

118 T.C. No. 11

UNITED STATES TAX COURT

SUNOCO, INC. AND SUBSIDIARIES, Petitioner v.  
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 19631-97.

Filed March 15, 2002.

P claimed foreign tax credits under sec. 901(a), I.R.C., on its consolidated returns for 1982, 1983, 1984, and 1986. In these proceedings, P seeks to change the method of computing the overall limitation on the credit imposed by sec. 904(a), I.R.C. Specifically, P seeks to change the manner in which it allocates and apportions interest expenses for purposes of computing taxable income from sources without the United States, the numerator of the limiting fraction. P claims that it is entitled to offset interest income against interest expenses before it allocates and apportions net interest expenses under sec. 1.861-8(e)(2), Income Tax Regs.

Held: Sec. 1.861-8(e)(2), Income Tax Regs., does not permit P to allocate and apportion net interest expenses. The Tax Court's decision in Bowater, Inc., & Subs. v. Commissioner, 101 T.C. 207 (1993), revd. 108 F.3d 12 (2d Cir. 1997), which holds the opposite, is hereby overruled.

Marjorie A. Burnett, Thomas D. Johnston, Robert L. Moore II, Michael J. McGoldrick, and Nancy M. Seweryn, for petitioner.

John A. Guarnieri, Richard H. Gannon, and Keith L. Gorman, for respondent.

OPINION

WHALEN, Judge: Respondent determined the following deficiencies in petitioner's Federal income tax:

<u>Year</u>	<u>Deficiency</u>
1979	\$10,563,157
1981	5,163,449
1983	35,916,359

Petitioner disputes the above deficiencies and further claims to have overpaid income taxes for 1979, 1981, and 1983 by at least \$25,082,591, \$6,881,055, and \$14,137,211, respectively.

After concessions, there are three issues for decision in this case. Each issue will be the subject of a separate opinion. The issue that is the subject of this opinion arises in the context of computing the overall limit imposed by section 904(a) on the foreign tax credits claimed by petitioner under section 901(a) for taxable years 1982, 1983, 1984, and 1986, referred to herein as the years in issue. In this opinion, all section

references are to the Internal Revenue Code as in effect during the years in issue, unless stated otherwise.

This issue involves the computation of income from sources without the United States, the numerator of the limiting fraction under section 904(a). Specifically, in allocating and apportioning interest expenses for purposes of computing taxable income from sources without the United States for the years in issue, the question is whether section 1.861-8(e)(2), Income Tax Regs., contemplates that the aggregate interest expense incurred by each member of petitioner's affiliated group of corporations for the taxable year can first be offset by that member's interest income. Stated more simply, the issue is whether netting of interest expense and interest income is permitted by section 1.861-8(e)(2), Income Tax Regs.

As a preliminary matter, we must decide an evidentiary objection raised by respondent. Respondent filed a motion in limine to exclude the testimony of an economist, Dr. J. Gregory Ballentine, who was called by petitioner as an expert witness. Respondent argues that Dr. Ballentine's testimony should be excluded because it represents "irrelevant and immaterial legal conclusions and opinions and does not assist the Court." Respondent also contends

that Dr. Ballentine's testimony should be excluded because it amounts to impermissible advocacy.

Respondent also proffered the testimony of an expert witness but did so only to preserve the Commissioner's right to offer such testimony if the testimony of petitioner's expert were admitted into evidence. At trial, the Court permitted both experts to testify and reserved ruling on respondent's motion in limine.

Petitioner offers the testimony of Dr. Ballentine to "assist the Court in interpreting the economic terms in section 1.861-8(e)(2)", Income Tax Regs. According to his report, Dr. Ballentine reached two overall conclusions: (1) "Netting interest income against interest expense implements the economic concept of the fungibility of money as it relates to sources of funds"; (2) "interest netting achieves a tax neutrality between borrowing and reducing cash balances as sources of funds." Petitioner argues the same two principles in the posttrial briefs filed on its behalf. Dr. Ballentine's report states that he was retained "to provide an economic evaluation of netting interest income against interest expense for purposes of the tax rules that apportion interest expense between domestic and foreign source income."

Rule 702 of the Federal Rules of Evidence, which governs the admissibility of expert testimony, provides:

If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise.\* \* \*

Thus, expert testimony is admissible under rule 702 if it assists the Court to understand the evidence or to determine a fact in issue.

The parties agree that the subject issue, involving the interpretation of section 1.861-8(e)(2), Income Tax Regs., is a question of law and that there are no facts in dispute. Thus, the question we must answer is whether Dr. Ballentine's testimony aids the Court in understanding the evidence. Dr. Ballentine's testimony provides economic examples and policy reasons as to why the appropriate measure of interest expense is net interest expense. Petitioner's brief reiterates these same concepts and includes the same examples.

We find that Dr. Ballentine's report and testimony merely advocate petitioner's position and do not aid the Court "to understand the evidence or to determine a fact

in issue". Fed. R. Evid. 702. Expert testimony is not admissible for such purposes. An expert who is merely an advocate of a party's position does not assist the Court in understanding the issue. See Hosp. Corp. of Am. v. Commissioner, 109 T.C. 21 (1997); Alumax, Inc. v. Commissioner, 109 T.C. 133 (1997), affd. 165 F.3d 822 (11th Cir. 1999); Snap-Drape, Inc. v. Commissioner, 105 T.C. 16, 20 (1995), affd. 98 F.3d 194 (5th Cir. 1996); Laureys v. Commissioner, 92 T.C. 101, 129 (1989); Robertson v. Commissioner, T.C. Memo. 1999-130, affd. without published opinion 87 AFTR2d 2001-1274, 2001-1 USTC par. 50,276 (9th Cir. 2001); see also Estate of Halas v. Commissioner, 94 T.C. 570, 577 (1990) ("In the context of valuation cases, we have observed that experts may lose their usefulness and credibility when they merely become advocates for one side.").

We conclude that Dr. Ballentine's testimony does not assist the Court in understanding the legal question issue and is not admissible. Accordingly, we shall grant respondent's motion in limine.

Most of the facts relating to the issue which is the subject of this opinion were stipulated by the parties. The stipulated facts and accompanying exhibits are so found and are hereby incorporated in this opinion.

Petitioner was incorporated under the laws of the Commonwealth of Pennsylvania. At the time the instant petition was filed on its behalf, petitioner's principal place of business and mailing address was in Philadelphia, Pennsylvania. During each of the tax years in issue, petitioner was the common parent of an affiliated group of corporations, as defined in section 1504(a), and it filed a consolidated Federal income tax return on behalf of itself and the other members of the affiliated group as permitted by section 1501.

At all times material to this case, petitioner and the other members of its affiliated group engaged in the business of acquiring and developing oil, gas, and other energy properties, of refining or otherwise preparing the natural resources produced from the properties for sale to customers, and of marketing and transporting those products to customers both in the United States and abroad. During the years in issue, petitioner and its affiliated corporations earned income from various sources, domestic and foreign, including income from interest, dividends, the production of oil and gas and other hydrocarbons, and the sale of products derived from the production of hydrocarbons.

Petitioner chose to use the foreign tax credit under section 901(a) in computing the tax liability of its affiliated group of corporations for consolidated return years 1982, 1983, 1984, and 1986. In computing the overall limitation on the credit under section 904(a), petitioner allocated and apportioned a portion of the interest expense of each member of the affiliated group to sources without the United States for purposes of computing the numerator of the limiting fraction under section 904(a); i.e., taxable income from sources without the United States. The following schedule sets forth the deduction for interest claimed by each member of petitioner's affiliated group for each of the years in issue, the portion of such amount that was allocated and apportioned to sources without the United States for each year, and the ratio of the latter to the former:

<u>1982</u>	<u>Interest expense</u>	<u>Apportioned to foreign source income</u>	<u>Ratio percent</u>
650 Leasing Co.	\$682,931	\$235,504	37.12
Sun Leasing Co.	4,729,086	2,729,628	57.72
666 Leasing Co.	4,072,539	2,138,083	52.50
670 Leasing Co.	1,830,136	853,210	46.62
673 Leasing Co.	1,627,381	727,928	44.73
675 Leasing Co.	1,983,276	1,002,744	50.56
652 Leasing Co.	794,330	356,448	44.87
Kee Leasing Co.	581,235	403,610	69.44
653 Leasing Co.	814,727	398,972	48.97
667 Leasing Co.	3,286,585	1,709,024	52.00
Millcreek Leasing Co.	830,407	202,492	24.38
DeSun Shipping	47,658	33,697	70.71
Eastern Sun Shipping	37,115	24,183	65.16
NY Sun Shipping	9,970,340	8,851,391	88.78
NJ Sun Shipping	143,340	116,170	81.05
PA Shipping	46,423	29,294	63.10
Phil Sun Shipping	10,809,958	3,214,297	29.74
Western Sun Shipping	50,003	31,980	63.96
Sun Transport, Inc.	3,650,045	1,465,486	40.15
Sun Note Co.	31,066,253	31,066,253	100.00
North Sea Oil Co.	65,897	65,897	100.00
Totem Ocean Trailer	<u>46,949</u>	<u>29,813</u>	63.50
	77,166,614	55,704,104	

<u>1983</u>	<u>Interest expense</u>	<u>Apportioned to foreign source income</u>	<u>Ratio percent</u>
650 Leasing Co.	\$612,220	\$357,904	58.46
Sun Leasing Co.	4,736,241	2,808,118	59.29
666 Leasing Co.	4,084,197	2,580,396	63.18
670 Leasing Co.	1,756,214	973,645	55.44
652 Leasing Co.	714,282	312,641	43.77
Kee Leasing Co.	504,412	357,058	70.79
653 Leasing Co.	736,315	375,962	51.06
667 Leasing Co.	3,160,356	2,019,783	63.91
Millcreek Leasing Co.	742,214	365,707	49.27
NY Sun Shipping	9,849,306	8,573,395	87.05
NJ Sun Shipping	208,102	129,266	62.12
Phil Sun Shipping	10,688,995	3,437,299	32.16
Texas Sun Shipping	33,963	12,819	37.74
Tropic Sun Shipping	474,700	272,684	57.44
Sun Transport, Inc.	2,644,781	926,810	35.04
Heleasco Fifteen	1,444,639	1,297,009	89.78
Sun Note Co.	<u>25,667,812</u>	<u>25,634,424</u>	99.87
	68,058,749	50,434,920	

<u>1984</u>	<u>Interest expense</u>	<u>Apportioned to foreign source income</u>	<u>Ratio percent</u>
Kee Leasing Co.	\$408,197	\$154,339	37.81
666 Leasing Co.	4,083,327	1,964,080	48.10
670 Leasing Co.	1,669,360	610,485	36.57
650 Leasing Co.	536,038	270,003	50.37
652 Leasing Co.	613,066	176,024	28.71
653 Leasing Co.	636,635	118,974	18.69
667 Leasing Co.	3,018,359	885,134	29.33
Sun Leasing Co.	4,689,864	2,059,788	43.92
NY Sun Shipping	9,712,823	9,165,743	94.37
Phil Sun Shipping	10,551,646	4,687,164	44.43
Tropic Sun Shipping	644,883	313,703	48.64
Sun Transport, Inc.	3,091,754	985,633	31.88
Sun Oil Trading Co.	<sup>1</sup> 627,633	32,260	5.14
Sun Note Co.	25,854,099	25,693,399	99.38
North Sea Sun Oil Co.	<u>7,681,288</u>	<u>7,541,569</u>	98.18
	73,818,972	54,658,298	

<sup>1</sup> One of petitioner's exhibits lists this amount as \$2,114,469. See p. 17, infra.

<u>1986</u>	<u>Interest expense</u>	<u>Apportioned to foreign source income</u>	<u>Ratio percent</u>
Kee Leasing Co.	\$213,410	\$27,604	12.93
666 Leasing Co.	3,907,731	1,750,664	44.80
670 Leasing Co.	1,468,580	621,944	42.35
650 Leasing Co.	404,732	189,415	46.80
Sun Leasing Co.	4,532,004	1,960,092	43.25
Millcreek Leasing Co.	435,448	102,064	23.44
Tropic Sun Shipping	644,829	242,814	37.66
Sun Transport, Inc.	2,356,829	650,044	27.58
Sunoco Overseas, Inc.	211,438	211,438	100.00
Sun Refining & Mktg. Co.	44,588,973	4,598,484	10.31
Sun Oil Trading Co.	549,406	8,918	1.62
Sun Co., Inc.	157,687,537	5,097,677	3.23
Sun Oil Intl.	7,190,703	2,487,983	34.60
North Sea Sun Oil Co.	28,050,064	27,208,562	97.00
Claymont Investment Co.	<u>217,180,793</u>	<u>47,426</u>	0.02
	469,422,477	45,205,129	

The parties have stipulated that "in most cases" the interest expense of each member of petitioner's affiliated group of corporations was apportioned "in general accordance with the optional gross income method [sic] of apportionment described in Treas. Reg. §1.861-8(e)(2)(vi)." The stipulation does not state which of the optional gross income methods described by sec. 1.861-8(e)(2)(vi), Income Tax Regs., was used in the case of any

member of the group. In any event, the following schedule shows the gross income of each member of petitioner's affiliated group of corporations for each of the subject years, that member's gross income from sources without the United States for each year, and the ratio of the latter to the former:

<u>1982</u>	<u>Gross income</u>	<u>Foreign gross income</u>	<u>Ratio percent</u>
650 Leasing Co.	\$3,288,110	\$1,221,496	37.15
Sun Leasing Co.	6,872,415	3,966,133	57.71
666 Leasing Co.	6,401,918	3,372,797	52.68
670 Leasing Co.	4,733,818	2,214,708	46.78
673 Leasing Co.	4,308,780	1,924,955	44.68
675 Leasing Co.	3,987,511	2,016,544	50.57
652 Leasing Co.	3,183,942	1,420,014	44.60
Kee Leasing Co.	1,720,403	1,194,921	69.46
653 Leasing Co.	3,209,671	1,576,737	49.12
667 Leasing Co.	7,577,559	3,950,760	52.14
Millcreek Leasing Co.	6,775,203	1,652,111	24.38
DeSun Shipping	1,868,480	1,321,135	70.71
Eastern Sun Shipping	340,725	222,010	65.16
NY Sun Shipping	8,302,978	6,755,590	81.36
NJ Sun Shipping	-814,965	575,083	-70.57
PA Shipping	3,912,021	2,468,565	63.10
Phil Sun Shipping	6,602,489	1,963,223	29.73
Western Sun Shipping	2,574,519	1,646,584	63.96
Sun Transport, Inc.	95,328,918	38,274,373	40.15
Sun Note Co.	43,260,421	41,406,722	95.72
North Sea Oil Co.	42,518,569	42,518,569	100.00
Totem Ocean Trailer	<u>92,031,992</u>	<u>57,380,743</u>	62.35
	347,985,477	219,043,773	

<u>1983</u>	<u>Gross income</u>	<u>Foreign gross income</u>	<u>Ratio percent</u>
650 Leasing Co.	\$2,593,100	\$1,508,054	58.16
Sun Leasing Co.	6,973,146	4,151,644	59.54
666 Leasing Co.	8,943,399	5,644,013	63.11
670 Leasing Co.	4,132,347	2,304,872	55.78
652 Leasing Co.	2,523,829	1,104,364	43.76
Kee Leasing Co.	2,012,673	1,424,195	70.76
653 Leasing Co.	2,552,479	1,306,385	51.18
667 Leasing Co.	6,427,811	4,098,914	63.77
Millcreek Leasing Co.	8,220,982	4,050,674	49.27
NY Sun Shipping	7,917,134	6,891,523	87.05
NJ Sun Shipping	3,008,541	1,868,808	62.12
Phil Sun Shipping	6,930,169	2,228,559	32.16
Texas Sun Shipping	1,392,393	525,539	37.74
Tropic Sun Shipping	3,047,355	1,750,507	57.44
Sun Transport, Inc.	85,157,516	29,842,158	35.04
Heleasco Fifteen	2,415,666	2,168,805	89.78
Sun Note Co.	<u>44,530,627</u>	<u>42,711,487</u>	95.91
	198,779,167	113,580,501	

<u>1984</u>	<u>Gross income</u>	<u>Foreign gross income</u>	<u>Ratio percent</u>
Kee Leasing Co.	\$2,014,039	\$761,330	37.80
666 Leasing Co.	8,573,805	4,137,017	48.25
670 Leasing Co.	4,362,352	1,586,209	36.36
650 Leasing Co.	2,657,644	1,339,771	50.41
652 Leasing Co.	2,557,004	731,691	28.62
653 Leasing Co.	2,592,171	483,157	18.64
667 Leasing Co.	6,563,855	1,936,224	20.50
Sun Leasing Co.	7,404,599	3,269,459	44.15
NY Sun Shipping	9,454,505	8,921,975	94.37
Phil Sun Shipping	5,129,727	2,278,684	44.42
Tropic Sun Shipping	4,004,764	1,948,117	48.64
Sun Transport, Inc.	73,123,906	23,311,476	31.88
Sun Oil Trading Co.	20,037,455	710,113	3.54
Sun Note Co.	40,344,826	40,094,056	99.38
North Sea Sun Oil Co.	<u>23,924,318</u>	<u>17,319,539</u>	72.39
	212,744,970	108,828,818	

<u>1986</u>	<u>Gross income</u>	<u>Foreign gross income</u>	<u>Ratio Percent</u>
Kee Leasing Co.	\$2,013,346	\$260,455	12.94
666 Leasing Co.	7,082,756	3,172,987	44.80
670 Leasing Co.	3,533,401	1,496,424	42.35
650 Leasing Co.	2,038,955	954,294	46.80
Sun Leasing Co.	6,194,365	2,679,882	43.26
Millcreek Leasing Co.	305,752	-83,676	27.37
Tropic Sun Shipping	3,986,919	1,501,298	37.66
Sun Transport, Inc.	79,520,790	21,932,881	27.58
Sunoco Overseas, Inc.	-108,199	290,314	100.00
Sun Refining & Mktg. Co.	672,597,605	1,095,517	0.16
Sun Oil Trading Co.	13,481,454	4,673,000	34.66
Sun Co., Inc.	760,884,991	23,864,572	3.14
Sun Oil Intl.	10,593,916	6,769,393	34.55
North Sea Sun Oil Co.	36,565,327	36,394,917	99.53
Claymont Investment Co.	<u>513,112,873</u>	<u>111,203</u>	00.02
	2,120,804,251	105,113,461	

In allocating and apportioning each member's interest expense to sources without the United States under one of the optional gross income methods described by section 1.861-8(e)(2)(vi), Income Tax Regs., petitioner started with the gross amount of each member's interest expense for the taxable year and did not offset that amount by the interest income earned by that member during the year.

As mentioned above, petitioner chose to use the foreign tax credit under section 901(a) in computing the tax liability of its affiliated group of corporations for consolidated return years 1982, 1983, 1984, and 1986. As to each of those years, the amount of foreign taxes for which a taxpayer could claim credit was subject to the overall limitation of section 904. Under that limitation, the amount of foreign tax credit could not exceed the tentative U.S. tax for the year (i.e., the U.S. tax before application of the foreign tax credit) multiplied by a fraction, the numerator of which is the taxable income from sources without the United States and the denominator of which is the entire taxable income. Sec. 904(a).

Generally, in the case of an affiliated group of corporations, the foreign tax credit is determined on a consolidated basis. Sec. 1.1502-4(c), Income Tax Regs. In computing the overall limitation under section 904(a)

for an affiliated group, the numerator of the limiting fraction is an amount equal to the total of the separate taxable incomes of the members of the group from sources without the United States, with certain adjustments that are not material to this case. See sec. 1.1502-4(d)(1), Income Tax Regs. The denominator of the limiting fraction under section 904(a) is the consolidated taxable income of the group computed in accordance with section 1.1502-11, Income Tax Regs. Sec. 1.1502-4(d)(2), Income Tax Regs. Thus, for each of the subject consolidated return years, petitioner was required to compute the "taxable income from sources without the United States" of each member of its affiliated group of corporations. Sec. 904(a). The total of those amounts is the numerator of the limiting fraction under section 904(a).

In these proceedings, petitioner seeks to make two changes in the method used to allocate and apportion interest expenses for purposes of computing each member's taxable income from sources without the United States. First, petitioner seeks to apportion the interest expenses of each member of its affiliated group using the asset method described in section 1.861-8(e)(2)(v), Income Tax Regs., for tax years 1982, 1983, and 1984, and using one of the optional gross income methods described by section

1.861-8(e)(2)(vi), Income Tax Regs., for tax year 1986. As mentioned above, petitioner had used one of the optional gross income methods described by section 1.861-8(e)(2)(vi), Income Tax Regs., in apportioning interest expenses on each of the subject returns. Respondent concedes that petitioner is entitled to make this change, as long as all members joining the 1986 return use one of the optional gross income methods described by section 1.861-8(e)(2)(vi), Income Tax Regs.

The second change sought by petitioner, the change at the heart of the instant controversy, involves petitioner's assertion that each member's interest expense to be allocated and apportioned under section 1.861-8(e)(2), Income Tax Regs., for purposes of computing the overall limitation under section 904(a), is "net interest expense", i.e., interest expense for the year less interest income but not less than zero, rather than gross interest expense. Respondent asserts that this change is improper.

To quantify petitioner's position, the following schedule sets forth the interest expense incurred by each member of petitioner's affiliated group of corporations, the interest income earned by that member, and the net interest expense of that member; i.e., interest expense less interest income but not less than zero:

<u>1982</u>	<u>Interest expense</u>	<u>Interest income</u>	<u>Net interest expense</u>
650 Leasing Co.	\$682,931	\$1,379,522	-0-
Sun Leasing Co.	4,729,086	1,512,776	\$3,216,310
666 Leasing Co.	4,072,539	1,904,855	2,167,684
670 Leasing Co.	1,830,136	1,740,970	89,166
673 Leasing Co.	1,627,381	1,253,296	374,085
675 Leasing Co.	1,983,276	836,661	1,146,615
652 Leasing Co.	794,330	1,285,273	-0-
Kee Leasing Co.	581,235	13,373	567,862
653 Leasing Co.	814,727	1,309,988	-0-
667 Leasing Co.	3,286,585	2,639,109	647,476
Millcreek Leasing Co.	830,407	1,357,133	-0-
DeSun Shipping	47,658	135,470	-0-
Eastern Sun Shipping	37,115	82,228	-0-
NY Sun Shipping	9,970,340	854,008	9,116,332
NJ Sun Shipping	143,340	16,205	127,135
PA Shipping	46,423	133,771	-0-
Phil Sun Shipping	10,809,958	448,677	10,361,281
Western Sun Shipping	50,003	66,869	-0-
Sun Transport Inc.	3,650,045	99,840	3,550,205
Sun Note Co.	31,066,253	32,754,418	-0-
North Sea Oil Co.	65,897	1,176,482	-0-
Totem Ocean Trailer	<u>46,949</u>	<u>1,668,617</u>	<u>-0-</u>
	77,166,614	52,669,541	31,364,151

<u>1983</u>	<u>Interest expense</u>	<u>Interest income</u>	<u>Net Interest expense</u>
650 Leasing Co.	\$612,220	\$684,172	-0-
Sun Leasing Co.	4,736,241	1,581,401	\$3,154,840
666 Leasing Co.	4,084,197	1,707,485	2,376,712
670 Leasing Co.	1,756,214	1,139,007	617,207
652 Leasing Co.	714,282	631,498	82,784
Kee Leasing Co.	504,412	6,765	497,647
653 Leasing Co.	736,315	658,732	77,583
667 Leasing Co.	3,160,356	1,489,361	1,670,995
MillCreek Leasing Co.	742,214	2,132,982	-0-
NY Sun Shipping	9,849,306	727,159	9,122,147
NJ Sun Shipping	208,102	449,738	-0-
Philadelphia Sun Shipping	10,688,995	855,141	9,833,854
Texas Sun Shipping	33,963	704,193	-0-
Tropic Sun Shipping	474,700	569,955	-0-
Sun Transport, Inc.	2,644,781	980,197	1,664,584
Heleasco Fifteen	1,444,639	246,861	1,197,778
Sun Note Co.	<u>25,667,812</u>	<u>37,161,016</u>	<u>-0-</u>
	68,058,749	51,725,663	30,296,131

<u>1984</u>	<u>Interest expense</u>	<u>Interest income</u>	<u>Net interest expense</u>
Kee Leasing Co.	\$408,197	\$10,538	\$397,659
666 Leasing Co.	4,083,327	2,209,163	1,874,164
670 Leasing Co.	1,669,360	1,369,504	299,856
650 Leasing Co.	536,038	715,947	-0-
652 Leasing Co.	613,066	671,202	-0-
653 Leasing Co.	636,635	704,840	-0-
667 Leasing Co.	3,018,359	1,611,875	1,406,484
Sun Leasing Co.	4,689,864	2,044,830	2,645,034
NY Sun Shipping	9,712,823	532,530	9,180,293
Phil Sun Shipping	10,551,646	676,120	9,875,526
Tropic Sun Shipping	644,883	1,040,764	-0-
Sun Transport, Inc.	3,091,754	35,223	3,056,531
Sun Oil Trading Co.	<sup>1</sup> 2,114,469	16,303,956	-0-
Sun Note Co.	25,854,099	33,533,894	-0-
North Sea Oil Co.	<u>7,681,288</u>	<u>2,196,279</u>	<u>5,485,009</u>
	75,305,808	63,656,665	34,220,556

<sup>1</sup> See p.10, supra.

<u>1986</u>	<u>Interest expense</u>	<u>Interest income</u>	<u>Net interest expense</u>
Kee Leasing Co.	\$213,410	\$9,844	\$203,566
666 Leasing Co.	3,907,731	736,783	3,170,948
670 Leasing Co.	1,468,580	540,553	928,027
650 Leasing Co.	404,732	130,367	274,365
Sun Leasing Co.	4,532,004	834,601	3,697,403
Millcreek Leasing Co.	435,448	662,752	-0-
Tropic Sun Shipping	644,829	1,148,919	-0-
Sun Transport, Inc.	2,356,829	646,275	1,710,554
Sunoco Overseas, Inc.	211,438	189,663	21,775
Sun Refining & Mkt., Inc.	44,588,973	23,675,379	20,913,594
Sun Oil Trading Co.	549,406	317,610	231,796
Sun Co., Inc.	157,687,537	937,176	156,750,361
Sun Oil Int.	7,190,703	12,824,523	-0-
North Sea Oil Co.	28,050,064	1,784,106	26,265,958
Claymont Investment Co.	<u>217,180,793</u>	<u>505,319,941</u>	<u>-0-</u>
	469,422,477	549,758,492	214,168,347

Petitioner argues that it is entitled to use the amount in column three of the above schedule, i.e., the net interest expense of each member of its affiliated group, as the starting point for allocating and apportioning that member's interest expense under section 1.861-8(e)(2), Income Tax Regs.

The parties have stipulated the amount of each member's interest expense to be allocated and apportioned to sources without the United States depending upon whether

netting is or is not permitted. These stipulations are summarized in the appendix to this Opinion.

In the appendix, each member's interest expense for 1982, 1983, and 1984 is apportioned to sources without the United States in accordance with the asset method described by section 1.861-8(e)(2)(v), Income Tax Regs. The parties have stipulated the ratio of each member's assets which relates to activities and properties that generated foreign source income during each year. See generally sec. 1.861-8(e)(2)(v), Income Tax Regs. Using that asset ratio, the amount of a member's interest expense to be apportioned to sources without the United States is computed, if netting is not permitted, by multiplying the ratio and the member's gross interest expense, or, if netting is permitted, by multiplying the ratio and the member's net interest expense.

In the appendix, each member's interest expense for 1986 is apportioned to sources without the United States in accordance with one of the optional gross income methods described by section 1.861-8(e)(2)(vi), Income Tax Regs. Generally, under that provision, assuming certain conditions are met, the deduction for interest is apportioned to sources within or without the United States ratably on the basis of a taxpayer's gross income. See id.

As shown in the appendix, the parties have stipulated two sets of gross income ratios for 1986, one set to be used assuming that netting is not permitted and the other set to be used assuming that netting is permitted. The amount of a member's interest expense to be apportioned to sources without the United States is computed, if netting is not permitted, by multiplying the first gross income ratio and the member's gross interest expense, or, if netting is permitted, by multiplying the second ratio and the member's net interest expense. The appendix has two schedules for 1986, one schedule summarizing the apportionment of gross interest (i.e., no netting) and one summarizing the apportionment of net interest (i.e., netting).

It appears that in computing the second set of gross income ratios for 1986, the ratios to be used if netting is permitted, the parties have adjusted the gross income of each member by subtracting therefrom the amount of interest income that is offset by interest expense. For example, in the case of Kee Leasing Co., the first income ratio of 12.94 percent, the ratio to be used in apportioning interest if netting is not permitted, was computed by dividing the company's gross income from sources without the United States, \$260,455, by the company's gross income,

\$2,013,345. On the other hand, the second income ratio of 13 percent, the ratio to be used in apportioning interest if netting is permitted, was computed after the amount of netted interest income, \$9,844, was subtracted from the company's gross income, the denominator of the fraction. Thus, the second ratio of 13 percent was computed by dividing \$260,455, the company's gross income from sources without the United States, by \$2,003,501, the company's total gross income less the amount of netted interest (\$2,013,345 minus \$9,844).

Similar adjustments were made to the gross income of each of the other 14 members of petitioner's affiliated group for purposes of computing the second gross income ratio; i.e., the ratio to be used in computing the interest expense to be apportioned to sources without the United States, assuming that netting is permitted.

Furthermore, in the case of one of the 15 members of petitioner's affiliated group of corporations, North Sea Sun Oil Co., a similar adjustment was made to the numerator of the fraction that constitutes the gross income ratio. That is, the interest income earned by that company during 1986, \$1,784,106, was subtracted from the company's foreign source gross income, \$36,394,917, to arrive at \$34,610,811, the numerator of the fraction. That amount was divided

by the excess of the company's total gross income, \$36,565,327, over its interest income, \$1,784,106, or \$34,781,221, to arrive at the gross income ratio of 99.51 percent.

Thus, in computing the second gross income ratio for North Sea Sun Oil Co. under section 1.861-8(e)(2)(vi), Income Tax Regs., the ratio to be used if netting is permitted, the interest income earned by North Sea Sun Oil Co. during 1986 was subtracted from both the numerator and the denominator of the fraction. The interest income earned during 1986 by each of the other 14 members of plaintiff's affiliated group was subtracted only from the denominator of the fraction in computing the second gross income ratio for each of those companies. We infer from this that the interest income earned by North Sea Sun Oil Co. in 1986 constituted gross income from sources without the United States, whereas the interest income earned by each of the other members of petitioner's affiliated group for 1986 constitutes gross income from sources within the United States.

The following schedule summarizes the revenue impact of the position of each of the parties with respect to the subject issue. It shows, based upon the parties' stipulation, the aggregate interest expense apportioned to

sources without the United States for each of the years in issue as claimed on petitioner's consolidated returns, the aggregate interest expense to be apportioned to foreign sources if there is no netting of interest expense and interest income, and the aggregate amount to be so apportioned if there is netting of interest expense and interest income. The last column of the schedule shows the difference between the amount of interest to be apportioned to sources without the United States, assuming that there is no netting, and the amount of interest to be so apportioned, assuming that there is netting:

Interest expense allocated and apportioned to sources without the United States

<u>Year</u>	<u>Per return</u>	<u>No netting</u>	<u>Netting</u>	<u>Difference</u>
1982	\$55,704,104	\$55,155,126	\$17,444,643	\$37,710,483
1983	50,434,920	47,362,922	17,200,130	30,162,792
1984	54,658,298	50,150,909	19,831,268	30,319,641
1986	<u>45,205,129</u>	<u>45,517,890</u>	<u>37,689,610</u>	<u>7,828,280</u>
	206,002,451	198,186,847	92,165,651	106,021,196

Thus, as shown above, if there is netting, then the aggregate interest expense to be allocated and apportioned to sources without the United States in computing the overall limitation on petitioner's foreign tax credit under section 904(a) would be substantially less for each of the 4 years in issue than the interest expense to be allocated and apportioned to sources without the United States if there is no netting. This difference is \$37,710,483, \$30,162,792, \$30,319,641, and \$7,828,280, for the years in

issue, respectively. Thus, the effect of netting would be to substantially increase petitioner's income from sources without the United States, the numerator of the limiting fraction under section 904(a), and to substantially increase the amount of petitioner's foreign tax credit for each of the years in issue.

Both parties rely on the regulations promulgated under the source rules, viz sections 861 through 864, especially section 1.861-8(e)(2), Income Tax Regs., to support their position that netting is permitted or that netting is not permitted. Petitioner does not contend that the regulations are contrary to the statute or unlawful in any respect. Therefore, as presented by the parties, the issue in this case is whether the netting of interest income and interest expense is permitted by the regulations promulgated under sections 861 through 864, principally section 1.861-8(e)(2), Income Tax Regs., that were in effect during the years 1982, 1983, 1983, and 1986, generally referred to herein as the subject regulations.

At the outset, we note that the principal regulation at issue in this case, section 1.861-8(e)(2), Income Tax Regs., was adopted on January 3, 1977, effective for taxable years beginning after December 31, 1976

(hereinafter referred to as the 1977 Regulation).

42 Fed. Reg. 1197 (Jan. 6, 1977).

In 1988, the Secretary of the Treasury issued temporary regulations dealing with the allocation and apportionment of interest expense and certain other expenses for purposes of the foreign tax credit rules and certain other international tax provisions to reflect the revisions to those rules made by the passage of the Tax Reform Act of 1986, Pub. L. 99-514, sec. 1215, 100 Stat. 2544. Section 1.861-9T(a), Temporary Income Tax Regs., 53 Fed. Reg. 35477 (Sept. 14, 1988), superseded the 1977 regulation for years beginning after December 31, 1986. Section 1.861-9T(a) contains virtually the same language found in section 1.861-8(e)(2)(i) and (ii) regarding the allocations and apportionment of interest expenses. In addition, section 1.861-9T(a), Temporary Income Tax Regs., supra, explicitly provides that "the term interest refers to the gross amount of interest expense incurred by a taxpayer in a given year." (Emphasis added.) Therefore, the 1988 temporary regulation explicitly prohibits netting for tax years beginning after December 31, 1986. The 1988 temporary regulations were not given retroactive effect and thus do not apply to the years in issue in this case.

See sec. 1.861-8T(h), Temporary Income Tax Regs., 53 Fed. Reg. 35477 (Sept. 14, 1988).

We do not agree with petitioner's contention that, by promulgating the new rules without retroactive effect, the Secretary of the Treasury indicated "that the express restrictive language requiring the use of gross interest expense for purposes of allocation and apportionment was intended as a change, rather than a clarification, of prior law." To the contrary, the 1988 temporary regulations, including section 1.861-9T(a), Temporary Income Tax Regs., supra, were promulgated to reflect the revisions made by the Tax Reform Act of 1986, including the enactment of section 864(e), which substantially changed some of the rules for the allocation and apportionment of interest expenses. These new provisions were made effective, for the most part, for tax years beginning after December 31, 1986. Tax Reform Act of 1986, Pub. L. 99-514, sec. 1215(c)(1), 100 Stat. 2545. It was appropriate to make the regulations reflecting those changes effective at the same time. In these circumstances, we do not believe that promulgating the new rules without retroactive effect suggests that the sentence in section 1.861-9T(a), Temporary Income Tax Regs., supra, quoted above, containing the words, "the gross amount of interest expense", was

intended as a change, rather than a clarification, of prior law.

The subject regulations are intended to be used in conjunction with certain "operative sections" of the Code which require the determination of the taxable income of the taxpayer from specific sources or activities. See sec. 1.861-8(f)(1), Income Tax Regs. The overall limitation on the foreign tax credit provided in section 904(a) is one such operative section. See id.

Under the subject regulations, the first step in determining a taxpayer's taxable income from a particular source or activity is to categorize the taxpayer's gross income into different groupings. See sec. 1.861-8(a)(1), (2), (4), Income Tax Regs. The regulations use the term "statutory grouping of gross income" to mean the gross income from a specific source or activity which must first be determined in order to arrive at taxable income from such specific source or activity under an operative section. Sec. 1.861-8(a)(4), Income Tax Regs. Gross income from other sources or activities is referred to as the "residual grouping of gross income". Id.

The overall limitation of section 904(a), the operative section in this case, requires the taxpayer to determine taxable income from sources without the United

States. Thus, the "statutory grouping of gross income" in this case is gross income from sources without the United States and the "residual grouping of gross income" is gross income from sources within the United States. See sec. 1.861-8(a)(4), (f)(1), Income Tax Regs.

The term "gross income from sources without the United States", the statutory grouping of gross income in this case, consists of those items of gross income specified in section 862(a), plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). Sec. 1.861-1(a)(2), Income Tax Regs. Similarly, "gross income from sources within the United States", the residual grouping of gross income in this case, consists of those items of gross income specified in section 861(a), plus the items of gross income allocated or apportioned to such sources in accordance with section 863(a). Sec. 1.861-1(a)(1), Income Tax Regs.

For example, in the case of interest income, section 861(a)(1) provides that, as a general rule, the interest on bonds, notes, or other interest-bearing obligations of residents of the United States, corporate or otherwise, shall be treated as income from sources within the United States. See sec. 1.861-2(a), Income Tax Regs. Section 862(a)(1) provides that interest income other than that

derived from sources within the United States shall be treated as income from sources without the United States. See sec. 1.862-1(a)(1)(i), Income Tax Regs.

The record in the instant case does not expressly provide the source of the interest income earned by any member of petitioner's affiliated group of corporations during any of the years in issue. Nevertheless, we infer that the interest income of petitioner's affiliated corporations, for the most part, would be treated under the source rules as U.S. source income. Otherwise, if the interest income of petitioner's affiliated corporations were treated as foreign source income, then, in each case, the interest income would be included in the numerator of the limiting fraction under section 904(a) and would offset the interest expenses in that grouping. Thus, if the interest income of petitioner's affiliated corporations were foreign source income, netting would have little or no impact on the amount of foreign tax credit. This inference is confirmed in the case of the interest income earned by the members of petitioner's group for 1986, as discussed above.

After finding the source of each item of the taxpayer's gross income and grouping the items of gross income into the statutory and residual groupings, the next

step in determining taxable income from a specific source or activity is to allocate and apportion the taxpayer's "expenses, losses, and other deductions" to each of the groupings of gross income. Sec. 1.861-8(a)(2), (b), and (c), Income Tax Regs. Taxable income from a particular source or activity is the difference between the aggregate items of gross income in that grouping and the sum of the expenses, losses, and other deductions that are properly allocated and apportioned thereto, and a ratable portion of any expenses, losses, or other deductions that cannot definitely be allocated to an item or class of gross income. See secs. 861(b), 862(b); secs. 1.861-1, 1.861-8(a)(1), Income Tax Regs.

The regulations provide rules of general applicability governing the allocation and apportionment of expenses, losses, and other deductions, see sec. 1.861-8(a), (b), (c), and (d), Income Tax Regs., as well as rules governing the allocation and apportionment of specific deductions, see sec. 1.861-8(e)(2) through (11), Income Tax Regs. Specific rules for the allocation and apportionment of interest expense are provided in section 1.861-8(e), Income Tax Regs.

The principal rule of general applicability is that a taxpayer's expenses, losses, and other deductions are to be

allocated to the "class of gross income" to which each deduction is "definitely related". Sec. 1.861-8(a)(3), (b)(1), Income Tax Regs. A deduction is considered definitely related to a class of gross income if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived and, thus, the deduction bears a factual relationship to the class of gross income. Sec. 1.861-8(b)(1) and (2), Income Tax Regs. Classes of gross income are not predetermined but must be determined on the basis of the deductions to be allocated. Sec. 1.861-8(b)(1), Income Tax Regs. They may consist of one or more items of gross income enumerated in section 61, such as compensation for services, gross income derived from business, gains derived from dealings in property, interest, rents, royalties, dividends, etc. Sec. 1.861-8(a)(3), (b)(1), Income Tax Regs.

If a deduction is definitely related to a class of gross income that is included in more than one grouping of gross income, or if the deduction is definitely related to all of the taxpayer's gross income, then the regulations further provide that the deduction shall be apportioned "by attributing the deduction to gross income (within the class to which the deduction has been allocated) which is in the

statutory grouping or in each of the statutory groupings and to gross income (within the class) which is in the residual grouping." Sec. 1.861-8(c)(1), Income Tax Regs. This attribution must reflect to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. See id. The method of apportionment for a particular deduction can take into consideration various bases and factors, such as a comparison of units sold attributable to the statutory grouping and to the residual grouping, a comparison of the amount of gross sales or receipts, a comparison of the costs of goods sold, a comparison of profit contribution, a comparison of expenses incurred, assets used, salaries paid, space utilized, and time spent which are attributable to the activities or properties giving rise to the class of gross income, and a comparison of the amount of gross income in the statutory grouping with the amount in the residual grouping. See id.

Finally, if the deduction is not definitely related to any gross income, then the regulations provide that it is to be apportioned ratably between the statutory grouping and (or among the statutory groupings) and the residual grouping in proportion to the amount of gross income in

each grouping. See sec. 1.861-8(b)(5), (c)(2), Income Tax Regs.

Thus, under the rules of general applicability, the approach of the regulations, with several exceptions, is that every deduction has a definite factual relationship to a particular class of gross income which constitutes less than all of the taxpayer's gross income. Based upon that approach, the rules of general applicability require each deduction to be allocated to the related class of gross income and to be apportioned, on some reasonable basis, to the statutory and residual groupings of gross income.

The regulations take a different approach in the specific rules governing the allocation and apportionment of interest expenses, set forth in section 1.861-8(e)(2), Income Tax Regs. The regulations describe this approach as follows:

(2) Interest--(i) In general. The method of allocation and apportionment for interest set forth in this paragraph (e)(2) is based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of any specific purposes for incurring an obligation on which interest is paid. This 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. Normally, creditors of a taxpayer subject the money advanced to the taxpayer to the risk of the taxpayer's entire activities and look to the general credit of the

taxpayer for payment of the debt. When money is borrowed for a specific purpose, such 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. For the method of determining the interest deduction allowed to foreign corporations under section 882(c), see sec. 1.882-5. [Sec. 1.861-8(e)(2)(i), Income Tax Regs.]

This is the provision of the regulations on which petitioner principally relies, sec. 1.861-8(e)(2)(i), Income Tax Regs. Based on the above approach, the regulations provide as follows:

the aggregate of deductions for interest shall be considered related to all income producing activities and properties of the taxpayer and, thus, allocable to all the gross income which the income producing activities and properties of the taxpayer generate, have generated, or could reasonably have been expected to generate. [Sec. 1.861-8(e)(2)(ii), Income Tax Regs.]

After stating the general rule in section 1.861-8(e)(2)(i), Income Tax Regs., that interest expense is "allocable to all gross income" of the taxpayer, the regulations provide various methods to apportion the taxpayer's interest expense between the statutory grouping of gross income (or among the statutory groupings of gross income) and the residual grouping. See sec. 1.861-8(e)(2)(v) and (vi), Income Tax Regs. Under the

"asset method", the deduction for interest is apportioned, generally, in accordance with the value (book value or fair market value) of the assets utilized or invested in the activity or property. See sec. 1.861-8(e)(2)(v), Income Tax Regs. This is the method that petitioner wishes to use for tax years 1982, 1983, and 1984, as mentioned above. Under the "optional gross income methods", the deduction for interest is apportioned, generally, on the basis of the gross income in the statutory grouping or groupings and in the residual grouping. Sec. 1.861-8(e)(2)(vi), Income Tax Regs. This is the method that petitioner wishes to use for tax year 1986, as mentioned above.

Significantly, the regulations provide an exception that applies in the case of interest incurred specifically to purchase specific property. See sec. 1.861-8(e)(2)(iv), Income Tax Regs. In that case, the interest is treated as definitely related to the gross income derived from the property and is apportioned accordingly. See id. In order for this exception to apply, certain facts and circumstances enumerated in the regulations must be found. These include the fact that the indebtedness was incurred to purchase the specific property, the fact that the proceeds of the loan were actually applied to that purpose, the fact that the property is the only security for the

loan, the fact that the return (cashflow) on or from the property will be sufficient to satisfy the payments under the loan, and the fact that the loan agreements place restrictions on the disposal or use of the property. See id.

Where it is found that an interest deduction is definitely related solely to specific property, the interest deductions are allocated solely to the gross income derived from the specific property. See sec. 1.861-8(e)(2)(iv)(B), Income Tax Regs. Thus, the income from the specific property is placed in a grouping of gross income in accordance with the usual rules for sourcing gross income, see secs. 1.861-2 through 1.861-7, Income Tax Regs., and the interest deduction is directly allocated to such gross income, see sec. 1.861-8(e)(2)(iv)(B), Income Tax Regs.

Finally, in the case of nonbusiness interest, such as interest paid by an individual on a mortgage on his personal residence, the interest is treated as not definitely related to any class of gross income, see sec. 1.861-8(b)(5), (c)(2), Income Tax Regs., and is apportioned ratably between the statutory grouping (or among the statutory groupings) and the residual grouping in

proportion to the amount of gross income in each grouping, see sec. 1.861-8(e)(2)(iii), Income Tax Regs.

Petitioner argues that, under the version of the section 861 regulations in effect during the years in issue, it "may allocate and apportion net interest, rather than gross, interest expense" in calculating taxable income from sources without the United states for purposes of section 904(a). Petitioner's position is based on its reading of section 1.861-8(e)(2)(i), Income Tax Regs., which is quoted above. Petitioner emphasizes that section 1.861-8(e)(2)(i), Income Tax Regs., states, in general, that the method of allocation and apportionment for interest is based on the approach that "money is fungible", and 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." Id. Petitioner notes that the regulation refers to "interest" as "the cost of borrowing" in the context of "the fungibility of money". Based thereon, petitioner argues that the language of the regulation "raises a contextual ambiguity with respect to the precise definition of 'interest' and 'the cost of borrowing'." According to petitioner, the term "interest" can mean either net interest or gross interest, depending on the context. Petitioner argues that, in the context of

the subject regulation which is based upon the fungibility of money approach, and, absent an express rule to the contrary, the term "interest" should be recognized to mean net interest expense; i.e., gross interest expense less interest income.

Petitioner asserts that the following "simplified example", demonstrates that recognizing "interest" or "the cost of borrowing" as net interest expense, implements the fungibility of money principle:

Assume \* \* \* that a business needs \$800,000, and has \$1 million in short-term instruments bearing interest at 10 percent per year, and the capacity to borrow funds with no fees and at 10 percent per year. The business can obtain the \$800,000 by reducing its holding of short-term interest bearing instruments or by borrowing. Either choice has exactly the same effect on the net income of the business. If the business borrows, interest expense will increase by \$80,000 per year; if the business sells the instruments, interest income will decrease by \$80,000 per year.

Petitioner argues that the two sources of funds in the above example, incurring debt and selling short-term interest bearing assets, are fungible and should be treated as fungible under the source rules, as would take place by recognizing interest as net interest expense. Petitioner also argues that "a corollary to the fungibility of these two sources of funds is the fact that reduced interest

income is essentially equivalent to increased interest expense."

Petitioner gives the following variation of the above example to illustrate its position that taxpayers in the same economic situation should be treated the same by interpreting "interest" and "cost of borrowing", as used in section 1.861-8(e)(2)(i), Income Tax Regs., to mean net interest:

Suppose business A has an immediate need of \$800,000 and uncertain future needs, and a line of credit of \$1 million at 10 percent, and immediately draws \$800,000 on the line of credit. The interest expenses on the \$800,000 would be \$80,000, rather than \$100,000. In contrast, business B has a substantially identical need of \$800,000 immediately and uncertain future needs, but has no line of credit. So, business B obtains a loan from a bank for \$1 million and invests the surplus \$200,000 in short-term instruments bearing 10 percent. Although business B's gross interest expense would be \$100,000, its cost of borrowing would be best described as \$80,000 (\$100,000-\$20,000).

Petitioner argues that in the context of section 1.861-8(e)(2), Income Tax Regs., which is based upon the "fungibility of money" and management's "flexibility as to sources of funds", the two firms in the above example are in the same economic situation and the cost of borrowing incurred by both firms should be treated the same, as would take place by recognizing interest as net interest expense.

Petitioner relies heavily on the Opinion of this Court in Bowater, Inc., & Subs. v. Commissioner, 101 T.C. 207 (1993), revd. 108 F.3d 12 (2d Cir. 1997), involving the same issue, viz, whether a taxpayer may offset interest income and interest expense in determining the amount of the interest deduction to be allocated and apportioned under section 1.861-8(e)(2), Income Tax Regs. In that case, the issue arose in the context of computing the combined taxable income (CTI) of the taxpayer and its domestic international sales corporation (DISC) attributable to qualified export receipts derived from the sale by the DISC of export property. See Bowater, Inc., & Subs. v. Commissioner, supra. Generally, in computing CTI attributable to qualified export receipts, expenses are to be allocated and apportioned in a manner consistent with the rules set forth in section 1.861-8, Income Tax Regs. Sec. 1.994-1(c)(6)(iii), Income Tax Regs. In Bowater, Inc., & Subs. v. Commissioner, supra, we held that interest expenses can be offset by interest income before the net interest expense is apportioned under section 1.861-8(e)(2), Income Tax Regs. Id.

Petitioner argues that we should follow Bowater, Inc., & Subs. v. Commissioner, supra, in the instant case, as we have on two prior occasions, Coca Cola Co. v. Commissioner,

106 T.C. 1, 6 (1996), and Computervision Intl. Corp. v. Commissioner, T.C. Memo. 1996-131, vacated and remanded 164 F.3d 73 (1st Cir. 1999). Petitioner also argues that we should reject the "faulty" reasoning of the Court of Appeals for the Second Circuit in its opinion reversing this Court's Bowater, Inc. opinion. See Bowater, Inc., & Subs. v. Commissioner, 108 F.3d 12 (2d Cir. 1997).

Respondent argues that the subject regulations are not ambiguous. To the contrary, respondent states that the "plain language of the Regulations" promulgated under section 861 "[mandates] the apportionment of interest expense among all income producing activities, including those that generate interest income, and [rejects] the 'netting' of interest expense and interest income". Respondent argues that this is made clear by two examples in the regulations, Examples (1) and (24) of section 1.861-8(g), Income Tax Regs., in which "'gross' interest expense, i.e., without reduction for interest income, [is apportioned] among each of the hypothetical taxpayer's income producing activities, including those that generate interest income." Respondent also argues that petitioner misinterprets "the Regulation's fungibility concept". Finally, respondent argues that petitioner's position ignores the fact that the regulations promulgated under

section 861 apportion "deductions" which, in the case of interest expenses means the amount deductible under section 163. In this connection, respondent points out that section 1.861-8(a)(2), Income Tax Regs., is headed "Allocation and apportionment of deductions in general", and that "there is nothing in the Regulations suggesting that the word 'deduction' should be defined differently under Treas. Reg. §1.861-8 than elsewhere in the Internal Revenue Code."

We disagree with petitioner that the language of section 1.861-8(e)(2)(i), Income Tax Regs., "raises a contextual ambiguity with respect to the precise definition of the terms 'interest expense' and 'the cost of borrowing.'" We also disagree that those terms were intended, or can be interpreted in the context of section 1.861-8(e)(2), Income Tax Regs., to refer to "net interest expense." In our view, the allocation and apportionment of net interest expense under section 1.861-8(e)(2), Income Tax Regs., is not permitted by the regulations; it would subvert the operation of the source rules, and it would lead to incongruous and erroneous results.

We believe that petitioner misconstrues section 1.861-8(e)(2)(i), Income Tax Regs., and finds an ambiguity where none exists. As discussed above, the rules of general

applicability for the allocation and apportionment of expenses, losses, and other deductions, set forth in section 1.861-8(a), (b), and (c), Income Tax Regs., are based on the approach that an expense, loss, or other deduction should be allocated to a class of income, composed of less than the taxpayer's entire gross income, as to which the deduction bears a factual relationship, and then, if necessary, apportioned between or among the statutory and residual groupings of gross income. See sec. 1.861-8(a), (b), and (c), Income Tax Regs. On the other hand, the rules that specifically govern the allocation and apportionment of interest expenses, with two limited exceptions, take the approach that interest expenses are related to all income-producing activities and properties of the taxpayer and thus are allocable to all of the taxpayer's gross income. See sec. 1.861-8(e)(2)(i) and (ii), Income Tax Regs.

The regulations state that the different approach for allocating interest expenses is based on the fact that "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." Sec. 1.861-8(e)(2)(i), Income Tax Regs. Thus, the regulations use the phrase "money is fungible"

in section 1.861-8(e)(2)(i), Income Tax Regs., simply to explain why the rules specifically dealing with interest expenses allocate interest expenses to all of the taxpayer's gross income, whereas the rules of general applicability treat other deductions as related to one or more classes of income.

In order to facilitate our discussion of the positions of the parties, it is helpful to review the following example. Assume that during the year a taxpayer, a domestic corporation, had gross operating income from domestic sales of \$800,000, gross operating income from foreign sales of \$500,000, operating expenses of \$300,000 attributable to domestic sales, and operating expenses of \$200,000 attributable to foreign sales. Assume further that, during the same year, the taxpayer realized interest income from U.S. sources of \$200,000 and interest expense of \$375,000. Finally, assume that the ratio of the value of the assets which relate to activities and properties that generate foreign source income to the value of all of the taxpayer's assets is the same as the ratio of the taxpayer's gross income from foreign sources to total gross income. Based upon these facts, the computation of the taxpayer's taxable income from U.S. and foreign sources, assuming that netting is not permitted, and the proportion

of each to the taxpayer's entire taxable income, as contemplated by section 904(a), are shown in the following schedule:

<u>No netting</u>	<u>Total</u>	<u>U.S. source</u>	<u>Foreign source</u>
Gross income			
Operating income	\$1,300,000	\$800,000	\$500,000
Interest income	<u>200,000</u>	<u>200,000</u>	<u>-0-</u>
Total	1,500,000	1,000,000	500,000
Gross income ratio	100%	66.67%	33.33%
Expenses			
Operating expenses	500,000	300,000	200,000
Interest expense	<u>375,000</u>	<u>250,000</u>	<u>125,000</u>
Total	875,000	550,000	325,000
Taxable income	625,000	450,000	175,000
Section 904(a) ratio	100%	72%	28%

Petitioner's position, is that section 1.861-8(e)(2) (i), Income Tax Regs., permits a taxpayer to offset interest expense with interest income before "net interest expense" is allocated and apportioned under section 1.861-8(e)(2), Income Tax Regs., to the different groupings of gross income for purposes of computing the taxpayer's taxable income in each grouping. Based on petitioner's position, the computation of the taxpayer's taxable income from U.S. and foreign sources, and the proportion of each to the taxpayer's entire taxable income as contemplated by section 904(a), are shown in the following schedule:

<u>With netting</u>	<u>Total</u>	<u>U.S. source</u>	<u>Foreign source</u>
Gross income			
Operating income	\$1,300,000	\$800,000	\$500,000
Interest income	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>
Total	1,300,000	800,000	500,000
Gross income ratio	100%	61.54%	38.46%
Expenses			
Operating expenses	500,000	300,000	200,000
Interest expense	<u>175,000</u>	<u>107,692</u>	<u>67,308</u>
Total	675,000	407,692	267,308
Taxable income	625,000	392,308	232,692
Sec. 904(a) ratio	100%	62.7692%	37.2308%

Thus, in this example, the netting of interest expense and interest income has the effect of increasing, from 28 percent to 37.23 percent, the proportion of the taxpayer's taxable income, \$625,000, that is attributable to foreign sources.

There are several consequences of netting that should be noted. First, in order for the netting computation to arrive at the taxpayer's correct taxable income, i.e., \$625,000 in the above example, the taxpayer's total gross income must be reduced by the amount of interest income that is offset against interest expense. This adjustment is necessary because only net interest expense is allocated and apportioned to the statutory grouping (i.e., foreign source) and the residual grouping (i.e., United States source) under section 1.861-8(e)(2), Income Tax Regs. Accordingly, the aggregate deductions used in the netting computation are less than actual aggregate deductions.

Thus, taxpayer's taxable income, i.e., the difference between the gross income in both groupings and the aggregate expenses allocated and apportioned thereto, will be overstated, unless the taxpayer's total gross income is reduced by the amount of interest income that was offset.

Continuing the above example, if interest expense and interest income are netted for purposes of allocating interest expenses but the amount of interest income offset by netting is not removed from the taxpayer's gross income, then the computation contemplated by section 904(a) would be as follows:

<u>With netting</u>	<u>Total</u>	<u>U.S. source</u>	<u>Foreign source</u>
Gross income			
Operating income	\$1,300,000	\$800,000	\$500,000
Interest income	<u>200,000</u>	<u>200,000</u>	<u>-0-</u>
Total	1,500,000	1,000,000	500,000
Gross income ratio	100%	66.67%	33.33%
Expenses			
Operating expenses	500,000	300,000	200,000
Interest expense	<u>175,000</u>	<u>116,667</u>	<u>58,333</u>
Total	675,000	416,667	258,333
Taxable income	825,000	583,333	241,667
Sec. 904(a) ratio	<sup>1</sup> 132%	<sup>1</sup> 93.3333%	<sup>1</sup> 38.6667%

<sup>1</sup> Based upon taxable income of \$625,000.

Thus, as illustrated above, if the taxpayer's gross income is not reduced, then the taxpayer's taxable income, \$625,000, would be overstated by the amount of the interest income that is offset by interest expense, \$200,000, and the section 904(a) ratio would not be based upon the

taxpayer's "entire taxable income for the same taxable year". Sec. 904(a). This raises a question about where in the regulations is there authority to reduce "gross income" by the amount of netted interest.

Second, an equally important consequence of netting is the fact that it increases the ratio under section 904(a), and thus increases the amount of foreign tax credit, only to the extent that the interest income that is absorbed by interest expense in the netting process is from U.S. sources. To the extent that a relatively greater amount of the interest income absorbed in the netting process is from foreign sources, then netting produces a lower ratio under section 904(a) than not netting.

In the above example, we assumed that all of the interest income, \$200,000, was from U.S. sources. In that case, the section 904(a) ratio computed without netting was 28 percent but was increased to 37.23 percent by netting. On the other hand, if we assume that the interest income is entirely from foreign sources, then the section 904(a) ratio, without netting, is 52 percent, computed as follows:

<u>No netting</u>	<u>Total</u>	<u>U.S. source</u>	<u>Foreign source</u>
Gross income			
Operating income	\$1,300,000	\$800,000	\$500,000
Interest income	<u>200,000</u>	<u>-0-</u>	<u>200,000</u>
Total	1,500,000	800,000	700,000
Gross income ratio	100%	53.33%	46.67%
Expenses			
Operating expenses	500,000	300,000	200,000
Interest expense	<u>375,000</u>	<u>200,000</u>	<u>175,000</u>
Total	875,000	500,000	375,000
Taxable income	625,000	300,000	325,000
Sec. 904(a) ratio	100%	48%	52%

If interest expense and interest income are netted, however, the ratio is reduced to 37.23 percent. Thus, even though the taxpayer received all of his interest income from foreign sources under the regulations dealing with interest income, sec. 1.861-2, Income Tax Regs., netting disregards the source of the interest income that is absorbed by interest expenses and causes the taxpayer to obtain the same foreign tax credit as another taxpayer who realized interest income entirely from U.S. sources. This example demonstrates that the netting of interest expense and interest income which petitioner argues arises from section 1.861-8(e)(2)(i), Income Tax Regs., fails to take into account the source of the interest income, and it causes interest income from entirely different sources to be treated the same.

In our view, petitioner's position that it "may allocate and apportion net, rather than gross, interest expense under section 1.861-8(e)(2), Income Tax Regs." is foreclosed by the language of that regulation. Section 1.861-8(e)(2)(ii), Income Tax Regs., provides that "the aggregate of deductions for interest" are allocable to "all the gross income" of the taxpayer for the year. As we read it, section 1.861-8(e)(2)(ii), Income Tax Regs., thus directs that the gross amount of the taxpayer's interest deductions, i.e., the aggregate of deductions for interest, be allocated to all of the taxpayer's gross income. In effect, section 1.861-8(e)(2)(ii), Income Tax Regs., forecloses petitioner's position that net interest expense, i.e., less than "the aggregate of deduction for interest", can be allocated to less than "all of the taxpayer's gross income", i.e., the excess of the taxpayer's gross income over the portion of the taxpayer's interest income that is offset by interest expenses.

Furthermore, petitioner's position that it "may allocate and apportion net, rather than gross, interest expense" is foreclosed by sections 861(a)(1), 862(a)(1), and the regulations promulgated thereunder, including sections 1.861-2(a) and 1.862-1(a), Income Tax Regs. Those

provisions define "gross income from sources within the United States" and "gross income from sources without the United States" to include all of the interest income earned by the taxpayer during the taxable year. Secs. 1.861-2(a), 1.862-1(a), Income Tax Regs. In computing gross income from sources within and without the United States, neither the statute nor the regulations contemplate that the portion of the taxpayer's gross income consisting of interest income for the year will be reduced or entirely offset by interest expenses.

As shown in the hypothetical example discussed above, such a reduction of the amount of the taxpayer's gross income would be necessary in a netting computation. Otherwise, the computation would overstate the taxpayer's taxable income for the year by the interest income that is offset by interest expense. The adjustment to gross income that would be necessary is depicted in the computation set forth in the hypothetical discussed above. It is similar to the adjustment that the parties made in computing the taxpayer's interest expense for 1986 as shown in the appendix.

Moreover, petitioner's position that it is entitled to allocate net interest expense under section 1.861-8(e)(2),

Income Tax Regs., means that the taxpayer's interest income, to the extent that it is offset by interest expense, is not included in the groupings of gross income, i.e. gross income from sources within and without the United States, contrary to sections 861(a)(1) and 862(a)(1). Sec. 861(a)(1). Thus, in our view, interest netting would subvert the operation of the source rules.

Generally, as discussed above, the source rules operate by assigning items of gross income to different groupings of gross income, such as income from sources within and without the United States, in accordance with standards set out in the statute, and by allocating and apportioning the taxpayer's expenses, losses, and other deductions to the different groupings. Items of gross income that constitute interest are assigned to groupings of gross income from sources within and without the United States generally in accordance with the residence of the payor. See sec. 1.861-2, Income Tax Regs.

Under interest netting, interest income is offset by interest expense and only net interest expense is allocated and apportioned under the source rules. In effect, the source of the interest income that is offset is not taken into account in the groupings of gross income and taxable

income, as contemplated under the source rules. Netting would, thus, subvert the operation of those rules.

Netting would also lead to the incongruous and erroneous results depicted in the hypothetical example discussed above in which a taxpayer who realized interest income entirely from foreign sources is treated the same as a taxpayer who realized the same interest income entirely from United States sources. As discussed above, to the extent that a relatively greater amount of interest income absorbed in the netting process is from foreign sources, then netting actually produces a lower taxable income from foreign sources than not netting.

As mentioned above, the issue in this case was first decided in connection with the 1977 Regulations, in Bowater, Inc., & Subs. v. Commissioner, 101 T.C. 207 (1993). In light of the opinion of the U.S. Court of Appeals for the Second Circuit reversing our opinion in Bowater, Inc., it is appropriate to reconsider our Bowater, Inc. opinion. It is also appropriate to reconsider Bowater, Inc., in light of the opinion of the U.S. Court of Appeals for the Fifth Circuit in Dresser Indus., Inc. v. United States, 238 F.3d 603 (5th Cir. 2001), in which that court holds that interest netting is not permitted

under section 1.861-8(e)(2), Income Tax Regs. In this connection, we note that our opinion in Bowater, Inc., in part, had relied upon the reasoning of a prior opinion of the U.S. Court of Appeals for the Fifth Circuit involving the predecessor of the 1977 regulation, Dresser Indus., Inc. v. Commissioner, 911 F.2d 1128 (5th Cir. 1990), revg. 92 T.C. 1276 (1989). Following our reconsideration of this issue, we now agree with both the U.S. Courts of Appeals for the Second and Fifth Circuits that the subject regulation, section 1.861-8(e)(2), Income Tax Regs., does not permit the netting of interest income and interest expense. In light of that, we hereby overrule our opinion in Bowater, Inc., & Subs. v. Commissioner, 101 T.C. 207 (1993).

For reasons set forth above,

An appropriate order will be  
issued granting respondent's  
motion in limine.

Reviewed by the Court.

SWIFT, GERBER, RUWE, COLVIN, HALPERN, BEGHE, CHIECHI, LARO, FOLEY, VASQUEZ, GALE, and MARVEL, JJ., agree with this opinion.

WELLS and THORNTON, JJ., did not participate in the consideration of this opinion.

Appendix

1982	<u>Interest expense</u>	<u>Net interest expense</u>	<u>Asset ratio percent</u>	<u>Interest apportioned to foreign source income</u>	
				No netting	Netting
650 Leasing Co.	\$682,931	-0-	34.34	\$234,519	-0-
Sun Leasing Co.	4,729,086	\$3,216,310	64.81	3,064,921	\$2,084,491
666 Leasing Co.	4,072,539	2,167,684	64.98	2,646,336	1,408,561
670 Leasing Co.	1,830,136	89,166	69.96	1,280,363	62,381
673 Leasing Co.	1,627,381	374,085	55.98	911,008	209,413
675 Leasing Co.	1,983,276	1,146,615	60.65	1,202,857	695,422
652 Leasing Co.	794,330	-0-	73.42	583,197	-0-
Kee Leasing Co.	581,235	567,862	44.47	258,475	252,528
653 Leasing Co.	814,727	-0-	89.11	726,003	-0-
667 Leasing Co.	3,286,585	647,476	80.00	2,629,268	517,981
Millcreek Leasing Co.	830,407	-0-	4.26	35,375	-0-
De Sun Shipping	47,658	-0-	0.58	276	-0-
Eastern Sun Shipping	37,115	-0-	0.51	189	-0-
NY Sun Shipping	9,970,340	9,116,332	90.23	8,996,238	8,225,666
NJ Sun Shipping	143,340	127,135	3.76	5,390	4,780
PA Shipping	46,423	-0-	2.70	1,253	-0-
Phil Sun Shipping	10,809,958	10,361,281	29.54	3,193,262	3,060,722
Western Sun Shipping	50,003	-0-	0.00	-0-	-0-
Sun Transport, Inc.	3,650,045	3,550,205	25.99	948,647	922,698
Sun Note Co.	31,066,253	-0-	91.39	28,391,449	-0-
North Sea Oil Co.	65,897	-0-	34.77	22,912	-0-
Totem Ocean Trailer	<u>46,949</u>	<u>-0-</u>	49.39	<u>23,188</u>	<u>-0-</u>
Total	77,166,614	31,364,151		55,155,126	17,444,643

1983	<u>Interest expense</u>	<u>Net interest expense</u>	<u>Asset ratio percent</u>	<u>Interest apportioned to foreign source income</u>	
				<u>No Netting</u>	<u>Netting</u>
650 Leasing Co.	\$612,220	-0-	27.22	\$166,646	-0-
Sun Leasing Co.	4,736,241	\$3,154,840	63.17	2,991,883	\$1,992,912
666 Leasing Co.	4,084,197	2,376,712	53.36	2,179,328	1,268,214
670 Leasing Co.	1,756,214	617,207	71.74	1,259,908	442,784
672 Leasing Co.	714,282	82,784	57.18	408,426	47,336
Kee Leasing Co.	504,412	497,647	43.41	218,965	216,029
653 Leasing Co.	736,315	77,583	67.56	497,454	52,415
667 Leasing Co.	3,160,356	1,670,995	83.00	2,623,095	1,386,926
Millcreek Leasing Co.	742,214	-0-	5.85	43,420	-0-
NY Sun Shipping	9,849,306	9,122,147	83.33	8,207,427	7,601,485
NJ Sun Shipping Co.	208,102	-0-	1.97	4,100	-0-
Phil Sun Shipping	10,688,995	9,833,854	29.29	3,130,807	2,880,336
Texas Sun Shipping	33,963	-0-	4.56	1,549	-0-
Tropic Sun Shipping	474,700	-0-	27.47	130,400	-0-
Sun Transport, Inc.	2,644,781	1,664,584	20.58	544,296	342,571
Heleasco Fifteen	1,444,639	1,197,778	80.91	1,168,857	969,122
Sun Note Co.	<u>25,667,812</u>	<u>-0-</u>	92.67	<u>23,786,361</u>	<u>-0-</u>
Total	68,058,749	30,296,131		47,362,922	17,200,130

1984	<u>Interest expense</u>	<u>Net interest expense</u>	<u>Asset ratio percent</u>	<u>Interest apportioned to foreign source income</u>	
				No netting	Netting
Kee Leasing Co.	\$408,197	\$397,659	17.77	\$72,537	\$70,664
666 Leasing Co.	4,083,327	1,874,164	33.48	1,367,098	627,470
670 Leasing Co.	1,669,360	299,856	48.22	804,965	144,591
650 Leasing Co.	536,038	-0-	6.90	36,987	-0-
652 Leasing Co.	613,066	-0-	38.08	233,456	-0-
653 Leasing Co.	636,635	-0-	25.12	159,923	-0-
667 Leasing Co.	3,018,359	1,406,484	37.98	1,146,373	534,183
Sun Leasing Co.	4,689,864	2,645,034	44.68	2,095,431	1,181,801
NY Sun Shipping	9,712,823	9,180,293	86.91	8,441,414	7,978,593
Phil Sun Shipping	10,551,646	9,875,526	35.37	3,732,117	3,492,974
Tropic Sun Shipping	644,883	-0-	12.02	77,515	-0-
Sun Transport, Inc.	3,091,754	3,056,531	16.87	521,579	515,637
Sun Oil Trading Co.	<sup>1</sup> 627,633	-0-	0.00	-0-	-0-
Sun Note Co.	25,854,099	-0-	93.06	24,059,825	-0-
North Sea Sun Oil Co.	<u>7,681,288</u>	<u>5,485,009</u>	96.36	<u>7,401,689</u>	<u>5,285,355</u>
Total	73,818,972	34,220,556		50,150,909	19,831,268

<sup>1</sup> See p. 9, supra

1986 No netting

	<u>Gross income</u>	<u>Foreign GI</u>	<u>Asset ratio percent</u>	<u>Interest expense</u>	<u>Gross income ratio percent</u> <sup>2</sup>	<u>\$1.861-8(e) (2)(vi)(A)</u>	<u>\$1.861-8(e) (2)(vi)(B)(1)</u>	<u>\$1.861-8(e) (2)(vi)(B)(2)</u>	<u>Interest apportioned</u>
Kee Leasing Co.	\$2,013,346	\$260,455	4.71	\$213,410	12.94	\$27,608	-	-	\$27,608
666 Leasing Co.	7,082,756	3,172,987	18.63	3,907,731	44.80	1,750,615	-	-	1750,615
670 Leasing Co.	3,533,401	1,496,424	42.66	1,468,580	42.35	621,956	-	-	621,956
650 Leasing Co.	2,038,955	954,294	0.00	404,732	46.80	189,427	-	-	189,427
Sun Leasing Co.	6,194,365	2,679,882	0.00	4,532,004	43.26	1,960,691	-	-	1,960,691
Millcreek Leasing Co.	<sup>1</sup> 305,752	-83,676	0.53	435,448	0.00	-	\$1,154	-	1,154
Tropic Sun Shipping	3,986,919	1,501,298	2.73	644,829	37.66	242,814	-	-	242,814
Sun Transport, Inc.	79,520,790	21,932,881	20.91	2,356,829	27.58	650,044	-	-	650,044
Sunoco Overseas, Inc.	-108,199	290,314	0.00	211,438	100.00	-	-	\$105,719	105,719
Sun Refining & Marketing Co.	672,597,605	1,095,517	20.27	44,588,973	0.16	-	4,519,092	-	4,519,092
Sun Oil Trading Co.	13,481,454	4,673,000	0.00	549,406	34.66	190,437	-	-	190,437
Sun Co., Inc.	760,884,991	23,864,572	6.47	157,687,537	3.14	-	<sup>3</sup> 5,097,676	-	<sup>3</sup> 5,097,676
Sun Oil Intl.	19,593,916	6,769,393	34.60	7,190,703	34.55	2,484,276	-	-	2,484,276
North Sea Sun Oil Co.	36,565,327	36,394,917	97.00	28,050,064	99.53	-	-	27,629,313	27,629,313
Claymont Investment Co.	<u>513,112,873</u>	<u>111,203</u>	0.00	<u>217,180,793</u>	0.02	47,068	-	-	<u>47,068</u>
Total	2,120,804,251	105,113,461		469,422,477					45,517,890

<sup>1</sup> Cannot reconcile this amount with the fact that this corporation realized interest income of \$646,275 during 1986.

<sup>2</sup> Foreign source gross income divided by total gross income.

<sup>3</sup> It appears that this amount should be \$5,101,192 (i.e., \$157,687,537 x 6.47 percent x 50 percent).

1986 Netting

	<u>Gross income</u>	<u>Foreign GI</u>	<u>Asset ratio percent</u>	<u>Interest expense</u>	<u>Interest income</u>	<u>Net interest</u>	<u>Gross income ratio percent</u> <sup>4</sup>	<u>\$1.861-8(e) (2)(vi)(A)</u>	<u>\$1.861-8(e) (2)(vi)(B)(1)</u>	<u>\$1.861-8(e) (2)(vi)(B)(2)</u>	<u>Interest apportioned</u>
Kee Leasing Co.	\$2,013,346	\$260,455	4.71	\$213,410	\$9,844	\$203,566	13.00	\$26,464	-	-	\$26,464
666 Leasing Co.	7,082,756	3,172,987	18.63	3,907,731	736,783	3,170,948	50.00	1,585,474	-	-	1,585,474
670 Leasing Co.	3,533,401	1,496,424	42.66	1,468,580	540,553	928,027	50.00	464,014	-	-	464,014
650 Leasing Co.	2,038,955	954,294	0.00	404,732	130,367	274,365	50.00	137,183	-	-	137,183
Sun Leasing Co.	6,194,365	2,679,882	0.00	4,532,004	834,601	3,697,403	50.00	1,848,702	-	-	1,848,702
Millcreek Leasing Co.	<sup>1</sup> 305,752	-83,676	0.53	435,448	662,752	-0-	0.00	-0-	-	-	-0-
Tropic Sun Shipping	3,986,919	1,501,298	2.73	644,829	1,148,919	-0-	44.92	-0-	-	-	-0-
Sun Transport, Inc.	79,520,790	21,932,881	20.91	2,356,829	646,275	1,710,554	27.81	475,659	-	-	475,659
Sunoco Overseas, Inc.	-108,199	290,314	0.00	211,438	189,663	21,775	100.00	-	-	10,888	10,888
Sun Refining & Marketing Co.	672,597,605	1,095,517	20.27	44,588,973	23,675,379	20,913,594	<sup>5</sup> 0.14	-	2,119,593	-	2,119,593
Sun Oil Trading Co.	13,481,454	4,673,000	0.00	549,406	317,610	231,796	35.50	82,285	-	-	82,285
Sun Company Inc.	760,884,991	23,864,572	6.47	157,687,537	937,176	156,750,361	3.14	-	<sup>6</sup> 5,067,379	-	<sup>6</sup> 5,067,379
Sun Oil Intl.	19,593,916	6,769,393	34.60	7,190,703	12,824,523	-0-	54.58	-0-	-	-	-0-
North Sea Sun Oil Co.	36,565,327	36,394,917	97.00	28,050,064	1,784,106	26,265,958	<sup>7</sup> 99.51	-	-	25,871,969	25,871,969
Claymont Investment Co.	<u>513,112,873</u>	<u>111,203</u>	0.00	<u>217,180,793</u>	<u>505,319,941</u>	<u>-0-</u>	0.04	-0-	-	-	<u>-0-</u>
Total	2,120,804,251	105,113,461		469,422,477	549,758,492	214,168,347					37,689,970

<sup>1</sup> Cannot reconcile this amount with the fact that this corporation realized interest income of \$646,275 during 1986.

<sup>4</sup> Foreign source gross income divided by the excess of total gross income over interest income.

<sup>5</sup> It appears that this percentage should be 0.17 percent (i.e., \$1,095,517 ÷ (\$672,597,605 - \$23,675,379)).

<sup>6</sup> It appears that this amount should be \$5,070,874 (i.e., \$156,750,361 x 6.47 percent x 50 percent).

<sup>7</sup> Interest income treated as foreign source income. Thus in computing the allocation ratio, 99.51 percent, interest income is removed from both the numerator and the denominator of the fraction (((\$36,394,917 - \$1,784,106) ÷ (\$36,565,327 - \$1,784,106)).