DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: August 31, 2001

MEMORANDUM FOR: Carol Binner, International Examiner, LMSB Group 1216

FROM: Elizabeth Beck, Chief, CC:INTL:6

SUBJECT: Allocation of Interest Expense in Commission FSC

This Chief Counsel Advice responds to your memorandum dated August 1, 2000. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

CorpA =
CorpA-FSC =
Products =
U.S. State =
U.S. Territory =
Date1 =
Taxable Year A =
Taxable Year B =

ISSUE

Whether the interest expense incurred by a commission foreign sales corporation ("FSC") that determines its income under the section 925(a)(2) combined taxable income method is 100% allocable to income effectively connected with the conduct of a trade or business within the United States and, thus, 100% deductible by the FSC.

CONCLUSION

The interest expense incurred by a commission FSC that determines its income under the section 925(a)(2) combined taxable income method is only partially allocable to income effectively connected with the conduct of a trade or business within the United States and, thus, only partially deductible by the FSC. This partial allocation of the interest expense of a commission FSC is determined as if the taxpayer were a buy/sell FSC that held export property assets rather than commissions receivable assets.

FACTS

CorpA is a subchapter C corporation organized in U.S. State. CorpA-FSC is a wholly-owned subsidiary of CorpA, incorporated in U.S. Territory. For Taxable Years A through B, CorpA-FSC had in place a valid election to be treated as a FSC pursuant to sections 922(a) and 927(f)(1) of the Internal Revenue Code and in all other respects continuously maintained its status as a FSC as defined in section 922(a).

At all relevant times, CorpA manufactured Products within the United States and exported some Products abroad with CorpA-FSC acting as its commission agent. CorpA agreed to pay CorpA-FSC the maximum commission allowed under section 925 and computed such commission under the section 925(a)(2) combined taxable income method of the administrative pricing rules. CorpA was a related supplier with respect to CorpA-FSC and sales of Products within the meaning of Temp. Treas. Reg. § 1.927(d)-2T.

For purposes of this advice only, we assume that Products constituted export property under section 927(a)(1) and that the gross receipts from sales of Products constituted foreign trading gross receipts under section 924(a)(1). We further assume that CorpA-FSC satisfied the foreign management requirements of sections 924(b)(1)(A) and 924(c) and the foreign economic processes requirements of sections 924(b)(1)(B) and 924(d) with respect to the transactions in question.

In calculating its commissions using the combined taxable income method, CorpA-FSC included as direct costs certain expenses incurred by CorpA pursuant to a service agreement entered into to satisfy the requirements of section 925(c). However, CorpA-FSC did not actually reimburse CorpA for such expenses either in cash or by means of a journal entry on its books for Taxable Years A through B. The taxpayer and Examination agree that CorpA-FSC's failure to reimburse CorpA caused an account payable to be deemed created on CorpA-FSC's books as of Date1, the due date of CorpA-FSC's timely filed (including extensions) United States income tax return. A corresponding account receivable was deemed created on CorpA's books. The account receivable accrued interest, and CorpA included that interest in its taxable income for every year the debt remained unpaid.

The taxpayer and Examination agree on all of the above facts. The parties disagree only on the method of allocating and apportioning CorpA-FSC's interest for the purpose of determining CorpA-FSC's taxable income.[1]

LAW

I. The FSC Statutory and Regulatory Framework

In determining FSC income from export property, interest expense of a FSC is accounted for under two circumstances, i.e., in computing the transfer price or commission from export property using the section 925(a)(2) combined taxable income method and in calculating the FSC's taxable income from foreign trade income. Section 925(a) provides that, in the case of a sale of export property to a FSC by a person described in section 482 ("the related supplier"), the taxable income of the FSC shall be based upon a transfer price that would allow the FSC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount that does not exceed the greatest of three enumerated pricing methods under that section.[2] The pricing method provided under section 925(a)(2) is the combined taxable income ("CTI") method. Under the CTI method, a FSC's taxable income from the sale of export property by the FSC may not exceed 23% of the CTI that is attributable to the foreign trading gross receipts derived from that property. I.R.C. § 925(a)(2). Section 924(a)(1) provides that foreign trading gross receipts ("FTGR") include the gross receipts of a FSC that are from the sale, exchange, or other disposition of export property.

Pursuant to the authority granted by section 925(b), Temp. Treas. Reg. § 1.925(a)-1T(d)(2) provides that,

> [i]f any transaction to which section 925 applies is handled on a commission basis for a related supplier by a FSC and if commissions paid to the FSC give rise to gross receipts to the related supplier which would have been foreign trading gross receipts under section 924(a) had the FSC made the sale directly, then (i) the administrative pricing methods of section 925(a)(1) or (2) may be used, to determine the FSC's commission . . . .

A commission FSC that uses the CTI method calculates its commission on a transaction using a CTI amount that equals

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[1] "Interest-netting," as discussed in Bowater, Inc. v. Commissioner, 108 F.3d 12 (2d Cir. 1997), is not involved in this case .

[2] See Temp. Treas. Reg. § 1.927(d)-2T for the definition of "related supplier."

> the excess of the related supplier's gross receipts from the transaction which would have been foreign trading gross receipts had the sale been made by the FSC directly over the related supplier's and the FSC's total costs, excluding the commission paid or payable to the FSC, but including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs (see § 1.471-11(c)(2)(ii)) which relate to the gross receipts from the transaction.

Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(iii). Noninventoriable costs include interest. Treas. Reg. § 1.471-11(c)(2)(ii)(e). These provisions are equivalent to those where a FSC acts as the principal with respect to the sale of export property. Compare Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(i). A commission FSC may earn in a taxable year an amount of income that is

> computed in a manner consistent with paragraph (c) of [Temp. Treas. Reg. § 1.925(a)-1T], which the FSC would have been permitted to earn under the gross receipts method, the combined taxable income method, of the section 482 method if the related supplier had sold (or leased) the property or service to the FSC and the FSC had in turn sold (or subleased) to a third party, whether or not a related party.

Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(ii). The maximum commission that a

> FSC may charge the related supplier is the amount of income determined under subdivisions (ii) and (iii) of this paragraph plus the FSC's total costs for the transaction as determined under paragraph (c)(6) of this section.

Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(iv).

A FSC may determine a transfer price or commission using an administrative pricing method only if the FSC or a person acting under contract with the FSC performs the activities described in section 924(d) and (e). I.R.C. § 925(c) and Temp. Treas. Reg. § 1.925(a)-1T(b)(2)(ii). If a FSC's related supplier performs such activities on behalf of the FSC,

> the requirements of section 925(c) will be met if the FSC pays the related supplier an amount equal to the direct and indirect expenses related to the required activities. See paragraph (c)(6)(ii) of this section for the amount of compensation due the related supplier. The payment

> made to the related supplier must be reflected on the FSC's books and must be taken into account in computing the FSC's and related supplier's combined taxable income. If it is determined that the related supplier was not compensated for all the expenses related to the required activities or if the entire payment is not reflected on the FSC's books or in computing combined taxable income, the administrative pricing methods may be used but proper adjustments will be made to the FSC's and related supplier's books or income.

Temp. Treas. Reg. § 1.925(a)-1T(b)(2)(ii).

A FSC commission determined under Temp. Treas. Reg. § 1.925(a)-1T(d)(2) is a category of gross income called foreign trade income ("FTI"). Section 923(b); Temp. Treas. Reg. § 1.923-1T(a). Section 923(a)(1) through (3) divides the FTI of a FSC into two categories, exempt FTI and non-exempt FTI. A FSC's exempt FTI is treated as foreign source income not effectively connected with the conduct of a trade or business within the United States ("non-ECI") and, thus, excluded from the gross income of the FSC. The FSC's non-exempt FTI (other than section 923(a)(2) income[3]) is treated as income effectively connected with a trade or business ("ECI") conducted through a permanent establishment of the FSC within the United States. I.R.C. § 921(d)(1); Temp. Treas. Reg. § 1.921-3T(a)(2)(ii). Investment income, which includes interest, is treated as ECI. I.R.C. § 921(d)(2); Treas. Reg. § 1.921-2(f)(Q&A 9).

Section 923(a)(3), which applies to income determined under the administrative pricing rules, provides that 15/23[4] of FTI derived from a transaction to which section 925(a)(1) or (2) applies is exempt FTI and, thus, non-ECI under section 921(a) while 8/23 of FTI is non-exempt and, thus, ECI under section 921(d)(1). Deductions, including interest, properly allocated and apportioned to FTI derived by a FSC from any transaction are allocated on a proportionate basis between the exempt FTI derived from such transaction and the non-exempt FTI derived from such transaction. I.R.C. § 921(b).

II. Allocation and Apportionment of FSC Interest Expense

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[3] Section 923(a)(2) non-exempt foreign trade income determined under the section 482 pricing method is the only type of non-exempt foreign trade income that is not treated as ECI under the FSC provisions. Section 921(d)(1)(B). Section 923(a)(2) income is not involved in this case.

[4] Although section 923(a)(3) provides the fraction 16/23, section 291(a)(4) and Temp. Treas. Reg. § 1.923-1T(b)(1) provide that only 15/23 of FTI is exempt where the FSC has only corporate shareholders.

As stated above, under the CTI method, a FSC's costs – including interest expense related to gross receipts from a transaction that results in a FSC commission – are deducted from FTGR to arrive at the related supplier's and FSC's CTI. Interest expense incurred with respect to unpaid section 925(c) expenses is related to gross receipts from a transaction that results in a FSC commission within the meaning of Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(iii) because the reimbursement of section 925(c) expenses is a prerequisite for the FSC commission under the administrative pricing rules.

The amount of interest expense deducted is determined in accordance with the allocation and apportionment rules of Treas. Reg. § 1.861-8. Temp. Treas. Reg. §§ 1.921-3T(b), 1.925(a)-1T(d)(2)(iii), and 1.925(a)-1T(c)(6)(iii)(D). Under Temp Treas. Reg. § 1.861-8T(e)(2), the rules concerning the allocation and apportionment of interest expense are set forth in Temp. Treas. Reg. §§ 1.861-9T through 1.861-13T. Temp. Treas. Reg. § 1.861-11T(f) provides rules for allocating interest expense of a FSC for the purpose of calculating CTI and the FSC commission income. For the purpose of calculating a FSC's taxable income, in general, the asset value-based method ("asset method") under Temp. Treas. Reg. § 1.861-9T(g)(1)(i) governs the deductibility of interest expense. However, Temp. Treas. Reg. § 1.861-9T(a) provides that the deductibility of the interest expense of a foreign corporation is determined under Treas. Reg. § 1.882-5. See also Treas. Reg. § 1.882-4(b)(1). Pursuant to section 882(c), Treas. Reg. § 1.882-5(b) allocates the interest expense of a foreign corporation in accordance with a three-step allocation formula, as in effect during the taxable years relevant to this case.[5]

In Step One of the three-step allocation formula, the taxpayer determines the average total value of all assets of the corporation that generate, have generated, or could reasonably have been or be expected to generate ECI for the taxable year. Treas. Reg. § 1.882-5(b)(1).

In Step Two of the three-step allocation formula, the taxpayer determines for the taxable year the amount of liabilities of the corporation connected with the conduct of a trade or business in the United States. Treas. Reg. § 1.882-5(b)(2). Such liabilities are called "U.S.-connected liabilities." Id. The taxpayer determines the amount of U.S.-connected liabilities by multiplying the asset value determined under Step One by either the fixed ratio or the actual ratio. Id.

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[5] Current Treas. Reg. § 1.882-5 applies only to taxable years beginning on or after June 6, 1996, and does not apply in this case. T.D. 8658, 1996-1 C.B. 161. Hereinafter, all references to Treas. Reg. § 1.882-5 are to the regulations as in effect during Taxable Years A through B unless otherwise indicated.

The taxpayer must elect on its return, for the first taxable year to which Treas. Reg. § 1.882-5 applies, to use either the fixed ratio or the actual ratio. Treas. Reg. § 1.882-5(b)(2). The regulations do not provide a "time, place, and manner" provision for making the election. However, administrative practice treats the election as made by a taxpayer that files a timely tax return for the first applicable taxable year, calculates the allocable expense, and claims the computed results of the method chosen. This administrative practice has been clarified by revised final regulations. See Treas. Reg. § 1.882-5(a)(7)(i) (1996); T.D. 8658, 1996-1 C.B. 161, 167 (1996).

In Step Three of the three-step allocation formula, the taxpayer must elect on its return, for the first taxable year to which Treas. Reg. § 1.882-5 applies, to use either the "branch book/dollar pool method" or the "separate currency pools method" for the purpose of determining the amount of its allowed interest deduction. Treas. Reg. § 1.882-5(b)(3).

ANALYSIS

I. The Rule of Section 882(c) and Treas. Reg. § 1.882-5 Generally

Generally, CorpA-FSC's expenses are allocated and apportioned pursuant to Treas. Reg. § 1.861-8, which references the interest expense and apportionment rules under Treas. Reg. § 1.861-9T. Temp. Treas. Reg. §§ 1.921-3T(b) and 1.925(a)-1T(c)(6)(iii)(D). Temp. Treas. Reg. § 1.861-9T(g) provides an asset method for allocating and apportioning interest expense. However, the asset method allocation and apportionment rules of Temp. Treas. Reg. § 1.861-9T(g) do not apply to the interest expense of a foreign corporation such as CorpA-FSC. Temp. Treas. Reg. § 1.861-9T(a); Treas. Reg. § 1.882-4(b)(1). The interest expense deduction allowed to a foreign corporation is determined under the three-step formula set forth in Treas. Reg. § 1.882-5(b). Treas. Reg. § 1.882-5(a); Temp. Treas. Reg. § 1.861-9T(a) (the interest deduction allowed to foreign corporations is determined under Treas. Reg. § 1.882-5); T.D. 7749, 1981-1 C.B. 390 (providing the version of Treas. Reg. § 1.882-5 applicable in this case). Treas. Reg. § 1.882-5 does not provide special rules for allocating FSC interest expense deductions.

Because section 882(c) allows deductions for expenses of foreign corporations only if they are connected with ECI, the deductibility of a FSC's interest expense depends on whether the interest expense is "connected" with ECI within the meaning of section 882(c). Generally, an expense of a foreign corporation is considered to be "connected" with ECI if it is properly allocated and apportioned to ECI under Temp. Treas. Reg. § 1.861-8. Treas. Reg. § 1.882-4(a)(1) and (b)(1). However, in the case of interest expense, the amount of the deduction allowed is determined by applying Treas. Reg. § 1.882-5.

In this case, CorpA-FSC is a foreign corporation with accrued interest expenses

as a result of its accounts payable. A portion of its commission income and all of its interest income, if any, are treated as ECI under section 921(d). Therefore, section 882(c) and Treas. Reg. § 1.882-5 apply to determine the amount of CorpA-FSC's interest expense which is deductible with respect to such ECI. Treas. Reg. § 1.882-5 provides that CorpA-FSC may deduct its interest from ECI in accordance with the three-step formula set forth in Treas. Reg. § 1.882-5(b).

II. Scenario for 100% Allocation of Interest Expense to ECI

Taxpayer argues that 100% of CorpA-FSC's interest expense is allocable to ECI and, thus, is wholly deductible. Such a 100% allocation is possible under the three-step allocation formula of Treas. Reg. § 1.882-5(b) only where all of the foreign corporation's income is ECI and all of its worldwide liabilities are properly booked or treated as booked in the U.S. trade or business.

To achieve a 100% allocation of interest expense to ECI under Treas. Reg. § 1.882-5, the following elements are required under the three-step formula. First, 100% of the corporation's assets must be assets that generate, have generated, or could reasonably have been or be expected to generate 100% ECI under Step One. Second, the corporation must elect the actual ratio under Step Two. Third, the corporation's U.S.-booked liabilities determined in Step Three must be equal to the corporation's worldwide liabilities determined in Step Two. Thus, CorpA-FSC's interest expense is 100% allocable to ECI, as taxpayer claims, only if all three of these elements are present. Solely for purposes of this analysis, we assume that the third element is satisfied in this case.

A. Actual Ratio Election Made under Step Two

CorpA-FSC's first income tax return to which Treas. Reg. § 1.882-5 was applicable purported to deduct 100% of the taxpayer's interest expense against ECI. Treas. Reg. § 1.882-5 requires the taxpayer to represent the Treas. Reg. § 1.882-5 election on the return. Taxpayer argues that CorpA-FSC's only assets during the taxable years at issue were the commission receivable and a checking account, both of which did or could generate only interest income which would be treated as ECI under section 921(d)(2). Pointing to these two ECI-generating assets, the taxpayer claimed on its return that 100% of CorpA-FSC's interest expense is allocable to ECI.

We conclude that CorpA-FSC's claim for 100% deductibility of its interest expense constituted a timely Treas. Reg. § 1.882-5 election to use the actual ratio described above. Accordingly, the Service should not seek to disallow a portion of the interest expense deduction on the grounds that the taxpayer did not properly elect the actual ratio for its initial required year. The validity of the actual ratio election, in combination with our assumption that CorpA-FSC's U.S.-booked liabilities are equal to its worldwide liabilities, however, dictates that the taxpayer's claim of 100% deductibility

is correct only if 100% of its assets give rise to 100% ECI as described in Step One. Taxpayer's claim for 100% allocation of CorpA-FSC's interest expense to ECI also constitutes a timely election to use the branch book/dollar pool method under Step Three.

B. Percentage of ECI-Generating Assets under Step One

Taxpayer argues that its only two assets, commissions receivable and a checking account, can generate only ECI in the form of interest income. It is unclear whether interest-bearing commissions receivable should be viewed as generating non-ECI commission income, ECI commission income, ECI interest income, or some combination thereof. If Taxpayer were correct that its receivables should be considered to generate only ECI, a mechanical application of Treas. Reg. § 1.882-5 in this case would permit CorpA-FSC to allocate 100% of its interest expense to ECI because 100% of its assets generate ECI. However, the proper application of this allocation rule must be considered in the broader context of the FSC statutory and regulatory framework which operates to reach a different conclusion as explained below.

III. Treas. Reg. § 1.882-5 – Step One Applied in the FSC Context

A. General Proposition

The FSC provisions permit a FSC to operate as a "buy/sell FSC" under section 925(a) or a "commission FSC" under section 925(b)(1). "Buy/sell" refers to a FSC that acts as the principal in a transaction that generates FTGR for the FSC. "Commission" refers to a FSC that acts as a commission agent in a transaction that generates gross receipts for the FSC's related supplier that would otherwise have constituted FTGR had the FSC acted as the principal. See generally Temp. Treas. Reg. § 1.925(a)-1T(d)(2).

The use of a commission FSC instead of a buy/sell FSC should not affect the amount of the FSC income from the sale of export property. The legislative history for the FSC provisions makes Congress' intent on this point clear:

> The same intercompany allocation to the FSC [FTI] will be permitted whether the FSC takes title as principal or acts as a commission agent.

Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 1057 (Comm. Print 1984). Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(ii) reflects this principle when it states that a commission FSC may earn in a taxable year an amount of income that is

> computed in a manner consistent with paragraph (c) of this section, which the FSC would have been permitted to earn under the gross receipts method, the combined taxable income method, or the section 482 method if the related supplier had sold (or leased) the property or service to the FSC and the FSC had in turn sold (or subleased) to a third party, whether or not a related party.

Thus, a commission FSC is entitled to the same amount of FSC FTI as a similarly situated buy/sell FSC, but may not receive more FTI than the buy/sell FSC. For example, suppose a buy/sell FSC pays its related supplier a transfer price that allows the FSC to compute $100 of FTI. The rule of Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(ii) provides that a similarly situated commission FSC may receive a commission from its related supplier based on FTI in an amount no greater than $100.

B. ECI-Generating Assets Differ in Buy/Sell FSCs and Commission FSCs

1. Export Property vs. Commissions Receivable

A buy/sell FSC's assets consist primarily of the export property that it purchases for sale or lease. Export property generates FTI which is, by definition, part ECI and part non-ECI. I.R.C. § 921(d). In contrast, a commission FSC's assets consist primarily of commissions receivable that generate only ECI in the form of interest.

Thus, one consequence of the fact that buy/sell FSCs and commission FSCs hold different kinds of assets is that a mechanical application of Treas. Reg. § 1.882-5 applies to the two FSC types inconsistently. For buy/sell FSCs that own export property which generates both ECI and non-ECI, Treas. Reg. § 1.882-5 permits only a partial allocation of interest expense to ECI under Step One of the three-step allocation formula. For commission FSCs that own commissions receivable instead of export property, Treas. Reg. § 1.882-5 permits allocation of all interest expense to ECI assuming that the taxpayer elects the actual ratio under Step Two and that its U.S.-booked liabilities equal its worldwide liabilities.

This result conflicts directly with the rule of Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(ii) which entitle a commission FSC to the same income from the sale of export property as a similarly situated buy/sell FSC. To prevent this violation of the principle of equal allocation of income for buy/sell and commission FSCs, Treas. Reg. § 1.882-5 should be applied to a commission FSC as if it were a buy/sell FSC with the result of equal tax treatment. In accordance with this principle, the "average total value of all assets" used in Step One of the three-step formula to determine the portion of a taxpayer's assets that generate ECI should be interpreted to result in the same amount of interest expense allocation between ECI and non-ECI that would have resulted had

the sales that gave rise to FTI been made through a buy/sell FSC. The remaining discussion analyzes the application of Temp. Treas. § 1.882-5 to a buy/sell FSC.

2. Bifurcation of Export Property for Purposes of Step One under Treas. Reg. § 1.882-5

Step One under Treas. Reg. § 1.882-5(b)(1) determines the value of assets that generate ECI. Export property generates only one type of income, FTI. By statute, FTI is treated as 15/23 non-ECI and 8/23 ECI where a FSC has only corporate shareholders. I.R.C. § 923(a)(3) and Temp. Treas. Reg. § 1.923-1T(b)(1). Therefore, 15/23 of export property can never generate ECI.

Under section 864 principles, some provisions require the split characterization of income, gains, and losses between ECI and non-ECI. In contrast, other provisions require the characterization of income, gains, and losses as entirely ECI or entirely non-ECI. Where income, gains, and losses may be split characterized, the assets that give rise to such income, gains, and losses are similarly split characterized.

While Treas. Reg. § 1.882-5(b)(1) refers to assets that generate ECI, the regulation does not distinguish between assets that generate only ECI and assets that generate both ECI and non-ECI. We conclude that the proper application of Treas. Reg. § 1.882-5(b)(1) requires that an asset such as export property that generates both ECI and non-ECI in determinable proportions be bifurcated so that only the portion of the asset which generates ECI is taken into account for purposes of valuing ECI-generating assets under Step One.

This view has been reflected in situations where U.S. branches of foreign banks have purchased securities with respect to which only a portion of the interest income, gains, and losses is ECI under the flush language of Treas. Reg. § 1.864-4(c)(5)(ii). The Service's view has been that, for purposes of apportioning the U.S. branch's interest expense, only a portion of the securities would be included in the asset value determination under Treas. Reg. § 1.882-5(b)(1). Accordingly, where assets cannot give rise to 100% ECI treatment on income, gains, and losses, the proportion of the asset that cannot give rise to ECI for any type of recognition event is economically severable and should be treated as an asset that gives rise only to non-ECI.

In this manner, a buy/sell FSC's export property cannot be considered to give rise to income that is treated as 100% ECI because section 921 requires that a portion of the FTI generated by the disposition of export property is non-ECI. Similarly, the commissions receivable of a commission FSC should be apportioned between ECI and non-ECI as if the FSC's income-generating asset were export property rather than receivables.

IV. Summary

To the extent that Treas. Reg. § 1.882-5 is silent concerning the treatment of receivables, the better view is to apply the regulation so that a commission FSC gets the same tax results as a similarly situated buy/sell FSC as provided under Temp. Treas. Reg. § 1.925(a)-1T(d)(2)(ii). Had CorpA-FSC been a buy/sell FSC, it is clear that a portion of the interest expense that it incurred would have to be allocated under the asset method to FTI, i.e., allocated to both ECI and non-ECI, because a large portion of its assets would consist of export property rather than commissions receivable. In short, the interest expense incurred by a commission FSC that determines its income under the section 925(a)(2) CTI method is only partially allocable to ECI and, thus, only partially deductible by the FSC. This partial allocation of the interest expense of a commission FSC to ECI is determined as if the taxpayer were a buy/sell FSC that held export property assets rather than commissions receivable assets.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

The plain language of Treas. Reg. § 1.882-5(b)(1) referring to assets "that generate, have generated, or could reasonably have been or be expected to generate income . . ." may support the view that the commission receivable should be allocated to interest income, because only interest may be earned on the commission receivable. Therefore, a mechanical application of Treas. Reg. § 1.882-5 without regard for the FSC principle of equal tax treatment for buy/sell and commission FSCs may result in 100% deductibility for CorpA-FSC's interest income against ECI. The view enunciated in this advice, however, is the view that the Service previously has taken in FSAs and letter rulings.

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If you have questions, please call the branch at 202-874-1490.

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