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

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

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

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

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

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

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

the Commissioner, in his discretion, may choose not to apply the rules of this paragraph. If the Commissioner exercises discretion under this paragraph (e)(5)(i), then paragraph (e) shall not apply to any extent to any interest expense of the taxpayer.

(1) Effective/applicability date. (1) In general, the rules of this section apply for taxable years beginning after December 31, 1986.

(2) Paragraphs (b)(3)(ii) (providing an operating costs test for purposes of the nonrecourse indebtedness exception) and (b)(6) (concerning excess collateralization of nonrecourse borrowings) of this section are applicable for taxable years commencing after December 31, 1988.

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


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

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

(d) Definition of affiliated group—(1) General rule. For purposes of this section, in general, the term affiliated group has the same meaning as is given that term by section 1504, except that section 936 corporations are also included within the affiliated group to the extent provided in paragraph (d)(2) of this section. Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected through 80-percent stock ownership with a common parent corporation which is an includible corporation (as defined in section 1504(b)). In the case of a corporation that either becomes or ceases to be a member of the group during the course of the corporation’s taxable year, only the interest expense incurred by the group member during
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the period of membership shall be allocated and apportioned as if all members of the group were a single corporation. In this regard, assets held during the period of membership shall be taken into account. Other interest expense incurred by the group member during its taxable year but not during the period of membership shall be allocated and apportioned without regard to the other members of the group.

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

(B) Exception for purposes of alternative minimum tax. The exclusion from the affiliated group of section 936 corporations under section 1504(b)(4) shall be operative for purposes of the application of this section solely in determining the amount of foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a).

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

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

Example. (A) Facts. X owns all of the stock of Y. XY constitutes an affiliated group of corporations within the meaning of section 1504(a) and uses the tax book value method of apportionment. In 2000, Y owns all of the stock of Z, a section 936 corporation. Z manufactures widgets in Puerto Rico. Y purchases these widgets and markets them exclusively in the United States. Of the three corporations, only Z has foreign source income, which includes both qualified possessions source investment income and general limitation income. In computing the section 30A benefit, Y and Z have elected the cost sharing method. Of the three corporations, only X has debt and, thus, only X incurs interest expense.

(B) Analysis for regular tax. Assume first that X has no alternative minimum tax liability. Under paragraph (d)(2) of this section, Z is treated as a member of the XY affiliated group for purposes of allocating and apportioning interest expense for regular tax purposes. As provided in §1.861–11T(b)(2), section 864(e)(1) and (5) do not apply in computing the combined taxable income of Y and Z under section 936, but these rules do apply in computing the foreign source taxable income of the XY affiliated group. The effect of including Z in the affiliated group is that X, the only debtor corporation in the group, must, under the asset method described in §1.861–9T(g), apportion a part of its interest expense to foreign source passive income and foreign source general limitation income. This is because the assets of Z that generate qualified possessions source investment income and general limitation income are included in computing the group apportionment fractions. The result is that, under section 904(c), X has an overall foreign loss in both the passive and general limitation categories, which currently offsets domestic income and must be recaptured against any subsequent years' foreign passive income and general limitation income, respectively, under the rules of that section.

(C) Analysis for alternative minimum tax. Assume, alternatively, that X is liable to pay the alternative minimum tax. Pursuant to section 59(a), X must compute its alternative minimum tax foreign tax credit as if section 904 were applied on the basis of alternative minimum taxable income instead of taxable income. Under paragraph (d)(2)(i)(B) of this section, for purposes of the apportionment of interest expense in determining alternative minimum taxable income within each limitation category, Z is not considered a member of the XY affiliated group. Thus, the stock (and not the assets) of Z are included in computing the group apportionment fractions. Pursuant to sections 59(g)(4)(C)(ii)(i)(IV), 861(a)(2)(A), and 862(a)(2), dividends paid by a section 936 corporation are foreign source income subject to a separate foreign tax credit limitation for alternative minimum tax purposes. Thus, under §1.861–9T(g)(3), the stock of Z must be considered attributable solely to the statutory
§ 1.861–11T Special rules for allocating and apportioning interest expense of an affiliated group of corporations (temporary).

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

(b) Scope of application—(1) Application of section 864(e)(1) and (5) (concerning the definition and treatment of affiliated groups). Section 864(e)(1) and (5) and the portions of this section implementing section 864(e)(1) and (5) apply to the computation of foreign source taxable income for purposes of section 904 (relating to various limitations on the foreign tax credit). Section 904 imposes separate foreign tax credit limitations on passive income, high withholding interest income, financial services income, shipping income, income consisting of dividends from each noncontrolled section 902 corporation, income consisting of dividends from a DISC or former DISC, taxable income attributable to foreign trade income within the meaning of section 923(b), distributions from a FSC