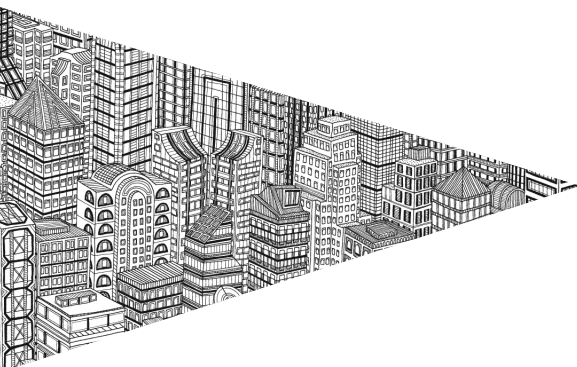


International Tax Alert



IRS and Treasury issue temporary regulations amending Reg. Sections 1.861-9T and 1.861-11T

On 13 January 2012, the Treasury Department (Treasury) and Internal Revenue Service (IRS) issued temporary regulations (the Revised Temporary Regulations) providing guidance on the allocation and apportionment of interest expense by corporations owning a 10% or greater interest in a partnership as well as the allocation and apportionment of interest expense using the fair market value method (the FMV method). The Revised Temporary Regulations amend the prior temporary regulations governing the application of the FMV method to “make clear” that related party debt is an asset in the hands of the creditor for purposes of applying the asset method and is included in the valuation of stock of a related person. For purposes of applying the FMV method, the Revised Temporary Regulations are effective for tax years *ending* on or after of their publication in the Federal Register (i.e., 17 January 2012). (In other words, for calendar year taxpayers, these rules are effective in 2012.)

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The Revised Temporary Regulations amend the prior temporary regulations to “clarify” that a corporate partner with a 10% or greater interest in a partnership allocates its direct interest expense to all of its assets, including its proportionate share of partnership assets. These amendments are effective for taxable years that *begin* after the effective date of the Revised Temporary Regulations (i.e., 17 January 2012). (In other words, for calendar year taxpayers, these rules will be effective in 2013.)

The temporary regulations also contain conforming amendments necessary to reflect the changes to Section 864 made under the 2010 Education Jobs and Medicaid Assistance Act (Pub. L. No. 111-226).

Discussion

Interest expense allocation by partners

Prior to the issuance of the Revised Temporary Regulations, Temp. Reg. Section 1.861-9T(e)(2) provided that a corporate partner with a 10% interest in a partnership apportions its distributive share of *partnership* interest expense by reference to the partner's assets, including the partner's pro rata share of the partnership's assets. By its terms, the rule applied only for purposes of apportioning interest expense incurred by the partnership. The rule did not address whether this aggregate approach applied for purposes of allocating any directly incurred interest expense of the partner; instead, it addressed only the partner's share of partnership interest expense. In contrast, the current regulations clearly address the treatment for partners with less than 10% partnership interest, requiring such partners to directly allocate their distributive share of the partnership interest expense to their distributive share of partnership gross income.¹ For purposes of allocating other interest expense incurred directly by such minority partners, the current regulations also clearly provide that the relevant asset is the partner's interest in the partnership rather than the partner's share of the partnership assets.²

The Revised Temporary Regulations now provide that a corporate partner with a 10% or greater interest in a partnership must allocate its direct

interest expense to all of its assets, including its proportionate share of partnership assets. The Revised Temporary Regulations also provide that when a corporate partner with a 10% or greater interest in a partnership uses the tax book value or alternative tax book value method and, therefore, must use the partnership's inside basis in its assets when allocating interest expense, the partnership's inside basis includes any Section 734(b) adjustments and any Section 734(b) adjustments of the corporate partner for this purpose. The effect of this change is twofold. First, taking into account the partner's share of the assets of the partnership, rather than the partnership interest itself, would affect the amount of basis used in applying the tax book value or alternative tax book value method in those cases in which there is partnership inside-outside basis disparity. Second, the changes could affect the character and source of the assets used in applying such method. If the partnership earns only US source income but holds some foreign assets (for example, stock in CFCs), a taxpayer treating the partnership interest as the relevant asset might have formerly apportioned interest expense to US source income, whereas, now the taxpayer must look through to its share of the assets of the partnership, requiring that interest expense instead be apportioned to foreign source income.

The Revised Temporary Regulations were also revised to provide a similar rule for individual partners who are

general partners or limited partners with a 10% or greater interest in the partnership (i.e., individuals required to look through to a partnership's assets for purpose of determining such individual's asset ratio for interest expense apportionment purposes).

The new rules are applicable to tax years beginning after 17 January 2012.

Fair market value method

Section 864 (e)(2) requires that the allocation and apportionment of interest expense be made on the basis of assets (the asset method). The regulations require a taxpayer to apportion its interest expense to the various statutory groupings based on the average total value of assets within each such grouping.³ This average total value of assets can be determined on the basis of either tax book value (TBV) or fair market value (FMV).⁴ Treas. Reg. Section 1.861-9T(h) provides a formulaic method for determining and apportioning the fair market value of a taxpayer's assets.

Prior to the issuance of the Revised Temporary Regulations, Reg. Section 1.861-9T(h) provided that the FMV method consists of the following six steps:

Step 1: Determine the fair market value of the consolidated group: The taxpayer determines the fair market value of the consolidated group without excluding the value of stock in foreign subsidiaries or any other asset.⁵

Step 2: Determine the fair market value of tangible assets: Determine the FMV of tangible assets held by the taxpayer and its pro rata share of tangible assets held by other related persons, excluding any stock or indebtedness in a related person.⁶

Step 3: Determine the fair market value of intangible assets: The intangible assets equal the aggregate FMV of all assets held by the consolidated group computed in Step 1, less the FMV of the tangible assets computed in Step 2.⁷

Step 4: Apportion the intangible asset among the taxpayer and related persons: The intangible asset value computed in Step 3 is apportioned among the taxpayer and all related persons on the basis of net income.⁸

Step 5: Characterize group's portion of intangible asset value: The portion of the intangible assets apportioned to the taxpayer in Step 4 must be characterized as provided in Reg. 1.861-9T(h)(3).⁹

Step 6: Determine the value of stock in a related person held by the taxpayer: The value of stock in a related person held by the taxpayer equals the sum of the following amounts reduced by the taxpayer's pro rata share of liabilities of such related person: (1) the portion of the value of intangible assets of the taxpayer and related persons that is apportioned to such related person under Step 4; (2) the taxpayer's pro rata share of tangible assets held by the related person (as determined under Step 2); and (3) the total value

of stock in all related person held by the related person as determined under this Step 6.¹⁰

The preamble to the Revised Temporary Regulations (the Preamble) states that the IRS and Treasury have become aware that certain taxpayers are taking the position that the language of Step 2 of the FMV method, which requires related party debt be excluded as an asset as part of the process for determining total intangible asset value, means that such debt also is not treated as an asset in the hands of the taxpayer for the broader purpose of applying the asset method. In addition, for purposes of valuing the stock in related persons under Step 6, some taxpayers are taking the position that those rules exclude related party debt as an asset (because of the reference in Step 6 to Step 2), but permit reduction of the value of the stock of the related person obligor by the amount of the related party debt as a liability (because Step 6 does not limit the reduction for liabilities to unrelated party liabilities).

The Preamble states that interpreting the regulations to require that the related party debt be taken into account as a liability for purposes of valuing stock in the related person without also treating the related party debt as an asset in the creditor's hands distorts the relative values of assets assigned to each statutory grouping and is contrary to general principles of the asset method.

The distortion referenced in the Preamble can best be illustrated with the following example:

USP, a domestic corporation, wholly owns CFC1 and CFC2, both foreign corporations. The aggregate trading value of USP's stock traded on established securities markets at the end of Year 1 is \$600. USP, CFC1, and CFC2 have no liabilities to unrelated parties. USP, CFC1, and CFC2 each own tangible assets with a value of \$200, for a cumulative value of \$600. USP has a loan to CFC1 for \$100. CFC1 has a loan to CFC2 for \$100.

If, as the preamble asserts, taxpayers took the position that when computing both the total value of the taxpayers assets and the value of the CFC1 stock, the receivables were not treated as assets, then the following would result: USP would have tangible assets of \$200 and would value its stock in CFC1 and CFC2 as having a value of \$100 each. The effect of this interpretation of the FMV method is that, although the fair market value of USP, CFC1, and CFC2 is \$600, when USCo determines the value of its assets under the 6 step process, USP would treat its assets, for purposes of apportioning interest expense, as having only \$400 of value.

The Revised Temporary Regulations amend the FMV method, and in particular Step 6 of the FMV method, to clarify that related party debt is an

asset that must be taken into account whether held by the taxpayer or a related person.

The Revised Temporary Regulations first revise Step 6 of the FMV method by adding a new paragraph that explicitly provides for the valuation of related party debt. Under the Revised Temporary Regulations, Step 6 of the FMV method now provides that a related party debt obligation held by a taxpayer has a value equal to the amount of the liability of the obligor related person. Further, under the Revised Temporary Regulations, Step 6 of the FMV method now provides that that the value of stock in a related person includes the taxpayer's pro rata share of related party debt held by the related person. Thus, the Revised Temporary Regulations make clear that related party debt is an asset in the hands of the creditor for purposes of applying the asset method and is included in the valuation of stock of a related person. Finally, the Revised Temporary Regulations provide a new example illustrating the changes made to Step 6 of the FMV method.

Under the Revised Temporary Regulations, in the example above, USP would treat the CFC1 receivable as an asset with a value of \$100 that attracts interest expense under the FMV method. In addition, the value of CFC1 stock in the hands of USP would be equal to (1) the value of the CFC2 receivable (i.e., \$100) plus the value of CFC1's tangible assets (i.e., 200), (2) reduced the value of CFC1's liabilities (i.e., 100), for a

total of \$200. The value of CFC2's stock in the hands of USP would equal the value of CFC's tangible assets (i.e., 200), reduced by CFC2's liabilities (i.e., \$100) for a total of \$100. USP total assets would equal (1) the value of USP's tangible assets (i.e., 200), (2) plus the value of its interest in the CFC1 receivable (i.e., \$100) (3) plus the value of its interest in CFC1 stock (i.e., \$200), (4) plus the value of its interest in CFC2 stock (i.e., \$100), for a cumulative amount equal to \$600, of which \$400 relates to stock or debt of CFC1 and CFC2 held by USP.

The Preamble states that no inference is intended regarding the interpretation of prior regulations as a result of the modifications in the Revised Temporary Regulations.

The new rules are applicable to taxable years ending on or after 17 January 2012.

Affiliated groups

Section 216 of the 2010 Education Jobs and Medicaid Assistance Act (the Act) amended the rules under Section 864(e)(5)(A) (defining an affiliated group for purposes of interest expense allocation) to provide that a foreign corporation is treated as a member of the affiliated group if more than 50% of its gross income for the taxable year is effectively-connected income (ECI) and at least 80% of the vote or value of its stock is owned directly or indirectly by members of the affiliated group. (For a detailed discussion of the international tax implications of the Act see

International Tax Alert, *Enacted International tax bill has immediate implications*, dated 16 August 2010.

Prior to the Act, under then Treas. Reg. Section 1.861-11T(d)(6)(ii), if between 50% and 80% of the foreign corporation's gross income was ECI, then only the assets that generated ECI, and a percentage of the foreign corporation's interest expense equal to the percentage of its assets that generate ECI, were taken into account. The amendments to Section 864(e)(5)(A) effectively overrode that regulatory rule requiring all assets and interest expense of the foreign corporation meeting the requirements of Section 864(e)(5)(A) to be taken into account for purposes of allocating interest expense. The Revised Treasury Regulations reflect the 2010 statutory change to Section 864(e)(5)(A).

Income tax accounting considerations

Interest expense allocation and apportionment provisions can, in certain circumstances, act to limit a taxpayer's foreign tax credit allowed for the year. This allocation and apportionment of interest between foreign and US sources and to the various separate limitation baskets determine the FTC limitation for each basket. These temporary regulations could change an entity's expectation of foreign source income for the applicable years and, thus, impact the amount of foreign tax credit that will be allowable on a tax return. These temporary regulations need to be considered for purposes

of determining the realizability of foreign tax credit deferred tax assets, based on the tax years impacted by the applicable effective dates. Companies, including those with a 31 January 2012 year-end, should evaluate other interim and annual income tax accounting implications, including those that may impact the annual effective tax rate.

For additional discussion on realizability of deferred tax assets, see section 6, Valuation allowances, in our Financial reporting developments publication, *Income taxes*. Interim reporting is discussed in section 20 of that publication.

Implications

The Revised Temporary Regulations make significant changes to the regulations governing interest expense apportionment. The Service has previously stated that guidance under Section 861 would be coming out but did not discuss what the

scope of the guidance would be. It is not clear if additional guidance will be forthcoming.

Taxpayers should review their method of apportioning interest expense with respect to their interests in partnerships to determine whether such methods are consistent with the Revised Temporary Regulations. In addition, taxpayers that use the FMV method for apportioning interest expense should carefully review their treatment of intercompany debt. Because the regulations apply to “taxable years” that end on or after 17 January 2012, the regulation must be applied to the whole year; therefore, taxpayers will need to consider the effect of these changes on their assets’ beginning of year values, keeping in mind that the FMV of an asset is the average of the beginning and end of year values.

Taxpayers that currently use the FMV method for interest expense apportionment may want to consider

whether switching to an alternate method, such as the tax book value method, is advisable. In order to change from the FMV method to an alternate method, consent of the IRS is required.

Taxpayers should also be aware that the changes to the regulations have different effective dates with the changes for the partnership interest becoming effective for taxable years beginning after 17 January 2012 and the changes for the FMV method applying to taxable years ending on or after 17 January 2012.

Note

The Financial reporting developments publication mentioned in this Tax Alert, and many of the publications produced by our US Professional Practice group, are available free in [AccountingLink](#). Please note that AccountingLink requires a one-time registration when it is initially opened.

Endnotes

1. Treas. Reg. Section 1.861-9T(e)(4)(i).
2. Treas. Reg. Section 1.61-9T(e)(ii).
3. Reg. Section 1.861-9T(g)(1)(i).
4. Reg. Section 1.861-9T(g)(1)(ii). Treas. Reg. Section 1.861-9 also allows for the “alternative tax book value” method as a third choice for valuing the assets.
5. Reg. Section 1.861-9T(h)(1)(i).
6. Reg. Section 1.861-9T(h)(1)(ii).
7. Reg. Section 1.861-9T(h)(1)(iii).
8. Reg. Section 1.861-9T(h)(2).
9. Reg. Section 1.861-9T(h)(3).
10. Reg. Section 1.861-9T(h)(4).

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