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IRS releases interest expense allocation and apportionment regulations

Overview

The IRS today issued temporary regulations that provide guidance regarding 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 temporary regulations also update the interest allocation regulations to conform to the statutory changes made by the Education Jobs and Medicaid Assistance Act affecting the affiliation of certain foreign corporations for purposes of Section 864(e). The text of the temporary regulations also serves as the text of proposed regulations.

Allocation of partner interest expense

Historically, the temporary regulations under Sections 861 and 864(e) have adopted an aggregate, or look-through, approach to apportioning a partner's distributive share of interest expense incurred by the partnership. Thus, they have provided the general rule that a partner's distributive share of the interest expense of a partnership is considered related to all income-producing activities and assets of the partner. Also, a corporate partner whose direct or indirect interest in the partnership is 10% or more must apportion 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 contrast, limited partners and corporate general partners with a less-than-10% partnership interest historically have been excepted from aggregate treatment. Such partners must directly allocate their distributive share of partnership interest expense to their distributive share of partnership gross income. In addition, for purposes of allocating other interest expense incurred directly by such a partner, the temporary regulations provide that the relevant asset is the partner's interest in the partnership, and not the partner's share of the partnership assets.

The new temporary regulations clarify 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 new 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 743(b) adjustments of the corporate partner for this purpose. A similar rule is also provided for individual partners who are general partners or limited partners with a 10% or greater interest in the partnership.

Related party debt under the fair market value method

Section 864(e)(2) requires that the allocation and apportionment of interest expense be made on the basis of assets and not gross income. For this purpose, taxpayers may elect to value assets based on their fair market value. Historically, the temporary regulations under Section 864(e) have set forth a multi-step methodology for determining the fair market value of a taxpayer's intangible assets. Once a taxpayer has determined the fair market value of its intangible assets, the temporary regulations have further provided a method for characterizing those assets. Finally, they have provided rules for determining the value of stock in a related person held by the taxpayer (or by another person related to the taxpayer).

The new temporary regulations clarify that related party debt is an asset that must be taken into account whether held by the taxpayer or a related person. Such a related party debt obligation has a value equal to the amount of the liability of the obligor related person, and 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 new temporary rules 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.

Effective date

The provisions of the new temporary regulations relating to partner interest expense apply to tax years beginning after January 17, 2012. The provisions relating to related party debt apply to tax years ending on or after January 17, 2012.

Comments and public hearing

Comments on the proposed regulations must be received by March 13, 2012. A public hearing is scheduled for April 3, 2012.

Temporary regs: http://www.ofr.gov/OFRUpload/OFRData/2012-00597_PI.pdf

Proposed regs: http://www.ofr.gov/OFRUpload/OFRData/2012-00595_PI.pdf

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