X to sell the stock on June 1, 1988 for $110. X identifies on its books and records by the close of January 5, 1988, that the portfolio stock purchases and the forward sale contract constitute part of the integrated financial transaction with respect to which the identified borrowing was incurred. Under § 1.954-2T(h), the income derived from the transaction would constitute income equivalent to interest. Assuming that the return on the investment to be derived on June 1, 1988, will be sufficient to pay the interest due on June 1, 1988, the interest on the borrowing is directly allocated to the gain from the investment.

Example (2). X does not constitute a financial services entity as defined in the regulations under section 904. X is in the business of, among other things, issuing credit cards to consumers and purchasing from merchants who accept the X card the receivables of consumers who make purchases with the X card. X borrows from Y in order to purchase X credit card receivables from Z, a merchant. Assuming that the Y borrowing satisfies the other requirements of paragraph (c)(2) of this section, the transaction nonetheless cannot constitute an integrated financial transaction because the purchase relates to the operation of X's trade or business.

Example (3). Assume the same facts as in Example 2, except that X borrows in order to purchase the receivables of A, a merchant who does not accept the X card and is not otherwise engaged directly or indirectly in any business transaction with X. Because the borrowing is not related to the operation of X's trade or business, the borrowing may qualify as an integrated financial transaction if the other requirements of paragraph (c)(2) of this section are satisfied.

(d) *Special rules.* In applying paragraphs (b) and (c) of this section, the following special rules shall apply.

(1) *Related person transactions.* The rules of this section shall not apply to the extent that any transaction—

(i) Involves either indebtedness between related persons (as defined in section § 1.861–8T(c)(2)) or indebtedness incurred from unrelated persons for the purpose of purchasing property from a related person; or

(ii) Involves the purchase of property that is leased to a related person (as defined in § 1.861–8T(c)(2)) in a transaction described in paragraph (b) of this section. If a taxpayer purchases property and leases such property in whole or in part to a related person, a portion of the interest incurred in connection with such an acquisition, based on the ratio that the value of the property leased to the related person bears to the total value of the property, shall not qualify for direct allocation under this section.

(2) *Consideration of assets or income to which interest is directly allocated in apportioning other interest expense.* In apportioning interest expense under § 1.861–9T, the year-end value of any asset to which interest expense is directly allocated under this section during the current taxable year shall be reduced to the extent provided in § 1.861–9T(g)(2)(iii) to reflect the portion of the principal amount of the indebtedness outstanding at year-end relating to the interest which is directly allocated. A similar adjustment shall be made to the end-of-year value of assets for the prior year for purposes of determining the beginning-of-year value of assets for the current year. These adjustments shall be made prior to averaging beginning-of-year and end-of-year values pursuant to § 1.861–9T(g)(2). In apportioning interest expense under the modified gross income method, gross income shall be reduced by the amount of income to which interest expense is directly allocated under this section.

(e) *Treatment of certain related controlled foreign corporation indebtedness*—(1) *In general.* In taxable years beginning after 1987, if a United States shareholder has incurred substantially disproportionate indebtedness in relation to the indebtedness of its related controlled foreign corporations so that such corporations have excess related person indebtedness (as determined under step 4 in subdivision (iv) of this paragraph (e)(1), the third party interest expense of the related United States shareholder (excluding amounts allocated under paragraphs (b) and (c)) in an amount equal to the interest income received on such excess related person indebtedness shall be allocated to gross income in the various separate limitation categories described in section 904(d)(1) in the manner prescribed in step 6 in subdivision (vi) of this paragraph (e)(1). This computation shall be performed as follows.

(i) *Step 1: Compute the debt-to-asset ratio of the related United States shareholder.* The debt-to-asset ratio of the related United States shareholder is the ratio between—

(A) The average month-end debt level of the related United States shareholder taking into account debt owing to any obligee who is not a related person as defined in section § 1.861–8T(c)(2), and

(B) The value of assets (tax book or fair market) of the related United States shareholder including stockholdings and obligations of related controlled foreign corporations but excluding stockholdings and obligations of members of the affiliated group (as defined in § 1.861–11T(d)).

(ii) *Step 2: Compute aggregate debt-to-asset ratio of all related controlled foreign corporations.* The aggregate debt-to-asset ratio of all related controlled foreign corporations is the ratio between—

(A) The average aggregate month-end debt level of all related controlled foreign corporations for their taxable years ending during the related United States shareholder's taxable year taking into account only indebtedness owing to persons other than the related United States shareholder or the related United States shareholder's other related controlled foreign corporations ("third party indebtedness"), and

(B) The aggregate value (tax book or fair market) of the assets of all related controlled foreign corporations for their taxable years ending during the related United States shareholder's taxable year excluding stockholdings in and obligations of the related United States shareholder or the related United States shareholder's other related controlled foreign corporations.

(iii) *Step 3: Compute aggregate related person debt of all related controlled foreign corporations.* This amount equals the average aggregate month-end debt level of all related controlled foreign corporations for their taxable years ending with or within the related United States shareholder's taxable year, taking into account only debt which is owned to the related United States shareholder ("related person indebtedness").

(iv) *Step 4: Computation of excess related person indebtedness and computation of the income therefrom*—(A) *General rule.* If the ratio computed under step 2 is less than applicable percentage of the ratio computed under step 1, the taxpayer shall add to the aggregate third party indebtedness of all related controlled foreign corporations determined under paragraph (e)(1)(ii)(A) of this section that portion of the related person indebtedness computed under step 3 that, when combined with the aggregate third party indebtedness of all controlled foreign corporations, makes the ratio computed under step 2 equal to applicable percentage of the ratio computed under step 1. The amount of aggregate related person debt that is so added to the aggregate third party debt of related controlled foreign corporations is considered to constitute excess related person indebtedness. For purposes of this paragraph (e)(1)(iv)(A), the term "applicable percentage" means the designated percentages for taxable years beginning during the following calendar years:

Taxable years beginning in	Applicable percentage
1988	50
1989	65
1990 and thereafter	80

(B) *Elective quadratic formula.* In calculating the amount of excess related party indebtedness of related controlled foreign corporations, the United States shareholder's debt-to-asset ratio may be adjusted to reflect the amount by which its debt and assets would be reduced had the related controlled foreign corporations incurred the excess related party indebtedness directly to third parties. In such case, the ratio computed in Step 1 is adjusted to reflect a reduction of both portions of the ratio by the amount of excess related person indebtedness as computed under this paragraph (e)(1)(ii)(A). Excess related person indebtedness may be computed under the following formula, under which excess related person indebtedness equals the smallest positive amount (not exceeding the aggregate amount of related controlled foreign corporation indebtedness) that is a solution to the following formula (with X equalling the amount of excess related person indebtedness):

$$\frac{\text{Aggregate third party debt of related US shareholder} - X}{\text{US shareholder assets} - X} \times \text{Applicable percentage for year} = \frac{\text{Aggregate third party debt of related CFCs} + X}{\text{Related CFC assets}}$$

Guidance concerning the solution of this equation is set forth in *Example* (2) of § 1.861-12(k).

(C) *Computation of interest income received on excess related party indebtedness.* The amount of interest income received on excess related person indebtedness equals the total interest income on related person indebtedness derived by the related United States shareholder during the taxable year multiplied by the ratio of excess related person indebtedness over the aggregate related person indebtedness for the taxable year.

(v) *Step 5: Determine the aggregate amount of related controlled foreign corporation obligations held by the related United States shareholder in each limitation category.* The aggregate amount of related controlled foreign corporation obligations held by the related United States shareholder in each limitation category equals the sum of the value of all such obligations in each limitation category. Solely for purposes of this paragraph (e)(1)(v), each debt obligation in a related controlled foreign corporation held by a related United States shareholder shall be attributed to separate limitation categories in the same manner as the stock of the obligor would be attributed under the rules of § 1.861-12T(c)(3), whether or nor such stock is held directly by such related United States shareholder.

(vi) *6: Direct allocation of United States shareholder third party interest expense.* Third party interest expense of the related United States shareholder equal to the amount of interest income received on excess related person indebtedness as determined in step 4 shall be allocated among the various separate limitation categories in proportion to the relative aggregate amount of related controlled foreign corporation obligations held by the related United States shareholder in each such category, as determined under step 5. The remaining portion of third party interest expense will be apportioned as provided in §§ 1.861-8T through 1.861-13T, excluding this paragraph.

(2) *Definitions*—(i) *United States shareholder.* For purposes of this paragraph, the term "United States shareholder" has the same meaning as defined by section 957, except that, in the case of a United States shareholder that is a member an affiliated group (as defined in § 1.861-11T(d)), the entire affiliated group shall be considered to constitute a single United States shareholder. The term "related United States shareholder" is the United States shareholder (as defined in this paragraph (e)(2)(i)) with respect to which related controlled foreign corporations (as defined in paragraph (e)(2)(ii) of this section) are related within the meaning of that paragraph.

(ii) *Related controlled foreign corporation.* For purposes of this section, the term "related controlled foreign corporation" means any controlled foreign corporation which is a related person (as defined in § 1.861-8T(c)(2)) to a United States shareholder (as defined paragraph (e)(2)(i) of this section).

(iii) *Value of assets and amount of liabilities.* For purposes of this section, the value of assets is determined under § 1.861-9T(g). Thus, in the case of assets that are denominated in foreign currency, the average of the beginning-of-year and end-of-year values is determined in foreign currency and translated into dollars using exchange rates on the last day of the related United States shareholder's taxable year. In the case of liabilities that are denominated in foreign currency, the average month-end debt level of such liabilities is determined in foreign currency and then translated into dollars using exchange rates on the last day of the related United States shareholder's taxable year.

(3) *Treatment of certain stock.* To the extent that there is insufficient related person indebtedness of all related controlled foreign corporations under step 3 in paragraph (e)(1)(iii) of this section to achieve as equal ratio in step 4 of paragraph (e)(1)(iv) of this section, certain stock held by the related United States shareholder will be treated as related person indebtedness. Such stock includes—

(i) Any stock in the related controlled foreign corporation that is treated in the same manner as debt under the law of any foreign country that grants a deduction for interest or original issue discount relating to such stock, and

(ii) Any stock in a related controlled foreign corporation that has made loans to, or held stock described in this paragraph (e)(3) in, another related controlled foreign corporation. However, such stock shall be treated as related person indebtedness only to the extent of the principal amount of such loans.

For purposes of computing income from excess related person indebtedness in step 4 of paragraph (e)(1)(iv) of this section, stock that is treated under this paragraph as related person indebtedness shall be considered to yield interest in an amount equal to the interest that would be computed on an equal amount of indebtedness under section 1274. Only dividends actually paid thereon shall be included in gross income for other purposes.

(4) *Adjustments to assets in apportioning other interest expense.* In apportioning interest expense under § 1.861-9T, the value of assets in each separate limitation category for the taxable year as determined under § 1.861-9T(g)(3) shall be reduced (but not below zero) by the principal amount of third party indebtedness of the related United States shareholder the interest expense on which is allocated to each such category under paragraph (e)(1) of this section.

(5) *Exceptions*—(i) *Per company rule.* If—

(A) A related controlled foreign corporation with obligations owing to a related United States shareholder has a greater proportion of passive assets than the proportion of passive assets held by the related United States shareholder,

(B) Such passive assets are held in liquid or short term investments, and

(C) There are frequent cash transfers between the related controlled foreign corporation and the related United States shareholder,

the Commissioner, in his discretion, may choose to exclude such a corporation from other related controlled foreign corporations in the application of the rules of this paragraph (e).

(ii) *Aggregate rule.* If it is determined that, in aggregate, the application of the rules of this paragraph (e) increases a taxpayer's foreign tax credit as determined under section 901(a), the Commissioner, in his discretion, may choose not to apply the rules of this paragraph. If the Commissioner exercises discretion under this paragraph (e)(5)(ii), then paragraph (e) shall not apply to any extent to any interest expense of the taxpayer.

§ 1.861-11T Special rules for allocating and apportioning interest expense of an affiliated group of corporations (Temporary regulations.)

(a) *In general.* Sections 1.861-9T, 1.861-10T, 1.861-12T, and 1.861-13T provide rules that are generally applicable in apportioning interest expense. The rules of this section relate to affiliated groups of corporations and implement section 864(e) (1) and (5), which requires affiliated group allocation and apportionment of interest expense. The rules of this section apply to taxable years beginning after December 31, 1986, except as otherwise provided in § 1.861-13T. Paragraph (b) of this section describes the scope of the application of the rule for the allocation and apportionment of interest expense of affiliated groups of corporations, which is contained in paragraph (c) of this section. Paragraph (d) of this section sets forth the definition of the term "affiliated group" for purposes of this section. Paragraph (e) describes the treatment of loans between members of an affiliated group. Paragraph (f) of this section provides rules concerning the affiliated group allocation and apportionment of interest expense in computing the combined taxable income of a FSC or DISC and its related supplier. Paragraph (g) of this section describes the treatment of losses caused by apportionment of interest expense in the case of an affiliated group that does not file a consolidated return.

(b) *Scope of application*—(1) *Application of section 864(e) (1) and (5) (concerning the definition and treatment of affiliated groups).* Section 864(e) (1) and (5) and the portions of this section implementing section 864(e) (1) and (5) apply to the computation of foreign source taxable income for purposes of section 904 (relating to various limitations on the foreign tax credit). Section 904 imposes separate foreign tax credit limitations on passive income, high withholding interest income, financial services income, shipping income, income consisting of dividends from each noncontrolled section 902 corporation, income consisting of dividends from a DISC or former DISC, taxable income attributable to foreign trade income within the meaning of section 923(b), distributions from a FSC or former FSC, and all other forms of foreign source income not enumerated above ("general limitation income"). Section 864(e) (1) and (5) and the portions of this section implementing section 864(e) (1) and (5) also apply in connection with section 907 to determine reductions in the amount allowed as a foreign tax credit under section 901. Section 864(e) (1) and (5) and the portions of this section implementing section 864(e) (1) and (5) also apply to the computation of the combined taxable income of the related supplier and a foreign sales corporation (FSC) (under sections 921 through 927) as well as the combined taxable income of the related supplier and a domestic international sales corporation (DISC) (under sections 991 through 997).

(2) *Nonapplication of section 864(e) (1) and (5) (concerning the definition and treatment of affiliated groups).* Section 864(e) (1) and (5) and the portions of this section implementing section 864(e) (1) and (5) do not apply to the computation of subpart F income of controlled foreign corporations (under sections 951 through 964), the computation of combined taxable income of a possessions corporation and its affiliates (under section 936), or the computation of effectively connected taxable income of foreign corporations. For the rules with respect to the allocation and apportionment of interest expenses of foreign corporations other than controlled foreign corporations, see §§ 1.882-4 and 1.882-5.

(c) *General rule for affiliated corporations.* Except as otherwise provided in this section, the taxable income of each member of an affiliated group within each statutory grouping shall be determined by allocating and apportioning the interest expense of each member according to apportionment fractions which are computed as if all members of such group were a single corporation. For purposes of determining these apportionment fractions, stock in corporations within the affiliated group (as defined in section 864(e)(5) and the rules of this section) shall not be taken into account. In the case of an affiliated group of corporations that files a consolidated return, consolidated foreign tax credit limitations are computed for the group in accordance with the rules of § 1.1502-4. Except as otherwise provided, all the interest expense of all members of the group will be treated as definitely related and therefore allocable to all the gross income of the members of the group and all the assets of all the members of the group shall be taken into account in apportioning this interest expense. For purposes of this section, the term "taxpayer" refers to the affiliated group (regardless of whether the group files a consolidated return), rather than to the separate members thereof.

(d) *Definition of affiliated group*—(1) *General rule.* For purposes of the section, in general, the term "affiliated group" has the same meaning as is given that term by section 1504, except that section 936 companies are also included within the affiliated group. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through 80-percent stock ownership with a common parent corporation which is an includible corporation (as defined in section 1504(b)). In the case of a corporation that either becomes or ceases to be a member of the group during the course of the corporation's taxable year, only the interest expense incurred by the group member during the period of membership shall be allocated and apportioned as if all members of the group were a single corporation. In this regard, assets held during the period of membership shall be taken into account. Other interest expense incurred by the group member during its taxable year but not during the period of membership shall be allocated and apportioned without regard to other members of the group.

(2) *Inclusion of section 936 corporations*—(i) The exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) is inoperative for purposes of this section. Thus, a possessions corporation meeting the ownership requirements of section 1504(a) with respect to which an election under section 936 is in effect for the taxable year is a member of the affiliated group.

(ii) *Example*—(A) *Facts.* X is the common parent of Y and Z. XY constitutes an affiliated group of corporations within the meaning of section 1504(a) and uses the tax book value method of apportionment. Y owns all the stock of Z, a possessions corporation with respect to which an election under section 936 is in effect for the taxable year. Z manufactures widgets in Puerto Rico. Y purchases these widgets and markets them exclusively in the United States. Of the three corporations, only Z has foreign source income, which includes both qualified possessions source investment income and general limitation income. For purposes of section 904, Z's qualified possessions source investment income constitutes foreign source passive income. In computing the section 936 benefit, Y and Z have elected the cost sharing method. Of the three corporations, only X has debt and, thus, only X incurs interest expense.

(B) *Analysis.* As provided in paragraph (b)(2) of this section, sections 864(e)(1) and

(5) do not apply in the computation of benefits under section 936(h). The effect of including Z in the affiliated group relates to the fact that X, the only debtor corporation in the group, must, under the asset method described in § 1.861-9T(g), apportion a part of its interest expense to foreign source passive income and foreign source general limitation income. This is because the assets of Z that generate qualified possessions source investment income and general limitation income are included in computing the group apportionment fractions. The result is that, under section 904(f), X has an overall foreign loss in both the passive and general limitation categories, which currently offsets domestic income and must be recaptured against any subsequent years' foreign passive income and general limitation income, respectively, under the rules of that section.

(3) *Treatment of life insurance companies subject to taxation under section 801*—(i) *General rule.* A life insurance company that is subject to taxation under section 801 shall be considered to constitute a member of the affiliated group composed of companies not taxable under section 801 only if a parent corporation so elects under section 1504(c)(2)(A) of the Code. If a parent does not so elect, no adjustments shall be required with respect to such an insurance company under paragraph (g) of this section.

(ii) *Treatment of stock.* Stock of a life insurance company that is subject to taxation under section 801 that is not included in an affiliated group shall be disregarded in the allocation and apportionment of the interest expense of such affiliated group.

(4) *Treatment of certain financial corporations*—(i) *In general.* In the case of an affiliated group (as defined in paragraph (d)(1) of this section), any member that constitutes financial corporations as defined in paragraph (d)(4)(ii) of this section shall be treated as a separate affiliated group consisting of financial corporations (the "financial group"). The members of the group that do not constitute financial corporations shall be treated as members of a separate affiliated group consisting of nonfinancial corporations ("the nonfinancial group").

(ii) *Financial corporation defined.* The term "financial corporation" means any corporation which meets all of the following conditions:

(A) It is described in section 581 (relating to the definition of a bank) or section 591 (relating to the deduction for dividends paid on deposits by mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations);

(B) Its business is predominantly with persons other than related persons (within the meaning of section 864(d)(4) and the regulations thereunder) or their customers; and

(C) It is required by state or Federal law to be operated separately from any other entity which is not such an institution.

(iii) *Treatment of bank holding companies.* The total aggregate interest expense of any member of an affiliated group that constitutes a bank holding company subject to regulation under the Bank Holding Company Act of 1956 shall be prorated between the financial group and the nonfinancial group on the basis of the assets in the financial and nonfinancial groups. For purposes of making this proration, the assets of each member of each group, and not the stock basis in each member, shall be taken into account. Any direct or indirect subsidiary of a bank holding company that is predominantly engaged in the active conduct of a banking, financing, or similar business shall be considered to be a financial corporation for purposes of this paragraph (d)(4). The interest expense of the bank holding company must be further apportioned in accordance with § 1.861-9T(f) to the various section 904(d) categories of income contained in both the financial group and the nonfinancial group on the basis of the assets owned by each group. For purposes of computing the apportionment fractions for each group, the assets owned directly by a bank holding company within each limitation category described in section 904(d)(1) (other than stock in affiliates or assets described in § 1.861-9T(f)) shall be treated as owned pro rata by the nonfinancial group and the financial group based on the relative amounts of investments of the bank holding company in the nonfinancial group and financial group.

(iv) *Consideration of stock of the members of one group held by members of the other group.* In apportioning interest expense, the nonfinancial group shall not take into account the stock of any lower-tier corporation that is treated as a member of the financial group under paragraph (d)(4)(i) of this section. Conversely, in apportioning interest expense, the financial group shall not take into account the stock of any lower-tier corporation that is treated as a member of the nonfinancial group under paragraph (d)(4)(i) of this section. For the treatment of loans between members of the financial group and members of the nonfinancial group, see paragraph (e)(1) of this section.

(5) *Example*—(i) *Facts.* X, a domestic corporation which is not a bank holding company, is the parent of domestic corporations Y and Z. Z owns 100 percent of the stock Z1, which is also a domestic corporation. X, Y, Z, and Z1 were organized after January 1, 1987, and constitute an affiliated group within the meaning of paragraph (d)(1) of this section. Y and Z are financial corporations described in paragraph (d)(4) of this section. X also owns 25 percent of the stock of A, a domestic corporation. Y owns 25 percent of the voting stock of B, a foreign corporation that is not a controlled foreign corporation. Z owns less than 10 percent of the voting stock of C, another foreign corporation. The foreign source income generated by Y's or Z's direct assets is exclusively financial services income. The foreign source income generated by X's or Z1's direct assets is exclusively general limitation income. X and Z1 are not financial corporations described in paragraph (d)(4)(ii) of this section. Y and Z, therefore, constitute a separate affiliated group apart from X and Z1 for purposes of section 864(e). The combined interest expense of Y and Z of $100,000 ($50,000 each) is apportioned separately on the basis of their assets. The combined interest expense of X and Z1 of $50,000 ($25,000 each) is allocated on the basis of the assets of the XZ1 group.

Analysis of the YZ group assets

Adjusted basis of assets of the YZ group that generate foreign source financial services income (excluding stock of foreign subsidiaries not included in the YZ affiliated group)	$200,000
Z's basis in the C stock (not adjusted by the allocable amount of C's earnings and profits because Z owns less than 10 percent of the stock) which would be considered to generate passive income in the hands of a nonfinancial services entity but is considered to generate financial services income when in the hands of Z, a financial services entity	$100,000
Y's basis in the B stock (adjusted by the allocable amount of B's earnings and profits) which generates dividends subject to a separate limitation for B dividends	$100,000
Adjusted basis of assets of the YZ group that generate U.S. source income	$600,000
Total assets	$1,000,000

Analysis of the XZ1 group assets

Adjusted basis of assets of the XZ1 group that generate foreign source general limitation income	$500,000
Adjusted basis of assets of the XZ1 group other than A stock that generate domestic source income	$1,900,000

X's basis in the A stock adjusted by the allocable amount of A's earnings and profits	$100,000
Total domestic assets	$2,000,000
Total assets	$2,500,000

(ii) *Allocation.* No portion of the $50,000 deduction of the YZ group is definitely related solely to specific property within the meaning of § 1.861-10T. Thus, the YZ group's deduction for interest is related to all its activities and properties. Similarly, no portion of the $50,000 deduction of the XZ1 group is definitely related solely to specific property within the meaning of § 1.861-10T. Thus, the XZ1 group's deduction for interest is related to all its activities and properties.

(iii) *Apportionment.* The YZ group would apportion its interest expense as follows:

To gross financial services income from sources outside the United States:

$$\$50{,}000 \times \frac{\$300{,}000}{\$1{,}000{,}000} \ldots\ldots \$15{,}000$$

To gross income subject to a separate limitation for dividends from B:

$$\$50{,}000 \times \frac{\$100{,}000}{\$1{,}000{,}000} \ldots\ldots \$5{,}000$$

To gross income from sources inside the United States:

$$\$50{,}000 \times \frac{\$600{,}000}{\$1{,}000{,}000} \ldots\ldots \$30{,}000$$

The XZ1 group would apportion its interest expense as follows:

To gross general limitation income from sources outside the United States:

$$\$50{,}000 \times \frac{\$500{,}000}{\$2{,}500{,}000} \ldots\ldots \$10{,}000$$

To gross income from sources inside the United States:

$$\$50{,}000 \times \frac{\$2{,}000{,}000}{\$2{,}500{,}000} \ldots\ldots \$40{,}000$$

(6) *Certain unaffiliated corporations.* Certain corporations that are not described in paragraph (d)(1) of this section will nonetheless be considered to constitute affiliated corporations for purposes of §§ 1.861–9T through 1.861–13T. These corporations include:

(i) Any includible corporation (as defined in section 1504(b) without regard to section 1504(b)(4)) if 80 percent of either the vote or value of all outstanding stock of such corporation is owned directly or indirectly by an includible corporation or by members of an affiliated group, and

(ii) Any foreign corporation if 80 percent of either the vote or value of all outstanding stock of such corporation is owned directly or indirectly by members of an affiliated group, and if more than 50 percent of the gross income of such corporation for the taxable year is effectively connected with the conduct of a United States trade or business. If 80 percent or more of the gross income of such corporation is effectively connected income, then all the assets of such corporation and all of its interest expense shall be taken into account. If between 50 and 80 percent of the gross income of such corporation is effectively connected income, then only the assets of such corporation that generate effectively connected income and a percentage of its interest expense equal to the percentage of its assets that generate effectively connected income shall be taken into account.

The attribution rules of section 318 shall apply in determining indirect ownership under this paragraph (d)(6). The Commissioner shall have the authority to disregard trusts, partnerships, and pass-through entities that break affiliated status. Corporations described in this paragraph (d)(6) shall be considered to constitute members of an affiliated group that does not file a consolidated return and shall therefore be subject to the limitations imposed under paragraph (g) of this section. The affiliated group filing a consolidated return shall be considered to constitute a single corporation for purposes of applying the rules of paragraph (g) of this section.

(e) *Loans between members of an affiliated group*—(1) *General rule.* In the case of loans (including any receivable) between members of an affiliated group, as defined in paragraph (d) of this section, for purposes of apportioning interest expense, the indebtedness of the member borrower shall not be considered an asset of the member lender. However, in the case of members of separate financial and nonfinancial groups under paragraph (d)(4) of this section, the indebtedness of the member borrower shall be considered an asset of the member lender and such asset shall be characterized by reference to the member lender's income from the asset as determined under paragraph (e)(2)(ii) of this section. For purposes of this paragraph (e), the terms "related person interest income" and "related person interest payment" refer to interest paid and received by members of the same affiliated group as defined in paragraph (d) of this section.

(2) *Treatment of interest expense within the affiliated group*—(i) *General rule.* A member borrower shall deduct related person interest payments in the same manner as unrelated person interest expense using group apportionment fractions computed under § 1.861–9T(f). A member lender shall include related person interest income in the same class of gross income as the class of gross income from which the member borrower deducts the related person interest payment.

(ii) *Special rule for loans between financial and nonfinancial affiliated corporations.* In the case of a loan between two affiliated corporations only one of which constitutes a financial corporation under paragraph (d)(4) of this section, the member borrower shall allocate and apportion related person interest payments in the same manner as unrelated person interest expense using group apportionment fractions computed under § 1.861–9T(f). The source of the related person interest income to the member lender shall be determined under section 861(a)(1).

(iii) *Special rule for high withholding tax interest.* In the case of an affiliated corporation that pays interest that is high withholding tax interest under § 1.904–5(f)(1) to another affiliated corporation, the interest expense of the payor shall be allocated to high withholding tax interest.

(3) *Back-to-back loans.* If a member of the affiliated group makes a loan to a nonmember who makes a loan to a member borrower, the rule of paragraphs (e) (1) and (2) of this section shall apply, in the Commissioner's discretion, as if the member lender made the loan directly to the member borrower, provided that the loans constitute a back-to-back loan transaction. Such loans will constitute a back-to-back loan for purposes of this paragraph (e) if the loan by the nonmember would not have been made or maintained on substantially the same terms irrespective of the loan of funds by the lending member to the nonmember or other intermediary party.

(4) *Examples.* The rules of this paragraph (e) may be illustrated by the following examples.

Example (1). X, a domestic corporation, is the parent of Y, a domestic corporation. X and Y were organized after January 1, 1987, and constitute an affiliated group within the meaning of paragraph (d)(1) of this section. Among X's assets is the note of Y for the amount of $100,000. Because X and Y are members of an affiliated group, Y's note does not constitute an asset for purposes of apportionment. The apportionment fractions for the relevant tax year of the XY group are 50 percent domestic, 40 percent foreign general, and 10 percent foreign passive. Y deducts its related person interest payment using those apportionment fractions. Of the $10,000 in related person interest income received by X, $5,000 consists of domestic source income, $4,000 consists of foreign general limitation income, and $1,000 consists of foreign passive income.

Example (2). X is a domestic corporation organized after January 1, 1987. X owns all the stock of Y, a domestic corporaiton. On June 1, 1987, X loans $100,000 to Z, an unrelated person. On June 2, 1987, Z makes a loan to Y with terms substantially similar to those of the loan from X to Z. Based on the facts and circumstances of the transaction, it is determined that Z would not have made the loan to Y on the same terms if X had not made the loan to Z. Because the transaction constitutes a back-to-back loan, as defined in paragraph (e)(3) of this section, the Commissioner may require, in his discretion, that neither the note of Y nor the note of Z may be considered an asset of X for purposes of this section.

(f) *Computations of combined taxable income.* In the computation of the combined taxable income of any FSC or DISC and its related supplier which is a member of an affiliated group under the pricing rules of sections 925 or 994, the combined taxable income of such FSC or DISC and its related supplier shall be reduced by the portion of the total interest expense of the affiliated group that is incurred in connection with those assets of the group used in connection with export sales involving that FSC or DISC. This amount shall be computed by multiplying the total interest expense of the affiliated group and interest expense of the FSC or DISC by a fraction the numerator of which is the assets of the affiliated group and of the FSC or DISC generating foreign trade income or gross income attributable to qualified export receipts, as the case may be, and the denominator of which is the total assets of the affiliated group and the FSC or DISC. Under this rule, interest of other group members may be attributed to the combined taxable income of a FSC or DISC and its related supplier without affecting the amount of interest otherwise deductible by the FSC or DISC, the related supplier or other member of the affiliated group. The FSC or DISC is entitled to only the statutory portion of the combined taxable income, net of any deemed interest expense, which determines the commission paid to the FSC or DISC or the transfer price of qualifying export property sold to the FSC or DISC.

(g) *Losses created through apportionment*—(1) *General rules.* In the case of an affiliated group that is eligible to file, but does not file, a consolidated return and in the case of any corporation described in paragraph (d)(6) of this section, the foreign tax credits in any separate limitation category are limited to the credits computed under the rules of this paragraph (g). As a consequence of the affiliated group allocation and apportionment of interest expense required by section 864(e)(1) and this section, interest expense of a group member may be apportioned for section 904 purposes to a limitation category in which that member has no gross income, resulting in a loss in that limitation category. The same is true in connection with any expense other than interest that is subject to apportionment under the rules of section 864(e)(6) of the Code. Any reference to "interest expense" in this paragraph (g) shall be treated as including such expenses. For purposes of this paragraph, the term "limitation category" includes domestic source income, as well as the types of income described in section 904(d)(1) (A) through (I). A loss of one affiliate in a limitation category will reduce the income of another member in the same limitation category if a consolidated return is filed. (See § 1.1502–4.) If a consolidated return is not filed, this netting does not occur. Accordingly, in such a case, the following adjustments among members are required in order to give effect to the group allocation of interest expense:

(i) Losses created through group apportionment of interest expense in one or more limitation categories within a given member must be eliminated; and

(ii) A corresponding amount of income of other members in the same limitation category must be recharacterized.

Such adjustments shall be accomplished, in accordance with paragraph (g)(2) of this section, without changing the total taxable income of any member and before the application of section 904(f). Section 904(f) (including section 904(f)(5)) does not apply to a loss created through the apportionment of interest expense to the extent that the loss is eliminated pursuant to paragraph (g)(2)(ii) of this section. For purposes of this section, the terms "limitation adjustment" and "recharacterization" mean the recharacterization of income in one limitation category as income in another limitation category.

(2) *Mechanics of computation*—(i) *Step 1: Computation of consolidated taxable income.* The members of an affiliated group must first allocate and apportion all other deductible expenses other than interest. The members must then deduct from their respective gross incomes within each limitation category interest expense apportioned under the rules of § 1.861–9T(f). The taxable income of the entire affiliated group within each limitation category is then totalled.

(ii) *Step 2: Loss offset adjustments.* If, after step 1, a member has losses in a given limitation category or limitation categories created through apportionment of interest expense, any such loss (*i.e.*, the portion of such loss equal to interest expense) shall be eliminated by offsetting that loss against taxable income in other limitation categories of that member to the extent of the taxable income of other members within the same limitation category as the loss. If the member has taxable income in more than one limitation category, then the loss shall offset taxable income in all such limitation categories on a pro rata basis. If there is insufficient domestic income of the member to offset the net losses in all foreign limitation categories caused by the apportionment of interest expense, the losses in each limitation category shall be recharacterized as domestic losses to the extent of the taxable income of other members in the same respective limitation categories. After these adjustments are made, the income of the entire affiliated group within each limitation category is totalled again.

(iii) *Step 3: Determination of amount subject to recharacterization.* In order to determine the amount of income to be recharacterized in step 4, the income totals computed under step 1 in each limitation category shall be subtracted from the income totals computed under step 2 in each limitation category.

(iv) *Step 4: Recharacterization.* Because any differences determined under step 3 represent deviations from the consolidated totals computed under Step 1, such differences (in any limitation category) must be eliminated.

(A) *Limitation categories to be reduced.* In the case of any limitation category in which there is a positive change, the income of group members with income in that limitation category must be reduced on a pro rata basis (by reference to net income figures as determined under Step 2) to the extent of such positive change ("limitation reductions"). Each member shall separately compute the sum of the limitation reductions.

(B) *Limitation categories to be increased.* In any case in which only one limitation category has a negative change in Step 3, the sum of the limitation reductions within each member is added to that limitation category. In the case in which multiple limitation categories have negative changes in Step 3, the sum of the limitation reductions within each member is prorated among the negative change limitation categories based on the ratio that the negative change for the entire group in each limitation category bears to the total of all negative changes for the entire group in all limitation categories.

(3) *Examples.* The following examples illustrate the principles of this paragraph.

Example (1)—(i) *Facts.* X, a domestic corporation, is the parent of domestic corporations Y and Z. X, Y, and Z were organized after Janaury 1, 1987, constitute an affiliated group within the meaning of paragraph (d)(1) of this section, but do not file a consolidated return. The XYZ group apportions its interest expense on the basis of the fair market value of its assets. X, Y, and Z have the following assets, interest expense, and taxable income before apportioning interest expense:

Assets	X	Y	Z	Total
Domestic	2,000.00	0	1,000.00	3,000.00
Foreign Passive	0	50.00	50.00	100.00
Foreign General	0	700.00	200.00	900.00
Interest expense	48.00	12.00	80.00	140.00
Taxable income (pre-interest):				
Domestic	100.00	0	63.00	163.00
Foreign Passive	0	5.00	5.00	10.00
Foreign General	0	60.00	35.00	95.00

(ii) *Step 1: Computation of consolidated taxable income.* Each member of the XYZ group apportions its interest expense according to group apportionment ratios determined under the asset method decribed in § 1.861–9T(f), yielding the following results:

Apportioned interest expense	X	Y	Z	Total
Domestic	36.00	9.00	60.00	105.00
Foreign Passive	1.20	0.30	2.00	3.50
Foreign General	10.80	2.70	18.00	31.50
Total	48.00	12.00	80.00	140.00

The members of the group then compute taxable income within each category by deducting the apportioned interest expense from the amounts of pre-interest taxable income specified in the facts in paragraph (i), yielding the following results:

Taxable income	X	Y	Z	Total
Domestic	64.00	−9.00	3.00	58.00
Foreign Passive	−1.20	4.70	3.00	6.50
Foreign General	−10.80	57.30	17.00	63.50
Total	52.00	53.00	23.00	128.00

(iii) *Step 2: Loss offset adjustments.* Because X and Y have losses created through apportionment, these losses must be eliminated by reducing taxable income of the member in other limitation categories. Because X has a total of $12 in apportionment losses and because it has only one limitation category with income (*i.e.,* domestic), domestic income must be reduced by $12, thus eliminating its apportionment losses. Because Y has a total of $9 in apportionment losses and because it has two limitation categories with income (*i.e.,* foreign passive and foreign general limitation), the income in these two limitation categories must be reduced on a pro rata basis in order to eliminate its apportionment losses. In summary, the following adjustments are required:

Loss offset adjustments	X	Y	Z	Total
Domestic	−12.00	+9.00	0	−3.00
Foreign Passive	+1.20	−0.68	0	+0.52
Foreign General	+10.80	−8.32	0	+2.48

These adjustments yield the following adjusted taxable income figures:

Adjusted taxable income	X	Y	Z	Total
Domestic	52.00	0	3.00	55.00
Foreign Passive	0	4.02	3.00	7.02
Foreign General	0	48.98	17.00	65.98
Total	52.00	53.00	23.00	128.00

(iv) *Step 3: Determination of amount subject to recharacterization.* The adjustments performed under Step 2 led to a change in the group's taxable income within each limitation category. The total loss offset adjustments column shown in paragraph (iii) above shows the net deviations between Step 1 and 2.

(v) *Step 4: Recharacterization.* The loss offset adjustments yield a positive change in the foreign passive and the foreign general limitation categories. Y and Z both have income in these limitation categories. Accordingly, the income of Y and Z in each of these limitation categories must be reduced on a pro rata basis (by reference to the adjusted taxable income figures) to the extent of the positive change in each limitation category. The total positive change in the foreign passive limitation category is $0.52. The adjusted taxable income of Y in the foreign passive limitation category is $4.02 and the adjusted taxable income of Z in the foreign passive limitation category is $3. Therefore, $0.30 is drawn from Y and $0.22 is drawn from Z. The total positive change in the foreign general limitation category is $2.48. The adjusted taxable income of Y in the foreign general limitation category is $48.98, and the adjusted tabable income of Z in the foreign general limitation category is $17. Therefore, $1.84 is drawn from Y and $.64 is drawn from Z.

The members must then separately compute the sum of the limitation reductions. Y has limitation reductions of $0.30 in the foreign passive limitation category and $1.84 in the foreign general limitation category, yielding total limitation reduction of $2.14. Under these facts, domestic income is the only limitation category requiring a positive adjustment. Accordingly, Y's domestic income is increased by $2.14. Z has limitation reductions of $0.22 in the foreign passive limitation category and $0.64 in the foreign general limitation category, yielding total limitation reductions of $0.86. Under these facts, domestic income is the only limitation category of Z requiring a positive adjustment. Accordingly, Z's domestic income is increased by $0.86.

Recharacterization adjustments	X	Y	Z	Total
Domestic	0	+2.14	+0.86	+3.00
Foreign Passive	0	−0.30	−0.22	−0.52
Foreign General	0	−1.84	−0.64	−2.48

These recharacterization adjustments yield the following final taxable income figures:

Final taxable income	X	Y	Z	Total
Domestic	52.00	2.14	3.86	58.00
Foreign Passive	0	3.72	2.78	6.50
Foreign General	0	47.14	16.36	63.50
Total	52.00	53.00	23.00	128.00

Example (2)—(i) *Facts.* X, a domestic corporation, is the parent of domestic corporations Y and Z. X, Y, and Z were organized after January 1, 1987, constitute an affiliated group within the meaning of paragraph (d)(1) of this section, but do not file a consolidated return. Moreover, X has served as the sole borrower in the group and, as a result, has sustained an overall loss. The XYZ group apportions its interest expense on the basis of the fair market value of its assets. X, Y, and Z have the following assets, interest expense, and taxable income before interest expense:

Assets	X	Y	Z	Total
Domestic	2,000	0	1,000	3,000
Foreign Passive	0	50	50	100
Foreign General	0	700	200	900
Interest Expense	140	0	0	140
Taxable Income (pre-interest):				
Domestic	100	0	100	200
Foreign Passive	0	5	5	10
Foreign General	0	70	35	105

(ii) *Step 1: Computation of consolidated taxable income.* Each member of the XYZ group apportions its interest expense according to group apportionment ratios determined under the asset method described in § 1.861–9T(g), yielding the following results:

Apportioned interest expense	X	Y	Z	Total
Domestic	105.00	0	0	105.00
Foreign Passive	3.50	0	0	3.50
Foreign General	31.50	0	0	31.50
Total	140.00	0	0	140.00

The members of the group then compute taxable income within each category by deducting the apportioned interest expense from the amounts of pre-interest taxable income specified in the facts in paragraph (i), yielding the following results:

Taxable income	X	Y	Z	Total
Domestic	−5.00	0	100.00	95.00
Foreign Passive	−3.50	5.00	5.00	6.50
Foreign General	−31.50	70.00	35.00	73.50
Total	−40.00	75.00	140.00	175.00

(iii) *Step 2: Loss offset adjustment.* Because X has insufficient domestic income to offset the sum of the losses in the foreign limitation categories caused by apportionment, the amount of apportionment losses in each limitation category shall be recharacterized as domestic losses to the extent of taxable income of other members in the same limitation category. This is accomplished by adding to each foreign limitation categories an amount equal to the loss therein and by subtracting the sum of such foreign losses from domestic income, as follows:

Loss offset adjustments	X	Y	Z	Total
Domestic	−35.00	0	0	−35.00
Foreign Passive	+3.50	0	0	+3.50
Foreign General	+31.50	0	0	+31.50

These adjustments yield the following adjusted taxable income figures:

Adjusted taxable income	X	Y	Z	Total
Domestic	−40	0	100	60
Foreign Passive	0	5	5	10
Foreign General	0	70	35	105
Total	−40	75	140	175

(iv) *Step 3: Determination of amount subject to recharacterization.* The adjustments performed under Step 2 led to a change in the group's taxable income within each limitation category. The total loss offset adjustment column shown in paragraph (iii) above shows the net deviations between Steps 1 and 2.

(v) *Step 4: Recharacterization.* The loss offset adjustments yield a positive change in the foreign passive and the foreign general limitation categories. Y and Z both have income in these limitation categories. Accordingly, the income of Y and Z in each of these limitation categories must be reduced on a pro rata basis (by reference to the adjusted taxable income figures) to the extent of the positive change in each limitation category. The total positive change in the foreign passive limitation category is $3.50. The adjusted taxable income of Y in the foreign passive limitation category is $5, and the adjusted taxable income of Z in the foreign passive limitation category is $5. Therefore, $1.75 is drawn from Y and $1.75 is drawn from Z. The total positive change in the foreign general limitation category is $31.50. The adjusted taxable income of Y in the foreign general limitation category is $70, and the adjusted tabable income of Z in the foreign general limitation category is $35. Therefore, $21 is drawn from Y and $10.50 is drawn from Z.

The members must then separately compute the sum of the limitation reductions. Y has limitation reductions of $1.75 in the foreign passive limitation category and $21 in the foreign general limitation category, yielding total limitation reductions of $22.75. Under these facts, domestic income is the only limitation category requiring a positive adjustment. Accordingly, Y's domestic income is increased by $22.75. Z has limitation reductions of $1.75 in the foreign passive limitation category and $10.50 in the foreign general limitation category, yielding total limitation reductions of $12.25. Under these facts, domestic income is the only limitation category requiring a positive adjustment. Accordingly, Z's domestic income is increased by $12.25.

Recharacterization adjustments	X	Y	Z	Total
Domestic	0	+22.75	+12.25	+35.00
Foreign Passive	0	−1.75	−1.75	−3.50
Foreign General	0	−21.00	−10.50	−31.50

These recharacterization adjustments yield the following final taxable income figures:

Final taxable income	X	Y	Z	Total
Domestic	−40.00	22.75	112.25	95.00
Foreign Passive	0	3.25	3.25	6.50
Foreign General	0	49.00	24.50	73.50
Total	−40.00	75.00	140.00	175.00

§ 1.861–12T Characterization rules and adjustments for certain assets (Temporary regulations.)

(a) *In general.* These rules are applicable to taxpayers in apportioning expenses under an asset method to income in various separate limitation categories under section 904(d), and supplement other rules provided in §§ 1.861–9T, 1.861–10T, and 1.861–11T. The rules of this section apply to taxable years beginning after December 31, 1986, except as otherwise provided in §1.861–13T. Paragraph (b) of this section describes the treatment of inventories. Paragraph (c)(1) of this section concerns the treatment of various stock assets. Paragraph (c)(2) of this section describes a basis adjustment for stock in nonaffiliated 10 percent owned corporations. Paragraph (c)(3) of this section sets forth rules for characterizing the stock in controlled foreign corporations. Paragraph (c)(4) of this section describes the treatment of stock of noncontrolled section 902 corporations. Paragraph (d)(1) of this section concerns the treatment of notes. Paragraph (d)(2) of this section concerns the treatment of the notes of controlled foreign corporations. Paragraph (e) of this section describes the treatment of certain portfolio securities that constitute inventory or generate income primarily in the form of gains. Paragraph (f) of this section describes the treatment of assets that are subject to the capitalization rules of section 263A. Paragraph (g) of this section concerns the treatment of FSC stock and of assets of the related supplier generating foreign trade income. Paragraph (h) of this section concerns the treatment of DISC stock and of assets of the related supplier generating qualified export receipts. Paragraph (i) of this section is reserved. Paragraph (j) of this section sets forth an example illustrating the rules of this section, as well as the rules of § 1.861–9T(g).

(b) *Inventories.* Inventory must be characterized by reference to the source and character of sales income, or sales receipts in the case of LIFO inventory, from that inventory during the taxable year. If a taxpayer maintains separate inventories for any federal tax purpose, including the rules for establishing pools of inventory items under sections 472 and 474 of the Code, each separate inventory shall be separately characterized in accordance with the previous sentence.

(c) *Treatment of stock*—(1) *In general.* Subject to the adjustment and special rules of paragraphs (c) and (e) of this section, stock in a corporation is taken into account in the application of the asset method described in § 1.861–9T(g). However, an affiliated group (as defined in § 1.861–11T(d)) does not take into account the stock of any member in the application of the asset method.

(2) *Basis adjustment for stock in nonaffiliated 10 percent owned corporations*—(i) *Taxpayers using the tax book value method.* For purposes of apportioning expenses on the basis of the tax book value of assets, the adjusted basis of any stock in a 10 percent owned corporation owned directly by the taxpayer shall be—

(A) Increased by the amount of the earnings and profits of such corporation (and of lower-tier 10 percent owned corporations) attributable to such stock and accumulated during the period the taxpayer or other members of its affiliated group held 10 percent or more of such stock, or

(B) Reduced (but not below zero) by any deficit in earnings and profits of such corporation (and of lower-tier 10 percent owned corporations) attributable to such stock for such period.

Solely for purposes of this section, a taxpayer's basis in the stock of a controlled foreign corporation shall not include any amount included in basis under section 961 or 1293(d) of the Code. For purposes of this paragraph (c)(2), earnings and profits and deficits are computed under the rules of section 312 and, in the case of a foreign corporation, section 902 and the regulations thereunder for taxable years of the 10 percent owned corporation ending on or before the close of the taxable year of the taxpayer. The rules of section 1248 and the regulations thereunder shall apply to determine the amount of earnings and profits that is attributable to stock without regard to whether earned and profits (or deficits) were derived (or incurred) during taxable years beginning before or after December 31, 1962. This adjustment is to be made annually and is noncumulative. Thus, the adjusted basis of the stock (determined without prior years' adjustments under this section) is to be adjusted annually by the amount of accumulated earnings and profits (or any deficit) attributable to such stock as of the end of each year. Earnings and profits or deficits of a qualified business unit that has a functional currency other than the dollar must be computed under this paragraph (c)(2) in functional currency and translated into dollars using the exchange rate at the end of the taxpayer's current taxable year with respect to which interest is being allocated (and not the exchange rates for the years in which the earnings and profits or deficits were derived or incurred).

(ii) *10 percent owned corporation defined*—(A) *In general.* The term "10 percent owned corporation" means any corporation (domestic or foreign)—

(*1*) Which is not included within the taxpayer's affiliated group as defined in §1.861–11T(d) (1) or (6),

(*2*) In which the members of the taxpayer's affiliated group own directly or indirectly 10 percent or more of the total combined voting power of all classes of the stock entitled to vote, and

(*3*) Which is taken into account for purposes of apportionment.

(B) *Rule of attribution.* Stock that is owned by a corporation, partnership, or trust shall be treated as being indirectly owned proportionately by its shareholders, partners, or beneficiaries. For this purpose, a partner's interest in stock held by a partnership shall be determined by reference to the partner's distributive share of partnership income.

(iii) *Earnings and profits of lower-tier corporations taken into account.* For purposes of the adjustment to the basis of the stock of the 10 percent owned corporation owned by the taxpayer under paragraph (c)(2)(i) of this section, the earnings and profits of that corporation shall include its pro rata share of the earnings and profits (or any deficit therein) of each succeeding lower-tier 10 percent owned corporation. Thus, a first-tier 10 percent owned corporation shall combine with its own earnings and profits its pro rata share of the earnings and profits of all such lower-tier corporations. The affiliated group shall then adjust its basis in the stock of the first-tier corporation by its pro rata share of the total combined earnings and profits of the first-tier and the lower-tier corporations. In the case of a 10 percent owned corporation whose tax year does not conform to that of the taxpayer, the taxpayer shall include the annual earnings and profits of such 10 percent owned corporation for the tax year ending within the tax year of the taxpayer, whether or not such 10 percent owned corporation is owned directly by the taxpayer.

(iv) *Special rules for foreign corporations in pre-effective date tax years.* Solely for purposes of determining the adjustment required under paragraph (c)(2)(i) of this section, for tax years beginning after 1912 and before 1987, financial earnings (or losses) of a foreign corporation computed using United States generally accepted accounting principles may be substituted for earnings and profits in making the adjustment required by paragraph (c)(2)(i) of this section. A taxpayer is not required to isolate the financial earnings of a foreign corporation derived or incurred during its period of 10 percent ownership or during the post-1912 taxable years and determine earnings and profits (or deficits) attributable under section 1248 principles to the taxpayer's stock in a 10 percent owned corporation. Instead, the taxpayer may include all historic financial earnings for purposes of this adjustment. If the affiliated group elects to use financial earnings with respect to any foreign corporation, financial earnings must be used by that group with respect to all foreign corporations, except that earnings and profits may in any event be used for controlled foreign corporations for taxable years beginning after 1962 and before 1987. However, if the affiliated group elects to use earnings and profits with respect to any single controlled foreign corporation for the 1963 through 1986 period, such election shall apply with respect to all its controlled foreign corporations.

(v) *Taxpayers using the fair market value method.* Because the fair market value of any asset which is stock will reflect retained earnings and profits, taxpayers who use the fair market value method shall not adjust stock basis by the amount of retained earnings and profits, as otherwise required by paragraph (c)(2)(i) of this section.

(vi) *Examples.* Certain of the rules of this paragraph (c)(2) may be illustrated by the following examples.

Example (1). X, an affiliated group that uses the tax book value method of apportionment, owns 20 percent of the stock of Y, which owns 50 percent of the stock of Z. X's basis in the Y stock is $1,000. X, Y, and Z have calendar taxable years. The undistributed earnings and profits of Y and Z at year-end attributable to X's period of ownership are $80 and $40, respectively. Because Y owns half of the Z stock, X's pro rata share of Z's earnings and profits attributable to X's Y stock is $4. X's pro rata share of Y's earnings attributable to X's Y stock is $16. For purposes of apportionment, the tax book value of the Y stock is, therefore, considered to be $1,020.

Example (2). X, an unaffiliated domestic corporation that was organized on January 1, 1987, has owned all the stock of Y, a foreign corporation with a functional currency other than the U.S. dollar, since January 1, 1987. Both X and Y have calendar taxable years. All of Y's assets generate general limitation income. X has a deductible interest expense incurred in 1987 of $160,000. X apportions its interest expense using the tax book value method. The adjusted basis of its assets that generate domestic income is $7,500,000. The adjusted basis of its assets that generate foreign source general limitation income (other than the stock of Y) is $400,000. X's adjusted basis in the Y stock is $2,000,000. Y has undistributed earnings and profits for 1987 of $100,000, translated into dollars from Y's functional currency at the exchange rate on the last day of X's taxable year. Because X is required under paragraph (b)(1) of this § 1.861–10T to increase its basis in the Y stock by the computed amount of earnings and profits, X's adjusted basis in the Y stock is considered to be $2,100,000, and its adjusted basis of assets that generate foreign source general limitation income is, thus, considered to be $2,500,000. X would apportion its interest expense as follows:

To foreign source general limitation income:

$$\text{Interest expense} \times \frac{\text{Adjusted basis of foreign general limitation assets}}{\text{Adjusted basis of foreign general limitation assets} + \text{Adjusted basis of domestic assets}}$$

$$\$160{,}000 \times \frac{\$2{,}500{,}000}{\$2{,}500{,}000+\$7{,}500{,}000} = \$40{,}000$$

To domestic source income:

$$\text{Interest expense} \times \frac{\text{Adjusted basis of domestic assets}}{\text{Adjusted basis of foreign general limitation assets} + \text{Adjusted basis of domestic assets}}$$

$$\$160{,}000 \times \frac{\$7{,}500{,}000}{\$2{,}500{,}000+\$7{,}500{,}000} = \$120{,}000$$

(3) *Characterization of stock of controlled foreign corporations*—(i) *In general.* Stock in a controlled foreign corporation (as defined in section 957) shall be characterized as an asset in the various separate limitation categories either on the basis of:

(A) The asset method described in paragraph (c)(3)(ii) of this section, or

(B) The modified gross income method described in paragraph (c)(3)(iii) of this section.

Stock in a controlled foreign corporation whose interest expense is apportioned on the basis of assets shall be characterized in the hands of its United States shareholders under the asset method described in paragraph (c)(3)(ii). Stock in a controlled foreign corporation whose interest expense is apportioned on the basis of gross income shall be characterized in the hands of its United States shareholders under the gross income method described in paragraph (c)(3)(iii).

(ii) *Asset method.* Under the asset method, the taxpayer characterizes the tax book value or fair market value of the stock of a controlled foreign corporation based on an analysis of the assets owned by the controlled foreign corporation during the foreign corporation's taxable year that ends with or within the taxpayer's taxable year. This process is based on the application of §1.861–9T(g) at the level of the controlled foreign corporation. In the case of a controlled foreign corporation that owns stock in one or more lower-tier controlled foreign corporations in which the United States taxpayer is a United States shareholder, the characterization of the tax book value of the fair market value of the stock of the first-tier controlled foreign corporation to the various separate limitation categories of the affiliated group must take into account the stock in lower-tier corporations. For this purpose, the stock of each such lower-tier corporation shall be characterized by reference to the assets owned during the lower-tier corporation's taxable year that ends during the taxpayer's taxable year. The analysis of assets within a chain of controlled foreign corporations must begin at the lowest-tier controlled foreign corporation and proceed up the chain to the first-tier controlled foreign corporation. For purposes of this paragraph (c), the value of any passive asset to which related person interest is allocated under § 1.904–5(c)(2)(ii) must be reduced by the principal amount of indebtedness on which such interest is incurred. Furthermore, the value of any asset to which interest expense is directly allocated under § 1.861–10T must be reduced as provided in § 1.861–9T(g)(2)(iii). See § 1.861–9T(h)(5) for further guidance concerning characterization of stock in a related person under the fair market value method.

(iii) *Modified gross income method.* Under the gross income method, the taxpayer characterizes the tax book value of the stock of the first-tier controlled foreign corporation based on the gross income net of interest expense of the controlled foreign corporation (as computed under § 1.861–9T(j)) within each relevant category for the taxable year of the controlled foreign corporation ending with or within the taxable year of the taxpayer. For this purpose, however, the gross income of the first-tier controlled foreign corporation shall include the total amount of net subpart F income of any lower-tier controlled foreign corporation that was excluded under the rules of § 1.861–9T(j)(2)(ii)(B).

(4) *Stock of noncontrolled section 902 corporation*—(i) *General rule.* Because each noncontrolled section 902 corporation constitutes a separate limitation category, the value of such stock, increased to the extent required under paragraph (c)(2) of this section, is attributable solely to each such category.

(ii) *Special rule for separate limitation losses*—(A) *Election.* If, as a result of the allocation and apportionment of interest expense using the asset method described in § 1.861–9T(g), the taxpayer has a loss in the separate limitation category for a given noncontrolled section 902 corporation, the taxpayer may elect to reallocate interest expense equal to such loss to any other separate limitation category that is in excess credit (without regard to carryovers from other years), to the extent that the reallocation of such interest to such other category does not create a loss in that category. For this purpose, the term "category in excess credit" means any category of income with respect to which the foreign income taxes paid or accrued for the current taxable year exceed the limitation computed under section 904 with respect to such category. The election to reallocate interest expense under this paragraph shall be made in the manner prescribed in § 1.861–9T(f)(3) (relating to the election to use a gross income method for controlled foreign corporations). Furthermore, such election is irrevocable and, thus, cannot be amended by an amended return.

(B) *Example.* X, a domestic corporation organized on January 1, 1987, incurred deductible interest expense in 1987 in the amount of $1,000,000. X uses the tax book value method of apportionment. X owns 25 percent of the stock of A, a noncontrolled section 902 corporation. At the end of 1987, the tax book value of X's assets by income grouping are as follows:

Domestic	$3,500,000
Foreign general limitation	1,000,000
Noncontrolled section 902 corporation	500,000

In 1987, A paid no dividends. X received $100,000 of foreign general limitation income, on which it incurred $50,000 of tax to foreign governments.

The stock of A constitutes ten percent of X's assets. Therefore, ten percent of X's interest expense ($100,000) is allocated and apportioned to the separate limitation category for dividends on the A stock. Since A paid no dividends, this amount would constitute a separate limitation loss under the rules of section 904(f)(5).

Because X incurred more tax to foreign governments on its foreign general limitation income than it can credit against its U.S. tax liability, for the current tax year, and because the reallocation of interest expense allocated and apportioned to dividends from A to foreign general limitation income would not create a loss in that category, X may elect to reallocate such interest expense to the foreign general limitation category to the extent of the loss in the separate limitation category for dividends received from A.

(d) *Treatment of notes*—(1) *General rule.* Subject to the adjustments and special rules of this paragraph (d) and paragraph (e) of this section, all notes held by a taxpayer are taken into account in the application of the asset method described in § 1.861–9T(g). However, the notes of an affiliated corporation are subject to special rules set forth in § 1.861–11T(e). For purposes of this section, the term "notes" means all interest bearing debt, including debt bearing original issue discount.

(2) *Characterization of related controlled foreign corporation notes.* The debt of a controlled foreign corporation shall be characterized according to the taxpayer's treatment of the interest income derived from that debt obligation after application of the look-through rule of section 904(d)(3)(C). Thus, a United States shareholder includes interest income from a controlled foreign corporation in the same category of income as the category of income from which the controlled foreign corporation deducts the interest expense. See section 954(b)(5) and § 1.904–5(c)(2) for rules concerning the allocation of related person interest payments to the foreign personal holding company income of a controlled foreign corporation.

(e) *Portfolio securities that constitute inventory or generate primarily gains.* Because gain on the sale of securities is sourced by reference to the residence of the seller, a resident of the United States will generally receive domestic source income (and a foreign resident will generally receive foreign source income) upon sale or disposition of securities that otherwise generate foreign source dividends and interest (or domestic source dividends and interest in the case of a foreign resident). Although under paragraphs (c) and (d) of this section securities are characterized by reference to the source and character of dividends and interest, the source and character of income on gain or disposition must also be taken into account for purposes of characterizing portfolio securities if:

(1) The securities constitute inventory in the hands of the holder, or

(2) 80 percent or more of the gross income generated by a taxpayer's entire portfolio of such securities during a taxable year consists of gains.

For this purpose, a portfolio security is a security in any entity other than a controlled foreign corporation with respect to which the taxpayer is a United States shareholder under section 957, a noncontrolled section 902 corporation with respect to the taxpayer, or a 10 percent owned corporation as defined in § 1.861–12(c)(2)(ii). In taking gains into account, a taxpayer must treat all portfolio securities generating foreign source dividends and interest as a single asset and all portfolio securities generating domestic source dividends as a single asset and shall characterize the total value of that asset based on the source of all income and gain generated by those securities in the taxable year.

(f) *Assets funded by disallowed interest*—(1) *Rule.* In the case of any asset in connection with which interest expense accruing at the end of the taxable year is capitalized, deferred, or disallowed under any provision of the Code, the adjusted basis or fair market value (depending on the taxpayer's choice of apportionment methods) of such an asset shall be reduced by the principal amount of indebtedness the interest on which is so capitalized, deferred, or disallowed.

(2) *Example.* The rules of this paragraph (f) may be illustrated by the following example.

Example. X is a domestic corporation which uses the tax book value method of apportionment. X has $1000 of indebtedness and $100 of interest expense. X constructs an asset with an adjusted basis of $800 before interest capitalization and is required under the rules of section 263A to capitalize $80 in interest expense. Because interest on $800 of debt is capitalized and because the production period is in progress at the end of X's taxable year, $800 of the principal amount of X's debt is allocable to the building. The $800 of debt allocable to the building reduces its adjusted basis for purposes of apportioning the balance of X's interest expense ($20).

(g) *Special rules for FSCs*—(1) *Treatment of FSC stock.* No interest expense shall be allocated or apportioned to stock of a foreign sales corporation ("FSC") to the extent that the FSC stock is attributable to the separate limitation for certain FSC distributions described in section 904(d)(1)(H). FSC stock is considered to be attributable solely to the separate limitation category described in section 904(d)(1)(H) unless the taxpayer can demonstrate that more than 20 percent of the FSC's gross income for the taxable year consists of income other than foreign trading income.

(2) *Treatment of assets that generate foreign trade income.* Assets of the related supplier that generate foreign trade income must be prorated between assets attributable to foreign source general limitation income and assets attributable to domestic source income in proportion to foreign source general limitation income and domestic source income derived from transactions generating foreign trade income.

(i) *Value of assets attributable to foreign source income.* The value of assets attributable to foreign source general limitation income is computed by multiplying the value of assets for the taxable year generating foreign trading gross receipts by a fraction:

(A) The numerator of which is foreign source general limitation income for the taxable year derived from transactions giving rise to foreign trading gross receipts, after the application of the limitation provided in section 927(e)(1), and

(B) The denominator of which is total income for the taxable year derived from the transaction giving rise to foreign trading gross receipts.

(ii) *Value of assets attributable to domestic source income.* The value of assets attributable to domestic source income is computed by subtracting from the total value of assets for the taxable year generating foreign trading gross receipts the value of assets attributable to foreign source general limitation income as computed under paragraph (g)(2)(i) of this section.

(h) *Special rules for DISCs*—(1) *Treatment of DISC stock.* No interest shall be allocated or apportioned to stock in a DISC (or stock in a former DISC to the extent that the stock in the former DISC is attributable to the separate limitation category described in section 904(d)(1)(F)).

(2) *Treatment of assets that generate qualified export receipts.* Assets of the related supplier that generate qualified export receipts must be prorated between assets attributable to foreign source general limitation income and assets attributable to domestic source income in proportion to foreign source general limitation income and domestic source income derived from transactions during the taxable year from transactions generating qualified export receipts.

(i) [Reserved.]

(j) *Examples.* Certain of the rules in this section and §§ 1.861–9T(g) and 1.861–10(e) are illustrated by the following example.

Example (1):

(1) *Facts.* X, a domestic corporation organized on January 1, 1987, has a calendar taxable year and apportions its interest expense on the basis of the tax book value of its assets. In 1987, X incurred a deductible third-party interest expense of $100,000 on an average month-end debt amount of $1 million. The total tax book value of X's assets (adjusted as required under paragraph (b) of this section for retained earnings and profits) is $2 million. X manufactures widgets. One-half of the widgets are sold in the United States and one-half are exported and sold through a foreign branch with title passing outside the United States.

X owns all the stock of Y, a controlled foreign corporation that also has a calendar taxable year and is also engaged in the manufacture and sale of widgets. Y has no earnings and profits or deficits in earnings and profits prior to 1987. For 1987, Y has taxable income and earnings and profits of $50,000 before the deductible for related person interest expense. Half of the $50,000 is foreign source personal holding company income and the other half is derived from widget sales and constitutes foreign source general limitation income. Assume that Y has no deductibles from gross income other than interest expense. Y's foreign personal holding company taxable income is included in X's gross income under section 951. Y paid no dividends in 1987. Prior to 1987, Y did not borrow any funds from X. The average month-end level of borrowings by Y from X in 1987 is $100,000, on which Y paid a total of $10,000 in interest. The total tax book value of Y's assets in 1987 is $500,000. Y has no liabilities to third parties. X elects pursuant to § 1.861–9T for Y to apportion Y's interest expense under the gross income method prescribed in § 1.861–9T(g).

In addition to its stock in Y, X owns 20 percent of the stock of Z, a noncontrolled section 902 corporation.

X's total assets and their tax book values are:

Asset	Tax book value
Plant & equipment	$1,000,000
Corporate headquarters	500,000
Inventory	200,000
Automobiles	20,000
Patents	50,000
Trademarks	10,000
Y stock (including paragraph (c)(2) adjustment)	80,000
Y note	100,000
Z stock	40,000

(2) *Categorization of Assets.*

Single Category Assets

1. Automobiles: X's automobiles are used exclusively by its domestic sales force in the generation of United States source income. Thus, these assets are attributable solely to the grouping of domestic income.

2. Y Note: Under paragraph (d)(2) of this section, the Y note in the hands of X is characterized according to X's treatment of the interest income received on the Y note. In determining the source and character of the interest income on the Y note, the look-through rules of sections 904(d)(3)(C) and 904(g) apply. Under section 954(b)(5) and § 1.904–5(c)(2)(ii), Y's $10,000 interest payment to X is allocated directly to, and thus reduces, Y's foreign personal holding company income of $25,000 (yielding foregin personal holding company taxable income of $15,000). Therefore, the Y note is attributable solely to the statutory grouping of foreign source passive income.

3. Z stock: Because Z is a noncontrolled section 902 corporation, the dividends paid by Z are subject to a separate limitation under section 904(d)(1)(E). Thus, this asset is attributable solely to the statutory grouping consisting of Z dividends.

Multiple Category Assets

1. Plant & equipment, inventory, patents, and trademarks: In 1987, X sold half its widgets in the United States and exported half outside the United States. A portion of the taxable income from export sales will be foreign source income, since the export sales were accomplished through a foreign branch and title passed outside the United States. Thus, these assets are attributable both to the statutory grouping of foreign general limitation and the grouping of domestic income.

2. Y Stock: Since Y's interest expense is apportioned under the gross income method prescribed in § 1.861–9T(j), the Y stock must be characterized under the gross income method described in paragraph (c)(3)(iii) of this section.

Assets without Directly Identifiable Yield

1. Corporate headquarters: This asset generates no directly identifiable income yield. The value of the asset is disregarded.

(3) *Analysis of Income Yield for Multiple Category Assets.*

1. Plant & Equipment, Inventory, patents, and trademarks: As noted above, X's 1987 widget sales were half domestic and half foreign. Assume that Example 2 of § 1.863–3(b)(2) applies in sourcing the export income from the export sales. Under Example 2, the income generated by the export sales is sourced half domestic and half foreign. The income gnerated by the domestic sales is entirely domestic source. Accordingly, three-quarters of the income gnerated on all sales is domestic source and one-quarter of the income is foriegn source. Thus, three-quarters of the fair market value of these assets are attributed to the grouping of domestic source income and one-quarter of the fair market value of these assets is attributed to the statutory grouping of foreign source general limitation income.

2. Y Stock: Under the gross income method described in paragraph (c)(3)(iii) of this section, Y's gross income net of interest expenses in each limitation category must be determined—$25,000 foreign source general limitation income and $15,000 of foreign source passive income. Of X's adjusted basis of $80,000 in Y stock, $50,000 is attributable to foreign source general limitation income and $30,000 is attributable to foreign source passive income.

(4) *Application of the Special Allocation Rule of § 1.861–10T(e).* Assume that the taxable year in question is 1990 and that the appliable percentage prescribed by § 1.861–10T(e)(1)(iv)(A) is 80 percent. Assume that X has elected to use the quadratic formula provided in § 1.861–10T(e)(1)(iv)(B).

Step 1. X's average month-end level of debt owning to unrelated persons is $1 million. The tax book value of X's assets is $2 million. Thus, X's debt-to-asset ratio computed under § 1.861–10T(e)(1)(i) is 1 to 2.

Step 2. The tax book value of Y's assets is $500,000. Because Y has no debt to persons other than X, Y's debt-to-asset ratio computed under § 1.861–10T(e)(1)(ii) is $0 to $500,000.

Step 3. Y's average month-end liabilities to X, as computed under § 1.861–10T(e)(1)(iii) for 1987 are $100,000.

Step 4. Adding the $100,000 of Y's liabilities owed to X as computed under Step 3 to Y's third party liabilities ($0) would be insufficient to make Y's debt-to-asset ratio computed in Step 2 ($100,000-to-$500,000, or 1:5) equal to at least 80 percent of X's debt-to-asset ratio computed under Step 1, as adjusted to reflect a reduction in X's debt and assets by the $100,000 of excess related person indebtedness (.80 x $5. ... /$1,900,000 or 1:2.6). Therefore, the entire amount of Y's liabilities to X ($100,000) constitute excess related person indebtedness under § 1.861-10T(e)(1)(ii). Thus, the entire $10,000 of interest received by X from Y during 1987 constitutes interest received on excess related person indebtedness.

Step 5. The Y note held by X has a tax book value of $100,000. Solely for purposes of § 1.861-10(e)(1)(v), the Y note is attributed to separate limitation categories in the same manner as the Y stock. Under paragraph (c)(3)(iii) of this section, of the $80,000 of Y stock held by X, $50,000 is attributable to foreign source general limitation income, and $30,000 is attributable to foreign source passive income. Thus, for purposes of §1.861-10T(e)(1)(v), $62,500 of the $100,000 Y note is considered to be a foreign source general limitation asset and $37,500 of the $100,000 Y note is considered to be a foreign source passive asset.

Step 6. Since $8,000 of the $10,000 in related person interest income received by Y constitutes interest received on excessive related person indebtedness, $10,000 of X's third party interest expense is allocated to X's debt investment in Y. Under § 1.861-10T(e)(1)(vi), 62.5 percent of the $10,000 of X's third party interest expense ($6,250) is allocated to foreign source general limitation income and 37.5 percent of the $10,000 of X's third party interest expense ($3,750) is allocated to foreign source passive income. As a result of this direct allocation, the value of X's assets generating foreign source general limitation income shall be reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign source general limitation income ($62,500), and X's assets generating foreign general limitation income shall be reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign passive income ($37,500).

(5) *Totals.*

Having allocated $10,000 of its third party interest expense to its debt investment in Y, X would apportion the $90,000 balance of its interest according to the following apportionment fractions:

Asset	Domestic source	Foreign general	Foreign passive	Noncontrolled section 902
Plant and equipment	$750,000	$250,000		
Inventory	$150,000	$50,000		
Automobiles	$20,000			
Patents	$37,500	$12,500		
Trademarks	$7,500	$2,500		
Y stock		$50,000	$30,000	
Y note			$100,000	
Z stock				$40,000
Totals	$965,000	$365,000	$130,000	$40,000
Adjustments for directly allocable interest		($62,250)	($37,750)	
Adjusted totals	$965,000	$302,750	$92,250	$40,000
Percentage	69	22	6	3

Example 2. Assume the same facts as in *Example* 1, except that Y has $100,000 of third party indebtedness. Further, assume for purposes of the application of the special allocation rule of § 1.861-10T(e) that the taxable year is 1990 and that the applicable percentage prescribed by § 1.861-10T(e)(1)(iv)(A) is 80 percent. The application of the § 1.861-10(e) would be modified as follows.

Step 1. X's debt-to-asset ratio computed under § 1.861-10T(e)(1)(i) remains 1 to 2 (or 0.5).

Step 2. The tax book value of Y's assets is $500,000. Y has $100,000 of indebtedness to third parties. Y's debt-to-asset ratio computed under § 1.861-10T(e)(1)(ii) is $100,000 to $500,000 (1:5 or 0.2).

Step 3. Y's average month-end liabilities to X, as computed under § 1.861-10T(e)(1)(iii) remain $100,000.

Step 4. X's debt-to-asset ratio is 0.5 and 80 percent of 0.5 is 0.4. Because Y's debt-to-asset ratio is 0.2, there is excess related person indebtedness, the amount of which can be computed based on the following formula:

$$\frac{\text{Aggregate third party debt of related U.S. shareholder}-X}{\text{U.S. shareholder assets}-X} \times \text{Applicable percentage for year } (0.8) = \frac{\text{Aggregate third party debt of related CFCs}+X}{\text{Related CFC assets}}$$

Supplying the facts as given, this equation is as follows:

$$\frac{1{,}000{,}000-X}{2{,}000{,}000-X} \times .8 = \frac{100{,}000+X}{500{,}000}$$

Multiply both sides by 500,000 and (2,000,000−X), yielding:

$$4\times10^{11}-400{,}000X=2\times10^{11}+2{,}000{,}000X-100{,}000X-X^2$$

Since there is an X^2 in this equation, a quadratic formula must be utilized to solve for X. Group the components in this equation, segregating the X and the X^2:

$$X^2+(-2{,}300{,}000)X+(2\times10^{11})=0$$

Apply the quadratic formula:

$$X=\frac{-b\pm\sqrt{b^2-4(a)(c)}}{2(a)}$$

a = 1 (coefficient of X^2)
b = −2,300,000 (coefficient of X)
c = 2×10^{11} (remaining element of equation)

Therefore, X equals either 90,519 or (2.21×10^{11}). for purposes of computing excess related person indebtedness, X is the lowest positive amount derived from this equation, which is 90,519.

Steps 5 and 6 are unchanged from *Example* 1, except that the total amount of interest on excess related party indebtedness is $9,051.

§ 1.861-13T Transition rules for interest expenses (Temporary regulations.) [Reserved]

§ 1.861-14T Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations (Temporary regulations.)

(a) *In general.* Section 1.861-11T provides special rules for allocating and apportioning interest expense of an affiliated group of corporations. The rules of this § 1.861-14T also relate to affiliated groups of corporations and implement section 864(e)(6), which requires affiliated group allocation and apportionment of expenses other than interest which are not directly allocable and apportionable to any specific income producing activity or property. In general, the rules of this section apply to taxable years beginning after December 31, 1986. Paragraph (b) of this section describes the scope of the application of the rule for the allocation and apportionment of such expenses of affiliated groups of corporations. Such rules is then set forth in paragraph (c) of this section. Paragraph (d) of this section contains the definition of the term "affiliated group" for purposes of this section. Paragraph (e) of this section describes the expenses subject to allocation and apportionment under the rules of this section. Paragraph (f) of this section provides rules concerning the affiliated group allocation and apportionment of such expenses in computing the combined taxable income of a FSC or DISC and its related supplier. Paragraph (g) of this section describes the treatment of losses caused by apportionment of such expenses in the case of an affiliated group that does not file a consolidated return. Paragraph (h) of this section provides rules concerning the treatment of the reserve expenses of a life insurance company. Paragraph (j) of this section provides examples illustrating the application of this section.

(b) *Scope*—(1) *Application of section 864(e)(6).* Section 864(e)(6) and this section apply to the computation of taxable income for purposes of computing separate limitations on the foreign tax credit under section 904. Section 864(e)(6) and this section also apply in connection with section 907 to determine reductions in the amount allowed as a foreign tax credit under section 901. Section 864(e)(6) and this section also apply to the computation of the combined taxable income of the related supplier and a foreign sales corporation (FSC) (under sections 921 through 927) as well as the combined taxable income of the related supplier and a domestic international sales corporation (DISC) (under sections 991 through 997).

(2) *Nonapplication of section 864(e)(6).* Section 864(e)(6) and this section do not apply to the computation of Subpart F income of controlled foreign corporations (under sections 951 through 964) or the computation of effectively connected taxable income of foreign corporations.

(3) *Application of section 864(e)(6) to the computation of combined taxable income of a possessions corporation and its affiliates.* [Reserved.]

(c) *General rule for affiliated corporations*—(1) *General rule.* (i) Except as otherwise provided in paragraph (c)(2) of this section, the taxable income of each member of an affiliated group within each statutory grouping shall be determined by allocating and apportioning the expenses described in paragraph (e) of this section of each member according to apportionment fractions which are computed as if all members of such group were a single corporation. For purposes of determining these apportionment fractions, any interaffiliate transactions or property that are duplicative with respect to the measure of apportionment chosen shall be eliminated. For example, in the application of an asset method of apportionment, stock in affiliated corporations shall not be taken into account, and loans between members of an affiliated group shall be treated in accordance with the rules of § 1.861-11T(e). Similarly, in the application of a gross income method of apportionment, interaffiliate dividends and interest, gross income from sales or services, and other interaffiliate gross income shall be eliminated. Likewise, in the application of a method of apportionment based on units sold or sales receipts, interaffiliate sales shall be eliminated.

(ii) Except as otherwise provided in this section, the rules of § 1.861-8T apply to the allocation and apportionment of the expenses described in paragraph (e) of this section. Thus, allocation under this paragraph (c) is accomplished by determining, with respect to each expense described in paragraph (e), the class of gross income to which the expense is definitely related and then allocating the deduction to such class of gross income. For this purpose, the gross income of all members of the affiliated group must be taken in account. Then, the expense is apportioned by attributing the expense to gross income (within the class to which the expense has been allocated) which is in the statutory grouping and to gross income (within the class) which is in the residual grouping. Section 1.861-8T(c)(1) identifies a number of factors upon which apportionment may be based, such as comparison of units sold, gross sales or receipts, assets used, or gross income. The apportionment method chosen must be applied consistently by each member of the affiliated group in apportioning the expense when more than one member incurred the expense or when members incurred separate portions of the expense. The apportionment fraction must take into account the apportionment factors contributed by all members of the affiliated group. In the case of an affiliated group of corporations that files a consolidated return, consolidated foreign tax credit limitations are computed for the group in accordance with the rules of § 1.1502-4. For purposes of this section the term "taxpayer" refers to the affiliated group (regardless of whether the group files a consolidated return), rather than to the separate members thereof.

(2) *Expenses relating to fewer than all members.* An expense relates to fewer than all members of an affiliated group if the expense is allocable under paragraph (e)(1) of this section to gross income of at least one member other than the member that incurred the

expense but fewer than all members of the affiliated group. The taxable income of the member that incurred the expense shall be determined by apportioning that expense under the rules of paragraph (c)(1) of this section as if the members of the affiliated group that derive gross income to which such expense is allocable under paragraph (e)(1) were treated as a single corporation.

(3) *Prior application of section 482.* The rules of this section do not supersede the application of section 482 and the regulations thereunder. Section 482 may be applied effectively to deny a deduction for an expense to one member of an affiliated group and to allow a deduction for that expense to another member of the affiliated group. In cases to which section 482 is applied, expenses shall be reallocated and reapportioned under section 864(e)(6) and this section after taking into account the application of section 482.

(d) *Definition of affiliated group*—(1) *General rule.* For purposes of this section, the term "affiliated group" has the same meaning as is given that term by section 1504, except that section 936 companies are also included within the affiliated group. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through 80% stock ownership with a common parent corporation which is an includible corporation (as defined in section 1504(b)). In the case of a corporation that either becomes or ceases to be a member of the group during the course of the corporation's taxable year, only the expenses incurred by the group member during the period of membership shall be allocated and apportioned as if all members of the group were a single corporation. In this regard, the apportionment factor chosen shall relate only to the period of membership. For example, if apportionment on the basis of assets is chosen, the average amount of assets (tax book value or fair market value) for the taxable year shall be multiplied by a fraction, the numerator of which is the number of months of the corporation's taxable year during which the corporation was a member of the affiliated group, and the denominator of which is the number of months within the corporation's taxable year. If apportionment on the basis of gross income is chosen, account shall be taken of gross income generated only during the period of membership. If apportionment on the basis of units sold or sales receipts is chosen, account shall be taken of units sold or sales receipts only during the period of membership. Expenses incurred by the group member during its taxable year, but not during the period of membership, shall be allocated and apportioned without regard to other members of the group.

(2) *Inclusion of section 936 corporations.* The exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) does not apply for purposes of this section. Thus, a possessions corporation meeting the ownership requirements of section 1504(a) with respect to which an election under section 936 is in effect for the taxable year is a member of the affiliated group.

(3) *Inclusion of financial corporations.* For purposes of this section, in the case of an affiliated group (as defined in paragraph (d)(1) of this section), any members that constitute financial corporations as defined in § 1.861-11T(d)(4)(ii) shall be treated as members of the affiliated group. The rule of § 1.861-11T(d)(4)(i), which treats such financial corporations as a separate affiliated group, applies only for purposes of allocation and apportionment of interest expense and does not apply to the allocation and apportionment of other expenses under this section.

(4) *Treatment of life insurance companies subject to taxation under section 801.* A life insurance company that is subject to taxation under section 801 shall be considered to constitute a member of the affiliated group composed of companies not taxable under section 801 only if a parent corporation so elects under section 1504(c)(2)(A) of the Code.

(e) *Expenses to be allocated and apportioned under this section*—(1) *Expenses not directly traceable to specific income producing activities or property.* (i) The expenses that are required to be allocated and apportioned under the rules of this section are expenses related to certain supportive functions, research and experimental expenses, stewardship expenses, and legal and accounting expenses, to the extent that such expenses are not directly allocable to specific income producing activities or property solely of the member of the affiliated group that incurred the expense. Interest expense of members of an affiliated group of corporations is allocated and apportioned under § 1.861-11T and not under the rules of this section. Expenses that are included in inventory costs or that are capitalized are not subject to allocation and apportionment under the rules of this section.

(ii) An item of expense is not considered to be directly allocable to specific income producing activities or property solely of the member incurring the expense if, were all members of the affiliated group treated as a single corporation, the expense would not be considered defintely related, within the meaning of § 1.861-8T(b)(2), only to a class of gross income derived solely by the member which actually incurred the expense. Furthermore, the expense is presumed not to be definitely related only to a class of gross income derived solely by the member incurring the expense (and is, therefore, presumed not to be directly allocable to specific income producing activities or property of that member) unless the taxpayer is able affirmatively to establish otherwise. As provided in paragraph (c)(1) of this section, expenses described in this paragraph (e)(1) generally shall be apportioned by the member incurring the expense according to apportionment fractions computed as if all members of the affiliated group were a single corporation. Under paragraph (c)(2) of this section, however, an expense shall be apportioned according to apportionment fractions computed as if only some (but fewer than all) members of the affiliated group were a single corporation, if the expense is considered allocable to gross income of at least one member other than the member incurring the expense but fewer than all members of the affiliated group. An item of expense shall be considered to be allocable to gross income of fewer than all members of the group if, were all members of the affiliated group treated as a single corporation, the expense would not be considered definitely related within the meaning of § 1.861-8T(b)(2) to gross income derived by all members of the group. In such case, the expense shall be considered allocable, for purposes of paragraph (c)(2) of this section, to gross income of those members of the group that generated (or could reasonably be expected to generate) the gross income to which the expense would be considered definitely related if the group were treated as a single corporation.

(2) *Research and experimental expenses*—

(i) *In general.* The allocation and apportionment of research and experimental expenses is governed by the rules of § 1.861-8T(e)(3). In the case of research and experimental expenses incurred by a member of an affiliated group, the rules of § 1.861-8T(e)(3) shall be applied as if all members of the affiliated group were a single taxpayer. Thus, research and experimental expenses shall be allocated to all income of all members of the affiliated group reasonably connected with the relevant broad product category to which such expenses are definitely related under § 1.861–8T(e)(3)(i). If fewer than all members of the affiliated group derive gross income reasonably connected with that relevant broad product cagetory, then such expenses shall be apportioned under the rules of this paragraph (c)(2) only among those members, as if those members were a single corporation. See *Example* (1) of paragraph (j) of this section. Such expenses shall then be apportioned, if the sales method is used, in accordance with the rules of § 1.861–8T(e)(3)(ii) between the statutory grouping (within the class of gross income) and the residual grouping (within the class of gross income) taking into account the amount of sales of all members of the affiliated group from the product category which resulted in such gross income. Section 1.861–8T(e)(3)(ii)(D), relating to sales of controlled parties, shall be applied as if all members of the affiliated group were the "taxpayer" referred to therein. If either of the optional gross income methods of apportionment is used, gross income of all members of the affiliated group that generate, have generated, or could reasonably have been expected to generate gross income within the relevant class of gross income must be taken into account.

(ii) *Expenses subject to the statutory moratorium.* The rules of this section do not apply to research and experimental expenses allocated under section 126 of Pub. L. 98–368.

(3) *Expenses related to supportive functions.* Expenses which are supportive in nature (such as overhead, general and administrative, supervisory expenses, advertising, marketing, and other sales expenses) are to be allocated and apportioned in accordance with the rules of § 1.861–8T(b)(3). To the extent that such expenses are not directly allocable under paragraph (e)(1)(ii) of this section to specific income producing activities or property of the member of the affiliated group that incurred the expense, such expenses must be allocated and apportioned as if all members of the affiliated group were a single corporation in accordance with the rules of paragraph (c) of this section. Specifically, such expenses must be allocated to a class of gross income that take into account gross income that is generated, has been generated, or could reasonably have been expected to have been generated by the members of the affiliated group. If the expenses relate to the gross income of fewer than all members of the affiliated group as determined under paragraph (c)(2) of this section, then those expenses must be apportioned under the rules of paragraph (c)(2) of this section, as if those fewer members were a single corporation. See *Example* (3) of paragraph (j) of this section. Such expenses must be apportioned between statutory and residual groupings of income within the appropriate class of gross income by reference to the apportionment factors contributed by the members of the affiliated group that are treated as a single corporation.

(4) *Stewardship expenses.* Stewardship expenses are to be allocated and apportioned in accordance with the rules of § 1.861–8T(e)(4). In general, stewardship expenses are considered definitely related and allocable to dividends received or to be received from a related corporation. If members of the affiliated group, other than the member that incurred the stewardship expense, receive or may receive dividends from the related corporation, such expense must be allocated and apportioned in accordance with the rules of paragraph (c) of this section as if all such members of the affiliated group that receive or may receive dividends were a single corporation. See *Example* (4) of paragraph (j) of this section. Such expenses must be apportioned between statutory and residual groupings of income within the appropriate class of gross income by reference to the apportionment factors contributed by the members of the affiliated group treated as a single corporation.

(5) *Legal and accounting fees and expenses.* Legal and accounting fees and expenses are to be allocated and apportioned under the rules of § 1.861–8T (e)(5). To the extent that such expenses are not directly allocable under paragraph (e)(1)(ii) of this section to specific income producing activities or property of the member of the affiliated group that incurred the expense, such expenses must be allocated and apportioned as if all members of the affiliated group were a single corporation. Specifically, such expenses must be allocated to a class of gross income that takes into account the gross income which is generated, has been generated, or could reasonably have been expected to have been generated by the other members of the affiliated group. If the expenses relate to the gross income of fewer than all members of the affiliated group as determined under paragraph (c)(2) of this section, then those expenses must be apportioned under the rules of paragraph (c)(2) of this section, as if those fewer members were a single corporation. See *Example* (5) of paragraph (j) of this section. Such expenses must be apportioned taking into account the apportionment factors contributed by the members of the group that are treated as a single corporation.

(f) *Computation of FSC or DISC combined taxable income.* In the computation under the pricing rules of sections 925 and 994 of the combined taxable income of any FSC or DISC and its related supplier which are members of an affiliated group, the combined taxable income of such FSC or DISC and its related supplier shall be reduced by the portion of the expenses of the affiliated group described in paragraph (e) of this section that is incurred in connection with export sales involving that FSC or DISC. In order to determine the portion of the expenses of the affiliated group that is incurred in connection with export sales by or through a FSC or DISC, the portion of the total of the apportionment factor chosen that relates to the generation of that export income must be determined. Thus, if gross income is the apportionment factor chosen, the portion of total gross income of the affiliated group that consists of combined gross income derived from transactions involving the FSC or DISC and related supplier must be determined. Similarly, if units sold or sales receipts is the apportionment factor chosen, the portion of total units sold or sales receipts that generated export income of the FSC or DISC and related supplier must be determined. The amount of the expense shall then be multiplied by a fraction, the numerator of which is the export related apportionment factor as determined above, and the denominator of which is the total apportionment factor. Thus, if gross income is the apportionment factor chosen, apportionment is based on a fraction, the numerator of which is export related combined gross income of the FSC or DISC and related supplier and the denominator of which is the total gross income of the affiliated group. Similarly, if units sold or sales receipts is the apportionment factor chosen, the fraction is the units sold or sales receipts that generated export income of the FSC or DISC and related supplier over the total units sold or sales receipts of the affiliated group. Under this rule, expenses of other group members may be attributed to the combined gross income of a FSC of DISC and its related supplier without affecting the amount of expenses (other than any commission payable by the related supplier to the FSC or DISC) otherwise deductible by the FSC or DISC, the related supplier, or other members of the affiliated group. The FSC or DISC must calculate combined taxable income, taking into account any reduction by expenses attributed from other members of the affiliated group to determine the commission derived by the FSC or DISC or the transfer price of qualifying export property sold to the FSC or DISC.

(g) *Losses created through apportionment.* In the case of an affiliated group that does not file a consolidated return, the taxable income in any separate limitation category must be adjusted under this paragraph (g) for purposes of computing the separate foreign tax credit limitations under section 904(d). As a consequence of the affiliated group allocation and apportionment of expenses required by section 864(e)(6) and this section, expenses of a group member may be apportioned for section 904 purposes to a limitation category with a consequent loss in that limitation category. For purposes of this paragraph, the term "limitation category" includes domestic source income, as well as the types of income described in section 904(d)(1) (A) through (I). A loss of one affiliate in a limitation category will reduce the income of another member in the same limitation category if a consolidated return is filed. (*See* § 1.1502–4.) If a consolidated return is not filed, this netting does not occur. Accordingly, in such a case, the following adjustments among members are required, in order to give effect to the group allocation of expense:

(1) Losses created through group apportionment of expense in one or more limitation categories within a given member must be eliminated; and

(2) A corresponding amount of income of other members in the same limitation category must be recharacterized. Such adjustments shall be accomplished in accordance with the rules of § 1.861–11T(g).

(h) *Special rule for the allocation of reserve expenses of a life insurance company.* An amount of reserve expenses of a life insurance company equal to the dividends received deduction that is disallowed because it is attributable to the policyholders' share of dividends received shall be treated as definitely related to such dividends. The remaining reserve expenses of such company shall be allocated and apportioned under the rules of § 1.861–8 and this section.

(i) [Reserved.]

(j) *Examples.* The rules of this section may be illustrated by the following examples. All of these examples assume that section 482 has not been applied by the Commissioner.

Example (1)—(i) *Facts.* P owns all of the stock of X and all of the stock of Y. P, X and Y are domestic corporations. P is a holding company for the stock of X and Y. Both X and Y manufacture and sell a product which is included in a broad product category listed in § 1.861–8(e)(3)(i). During 1988, X incurred $100,000 on research connected with that product. All of the research was performed in the United States. In 1988, the domestic sales by X of the product totalled $400,000 and the foreign sales of the product totalled $200,000; Y's domestic sales of the product totalled $200,000 and Y's foreign sales of the product totalled $200,000. In 1988, X's gross income is $300,000, of which $200,000 is from domestic sales and $100,000 is from foreign sales; Y's gross income is $200,000 of which $100,000 is from domestic sales and $100,000 is from foreign sales.

(ii) P, X and Y are affiliated corporations within the meaning of section 864(e)(5) and this section. There search expenses incurred by X are allocable to all income connected with the relevant broad category listed in §1.861–8T(e)(3)(i). Both X and Y have gross income includible within the class of gross income related to that product category. Accordingly, the research and experimental expenses incurred by X are to be allocated and apportioned as if X and Y were a single corporation. The apportionment for 1988 is as follows:

Tentative Apportionment on the Basis of Sales

Research expenses to be apportioned $100,000
Exclusive apportionment to United States source gross income $30,000
Research expense to be apportioned on the basis of sales $70,000

Apportionment of research expense to foreign source general limitation income:

$$\$70{,}000 \times \frac{\$200{,}000+\$200{,}000}{\$600{,}000+\$400{,}000} = \$28{,}000$$

Apportionment of research expense to United States source gross income:

$$\$70{,}000 \times \frac{\$400{,}000+\$200{,}000}{\$600{,}000+\$400{,}000} = \$42{,}000$$

Total apportioned deduction for research $100,000
Of which—
Apportioned to foreign source gross income $28,000
Apportioned to U.S. source gross income ($30,000+$42,000) $72,000

Tentative Apportionment on the Basis of Gross Income

Research expense apportioned to foreign source gross income:

$$\$100{,}000 \times \frac{\$100{,}000+\$100{,}000}{\$300{,}000+\$200{,}000} = \$40{,}000$$

Research expense apportioned to United States income:

$$\$100,000 \times \frac{\$200,000+\$100,000}{\$300,000+\$200,000} = \$60,000$$

Example (2)—(i) *Facts.* P owns all of the stock of X, which owns all of the stock of Y. P, X and Y are all domestic corporations. P has incurred general training program expenses of $100,000 in 1987. Employees of P, X and Y participate in the training program. In 1987, P had United States source gross income of $200,000 and foreign source general limitation income of $200,000; X had U.S. source gross income of $100,000 and foreign source general limitation income of $100,000; and Y had U.S. source gross income of $300,000 and foreign source general limitation income of $100,000.

(ii) *Analysis.* P, X and Y are an affiliated group of corporations within the meaning of section 864(e)(5). The training expenses incurred by P are not definitely related solely to specific income producing activities or property of P. The employees of X and Y also participate in the training program. Thus, this expense relates to gross income generated by P, X and Y. This expense is definitely related and allocable to all of the gross income from foreign and domestic sources of P, X and Y. It is assumed that apportionment on the basis of gross income is reasonable. The apportionment of the expense is as follows:

Apportionment of $100,000 expense to foreign source general limitation income:

$$\$100,000 \times \frac{\$200,000+\$100,000+\$100,000}{\$400,000+\$200,000+\$400,000} = \$40,000$$

Apportionment of $100,000 expense to United States source gross income:

$$\$100,000 \times \frac{\$200,000+\$100,000+\$300,000}{\$400,000+\$200,000+\$400,000} = \$60,000$$

Total apportioned expense $100,000

Example (3)—(i) *Facts.* The facts are the same as in *Example* (2) above, except that only employees of P and X participate in the training program.

(ii) *Analysis.* Because only the employees of P and X participate in the training program and they perform no services for Y, the expense relates only to gross income generated by P and X. Accordingly, the $100,000 expense must be allocated and apportioned as if P and X were a single corporation. The apportionment of the $100,000 expense is as follows:

Apportionment of $100,000 expense to foreign source general limitation income:

$$\$100,000 \times \frac{\$200,000+\$100,000}{\$400,000+\$200,000} = \$50,000$$

Apportionment of $100,000 expense to U.S. source gross income:

$$\$100,000 \times \frac{\$200,000+\$100,000}{\$400,000+\$200,000} = \$50,000$$

Example (4)—(i) *Facts.* P owns all of the stock of X which owns all of the stock of Y. P and X are domestic corporations; Y is a foreign corporation. In 1987 P incurred $10,000 of stewardship expenses relating to an audit of Y.

(ii) *Analysis.* The stewardship expenses incurred by P are not directly allocable to specific income producing activities or property of P. The expense is definitely related and allocable to dividends received or to be received by X. Accordingly, the expense of P is allocated and apportioned as if P and X were a single corporation. The expense is definitely related to dividends received or to be received by X from Y, a foreign corporation. Such dividends are foreign source general limitation income. Thus, the entire amount of the expense must be allocated to foreign source dividend income.

Example (5)—(i) *Facts.* P owns all of the stock of X which owns all of the stock of Y. P, X and Y are all domestic corporations. In 1987, P incurred $10,000 legal expense relating to the testimony of certain employees of P in connection with litigation to which Y is a party. This expense is not allocable to specific income of Y. In 1987, Y had $100,000 foreign source general limitation income and $300,000 U.S. source gross income.

(ii) *Analysis.* The legal expenses incurred by P are not definitely related solely to specific income producing activities or property of P. The expense is definitely related and allocable to the class of gross income which includes only gross income generated by Y. Accordingly, the expense of P is allocated and apportioned as if Y were the only member of the affiliated group, as follows:

Apportionment of legal expenses to foreign source general limitation income:

$$\$10{,}000 \times \frac{\$100{,}000}{\$400{,}000} \ldots\ldots \$2{,}500$$

Apportionment of legal expenses to U.S. source gross income:

$$\$10{,}000 \times \frac{\$300{,}000}{\$400{,}000} \ldots\ldots \$7{,}500$$

Example (6)—(i) *Facts.* P owns all of the stock of R, which owns all of the stock of F. P and R are domestic corporations, and F is a foreign sales corporation under section 922 of the Code. R and F have entered into an agreement whereby F is paid a commission with respect to sales of product A. In 1987, P had gross receipts of $1,000,000 from domestic sales of product A, and gross receipts of $1,000,000 from foreign sales of product A. R had gross receipts of $1,000,000 from domestic sales of product A, and $1,000,000 from export sales of product A. R's cost of goods sold attributable to export sales is $500,000. R has deductible expenses of $100,000 directly related to its export sales, and F has such deductible expenses of $100,000. During 1987, P incurred an expense of $100,000 for marketing studies involving the worldwide market for product A.

(ii) *Analysis.* P and R are an affiliated group of corporations within the meaning of section 864(e)(5) and this section. The expense incurred by P for marketing studies regarding the worldwide market for product A is an expense that is not directly related solely to the activities of P, but also to the activities of R. This expense must be allocated and apportioned under the rules of paragraph (c)(1) of this section, as if P and R were a single corporation. The expense is allocable to the class of gross income that includes all gross income generated by sales of product A. Apportionment on the basis of gross receipts is reasonable under these facts. F, a foreign corporation, is not a member of the affiliated group. However, for purposes of determining F's commission on its sales, the combined gross income of F and R must be reduced by the portion of the marketing studies expense of P that is incurred in connection with export sales involving F under the rules of paragraph (f) of this section. The computation of the combined taxable income of R and F is as follows:

Combined Taxable Income of R and F

R's gross receipts from export sales	$1,000,000
R's cost of goods sold	$500,000
Combined Gross Income	$500,000
Less:	
R's other deductible expenses	$100,000
F's other deductible expenses	100,000
Apportionment of P's expense:	
$\$100{,}000 \times \frac{\$1{,}000{,}000}{\$200{,}000 + \$2{,}000{,}000}$	$25,000
Total	$225,000
Combined Taxable Income	$275,000

Par. 6. Section 1.863–3 is amended by revising paragraph (b)(2) *Example* (2), subdivisions (i) and (ii) to read as follows:

§ 1.863–3 Income from the sale of personal property derived partly from within and partly from without the United States.

* * * * *

(b) *Income partly from sources within a foreign country.*

* * * * *

(2) *Allocation or apportionment.*

* * * * *

Example (2). (i) and (ii) [Reserved] For guidance, see § 863–3T(b)(2) *Example* (2)(i) and (ii).

* * * * *

Par. 7. A new § 1.863–3T is added immediately after § 1.863–3 to read as follows:

§ 1.863–3T Income from the sale of personal property derived partly from within and partly from without the United States (Temporary regulations).

(a) [Reserved]

(b) *Income partly from sources within a foreign country.*

(1) [Reserved]

(2) *Allocation or apportionment.*

Example (1) [Reserved]

Example (2). (i) Where an independent factory or production price has not been established as provided under *Example* (1), the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States shall be computed.

(ii) Of this gross amount, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction, the numerator of which consists of the value of the taxpayer's property within the United States and the denominator of which consists of the value of the taxpayer's property both within the United States and within the foreign country. The remaining one-half of such gross income shall be apportioned in accordance with the gross sales of the taxpayer within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the taxpayer's gross sales for the taxable year or period within the United States, and the denominator of which consists of the taxpayer's gross sales for the taxable year or period both within the United States and within the foreign country. Deductions from gross income that are allocable and apportionable to gross income described in paragraph (i) of this *Example 2* shall be apportioned between the United States and foreign source portions of such income, as determined under this paragraph (ii), on a pro rata basis, without regard to whether the deduction relates primarily or exclusively to the production of property or to the sale of property.

(b)(2) *Example* (2)(iii) through (c)(4) [Reserved]

Subchapter G—[Amended]

Regulations Under Tax Conventions

Par. 8. The following regulations under tax conventions are hereby removed.

1. Part 501—Australia
2. Part 504—Belgium
3. Part 505—Netherlands
4. Part 506—Japan
5. Part 507—United Kingdom
6. Part 511—Finland
7. Part 512—Italy
8. Part 518—New Zealand
9. Part 519—Canada

OMB Control Numbers the Paperwork Reduction Act

PART 602—[AMENDED]

Par. 9. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 10. Section 602.101(c) is amended by inserting in the appropriate place in the table:

§ 1.861–9T	1545–1072.
§ 1.861–12T	1545–1072.

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

Approved: August 24, 1988.

O. Donaldson Chapoton,

Assistant Secretary of the Treasury.

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