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 taxable 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

[T.D. 8228, 53 FR 35490, Sept. 14, 1988, as amended by T.D. 8916, 65 FR 274, Jan. 3, 2001]

§ 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:

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

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

To domestic source income:

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

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

(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 corporations*—(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 generated on all sales is domestic source and one-quarter of the income is foreign 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 × $900,000/$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:

$$4 \times 10^{11} - 400{,}000X = 2 \times 10^{11} + 2{,}000{,}000X - 100{,}000X - X^2$$

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≤

$$X^2 + (-2{,}300{,}000)X + (2 \times 10^{11}) = 0$$

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.

[T.D. 8228, 53 FR 35495, Sept. 14, 1988]

§ 1.861–13T Transition rules for interest expenses (temporary regulations).

(a) *In general*—(1) *Optional application.* The rules of this section may be applied at the choice of a corporate taxpayer. In the case of an affiliated group, however, the choice must be made on a consistent basis for all members. Therefore, a corporate taxpayer (or affiliated group) may allocate and apportion its interest expense entirely on the basis of the rules contained in §§ 1.861–8T through 1.861–12T and without regard to the rules of this section. The choice is made on an annual basis and, thus, is not binding with respect to subsequent tax years.

(2) *Transition relief.* This section contains transitional rules that limit the application of the rules for allocating and apportioning interest expense of corporate taxpayers contained in §§ 1.861–8T through 1.861–12T, which are applicable in allocating and apportioning the interest expense of corporate taxpayers generally for taxable years beginning after 1986. Sections 1.861–9(d) (relating to individuals, estates, and certain trusts) and 1.861–9(e) (relating to partnerships) are effective for taxable years beginning after 1986. Thus, the taxpayers to whom those sections apply do not qualify for transition relief under this section.

(3) *Indebtedness defined.* For purposes of this section, the term ''indebtedness'' means any obligation or other evidence of indebtedness that qenerates an expense that constitutes interest expense within the meaning of § 1.861–9T(a). In the case of an obligation that does not bear interest initially, but becomes interest bearing with the lapse of time or upon the occurrence of an event, such obligation shall only be considered to constitute indebtedness when it first bears interest. Obligations that are outstanding as of November 16, 1985 shall only qualify for transition relief under this section if they bear interest-bearing as of that date. For this purpose, any obligation that has original issue discount within the meaning of section 1273(a)(1) of the Code shall be considered to be interest-bearing.

(4) *Exceptions.* The term ''indebtedness'' shall not include any obligation existing between affiliated corporations, as defined in § 1.861–11T(d). Moreover, the term ''indebtedness'' shall not include any obligation the interest on which is directly allocable under §§ 1.861–10T(b) and 1.861–10T(c). Under § 1.861–9T(b)(6)(iv)(B), certain interest expense is directly allocated to the gain derived from an appropriately identified financial product. When interest expense on a liability is reduced by such gain, the principal amount of such liability shall be reduced pro rata by the relative amount of interest expense that is directly allocated.

(b) *General phase-in*—(1) *In general.* In the case of each of the first three taxable years of the taxpayer beginning after December 31, 1986, the rules of §§ 1.861–8T through 1.861–12T shall not apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness which does not exceed the general phase-in amount, as defined in paragraph (b)(2) of this section.

(2) *General phase-in amount defined.* Subject to the limitation imposed by paragraph (b)(3) of this section, the general phase-in amount means the amount which is the applicable percentage (determined under the following table) of the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985: