permitted by § 1.861–13T, see § 1.861–8 (Revised as of April 1, 1986).

[T.D. 8228, 53 FR 35474, Sept. 14, 1988, as amended by T.D. 8286, 55 FR 3054, Jan. 30, 1990; T.D. 8337, 56 FR 10369, Mar. 12, 1991; T.D.8597, 60 FR 36679, July 18, 1995; T.D. 8805, 64 FR 1509, Jan. 11, 1999; T.D. 8973, 66 FR 67083, Dec. 28, 2001]

§ 1.861–9 Allocation and apportionment of interest expense.

(a) through (h)(4) [Reserved]. For further guidance, see § 1.861–9T(a) through (h)(4).

(h)(5) *Characterizing stock in related persons*—(i) *General rule*. Stock in a related person held by the taxpayer or by another related person shall be characterized on the basis of the fair market value of the taxpayer's pro rata share of assets held by the related person attributed to each statutory grouping and the residual grouping under the stock characterization rules of § 1.861–12T(c)(3)(ii), except that the portion of the value of intangible assets of the taxpayer and related persons that is apportioned to the related person under § 1.861–9T(h)(2) shall be characterized on the basis of the net income before interest expense of the related person within each statutory grouping or residual grouping (excluding income that is passive under § 1.904–4(b)).

(ii) *Special rule for section 936 corporations regarding alternative minimum tax*. For purposes of characterizing stock in a related section 936 corporation 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), the rules of § 1.861–9T(g)(3) shall apply and § 1.861–9(h)(5)(i) shall not apply. Thus, for taxable years beginning after December 31, 1989, and before January 1, 1994, stock in a related section 936 corporation is characterized for alternative minimum tax purposes as a foreign source passive asset because the stock produces foreign source passive dividend income under sections 861(a)(2)(A), 862(a)(2), and 904(d)(2)(A) and the regulations under those sections. For taxable years beginning after December 31, 1993, stock in a related section 936 corporation would be characterized for alternative minimum tax purposes as an asset subject to the separate limitation for section 936 corporation dividends because the stock produces foreign source dividend income that, for alternative minimum tax purposes, is subject to a separate foreign tax credit limitation under section 56(g)(4)(C)(iii)(IV). However, stock in a section 936 corporation is characterized as a U.S. source asset to the extent required by section 904(g). For the definition of the term *section 936 corporation*, see § 1.861–11(d)(2)(ii).

(iii) *Effective date*. This paragraph (h)(5) applies to taxable years beginning after December 31, 1989.

[T.D. 8916, 66 FR 272, Jan. 3, 2001]

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

(a) *In general*. Any expense that is deductible under section 163 (including original issue discount) constitutes interest expense for purposes of this section, as well as for purposes of §§ 1.861–10T, 1.861–11T, 1.861–12T, and 1.861–13T. The term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year. The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. Exceptions to the fungibility rule are set forth in § 1.861–10T. The fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. When borrowing will generally free other funds for other purposes, and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes. Consistent with the principles of fungibility, except as otherwise provided, the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate, have generated, or could reasonably have been expected to generate. In the case of the interest expense of members of an affiliated group, interest expense shall be considered to be allocable to all gross income of the members of the group under §1.861–11T. That section requires the members of an affiliated group to allocate and apportion the interest expense of each member of the group as if all members of such group were a single corporation. For the method of determining the interest deduction allowed to foreign corporations under section 882(c), see §1.882–5.

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

(ii) Examples. The rule of this paragraph (b)(1) may be illustrated by the following examples.

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

Example 2. X, a domestic corporation with a dollar functional currency, borrows 100 pounds on January 1, 1987 for a three-year term at an interest rate greater than the applicable federal rate for dollar loans. At this time, the interest rate on the pound was approximately equal to the interest rate on dollar borrowings and the forward price on the pound, vis-a-vis the dollar, was approximately equal to the spot price. On January 1, 1987, X converted 100 pounds into dollars and entered into a currency swap that substantially hedged X's foreign currency exposure on the pound borrowing, both with respect to interest and principal. The borrowing, coupled with the swap, represents a series of related transactions in which the taxpayer secures the use of funds in its functional currency. Any net foreign currency loss on this series of transactions constitutes a loss incurred substantially in consideration of the time value of money and shall be apportioned in the same manner as interest expense. Thus, if the pound depreciates against the dollar, such that when the first payment on the pound borrowing is due the taxpayer has a currency loss on the swap payment hedging its first interest payment, such loss shall, even if the transaction is not integrated under section 988(d), be allocated and apportioned in the same manner as interest expense under the authority of this paragraph (b)(1).

Example 3. On January 1, 1987, X, a domestic corporation with a dollar functional currency, enters into a dollar interest rate swap contract with Y, a domestic counterparty. Under the terms of this agreement, X agrees to pay Y floating rate interest with respect to a notional principal amount of $100 for five years. In return, Y agrees to pay X fixed rate interest at 10 percent with respect to a notional principal amount of $100 for five years. On the same day, Y prepays the fixed leg of the swap by making a lump sum payment of $37 to X. This lump sum payment represents the present value of five $10 swap payments. Because X secures the use of $37 in this transaction, any net swap expense arising from the transaction represents an expense incurred substantially in consideration of the time value of money. Assuming this lump sum payment is not otherwise characterized as a loan from Y to X, and that X must amortize the $37 lump sum payment under the principles of Notice 89–21, any net swap expense incurred by X with respect to this transaction (*i.e.*, the excess, if any, of X's annual swap payment to Y over the annual amortization of the $37 lump sum payment that is taken into income by X) represents an expense equivalent to interest expense. The result would be the same if X sold the fixed leg to a third party for $37. While this example presents the case of a lump sum payment, the rules of paragraph (b)(1) would also apply to any transaction in which the swap payments are not substantially contemporaneous if the pricing of the transaction is materially affected by the time value of money. Thus, expenses and losses will be subject to apportionment under the rules of this section to the extent that such expenses or losses were incurred in consideration of the time value of money.

(2) *Certain foreign currency borrowings*—(i) *Rule.* If a taxpayer borrows in a nonfunctional currency at a rate of interest that is less than the applicable federal rate (or its equivalent in functional currency if the functional

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

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

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

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

(3) *Losses on sale of certain receivables*—(1) *General rule.* Any loss on the sale of a trade receivable (as defined in § 1.954–2(h)) shall be allocated and apportioned, solely for purposes of this section and §§ 1.861–10T, 1.861–11T, 1.861–12T, and 1.861–13T, in the same manner as interest expense, unless at the time of sale of the receivable, it bears interest at a rate which is at least 120 percent of the short term applicable federal rate (as determined under section 1274(d) of the Code), or its equivalent in foreign currency in the case of receivables denominated in foreign currency, determined at the time the receivable arises. This treatment shall not affect the characterization of such expense as interest for other purposes of the Internal Revenue Code.

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

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

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

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

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

(6) *Financial products that alter effective cost of borrowing*—(i) *In general.* Various derivative financial products can be part of transactions or series of transactions described in paragraph (b)(1) of this section. Such derivative financial products, including interest rate swaps, options, forwards, caps, and collars, potentially alter a taxpayer's effective cost of borrowing with respect to an actual liability of the taxpayer. For example, a taxpayer that is obligated to pay interest at a fixed rate may, in effect, pay interest at a floating rate by entering into an interest rate swap. Similarly, a taxpayer that is obligated to pay interest at a floating rate may, in effect, limit its exposure to rising interest rates by purchasing a cap. Such a taxpayer may have gains or losses associated with such derivative financial products. This paragraph (b)(6) provides rules for the treatment of gains and losses from such derivative financial products (''financial products'') that are part of transactions described in paragraph (b)(1) of this section and that are used by the taxpayer to alter its effective cost of borrowing with respect to an actual liability. This paragraph (b)(6) shall only apply where the hedge and the borrowing are in the same currency and shall not apply to the extent otherwise provided in section 988 and the regulations thereunder. The allocation and apportionment of a loss under this paragraph (b) shall not affect the characterization of such loss as capital or ordinary for other purposes of the Code and the regulations thereunder.

(ii) *Definition of gain and loss.* For purposes of this paragraph (b)(6), the term ''gain'' refers to the excess of the amounts properly taken into income under a financial product that alters the effective cost of borrowing over the amounts properly allowed as a deduction thereunder within a given taxable year. See. *e.g.*, Notice 89–21. The term ''loss'' refers to the excess of the amounts properly allowed as a deduction under such a financial product over the amounts properly taken into income thereunder within a given taxable year.

(iii) *Treatment of gain or loss on the disposition of a financial product.* [Reserved]

(iv) *Entities that are not financial services entities.* An entity that does not constitute a financial services entity within the meaning of § 1.904–4(e)(3) shall treat gains and losses on financial products described in paragraph (b)(6)(i) of this section as follows.

(A) *Losses.* Losses on any financial product described in paragraph (b)(6)(i) of this section shall be apportioned in the same manner as interest expense whether or not such financial product is identified by the taxpayer under paragraph (b)(6)(iv)(C) of this section as a liability hedge.

(B) *Gains.* Gains on any financial product described in paragraph (b)(6)(i) of this section shall reduce the taxpayer's total interest expense that is subject to apportionment, but only if such financial product is identified by the taxpayer under paragraph (b)(6)(iv)(C) of this section as a liability hedge. Such reduction is accomplished by directly allocating interest expense to the income derived from such a financial product.

(C) *Identification of financial products.* A taxpayer can identify a financial product described in paragraph (b)(6)(i) of this section as hedging a particular interest-bearing liability (or any group of such liabilities) by clearly identifying on its books and records on the same day that it becomes a party to such arrangement that such arrangement hedges a given liability (or group of liabilities). In the case of a partial hedge, such identification shall apply to only that part of the liability that is hedged. If the taxpayer clearly identifies on its books and records a financial product as a hedge of an interest-bearing asset (or any group of such assets), it will create a rebuttable presumption that such financial product is not described in paragraph (b)(6)(i) of this section. A taxpayer may identify a hedge as relating to an anticipated liability, provided that such liability is in fact incurred within 120 days following the date of such identification. Gains and losses on such an anticipatory arrangement accruing prior to the time at which the liability is incurred shall constitute an adjustment to interest expense.

(v) *Financial services entities.* [Reserved]

(vi) *Dealers.* The rule of paragraph (b)(6)(iv) of this section shall not apply to a person acting in its capacity as a regular dealer in the financial products described in paragraph (b)(6)(i) of this section. Instead, losses sustained by a regular dealer in connection with such financial products shall be allocated to the class of gross income from such arrangements. Gains of a regular dealer in notional principal contracts are governed by the rules of §1.863–7T(b). Amounts received or accrued by any person from any financial product that is integrated as specified in Notice 89–90 with an asset shall not be treated as amounts received or accrued by a person acting in its capacity as a regular dealer in financial products.

(vii) *Examples.* The principles of this paragraph (b)(6) may be illustrated by the following examples.

Example 1. X is not a financial services entity or regular dealer in the financial products described in paragraph (b)(6)(i) of this section and has a dollar functional currency. In 1990, X incurred a total of $200 of interest expense. On January 1, 1990, X entered into an interest rate swap agreement with Y, in order to hedge its interest rate exposure with respect to a pre-existing floating rate liability. On the same day, X properly identified the agreement as a hedge of such liability. Under the agreement, X is required to pay Y an amount equal to a fixed rate of 10 percent on a notional principal amount of $1,000. Y is required to pay X an amount equal to a floating rate of interest on the same notional principal amount. Under the agreement, X received from Y during 1990 a net payment of $25. Because X identified the swap agreement as a liability hedge under the rules of paragraph (b)(6)(iv)(C), X may effectively reduce its total allocable interest expense for 1990 to $175 by directly allocating $25 of interest expense to the swap income. Had X not properly identified the swap as a liability hedge, this swap payment would have been treated as domestic source income in accordance with the rule of §1.863–7T(b).

Example 2. Assume the same facts as Example (1), except that X did not properly identify the agreement as a liability hedge on January 1, 1990. In 1990, X made a net payment of $25 to Y under the swap agreement. This swap payment is allocated and apportioned in the same manner as interest expense under the rules of paragraph (b)(6)(iv)(A).

(viii) *Effective dates*—(A) *Losses.* The rules of this paragraph (b)(6) shall apply to losses on any transaction described in paragraph (b)(6)(i) of this section that was entered into after September 14, 1988.

(B) *Gains.* Except as provided in paragraph (b)(6)(viii)(C) of this section, the rules of this paragraph (b)(6) shall apply to any gain that was realized on any transaction described in paragraph (b)(6)(i) of this section that was entered into after August 14, 1989.

(C) *Exception for interim gains.* Taxpayers shall be permitted to apply the rules of this paragraph (b)(6) to any gain that was realized on any transaction described in paragraph (b)(6)(i) of this section that was entered into after September 14, 1988 and on or before August 14, 1989, if the taxpayer can demonstrate to the satisfaction of the

Commissioner that substantially all of the arrangements described in paragraph (b)(6)(i) of this section to which the taxpayer became a party during that interim period were identified on the taxpayer's books and records with the liabilities of the taxpayer in a substantially contemporaneous manner and that all losses and expenses that are subject to the rules of this paragraph (b)(6) were treated in the same manner as interest expense. For this purpose, arrangements that were identified in a substantially contemporaneous manner with the taxpayer's assets shall be ignored.

(7) *Foreign currency gain or loss.* In addition to the rules of paragraph (b)(1), (b)(2), and (b)(6) of this section, any foreign currency loss that is treated as an adjustment to interest expense under regulations issued under section 988 shall be allocated and apportioned in the same manner as interest expense. Any foreign currency gain that is treated as an adjustment to interest expense under regulations issued under section 988 shall offset apportionable interest expense.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(6) Example—(i) Facts. A, B, and C are partners in a limited partnership. A is a corporate general partner, owns a 5 percent interest in the partnership, and has an adjusted basis in its partnership interest, determined without regard to section 752 of the Code, of $5. A's investment in the partnership is not held in the ordinary course of the taxpayer's active trade or business, as defined in § 1.904–7(i)(2). B, a corporate limited partner, owns a 70 percent interest in the partnership, and has an adjusted basis in its partnership interest, determined without regard to section 752 of the Code, of $70. C is an individual limited partner, owns a 25 percent interest in the partnership, and has an adjusted basis in the partnership interest, determined without regard to section 752 of the Code, of $25. The partners' interests in the profits and losses of the partnership conform to their respective interests. None of the interest expense incurred directly by any of the partners is directly allocable to their partnership interest under § 1.861–10T. The ABC partnership's sole assets are two apartment buildings, one domestic and the other foreign. The domestic building has an adjusted inside basis of $600 and the foreign building has an adjusted inside basis of $500. Each of the buildings is subject to a nonrecourse liability in the amount of $500. The ABC partnership's total interest expense for the taxable year is $120, both nonrecourse liabilities bearing interest at the rate of 12 percent. The indebtedness on the domestic building qualifies for direct allocation under the rules of § 1.861–10T. The indebtedness on the foreign building does not so qualify. The partnership incurred no foreign taxes. The partnership's gross income for the taxable year is $360, consisting of $100 in foreign source income and $260 in domestic source income. Under § 1.752–1(e), the nonrecourse liabilities of the partnership are allocated among the partners according to their share of the partnership profits. Accordingly, the adjusted basis of A, B, and C in their respective partnership interests (for other than apportionment purposes) is, respectively, $55, $770, and $275.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(4) *Other relevant provisions.* Affiliated groups of corporations are subject to special rules set forth in §1.861–11T. Section 1.861–12T sets forth rules relating to basis adjustments for stock in nonaffiliated 10 percent owned corporations, special rules relating to the consideration and characterization of certain assets in the apportionment of interest expense, and to other special rules pertaining to the apportionment of interest expense. Section 1.861–13T contains transition rules limiting the application of the rules of §§1.861–8T through 1.861–12T, which are otherwise applicable to taxable years beginning

after 1986. In the case of an affiliated group of corporations as defined in § 1.861–11T(d), any reference in §§ 1.861–8T through 1.861–13T to the ''taxpayer'' with respect to the allocation and apportionment of interest expense generally denotes the entire affiliated group of corporations and not the separate members thereof, unless the context otherwise requires.

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

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

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

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

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

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

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

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

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

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

To foreign source general limitation income:

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

To domestic source income:

$$\$150{,}000 \times \frac{\$300{,}000}{\$3{,}600{,}000} \ldots\ldots \$125{,}000$$

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

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

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

To foreign source general limitation income:

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

To domestic source income:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(h) *The fair market value method.* An affiliated group (as defined in § 1.861–11T(d)) or other taxpayer (the ''taxpayer'') that elects to use the fair market value method of apportionment shall value its assets according to the following methodology.

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

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

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

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

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

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

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

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

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

(5) [Reserved]. For further guidance, see §1.861–9(h)(5).

(6) *Adjustments for apportioning related person expenses*. For purposes of apportioning expenses of a related person, the value of stock in a second related person as otherwise determined under

paragraph (h)(4) of this section (which is determined on the basis of the taxpayer's percentage ownership interest in the second related person) shall be increased to reflect the first related person's percentage ownership interest in the second related person to the extent it is larger.

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

(i) [Reserved]

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

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

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

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

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

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

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

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

[T.D. 8228, 53 FR 35477, Sept. 14, 1988, as amended by T.D. 8257, 54 FR 31819, Aug. 2, 1989; T.D. 8597, 60 FR 36679, July 18, 1995; T.D. 8658, 61 FR 9329, Mar. 8, 1996; T.D. 8916, 66 FR 273, Jan. 3, 2001]

§ 1.861–10 Special allocations of interest expense.

(a)–(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