# US Outbound Tax Newsalert

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## *Temporary regulations under section 861 make a few targeted changes to the allocation and apportionment of interest*

Temporary and proposed regulations issued under section 861 on January 13, 2012 do not make major changes to the existing regulatory guidance for the allocation and apportionment of interest expense. The new regulations address three aspects of interest allocation and apportionment: (1) where a corporation owns a partnership interest of ten percent or more; (2) where interest expense is allocated and apportioned using the fair market value method, and related-party debt must be taken into account; and (3) where statutory changes made by the Education Jobs and Medicaid Assistance Act (the "EJMAA") affect the treatment of assets owned by certain foreign affiliates for purposes of section 864(e).

These temporary section 861 regulations are effective prospectively for tax years beginning after January 17, 2012 and will expire on January 13, 2015.

The discussion below presents the changes made in the temporary regulations.

### *Interest expense allocation by corporate partners*

In general, Temp. Treas. Reg. §1.861-9T(e) provides rules governing interest expense apportionment by a partner in a partnership, using an aggregate, or look-through, approach to apportioning a partner's distributive share of the interest expense incurred by the partnership. Existing Temp. Treas. Reg. §1.861-9T(e)(1) directs that a partner's distributive share of a partnership's interest expense is considered to be

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related to all income-producing activities and assets of the partner.

The new Temp. Treas. Reg. §1.861-9T(e)(2) follows this approach in clarifying that a corporate partner whose direct or indirect partnership interest is ten percent or more must allocate its direct interest expense to all of the partner's assets, including its proportionate share of the partnership's assets. The new temporary regulations further clarify that, where a corporate partner with a ten percent or greater interest in a partnership uses the tax book value (or alternative tax book value) method for interest expense apportionment, and therefore must use the partnership's inside basis in its assets, the partnership's inside basis will include for this purpose any section 734(b) adjustments and any section 743(b) adjustments of the corporate partner.

The new Temp. Treas. Reg. §1.861-9T(e)(3) provides similar rules for individuals who are general partners or limited partners with a ten percent or greater interest in a partnership. Note that, under existing rules, limited partners (whether individual or corporate) and corporate general partners owning a partnership interest of less than ten percent are excepted from aggregate treatment and must directly allocate their distributive share of partnership interest expense to their distributive share of partnership gross income, using the partner's interest in the partnership as the relevant asset for purposes of allocating other interest expense.

***Observation:*** Note that the regulations do not specify the treatment of members or shareholders in an eligible entity treated as a partnership; presumably they would be treated as general partners.

## *Application of the fair market value method*

In general, section 864(e)(2) requires the allocation and apportionment of interest expense on the basis of assets, with interest expense apportioned among statutory and residual groupings of gross income in proportion to the average total value of assets within each such grouping for the taxable year. For this purpose, taxpayers may elect to value assets based on their fair market value (the "FMV method"), tax book value, or alternative tax book value.

The existing temporary regulations set forth a multi-step methodology for determining the fair market value of a taxpayer's assets. With respect to the value of intangible assets:

> *Step 1:* Determine the aggregate value of assets owned (directly or indirectly).
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> *Step 2:* Value the tangible assets, excluding any stock or indebtedness in a related person.
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> *Step 3*: Subtract the amount determined in Step 2 from the amount determined in Step 1 to arrive at total intangible asset value.
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> *Step 4*: Intangible assets are then apportioned among affiliates under Temp. Treas. Reg. §1.861-9T(h)(2) on the basis of net income.

*Step 5*: Once the taxpayer determines the fair market value of intangible assets, those assets must be characterized as provided in Temp. Treas. Reg. §1.861-9T(h)(3).

*Step 6*: The rules in Temp. Treas. Reg. §1.861-9T(h)(4) apply to determine the value of stock in a related person held by the taxpayer (or a related person).

For purposes of Step 6, Temp. Treas. Reg. §1.861-9T(h)(4) calculates the value of stock in a related person as the sum of (i) the intangible assets apportioned to the related person in Step 4; (ii) the tangible assets (as determined in Step 2) held by the related person, and (iii) the total value of stock held in all other related persons held by the related person (all less the taxpayer's pro rata share of liabilities of such related person).

The new temporary regulations on determining asset value under the FMV method have been formulated in response to taxpayer positions that run counter to the IRS' interpretation of the existing rules. In particular, certain taxpayers have taken the position that the language of Step 2, which requires related-party debt to be excluded as an asset, means that such debt is not treated as an asset in the hands of the taxpayer at all for the broader purpose of determining asset value under the FMV method. Moreover, for purposes of valuing the stock in related persons under Step 6, some taxpayers have taken the position that those rules exclude related-party debt as an asset (because of a cross-reference in Temp. Treas. Reg. §1.861-9T(h)(4) to Temp. Treas. Reg. §1.861-9T(h)(1)(ii)), but permit reduction of the related person obligor's stock value by the amount of the related-party debt as a liability (because the language of Temp. Treas. Reg. §1.861-9T(h)(4)(ii) does not limit the reduction for liabilities to unrelated party liabilities).

Because the IRS and Treasury Department believe that taking the related-party debt 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 is contrary to the general principles of the interest expense apportionment regulations, the new temporary regulations amend Temp. Treas. Reg. §1.861-9T(h)(4) to require that related-party debt be taken into account, whether held by the taxpayer or a related person. The new regulatory scheme provides expressly for the valuation of related-party debt, specifying that a related-party debt obligation held by a taxpayer (or a related person) has a value equal to the obligor related person's liability amount. The new temporary regulations also require that a related person's stock value includes the taxpayer's pro rata share of related-party debt held by the related person.

In addition, the new temporary regulations offer a new example to illustrate the changes made to Temp. Treas. Reg. §1.861-9T(h)(4). As the IRS and Treasury explain in summarizing the new temporary regulations, the changes are intended to clarify 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 a related person's stock, to ensure that both the receivable and the payable sides of related-party debt are included for valuation purposes under the FMV method. Moreover, the new regulations seek to ensure that the value of each side is determined in a consistent manner. The explanation emphasizes that no inference is intended regarding the interpretation of prior regulations.

***Observation:*** These regulation changes for applying the FMV method are targeted narrowly to a particular set of tax planning techniques, but they will affect a much wider population of taxpayer s that have related-party debt arrangements. The comment regarding interpretation of prior regulations suggests that the IRS might apply the position reflected in the new regulations in auditing years before the effective date.

## *Foreign affiliates with effectively-connected income*

Under section 864(e)(1), the interest expense of each affiliated group member is allocated and apportioned as if all such group members were a single corporation.

The EJMAA amended section 864(e)(5)(A) to treat a foreign corporation as an affiliated group member for interest allocation and apportionment purposes if (1) more than 50 percent of such foreign corporation's gross income for a given tax year is effectively connected to a U.S. trade or business ("effectively-connected income"), and (2) at least 80 percent (by either vote or value) of all such foreign corporation's outstanding stock is owned, directly or indirectly, by members of the affiliated group. Where those conditions apply, the statutory change required that all of the qualifying foreign corporation's assets and interest expense be taken into account for purposes of applying the interest apportionment rules for affiliated groups. These new temporary regulations revise Temp. Treas. Reg. §1.861-11T(d)(6) to reflect the statutory change.

As the IRS and Treasury explain, before the statute was amended, the term "affiliated group" was defined by reference to the section 1504 rules for determining whether corporations are eligible to file consolidated returns, which generally exclude foreign corporations from an affiliated group. Prior to the new temporary regulation amendments, Temp. Treas. Reg. §1.861-11T(d)(6)(ii) provided that certain foreign corporations were nevertheless treated as affiliated corporations for purposes of allocating and apportioning interest expense if at least 80 percent of the corporations' outstanding stock was owned by members of an affiliated group, and more than 50 percent of the corporations' gross income was effectively connected. Where a foreign corporation was treated as an affiliated corporation for interest allocation and apportionment purposes, Temp. Treas. Reg. §1.861-11T(d)(6)(ii) previously determined the percentage of assets and income taken into account for purposes of applying the affiliated-group interest apportionment rules depending on the percentage of the corporation's gross income that was effectively connected. Specifically, if 80 percent or more of the foreign corporation's gross income was effectively connected, then all of the corporation's assets and interest expense would be taken into account; however, if the effectively-connected percentage of the foreign corporation's gross income was between 50 and 80 percent, then only the corporation's assets that generated effectively-connected income -- and a percentage of its interest expense equal to the percentage of its assets that generated effectively-connected income -- would be taken into account.

***Observation:*** This regulation change merely applies the statutory amendment that was intended to combat a tax planning technique allowing certain U.S. companies with foreign affiliates to remove those affiliates from their asset apportionment base by ensuring that 50-80 percent of the affiliate's income was effectively connected to a U.S. trade or business.

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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