



Treasury Decisions
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DEPARTMENT OF THE TREASURY
Internal Revenue Service

26 CFR Part 1

57 FR 13019

Allocation and Apportionment of Interest Expense

T.D. 8410

DATE: April 15, 1992

ACTION: Final regulations.

SUMMARY: This document contains final Income Tax Regulations relating to the allocation and apportionment of interest expense for purposes of computing taxable income from sources within and without the United States. The final regulations require that, in certain circumstances, third party interest expense of an affiliated group of corporations be allocated directly to foreign source income. These final regulations implement section 864(e) of the Internal Revenue Code of 1986.

DATES:

EFFECTIVE DATE: These regulations are effective for and apply to taxable years beginning after December 31, 1991. However, at the choice of the taxpayer, these regulations may be applied to taxable years beginning after December 31, 1987. Display Classification Information Display Classification Information Display Classification Information Display Classification Information Display Classification Information Display Classification Information Display Classification Information

ADDRESSES:

FOR FURTHER INFORMATION CONTACT: Judith Cavell 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:CORP:T:R (INTL-0952-86) (202-566-6442, not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

Proposed regulations which would have implemented section 864(e) of the Internal Revenue Code of 1986 were published in the Federal Register at *52 FR 34580* on September 11, 1987. Those proposed regulations were withdrawn and replaced by temporary regulations and a notice of proposed rulemaking by cross-reference to temporary regulations

published on September 14, 1988, in the Federal Register at 53 FR 35525 and 53 FR 35467, respectively.

On March 12, 1991, the Federal Register published proposed regulation § 1.861-10(e) withdrawing and replacing the earlier regulation § 1.861-10(e) proposed by cross-reference, but not withdrawing and replacing the corresponding temporary regulation § 1.861-10T(e). Written comments responding to this latest notice were received, and a public hearing was held on June 21, 1991. The Treasury Department hereby issues final regulation § 1.861-10(e), which incorporates, where appropriate, comments concerning the proposed regulations.

Explanation of Provisions

A. Summary of Regulation

Section 1.861-10(e) provides generally that a U.S. affiliated group ("U.S. group") which has both excess loans to related controlled foreign corporations ("excess related group indebtedness") and excess borrowing by the U.S. group from unrelated parties ("excess U.S. shareholder indebtedness") in the same taxable year must allocate directly to foreign source income an amount of interest expense equal to the amount of interest income received by the U.S. group with respect to excess related group indebtedness (or, if smaller, an amount of related group indebtedness equal to the amount of excess of U.S. shareholder indebtedness).

Section 1.861-10(e) employs a three-step process. In Step One, a U.S. group determines the amount of excess related group indebtedness (if any) for the current year by comparing its actual related group indebtedness for the year to the amount of allowable related group indebtedness for the year. The amount of allowable related group indebtedness is determined by multiplying the aggregate asset value of all related controlled foreign corporations (the "related CFC group") by the foreign base period ratio for the year. The foreign base period ratio for any taxable year is the average of the ratios of related group indebtedness to related CFC group assets for each of the five immediately preceding years.

In Step Two, the U.S. group determines the amount of excess of U.S. shareholder indebtedness (if any) for the current year by comparing its actual U.S. shareholder indebtedness for the year to the amount of allowable U.S. shareholder indebtedness for the year. The amount of allowable U.S. shareholder indebtedness is determined by multiplying the aggregate asset value of the U.S. group by the U.S. base period ratio for the year. The U.S. base period ratio for any taxable year is the average of the ratios of U.S. shareholder indebtedness to U.S. group assets for each of the five immediately preceding years.

In Step Three, the U.S. group compares the Step One amount of excess related group indebtedness and the Step Two amount of excess U.S. shareholder indebtedness. The amount of "allocable related group indebtedness" is the smaller of the two amounts. Interest expense, in an amount equal to the amount of interest income received by the U.S. group on allocable related group indebtedness, must be allocated directly to foreign source income of the U.S. group. This interest expense is allocated to separate limitation categories for purposes of section 904(d) in proportion to the amounts of related group indebtedness held by the U.S. group in each category. Several safe harbor rules and other special rules are provided. In addition, § 1.861-10(e)(9) provides rules for the application of § 1.861-10(e) by start-up companies and in the context of corporate acquisitions, dispositions and section 355 distributions.

B. Significant Comments and Revisions

Under § 1.861-10 (e)(2)(v)(A) and (e)(3)(v)(A), the foreign and U.S. base periods for any taxable year consist of the five immediately preceding taxable years. Under § 1.861-10 (e)(2)(v)(B) and (e)(3)(v)(B), U.S. group may choose, as its initial base years, the five years consisting of the 1982 taxable year through the 1986 taxable year. Under § 1.861-10 (e)(2)(v)(C) and (e)(3)(v)(C), a taxpayer that chooses to apply § 1.861-10(e) only with respect to taxable years beginning after December 31, 1991 and that does not choose the initial base years described in § 1.861-10 (e)(2)(v)(B) and (e)(3)(v)(B) may not include the taxable year immediately preceding the first effective taxable year within any base period. Section 1.861-10 (e)(2)(v)(D) and (e)(3)(v)(D) clarify that the same initial base years must be chosen for the foreign base period ratio and the U.S. base period ratio, and § 1.861-10 (e)(2)(iv) and (e)(3)(iv) have been revised to

clarify that the 110 percent limitations imposed by those sections do not apply with respect to each of the five initial base years.

Several commenters suggested that the foreign and U.S. base period ratios be calculated on a "weighted average" basis. Under this method, the sum of the amounts of related group indebtedness or U.S. shareholder indebtedness for each of the five base years would be divided by the sum of the aggregate values of related CFC group assets or U.S. group assets, respectively, for each of the five base years. This method would effectively give greater weight to years in which asset values are relatively large. The suggested method might thus be viewed as beneficial for some taxpayers with growing domestic and foreign operations, since it would give greater weight to more recent years. However, it could also penalize some taxpayers whose domestic or foreign operations are decreasing in size by giving less weight to more recent years. The method of § 1.861-10 (e)(2)(iv) and (e)(3)(iv) gives equal weight to each base year and thus results in a more accurate approximation of the average level of each indebtedness-to-asset ratio during the base period.

Several commenters suggested that direct allocation of interest expense be required only when a taxpayer's actual amounts of related group indebtedness and U.S. shareholder indebtedness vary from its amounts of allowable related group indebtedness and allowable U.S. shareholder indebtedness, respectively, by a specified percentage (*e.g.*, by 10 percent). The commenters noted in particular that exchange rate fluctuation may cause uncontrollable fluctuations in either or both of the two indebtedness-to-asset ratios. This suggestion was not adopted. The comparison of current year amounts of related group and U.S. shareholder indebtedness to allowable amounts computed on the basis of average historical indebtedness-to-asset ratios (rather than absolute amounts for a prior year) is intended to accommodate year-to-year changes in the relevant indebtedness amounts for other than tax reasons. In addition, the translation rules provided in § 1.861-10(e)(8)(i) should prevent any fluctuation in either indebtedness-to-asset ratio that is due solely to exchange rate fluctuations, and the provisions of § 1.861-10(e)(9) should accommodate fluctuations caused by significant corporate events.

Section 1.861-10(e)(2)(iv) provides that, for purposes of computing the foreign base period ratio for any taxable year, the ratio of related group indebtedness to related CFC group assets for any base year may not exceed 110 percent of the foreign base period ratio for that base year. Section 1.861-10(e)(3)(iv) provides a corresponding limitation with respect to the U.S. base period ratio. Several commenters stated that limitations of 110 percent place taxpayers with initially low foreign and U.S. base period ratios at a disadvantage, relative to taxpayers with initially high base period ratios. These commenters argued that a higher percentage limitation would reduce this disadvantage and better accommodate non-abusive transactions. This suggestion has not been adopted, because the Service believes that a 110 percent limitation provides sufficient flexibility for gradual adjustments in the foreign and U.S. base period ratios and that the rules of § 1.861-10 (e)(9) sufficiently accommodate significant corporate events. To reduce the potential for disadvantage of taxpayers with initially low base period ratios, § 1.861-10 (e)(2)(iv) and (e)(3)(iv) have been amended to provide that the 110 percent limitation does not apply with respect to any base period year for which the relevant indebtedness-to-asset ratio does not exceed 0.10.

A number of commenters suggested that, for purposes of computing the foreign base period ratio, the ratio of related group indebtedness to related CFC group assets taken into account for any base year be no less than 90 percent of the foreign base period ratio for that base year. A corresponding limitation was suggested with respect to the U.S. base period ratio. The commenters argued that these additional limitations were necessary to counterbalance the restrictive effect of the 110 percent limitations imposed by § 1.861-10 (e)(2)(iv) and (e)(3)(iv). This suggestion was not adopted. The 110 percent limitations of § 1.861-10 (e)(2)(iv) and (e)(3)(iv) are necessary to prevent avoidance of § 1.861-10 (e). As anti-avoidance rules, they provide no rationale for the inclusion of reciprocal rules beneficial to the taxpayer. In addition, the Service believes that the suggested 90% limitation would have effectively preserved any relative advantage now enjoyed by taxpayers with initially high foreign and U.S. base period ratios.

Redundant "safe harbor" language of proposed § 1.861-10 (e)(2)(vii)(B) and (e)(3)(vii) has been eliminated. In response to taxpayer comments, a new safe harbor has been added to § 1.861-10(e)(3)(vii) under which a U.S. group is considered to have no excess U.S. shareholder indebtedness in any taxable year in which its ratio of U.S. shareholder

indebtedness to U.S. group assets does not exceed 0.10. This new safe harbor is intended to relieve taxpayers who, by virtue of having historically low U.S. base period ratios, may trigger the application of § 1.861-10(e) with minimal fluctuations in U.S. group borrowing. A suggestion that a higher safe harbor ratio be provided in § 1.861-10(e)(2)(vii)(B) was not adopted.

A number of commenters argued that the foreign base period ratio used in determining excess related group indebtedness under § 1.861-10(e)(2)(i) for any taxable year should be no less than 0.10 (the safe harbor ratio provided in § 1.861-10(e)(2)(vii)(B)). It was suggested that this rule would avoid disparate treatment of taxpayers with foreign base period ratios slightly lower than 0.10 and taxpayers with foreign base period ratios slightly higher than 0.10. This suggestion assumes incorrectly, however, that the safe harbor of § 1.861-10(e)(2)(vii)(B) is intended to provide all taxpayers with an exemption from direct allocation for related group indebtedness in an amount equal to 10 percent of the value of related CFC group assets. In fact, the safe harbor rule is intended only to relieve taxpayers with relatively low levels of related group indebtedness from the computational burdens of § 1.861-10(e). The Service believes that revised § 1.861-10(e)(2)(iv), under which the 110 percent limitation imposed by paragraph (e)(2)(iv) does not apply with respect to base years in which the ratio of related group indebtedness to related CFC group assets does not exceed 0.10, will mitigate any potential disparity in the treatment of taxpayers with foreign base period ratios slightly higher and slightly lower, respectively, than 0.10. The new safe harbor rule of § 1.861-10(e)(3)(vii), and revised § 1.861-10(e)(3)(iv), will operate in an analogous manner with respect to the ratio of U.S. shareholder indebtedness to U.S. group assets.

Several commenters recommended that the aggregate value of U.S. group assets used to compute allowable U.S. shareholder indebtedness under § 1.861-10(e)(3)(iii)(A) not be reduced by the amount of excess related group indebtedness for the year (as determined under Step One in § 1.861-10(e)(2)). This suggestion has not been adopted, because this reduction is necessary to effectuate a dollar-for-dollar matching of disproportionate U.S. shareholder indebtedness to excess related group indebtedness under § 1.861-10(e)(4).

In response to taxpayer comments, § 1.861-10(e)(6) has been revised to provide that the aggregate asset value of a related CFC for any taxable year may be determined by reference to the asset values reflected on a Form 5471 (or attachment thereto) filed for such taxable year. Form 5471 asset values must be used consistently, however, for all related CFCs and for all taxable years. In addition, Form 5471 asset values may be used only if the taxable year of each related CFC begins with, or no more than one month earlier than, the taxable year of the U.S. group. Beginning of year asset values, whether for a related CFC or for the U.S. group, are the same as the corresponding asset values as of the end of the immediately preceding year.

Several commenters suggested that a provision similar to the fixed stock writeoff method provided in proposed regulation § 1.163(j)-5(e) be added to § 1.861-10(e) to accommodate the acquisition of a related CFC or U.S. group member by means of a stock acquisition for which a section 338 election is not made. The commenters noted that a stock acquisition of this type can result in a substantial, non-abusive increase in the relevant indebtedness-to-asset ratio for a U.S. group that values assets by reference to tax book value (rather than fair market value). The suggested modification was not adopted. However, the Service intends to consider the proper treatment of such stock acquisitions in the context of forthcoming final regulations under section 864(e) relating to the allocation and apportionment of interest expense.

In response to taxpayer comments, § 1.861-10(e)(8)(i) has been added to provide that all amounts of related group indebtedness and U.S. shareholder indebtedness and all related CFC group and U.S. group asset values that are denominated in a currency other than U.S. dollars are to be translated into dollars at an average exchange rate for the current taxable year. This translation rule applies with respect to indebtedness amounts and asset values for each of the five base years, as well as to amounts and values for the current year, and thus will require taxpayers to redetermine base year indebtedness amounts and asset values on an annual basis. Use of a current year exchange rate to translate all non-dollar amounts should prevent the application of § 1.861-10(e) to any taxpayer solely by virtue of exchange rate fluctuations.

Although proposed § 1.861-10(e)(8)(i) has been deleted, the Service will apply, for purposes of § 1.861-10(e), the definition of "indebtedness" contained in § 1.861-13T(a)(3). The Service anticipates that final regulations forthcoming under section 864(e) will incorporate a definition of "indebtedness" similar to that of § 1.861-13T(a)(3) and applicable for all purposes of the regulations under section 864(e).

Section § 1.861-10(e)(8)(iii) has been added to clarify that indebtedness which qualifies for direct allocation of interest expense under § 1.861-10T (b) or (c) is excluded from related group indebtedness or U.S. shareholder indebtedness, and the value of any asset which is the subject of qualified non-recourse indebtedness under § 1.861-10T(b) or an integrated financial transaction under § 1.861-10T(c) is excluded from the aggregate asset value of the related CFC group or the U.S. group. Exempt assets (within the meaning of § 1.861-8T(d)) are included, however, in determining aggregate asset values under § 1.861-10(e)(8)(ii).

New § 1.861-10(e)(8)(iv) has been added to clarify that receivables arising between related CFCs (or between members of the U.S. group) do not constitute assets of the related CFC (or U.S. group member) holding such receivables.

The special reclassification rule of § 1.861-10(e)(8)(v) has been revised to apply in the context of multiple tiers of CFCs. Section 1.861-10(e)(8)(vi) clarifies that its special reclassification rule does not apply to CFC stock that gives rise to a CFC deduction for dividends paid under an integrated tax system.

Several commenters suggested that § 1.861-10(e)(9)(i) provide a higher presumed ratio of related group indebtedness to related CFC group assets for base years in which a U.S. group holds no related CFC stock. This suggestion has not been adopted.

Several commenters requested additional guidance under § 1.861-10(e)(9)(iii)(A) and (v)(A) as to the manner in which the values of assets acquired or divested near the end or beginning of a year should be weighted to avoid substantial distortions. These sections have been revised to clarify that the Service is concerned only with transactions occurring within three months of the end or beginning of a year. While the appropriate weighting method will vary, depending upon the facts of a particular situation, one method likely to produce reasonable results in many situations would be to prorate asset values acquired or divested within three months of the end or beginning of a year.

The separate group acquisition and disposition elections of proposed § 1.861-10(e)(9) (iv) and (vi) have been replaced with new elections under which taxpayers may recompute base period ratios as if acquired (or divested) corporations had (or had not) been members of the taxpayer's U.S. group or related CFC group at the beginning of the acquisition (or disposition) year and during base years prior to the acquisition (or disposition) year. The Service believes that these new elections will be less complex to apply and will provide greater relief.

Several commenters suggested that relief be provided in § 1.861-10(e)(9) for acquisitions and dispositions of substantial assets. This suggestion was not adopted, in view of the many options available to taxpayers in structuring asset transactions. As a result, specific relief provisions would be prohibitively complex to construct and administer. In addition, because taxpayers have greater flexibility in structuring asset transactions, relief provisions are less necessary in this context than in the context of stock transactions.

Commenters on the alternative version of Step Two described in the preamble to the proposed regulations suggested that this alternative be available on an elective basis. This suggestion was not adopted.

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. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the

Internal Revenue Code, the proposed regulations were submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Judith Cavell of the Office of the Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. Other personnel from the Internal Revenue Service and Treasury Department participated in developing the regulations.

List of Subjects in 26 CFR 1.861-1 Through 1.864-12

Income taxes, United States investments abroad.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1 -- INCOME TAX: TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 * * *

Section 1.861-10(e) 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 to read as follows:

§ 1.861-10 Special allocations of interest expense.

(a) through (d). [Reserved]

(e) *Treatment of certain related group indebtedness* -- (1) *In general.* If, for any taxable year beginning after December 31, 1991, a U.S. shareholder (as defined in paragraph (e)(5)(i) of this section) has both --

(i) Excess related group indebtedness (as determined under Step One in paragraph (e)(2) of this section) and

(ii) Excess U.S. shareholder indebtedness (as determined under Step Two in paragraph (e)(3) of this section),

the U.S. shareholder shall allocate, to its gross income in the various separate limitation categories described in section 904(d)(1), a portion of its interest expense paid or accrued to any obligee who is not a member of the affiliated group (as defined in § 1.861-11T(d)) of the U.S. shareholder ("third party interest expense"), excluding amounts allocated under paragraphs (b) and (c) of § 1.861-10T. The amount of third party interest expense so allocated shall equal the total amount of interest income derived by the U.S. shareholder during the year from related group indebtedness, multiplied by the ratio of the lesser of the foregoing two amounts of excess indebtedness for the year to related group indebtedness for the year. This amount of third party interest expense is allocated as described in Step Three in paragraph (e)(4) of this section.

(2) *Step One: Excess related group indebtedness.* (i) The excess related group indebtedness of a U.S. shareholder for the year equals the amount by which its related group indebtedness for the year exceeds its allowable related group indebtedness for the year.

(ii) The "related group indebtedness" of the U.S. shareholder is the average of the aggregate amounts at the beginning and end of the year of indebtedness owed to the U.S. shareholder by each controlled foreign corporation

which is a related person (as defined in paragraph (e)(5)(ii) of this section) with respect to the U.S. shareholder.

(iii) The "allowable related group indebtedness" of a U.S. shareholder for the year equals --

(A) The average of the aggregate values at the beginning and end of the year of the assets (including stock holdings in and obligations of related persons, other than related controlled foreign corporations) of each related controlled foreign corporation, multiplied by

(B) The foreign base period ratio of the U.S. shareholder for the year.

(iv) The "foreign base period ratio" of the U.S. shareholder for the year is the average of the related group debt-to-asset ratios of the U.S. shareholder for each taxable year comprising the foreign base period for the current year (each a "base year"). For this purpose, however, the related group debt-to-asset ratio of the U.S. shareholder for any base year may not exceed 110 percent of the foreign base period ratio for that base year. This limitation shall not apply with respect to any of the five taxable years chosen as initial base years by the U.S. shareholder under paragraph (e)(2)(v) of this section or with respect to any base year for which the related group debt-to-asset ratio does not exceed 0.10.

(v)(A) The foreign base period for any current taxable year (except as described in paragraphs (e)(2)(v) (B) and (C) of this section) shall consist of the five taxable years immediately preceding the current year.

(B) The U.S. shareholder may choose as foreign base periods for all of its first five taxable years for which this paragraph (e) is effective the following alternative base periods:

(1) For the first effective taxable year, the 1982, 1983, 1984, 1985 and 1986 taxable years;

(2) For the second effective taxable year, the 1983, 1984, 1985 and 1986 taxable years and the first effective taxable year;

(3) For the third effective taxable year, the 1984, 1985 and 1986 taxable years and the first and second effective taxable years;

(4) For the fourth effective taxable year, the 1985 and 1986 taxable years and the first, second and third effective taxable years; and

(5) For the fifth effective taxable year, the 1986 taxable year and the first, second, third and fourth effective taxable years.

(C) If, however, the U.S. shareholder does not choose, under paragraph (e)(10)(ii) of this section, to apply this paragraph (e) to one or more taxable years beginning before January 1, 1992, the U.S. shareholder may not include within any foreign base period the taxable year immediately preceding the first effective taxable year. Thus, for example, a U.S. shareholder for which the first effective taxable year is the taxable year beginning on October 1, 1992, may not include the taxable year beginning on October 1, 1991, in any foreign base period. Assuming that the U.S. shareholder does not elect the alternative base periods described in paragraph (e)(2)(v)(B) of this section, the initial foreign base period for the U.S. shareholder will consist of the taxable years beginning on October 1 of 1986, 1987, 1988, 1989, and 1990. The foreign base period for the U.S. shareholder for the following taxable year, beginning on October 1, 1993, will consist of the taxable years beginning on October 1 of 1987, 1988, 1989, 1990, and 1992.

(D) If the U.S. shareholder chooses the base periods described in paragraph (e)(2)(v)(B) of this section as foreign base periods, it must make a similar election under paragraph (e)(3)(v)(B) of this section with respect to its U.S. base periods.

(vi) The "related group debt-to-asset ratio" of a U.S. shareholder for a year is the ratio between --

(A) The related group indebtedness of the U.S. shareholder for the year (as determined under paragraph (e)(2)(ii) of this section); and

(B) The average of the aggregate values at the beginning and end of the year of the assets (including stock holdings in and obligations of related persons, other than related controlled foreign corporations) of each related controlled foreign corporation.

(vii) Notwithstanding paragraph (e)(2)(i) of this section, a U.S. shareholder is considered to have no excess related group indebtedness for the year if --

(A) Its related group indebtedness for the year does not exceed its allowable related group indebtedness for the immediately preceding year (as determined under paragraph (e)(2)(iii) of this section); or

(B) Its related group debt-to-asset ratio (as determined under paragraph (e)(2)(vi) of this section) for the year does not exceed 0.10.

(3) *Step Two: Excess U.S. shareholder indebtedness.* (i) The excess indebtedness of a U.S. shareholder for the year equals the amount by which its unaffiliated indebtedness for the year exceeds its allowable indebtedness for the year.

(ii) The "unaffiliated indebtedness of the U.S. shareholder is the average of the aggregate amounts at the beginning and end of the year of indebtedness owed by the U.S. shareholder to any obligee, other than a member of the affiliated group (as defined § 1.861-11T(d)) of the U.S. shareholder.

(iii) The "allowable indebtedness" of a U.S. shareholder for the year equals --

(A) The average of the aggregate values at the beginning and end of the year of the assets of the U.S. shareholder (including stock holdings in and obligations of related controlled foreign corporations, but excluding stock holdings in the obligations of members of the affiliated group (as defined in § 1.861-11T(d)) of the U.S. shareholder), reduced by the amount of the excess related group indebtedness of the U.S. shareholder for the year (as determined under Step One in paragraph (e)(2) of this section), multiplied by

(B) The U.S. base period ratio of the U.S. shareholder for the year.

(iv) The "U.S. base period ratio" of the U.S. shareholder for the year is the average of the debt-to-asset ratios of the U.S. shareholder for each taxable year comprising the U.S. base period for the current year (each a "base year"). For this purpose, however, the debt-to-asset ratio of the U.S. shareholder for any base year may not exceed 110 percent of the U.S. base period ratio for that base year. This limitation shall not apply with respect to any of the five taxable years chosen as initial base years by the U.S. shareholder under paragraph (e)(3)(v) of this section or with respect to any base year for which of the debt-to-asset ratio does not exceed 0.10.

(v)(A) The U.S. base period for any current taxable year (except as described in paragraphs (e)(3)(v) (B) and (C) of this section) shall consist of the five taxable years immediately preceding the current year.

(B) The U.S. shareholder may choose as U.S. base periods for all of its first five taxable years for which this paragraph (e) is effective the following alternative base periods:

(1) For the first effective taxable year, the 1982, 1983, 1984, 1985 and 1986 taxable years;

(2) For the second effective taxable year, the 1983, 1984, 1985 and 1986 taxable years and the first effective taxable year;

(3) For the third effective taxable year, the 1984, 1985 and 1986 taxable years and the first and second effective taxable years;

(4) For the fourth effective taxable year, the 1985 and 1986 taxable years and the first, second and third effective taxable years; and

(5) For the fifth effective taxable year, the 1986 taxable year and the first, second, third and fourth effective taxable years.

(C) If, however, the U.S. shareholder does not choose, under paragraph (e)(10)(ii) of this section, to apply this paragraph (e) to one or more taxable years beginning before January 1, 1992, the U.S. shareholder may not include within any U.S. base period the taxable year immediately preceding the first effective taxable year. Thus, for example, a U.S. shareholder for which the first effective taxable year is the taxable year beginning on October 1, 1992, may not include the taxable year beginning on October 1, 1991, in any U.S. base period. Assuming that the U.S. shareholder does not elect the alternative base periods described in paragraph (e)(3)(v)(B) of this section, the initial U.S. base period for the U.S. shareholder will consist of the taxable years beginning on October 1, of 1986, 1987, 1988, 1989, and 1990. The U.S. base period for the U.S. shareholder for the following taxable year, beginning on October 1, 1993, will consist of the taxable years beginning on October 1, 1987, 1988, 1989, 1990, and 1992.

(D) If the U.S. shareholder chooses the base periods described in paragraph (e)(3)(v)(B) of this section as U.S. base periods, it must make a similar election under paragraph (e)(2)(v)(B) of this section with respect to its foreign base periods.

(vi) The "debt-to-asset ratio" of a U.S. shareholder for a year is the ratio between --

(A) The unaffiliated indebtedness of the U.S. shareholder for the year (as determined under paragraph (e)(3)(ii) of this section); and

(B) The average of the aggregate values at the beginning and end of the year of the assets of the U.S. shareholder. For this purpose, the assets of the U.S. shareholder include stock holdings in and obligations of related controlled foreign corporations but do not include stock holdings in and obligations of members of the affiliated group (as defined in § 1.861-11T(d)).

(vii) A U.S. shareholder is considered to have no excess indebtedness for the year if its debt-to-asset ratio (as determined under paragraph (e)(3)(vi) of this section) for the year does not exceed 0.10.

(4) *Step Three: Allocation of third party interest expense.* (i) A U.S. shareholder shall allocate to its gross income in the various separate limitation categories described in section 904(d)(1) a portion of its third party interest expense incurred during the year equal in amount to the interest income derived by the U.S. shareholder during the year from allocable related group indebtedness.

(ii) The "allocable related group indebtedness" of a U.S. shareholder for any year is an amount of related group indebtedness equal to the lesser of --

(A) The excess related group indebtedness of the U.S. shareholder for the year (determined under Step One in paragraph (e)(2) of this section); or

(B) The excess U.S. shareholder indebtedness for the year (determined under Step Two in paragraph (e)(3) of this section).

(iii) The amount of interest income derived by a U.S. shareholder from allocable related group indebtedness during the year equals the total amount of interest income derived by the U.S. shareholder during the year with respect to related group indebtedness, multiplied by the ratio of allocable related group indebtedness for the year to the aggregate amount of related group indebtedness for the year.

(iv) The portion of third party interest expense described in paragraph (e)(4)(i) of this section shall be allocated in proportion to the relative average amounts of related group indebtedness held by the U.S. shareholder in each separate limitation category during the year. The remaining portion of third party interest expense of the U.S. shareholder for the year shall be apportioned as provided in §§ 1.861-8T through 1.861-13T, excluding paragraph (e) of § 1.861-10T and this paragraph (e).

(v) The average amount of related group indebtedness held by the U.S. shareholder in each separate limitation category during the year equals the average of the aggregate amounts of such indebtedness in each separate limitation category at the beginning and end of the year. Solely for purposes of this paragraph (e)(4), each debt obligation of a related controlled foreign corporation held by the U.S. shareholder at the beginning or end of the year is 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 not such stock is held directly by the U.S. shareholder.

(vi) The amount of third party interest expense of a U.S. shareholder allocated pursuant to this paragraph (e)(4) shall not exceed the total amount of the third party interest expense of the U.S. shareholder for the year (excluding any third party interest expense allocated under paragraphs (b) and (c) of § 1.861-10T).

(5) *Definitions.* For purposes of this paragraph (e), the following terms shall have the following meanings.

(i) *U.S. shareholder.* The term "U.S. shareholder" has the same meaning as the term "United States shareholder" when used in section 957, except that, in the case of a United States shareholder that is a member of an affiliated group (as defined in § 1.861-11T(d)), the entire affiliated group is considered to constitute a single U.S. shareholder.

(ii) *Related person.* For the definition of the term "related person", see § 1.861-8T(c)(2). A controlled foreign corporation is considered "related" to a U.S. shareholder if it is a related person with respect to the U.S. shareholder.

(6) *Determination of asset values.* A U.S. shareholder shall determine the values of the assets of each related controlled foreign corporation (for purposes of Step One in paragraph (e)(2) of this section) and the assets of the U.S. shareholder (for purposes of Step Two in paragraph (e)(3) of this section) for any year in accordance with the valuation method (tax book value of fair market value) elected for that year pursuant to § 1.861-9T(g). However, solely for purposes of this paragraph (e), a U.S. shareholder may instead choose to determine the values of the assets of all related controlled foreign corporations by reference to their values as reflected on Forms 5471 (the annual information return with respect to each related controlled foreign corporation), subject to the translation rules of paragraph (e)(8)(i) of this section. This method of valuation may be used only if the taxable years of each of the related controlled foreign corporations begin with, or no more than one month earlier than, the taxable year of the U.S. shareholder. Once chosen for a taxable year, this method of valuation must be used in each subsequent taxable year and may be changed only with the consent of the Commissioner.

(7) *Adjustments to asset value.* For purposes of apportioning remaining interest expense under § 1.861-9T, a U.S. shareholder shall reduce (but not below zero) the value of its assets for the year (as determined under § 1.861-9T (g) (3) or (h)) by an amount equal to the allocable related group indebtedness of the U.S. shareholder for the year (as determined under Step Three in paragraph (e)(4)(ii) of this section). This reduction is allocated among assets in each separate limitation category in proportion to the average amount of related group indebtedness held by the U.S. shareholder in each separate limitation category during the year (as determined under Step Three in paragraph (e)(4)(v) of this section).

(8) *Special rules -- (i) Exchange rates.* All indebtedness amounts and asset values (including current year and base year amounts and values) denominated in a foreign currency shall be translated into U.S. dollars at the exchange rate for the current year. The exchange rate for the current year may be determined under any reasonable method (e.g., average of month-end exchange rates for each month in the current year) if it is consistently applied to the current year and all base years. Once chosen for a taxable year, a method for determining an exchange rate must be used in each subsequent

taxable year and will be treated as a method of accounting for purposes of section 446. A taxpayer may apply a different translation rule only with the prior consent of the Commissioner. In this regard, the Commissioner will be guided by the extent to which a different rule would reduce the comparability of dollar amounts of indebtedness and dollar asset values for the base years and the current year.

(ii) *Exempt assets.* Solely for purposes of this paragraph (e), any exempt assets otherwise excluded under section 864(e)(3) and § 1.861-8T(d) shall be included as assets of the U.S. shareholder or related controlled foreign corporation.

(iii) *Exclusion of certain directly allocated indebtedness and assets.* Qualified nonrecourse indebtedness (as defined in § 1.861-10T(b)(2)) and indebtedness incurred in connection with an integrated financial transaction (as defined in § 1.861-10T(c)(2)) shall be excluded from U.S. shareholder indebtedness and related group indebtedness. In addition, assets which are the subject of qualified nonrecourse indebtedness or integrated financial transactions shall be excluded from the assets of the U.S. shareholder and each related controlled foreign corporation.

(iv) *Exclusion of certain receivables.* Receivables between related controlled foreign corporations (or between members of the affiliated group constituting the U.S. shareholder) shall be excluded from the assets of the related controlled foreign corporation (or affiliated group member) holding such receivables. See also § 1.861-11T(e)(1).

(v) *Classification of certain loans as related group indebtedness.* If --

(A) A U.S. shareholder owns stock in a related controlled foreign corporation which is a resident of a country that

--

(1) Does not impose a withholding tax of 5 percent or more upon payments of dividends to a U.S. shareholder; and

(2) Does not, for the taxable year of the controlled foreign corporation, subject the income of the controlled foreign corporation to an income tax which is greater than that percentage specified under § 1.954-1T(d)(1)(i) of the maximum rate of tax specified under section 11 of the Code, and

(B) The controlled foreign corporation has outstanding a loan or loans to one or more other related controlled foreign corporations, or the controlled foreign corporation has made a direct or indirect capital contribution to one or more other related controlled foreign corporations which have outstanding a loan or loans to one or more other related controlled foreign corporations,

then, to the extent of the aggregate amount of its capital contributions in taxable years beginning after December 31, 1986, to the related controlled foreign corporation that made such loans or additional contributions, the U.S. shareholder itself shall be treated as having made the loans described in paragraph (e)(8)(v)(B) of this section and, thus, such loan amounts shall be considered related group indebtedness. However, for purposes of paragraph (e)(4) of this section, interest income derived by the U.S. shareholder during the year from related group indebtedness shall not include any income derived with respect to the U.S. shareholder's ownership of stock in the related controlled foreign corporation that made such loans or additional contributions.

(vi) *Classification of certain stock as related person indebtedness.* In determining the amount of its related group indebtedness for any taxable year, a U.S. shareholder must treat as related group indebtedness its holding of stock in a related controlled foreign corporation if, during such taxable year, such related controlled foreign corporation claims a deduction for interest under foreign law for distributions on such stock. However, for purposes of paragraph (e)(4) of this section, interest income derived by the U.S. shareholder during the year from related group indebtedness shall not include any income derived with respect to the U.S. shareholder's ownership of stock in the related controlled foreign corporation.

(9) *Corporate events* -- (i) *Initial acquisition of a controlled foreign corporation.* If the foreign base period of the

U.S. shareholder for any year includes a base year in which the U.S. shareholder did not hold stock in any related controlled foreign corporation, then, in computing the foreign base period ratio, the related group debt-to-asset ratio of the U.S. shareholder for any such base year shall be deemed to be 0.10.

(ii) *Incorporation of U.S. shareholder -- (A) Nonapplication.* This paragraph (e) does not apply to the first taxable year of the U.S. shareholder. However, this paragraph (e) does apply to all following years, including years in which later members of the affiliated group may be incorporated.

(B) *Foreign and U.S. base period ratios.* In computing the foreign and U.S. base period ratios, the foreign and U.S. base periods of the U.S. shareholder shall be considered to be only the period prior to the current year that the U.S. shareholder was in existence if this prior period is less than five taxable years.

(iii) *Acquisition of additional corporations. (A)* If a U.S. shareholder acquires (directly or indirectly) stock of a foreign or domestic corporation which, by reason of the acquisition, then becomes a related controlled foreign corporation or a member of the affiliated group, then in determining excess related group indebtedness or excess U.S. shareholder indebtedness, the indebtedness and assets of the acquired corporation shall be taken into account only at the end of the acquisition year and in following years. Thus, amounts of indebtedness and assets and the various debt-to-asset ratios of the U.S. shareholder existing at the beginning of the acquisition year or relating to preceding years are not recalculated to take account of indebtedness and assets of the acquired corporation existing as of dates before the end of the year. If, however, a major acquisition is made within the last three months of the year and a substantial distortion of values for the year would otherwise result, the taxpayer must take into account the average values of the acquired indebtedness and assets weighted to reflect the time such indebtedness is owed and such assets are held by the taxpayer during the year.

(B) In the case of a reverse acquisition subject to this paragraph (e)(9), the rules of § 1.1502-75(d)(3) apply in determining which corporations are the acquiring and acquired corporations. For this purpose, whether corporations are affiliated is determined under § 1.861-11T(d).

(C) If the stock of a U.S. shareholder is acquired by (and, by reason of such acquisition, the U.S. shareholder becomes affiliated with) a corporation described below, then such U.S. shareholder shall be considered to have acquired such corporation for purposes of the application of the rules of this paragraph (e). A corporation to which this paragraph (e)(9)(iii)(C) applies is --

(1) A corporation which is not affiliated with any other corporation (other than other similarly described corporation); and

(2) Substantially all of the assets of which consist of cash, securities and stock.

(iv) *Election to compute base period ratios by including acquired corporations.* A U.S. shareholder may choose, solely for purposes of paragraph (e)(9) (i) and (iii) of this section, to compute its foreign and U.S. base period ratios for the acquisition year and all subsequent years by taking into account the indebtedness and asset values of the acquired corporation or corporations (including related group indebtedness owed to a former U.S. shareholder) at the beginning of the acquisition year and in each of the five base years preceding the acquisition year. This election, if made for an acquisition, must be made for all other acquisitions occurring during the same taxable year or initiated in that year and concluded in the following year.

(v) *Dispositions.* If a U.S. shareholder disposes of stock of a foreign or domestic corporation which, by reason of the disposition, then ceases to be a related controlled foreign corporation or a member of the affiliated group (unless liquidated or merged into a related corporation), in determining excess related group indebtedness or excess U.S. shareholder indebtedness, the indebtedness and assets of the divested corporation shall be taken into account only at the beginning of the disposition year and for the relevant preceding years. Thus, amounts of indebtedness and assets and the various debt-to-asset ratios of the U.S. shareholder existing at the end of the year or relating to following years are not

affected by indebtedness and assets of the divested corporation existing as of dates after the beginning of the year. If, however, a major disposition is made within the first three months of the year and a substantial distortion of values for the year would otherwise result, the taxpayer must take into account the average values of the divested indebtedness and assets weighted to reflect the time such indebtedness is owed and such assets are held by the taxpayer during the year.

(vi) *Election to compute base period ratios by excluding divested corporations.* A U.S. shareholder may choose, solely for purposes of paragraph (e) (9) (v) and (vii) of this section, to compute its foreign and U.S. base period ratios for the disposition year and all subsequent years without taking into account the indebtedness and asset values of the divested corporation or corporations at the beginning of the disposition year and in each of the five base years preceding the disposition year. This election, if made for a disposition, must be made for all other dispositions occurring during the same taxable year or initiated in that year and concluded in the following year.

(vii) *Section 355 transactions.* A U.S. corporation which becomes a separate U.S. shareholder as a result of a distribution of its stock to which section 355 applies shall be considered --

(A) As disposed of by the U.S. shareholder of the affiliated group of which the distributing corporation is a member, with this disposition subject to the rules of paragraphs (e) (9) (v) and (vi) of this section; and

(B) As having the same related group debt-to-asset ratio and debt-to-asset ratio as the distributing U.S. shareholder in each year preceding the year of distribution for purposes of applying this paragraph (e) to the year of distribution and subsequent years of the distributed corporation.

(10) *Effective date -- (i) Taxable years beginning after December 31, 1991.* The provisions of this paragraph (e) apply to all taxable years beginning after December 31, 1991.

(ii) *Taxable years beginning after December 31, 1987 and before January 1, 1992.* The provisions of § 1.861-10T (e) apply to taxable years beginning after December 31, 1987, and before January 1, 1992. The taxpayer may elect to apply the provisions of this paragraph (e) (in lieu of the provisions of § 1.861-10T (e)) for any taxable year beginning after December 31, 1987, but this paragraph (e) must then be applied to all subsequent taxable years.

(11) The following example illustrates the provisions of this paragraph (e):

Example. (i) *Facts.* X, a domestic corporation, elects to apply this paragraph (e) to its 1990 tax year. X has a calendar taxable year and apportions its interest expense on the basis of the tax book value of its assets. In 1990, X incurred deductible third-party interest expense of \$24,960 on an average amount of indebtedness (determined on the basis of beginning-of-year and end-of-year amounts) of \$249,600. X manufactures widgets, all of which are sold in the United States. X owns all of 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 deficit of earnings and profits attributable to taxable years prior to 1987. X's total assets and their average tax book values (determined on the basis of beginning-of-year and end-of-year tax book values) for 1990 are:

Asset	Average tax book value
Plant and equipment	\$315,000
Corporate headquarters	60,000
Y stock	75,000

Y note	50,000
Total	500,000

Y had \$25,000 of income before the deduction of any interest expense. Of this total, \$5,000 is high withholding tax interest income. The remaining \$20,000 is derived from widget sales, and constitutes foreign source general limitation income. Assume that Y has no deductions from gross income other than interest expense. During 1990, Y paid \$5,000 of interest expense to X on the Y note and \$10,000 of interest expense to third parties, giving Y total interest expense of \$15,000. X elects pursuant to § 1.861-9T to apportion Y's interest expense under the gross income method prescribed in section 1.861-9T (j).

(ii) *Step 1*: Using a beginning and end of year average, X (the U.S. shareholder) held the following average amounts of indebtedness of Y and Y had the following average asset values:

	1985	1986-88	1989	1990
(A) Related group indebtedness	\$11,000	24,000	26,000	50,000
(B) Average Value of Assets of Related CFC	100,000	200,000	200,000	250,000
(C) Related Group Debt-to-Asset Ratio	.11	.12	.13	.20

(1) X's "foreign base period ratio" for 1990, an average of its ratios of related group indebtedness to related group assets for 1985 through 1989, is:

$$(.11+.12+.12+.12+.13)/5=.12$$

(2) X's "allowable related group indebtedness" for 1990 is:

$$\mathbf{\$250,000 \times .12 = \$30,000.}$$

(2) X's "excess related group indebtedness" for 1990 is:

$$\mathbf{\$50,000 - X. 12 = \$30,000}$$

X's related group indebtedness of \$50,000 for 1990 is greater than its allowable related group indebtedness of \$24,000 for 1989 (assuming a foreign base period ratio in 1989 of .12), and X's related group debt-to-asset ratio for 1990 is .20, which is greater than the ratio of .10 described in paragraph (e)(2)(vii)(B) of this section. Therefore, X's excess related group indebtedness for 1990 remains at 20,000.

(iii) *Step 2*: Using a beginning and end of year average, X has the following average amounts of U.S. and foreign indebtedness and average asset values:

1985	1986	1987	1988	1989	1990
------	------	------	------	------	------

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(1)	\$231,400	225,000	225,000	225,000	220,800	249,600
(2)	445,000	450,000	450,000	450,000	460,000	480,000
						(a)
(3)	.52	.50	.50	.50	.48	.52

(1) U.S. and foreign indebtedness

(2) Average value of assets of U.S. shareholder

(3) Debt-to-Asset ratio of U.S. shareholder

(a) [500,000-20,000 (excess related group indebtedness determined in Step 1)]

X's "U.S. base period ratio" for 1990 is:

$$(.52+.50+.50+.50+.48)/5=.50$$

X's "allowable indebtedness" for 1990 is:

$$\mathbf{\$480,000 \times .50 = \$240,000}$$

X's "excess U.S. shareholder indebtedness" for 1990 is:

$$\mathbf{\$249,000 - \$240,000 = \$9,600}$$

X's debt-to-asset ratio for 1990 is .52, which is greater than the ratio of .10 described in paragraph (e)(3)(vii) of this section. Therefore, X's excess U.S. shareholder indebtedness for 1990 remains at \$9,600.

(iv) *Step 3:* (a) Since X's excess U.S. shareholder indebtedness of \$9,600 is less than its excess related group indebtedness of \$20,000, X's allocable related group indebtedness for 1990 is \$9,600. The amount of interest received by X during 1990 on allocable related group indebtedness is:

$$\mathbf{\$5,000 \times \$9,600/\$50,000 = \$960}$$

(b) Therefore, \$969 of X's third party interest expense (\$24,960) shall be allocated among various separate limitation categories in proportion to the relative average amounts of Y obligations held by X in each such category. The amount of Y obligations in each limitation category is determined in the same manner as the stock of Y would be attributed under the rules of § 1.861-12T(c)(3). 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 § 1.861-12T(c)(3)(iii). Y's gross income net of interest expense is determined as follows:

Foreign source high withholding tax interest income --

$$=\$5,000 - [(\$15,000) \text{ multiplied by } (\$5,000)/(\$5,000 + \$20,000)]$$

$$=\$2,000$$

and

Foreign source general limitation income --

$$= \$20,000 - [(\$15,000) \text{ multiplied by } (\$20,000) / (\$5,000 + \$20,000)]$$

$$= \$8,000.$$

(c) Therefore, \$192 $[(\$960 \times \$2,000) / (\$2,000 + \$8,000)]$ of X's third party interest expense is allocated to foreign source high withholding tax interest income and \$768 $[(\$960 \times \$8,000) / (\$2,000 + \$8,000)]$ is allocated to foreign source general limitation income.

(v) As a result of these direct allocations, for purposes of apportioning X's remaining interest expense under § 1.861-9T, the value of X's assets generating foreign source general limitation income is reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign source general limitation income (\$7,680), and the value of X's assets generating foreign source high withholding tax interest income is reduced by the principal amount of indebtedness the interest on which is directly allocated to foreign source high withholding tax interest income (\$1,920), determined as follows:

Reduction of X's assets generating foreign source general limitation income:

X's allocable related group indebtedness	X Y's Foreign source general limitation income
	DY's Foreign source income
\$9,600	X $\$8,000 / (\$8,000 + \$2,000)$ = \$7,680

Reduction of X's assets generating foreign source high withholding tax interest income:

X's allocable related group indebtedness	X Y's Foreign source high withholding tax interest income
	DY's For-

eign
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\$9,600

X $\$2,000/(\$8,000+\$2,000)$
=\$1,920

David G. Blattner,

Acting Commissioner of Internal Revenue.

Approved: January 24, 1992.

Kenneth W. Gideon.

Assistant Secretary of the Treasury.

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