

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.

[T.D. 8228, 53 FR 35485, Sept. 14, 1988]

§ 1.861-11 Special rules for allocating and apportioning interest expense of an affiliated group of corporations.

(a) through (c) [Reserved]. For further guidance, see § 1.861-11T(a) through (c).

(d) *Definition of affiliated group*—(1) *General rule.* For purposes of this section, in general, the term *affiliated group* has the same meaning as is given that term by section 1504, except that section 936 corporations are also included within the affiliated group to the extent provided in paragraph (d)(2) of this section. 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 the other members of the group.

(2) *Inclusion of section 936 corporations*—(i) *Rule*—(A) *In general.* Except as otherwise provided in paragraph (d)(2)(i)(B) of this section, the exclusion of section 936 corporations from the affiliated group under section 1504(b)(4) does not apply for purposes of this section. Thus, a section 936 corporation that meets the ownership re-

quirements of section 1504(a) is a member of the affiliated group.

(B) *Exception for purposes of alternative minimum tax.* The exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) shall be operative for purposes of the application of this section solely in determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a). Thus, a section 936 corporation that meets the ownership requirements of section 1504(a) is not a member of the affiliated group for purposes of determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a).

(ii) *Section 936 corporation defined.* For purposes of this section, § 1.861-9, and § 1.861-14, the term *section 936 corporation* means, for any taxable year, a corporation with an election in effect to be eligible for the credit provided under section 936(a)(1) or section 30A for the taxable year.

(iii) *Example.* This example illustrates the provisions of paragraph (d)(2)(i) of this section:

Example—(A) Facts. X owns all of the stock of Y. XY constitutes an affiliated group of corporations within the meaning of section 1504(a) and uses the tax book value method of apportionment. In 2000, Y owns all of the stock of Z, a section 936 corporation. 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 30A 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 for regular tax.* Assume first that X has no alternative minimum tax liability. Under paragraph (d)(2) of this section, Z is treated as a member of the XY affiliated group for purposes of allocating and apportioning interest expense for regular tax purposes. As provided in § 1.861-11T(b)(2), section 864(e)(1) and (5) do not apply in computing the combined taxable income of Y and Z under section 936, but these rules do apply in computing the foreign source taxable income

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of the XY affiliated group. The effect of including Z in the affiliated group is 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.

(C) *Analysis for alternative minimum tax.* Assume, alternatively, that X is liable to pay the alternative minimum tax. Pursuant to section 59(a), X must compute its alternative minimum tax foreign tax credit as if section 904 were applied on the basis of alternative minimum taxable income instead of taxable income. Under paragraph (d)(2)(i)(B) of this section, for purposes of the apportionment of interest expense in determining alternative minimum taxable income within each limitation category, Z is not considered a member of the XY affiliated group. Thus, the stock (and not the assets) of Z are included in computing the group apportionment fractions. Pursuant to sections 59(g)(4)(C)(iii)(IV), 861(a)(2)(A), and 862(a)(2), dividends paid by a section 936 corporation are foreign source income subject to a separate foreign tax credit limitation for alternative minimum tax purposes. Thus, under §1.861-9T(g)(3), the stock of Z must be considered attributable solely to the statutory grouping consisting of foreign source dividends from Z. The effect of excluding Z from the affiliated group is that X must apportion a part of its interest expense to the separate category for foreign source dividends from Z in computing alternative minimum taxable income within each separate category. If, as a result, under section 904(f), X has a separate limitation loss or an overall foreign loss in the category for dividends from Z for alternative minimum tax purposes, then that loss must be allocated against X's other income (separate limitation or United States source, as the case may be). The loss must be recaptured in subsequent years under the rules of section 904(f) for purposes of the alternative minimum tax foreign tax credit.
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(iv) *Effective date.* This paragraph (d)(2) applies to taxable years beginning after December 31, 1989.

(d)(3) through (6) [Reserved]. For further guidance, see §1.861-11T(d)(3) through (6).

(7) *Special rules for the application of §1.861-11T(d)(6).* The attribution rules of section 1563(e) and the regulations under that section shall apply in determining indirect ownership under §1.861-11T(d)(6). The Commissioner shall have the authority to disregard trusts, partnerships, and pass-through entities that break affiliated status. Corporations described in §1.861-11T(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 §1.861-11T(g). The affiliated group filing a consolidated return shall be considered to constitute a single corporation for purposes of applying the rules of §1.861-11T(g). For taxable years beginning after December 31, 1989, §1.861-11T(d)(6)(i) shall not apply in determining foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a) to the extent that such application would result in the inclusion of a section 936 corporation within the affiliated group. This paragraph (d)(7) applies to taxable years beginning after December 31, 1986.

(e) through (g) [Reserved]. For further guidance, see §1.861-11T(e) through (g).

[T.D. 8916, 66 FR 273, Jan. 3, 2001]

§ 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