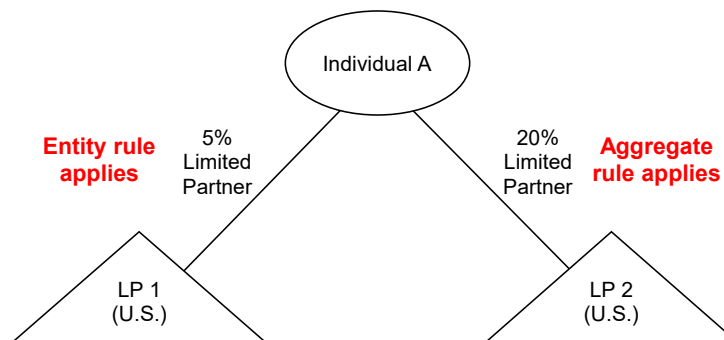


## Reg. 1.861-9 and -9T: Interest Expense Allocation Example With An Individual Owning Partnerships

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Individual A's share of (from K-3):

Avg. Assets	\$50
Avg. Liabilities	\$30
Avg. Individ. A's Capital Account	\$20
LP's Int. exp.	\$5
Gross pass. fgn. src. inc.	\$2
Gross US source inc.	\$8
Total gross income	\$10

Individual A's share of (from K-3):

Avg. Assets	\$50
Avg. Liabilities	\$30
Avg. Individ. A's Capital Account	\$20
LP's Int. exp.	\$5
Gross pass. fgn. src. inc.	\$4
Gross US source inc.	\$6
Total gross income	\$10

Investment interest expense directly incurred	20	Alloc'd based on inv. assets
Indiv. A's share of LP 1 inv. int. exp. (entity rule)	5	Alloc'd based on LP 1's gr. inc.
Indiv. A's share of LP 2 inv. int. exp. (aggreg. rule)	5	Alloc'd based on inv. assets
Total inv. int. exp. to be allocated by Indiv. A	30	

	US	Foreign Passive	Total	
Investment assets other than the LPs	700	300	1,000	(30% to foreign)
Net basis in LP 1 p'ship interest	16	4	20	(20% to foreign)
Share of LP 2 assets	30	20	50	(40% to foreign)
Total assets	746	324	1,070	
Percentage	69.7%	30.3%		

Int. exp. alloc'd based on assets	17	8	25
Int. exp. alloc'd based on inc.	4	1	5
Total inv. interest expense allocation	21	9	30

(This example has just focused on investment interest expense. If Individual A had business interest expense and/or passive interest expense (directly or through partnerships), similar calculations would need to be performed for those categories separately.)

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(Note that some of the regulation citations below are to the regulations under -9 and others are to regulations under -9T.)

### Individual A's Own Activities

Individual A directly incurs investment interest expense of \$20 during the year. Individual A directly owns investment assets. The average tax book value of those assets at the beginning and end of the year is \$1,000. Reg. 1.861-9(g)(2)(i). These investment assets generate gross US-source income of \$70 and gross passive basket foreign-source income of \$30. Thus, \$700 of the assets are characterized as US assets and \$300 of the assets are characterized as foreign-source passive limitation assets. Reg. 1.861-9T(g)(3).

Individual A generally must allocate her investment interest expense based on her worldwide investment assets. Reg. 1.861-9T(d)(1)(ii).

Individual A is a limited partner in two limited partnerships: LP 1 and LP 2.

### LP 1 (entity rule)

For LP 1 she owns less than 10%. Thus, for LP 1 she will apply the "entity rule". Reg. 1.861-9(e)(4)(i) and -9T(e)(4)(ii).

Under the entity rule, Individual A will allocate her share of LP 1's interest expense based on the gross income of LP 1. Reg. 1.861-9(e)(4)(i). Because 20% of LP 1's gross income was passive foreign-source income, Individual A will allocate 20% of the \$5 of LP 1's interest expense to passive foreign-source income. That is, \$1 of the \$5 will be allocated to passive foreign-source income, and the remaining \$4 will be allocated against US-source income.

For purposes of allocating "other" investment interest expense (i.e., interest expense not incurred by LP 1), Individual A will only include the "net" average value of her interest in LP 1. Reg. 1.861-9T(e)(4)(ii). Thus, in computing Individual A's tax basis in her interest in the LP 1 partnership, she will not include her share of the partnerships' liabilities. In this example, Individual A's net tax basis is \$20. Because LP 1 generated 20% of its gross income as passive foreign-source income, 20% (\$4) of the average asset will be considered a passive foreign asset and 80% (\$16) of the average asset will be considered a US asset. Reg. 1.861-9T(g)(3).

### LP 2 (aggregate rule)

For LP 2 Individual A owns more than 10%. Thus, for LP 2 she will apply the "aggregate rule". Reg. 1.861-9T(e)(1) and -9(e)(3).

Under the aggregate rule, Individual A's share of LP 2's interest expense is considered as related to all of Individual A's income producing activities and assets. In other words, Individual A will include her share of LP 2's interest expense as if she paid the interest expense directly. Reg. 1.861-9T(e)(1).

In allocating her interest expense, Individual A will include her share of the LP 2 [gross] assets. Reg. 1.861-9(e)(3). The character of Individual A's share of LP 2's assets is determined by reference to the character of LP 2's gross income. Reg. 1.861-9T(e)(1) and -9T(g)(3). Because LP 2 generated 40% of its gross income as passive foreign-source income, 40% (\$20) of the average assets will be considered passive foreign assets and 60% (\$30) of the average assets will be considered a US assets.