



[4830-01-P]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9571]

RIN 1545- BJ84

Allocation and Apportionment of Interest Expense

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that provide guidance regarding the allocation and apportionment of interest expense. These temporary regulations provide guidance concerning the allocation and apportionment of interest expense by corporations owning a 10 percent or greater interest in a partnership, as well as the allocation and apportionment of interest expense using the fair market value method. These temporary regulations also update the interest allocation regulations to conform to the statutory changes made by section 216 of the legislation commonly referred to as the Education Jobs and Medicaid Assistance Act (EJMAA), enacted on August 10, 2010, affecting the affiliation of certain foreign corporations for purposes of section 864(e). These regulations affect taxpayers that allocate and apportion interest expense. The text of these temporary regulations also serves as the text of the proposed regulations (REG-113903-10) set forth in the notice of proposed rulemaking on this subject published elsewhere in this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Dates: For dates of applicability, see §§1.861-9T(k) and 1.861-11T(h).

FOR FURTHER INFORMATION CONTACT: Jeffrey L. Parry, (202) 622-3850 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

I. Interest Expense Allocation by Partners

Section 1.861-9T(e) provides rules governing the apportionment of interest expense by a partner in a partnership. In general, §1.861-9T(e) adopts an aggregate, or look-through, approach to apportioning a partner's distributive share of interest expense incurred by the partnership. Section 1.861-9T(e)(1) provides 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. Similarly, §1.861-9T(e)(2) requires that a corporate partner whose direct or indirect interest in the partnership is 10 percent or more 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 (whether individual or corporate) and corporate general partners with a less-than-10-percent partnership interest are excepted from aggregate treatment. Under §1.861-9T(e)(4)(i), 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, §1.861-9T(e)(4)(ii) provides that the relevant asset is the partner's interest in the partnership, and not the partner's share of the partnership assets. This approach for such minority partners avoids the potential administrative burden that an aggregate approach would impose on such minority partners.

These temporary regulations revise §1.861-9T(e)(2) to clarify that a corporate partner with a 10 percent 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 IRS and the Treasury Department believe that an aggregate approach for corporate partners with a 10 percent or greater interest in the partnership is appropriate and consistent with the aggregate approach applicable to apportioning such partner's distributive share of interest expense incurred by the partnership.

These temporary regulations also revise §1.861-9T(e)(2) to provide that when a corporate partner with a 10 percent 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. Section 1.861-9T(e)(3) is also revised to provide a similar rule for individual partners who are general partners or limited partners with a 10 percent or greater interest in the partnership.

II. 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 (the asset method).

Under the asset method, interest expense is apportioned between (or among) statutory and residual groupings of gross income in proportion to the average total values 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. §§1.861-8T(c)(2) and 1.861-9(i).

The temporary regulations set forth a multi-step methodology for determining the fair market value of a taxpayer's assets. Section 1.861-9T(h)(1) provides rules for determining the fair market value of the taxpayer's intangible assets. First, the taxpayer determines the aggregate value of assets that it and its subsidiaries own (Step 1); second, the taxpayer values its tangible assets, excluding any stock or indebtedness in a related person (Step 2); and third, it subtracts the amount determined in Step 2 from the amount determined in Step 1 to arrive at total intangible asset value (Step 3). The intangible assets owned by the taxpayer are then apportioned among the taxpayer's affiliates under §1.861-9T(h)(2) on the basis of net income (Step 4).

Once a taxpayer has determined the fair market value of its intangible assets, those assets must be characterized as provided in §1.861-9T(h)(3) (Step 5). Finally, the rules of §1.861-9T(h)(4) apply to determine the value of stock in a related person held by the taxpayer (or by another person related to the taxpayer) (Step 6). Under those rules, §1.861-9T(h)(4) states that the value of such stock is equal to the sum of the following amounts, less the taxpayer's pro rata share of liabilities of such related person: (i) the intangible assets apportioned to the related person in Step 4, above; (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.

The IRS and the Treasury Department 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 to 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 §1.861-9T(h)(4) to §1.861-9T(h)(1)(ii)), 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 the language of §1.861-9T(h)(4)(ii) does not limit the reduction for liabilities to unrelated party liabilities).

The IRS and the Treasury Department believe 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. This result is contrary to the general principles of the §1.861-9 regulations, which are based on the concept that interest expense must be apportioned on the basis of the value of all assets. Accordingly, these temporary regulations amend §1.861-9T(h)(4) to reflect the fact that related party debt is an asset that must be taken into account whether held by the taxpayer or a related person.

These temporary regulations first revise §1.861-9T(h)(4) by adding a new paragraph §1.861-9T(h)(4)(i) to provide for the valuation of related party debt. Prior to its revision by these temporary regulations, §1.861-9T(h)(4) provided for the valuation of

the stock of a related person, but the regulations did not provide any explanation of how the related party debt is to be valued. As revised by these temporary regulations, §1.861-9T(h)(4)(i) provides that a related party debt obligation held by a taxpayer or another person related to the taxpayer has a value equal to the amount of the liability of the obligor related person. These temporary regulations also revise §1.861-9T(h)(4) by providing 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. Finally, these temporary regulations provide a new example illustrating the changes made to §1.861-9T(h)(4).

These amendments 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. Very broadly, these changes ensure that both the receivable and the payable sides of related party debt are included for valuation purposes under the FMV method, and that the value of each side is determined in a consistent manner. No inference is intended regarding the interpretation of prior regulations as a result of these modifications.

III. Affiliated Groups

The interest expense of each member of an affiliated group is allocated and apportioned as if all members of such group were a single corporation. Section 864(e)(1). Prior to its amendment by the EJMAA, section 864(e)(5)(A) defined the term "affiliated group" by reference to the rules under section 1504 for determining whether corporations are eligible to file consolidated returns. The section 1504 rules generally exclude foreign corporations from an affiliated group. Section 1.861-11T(d)(6)(ii) provides that certain foreign corporations are nevertheless treated as affiliated

corporations for purposes of allocating and apportioning interest expense if (1) at least 80 percent of either the vote or value of the corporation's outstanding stock is owned directly or indirectly by members of an affiliated group, and (2) more than 50 percent of the corporation's gross income for the taxable year is effectively connected with the conduct of a trade or business in the United States (effectively connected income).

In the case of a foreign corporation that is treated as an affiliated corporation for interest allocation and apportionment purposes, §1.861-11T(d)(6)(ii) provides that the percentage of assets and income that is taken into account for purposes of applying the affiliated group interest apportionment rules depends on the percentage of the corporation's gross income that is effectively connected income. If 80 percent or more of the foreign corporation's gross income is effectively connected income, then all of the corporation's assets and interest expense are taken into account. If, instead, between 50 percent and 80 percent of the foreign corporation's gross income is effectively connected income, then only the corporation's assets that generate effectively connected income and a percentage of its interest expense equal to the percentage of its assets that generate effectively connected income are taken into account.

Section 864(e)(5)(A), as amended by the EJMAA, provides that a foreign corporation will be treated as a member of an affiliated group for interest allocation and apportionment purposes if (1) more than 50 percent of the gross income of such foreign corporation for the taxable year is effectively connected income, and (2) at least 80 percent of either the vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the affiliated group. In such event, all of the qualifying foreign corporation's assets and interest expense are taken into account for

purposes of applying the affiliated group interest apportionment rules. These temporary regulations revise §1.861-11T(d)(6) to reflect these statutory changes.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f), these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Jeffrey L. Parry of the Office of Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.861-9T is amended by:

1. Revising the first two sentences of paragraph (e)(2), the fifth sentence of (e)(3), and paragraph (h)(4);
2. Adding four sentences before the last sentence of paragraph (k); and
3. Adding paragraph (l).

The revisions and additions read as follows:

§1.861-9T Allocation and apportionment of interest expense (temporary).

* * * * *

(e) * * *

(2) Corporate partners whose interest in the partnership is 10 percent or more. A corporate partner shall apportion its interest expense (including the partner's distributive share of partnership interest expense) by reference to the partner's assets, including the partner's pro rata share of partnership assets, under the rules of paragraph (f) of this section if the corporate partner's direct and indirect interest in the partnership (as determined under the attribution rules of section 318) is 10 percent or more. A corporation using the tax book value method or alternative tax book value method of apportionment shall use the partnership's inside basis in its assets, including adjustments under sections 734(b) and 743(b), if any, and adjusted to the extent required under §1.861-10T(d)(2). * * *

(3) Individual partners who are general partners or who are limited partners with an interest in the partnership of 10 percent or more. * * * An individual using the tax book value or alternative tax book value method of apportionment shall use the partnership's inside basis in its assets, including adjustments under sections 734(b) and 743(b), if any, and adjusted to the extent required under §1.861-10T(d)(2). * * *

* * * * *

(h) * * *

(4) Valuing related party debt and stock in related persons – (i) Related party debt. For purposes of this section, the value of a debt obligation of a related person held by the taxpayer or another person related to the taxpayer equals the amount of the liability of the obligor related person.

(ii) Stock in related persons. The value of stock in a related person held by the taxpayer or by another person related to the taxpayer equals the sum of the following amounts reduced by the taxpayer's pro rata share of liabilities of such related person:

(A) The portion of the value of intangible assets of the taxpayer and related persons that is apportioned to such related person under paragraph (h)(2) of this section;

(B) The taxpayer's pro rata share of tangible assets held by the related person (as determined under paragraph (h)(1)(ii) of this section);

(C) The taxpayer's pro rata share of debt obligations of any related person held by the related person (as valued under paragraph (h)(4)(i) of this section); and

(D) The total value of stock in all related persons held by the related person as determined under this paragraph (h)(4).

(iii) Example. (A) Facts. USP, a domestic corporation, wholly owns CFC1 and owns 80% of CFC2, both foreign corporations. The aggregate trading value of USP's stock traded on established securities markets at the end of Year 1 is \$700 and the amount of USP's liabilities to unrelated persons at the end of Year 1 is \$400. Neither CFC1 nor CFC2 has liabilities to unrelated persons at the end of Year 1. USP owns plant and equipment valued at \$500, CFC1 owns plant and equipment valued at \$400, and CFC2 owns plant and equipment valued at \$250. The value of these assets has been determined using generally accepted valuation techniques, as required by §1.861-9T(h)(1)(ii). There is an outstanding loan from CFC2 to CFC1 in an amount of \$100. There is also an outstanding loan from USP to CFC1 in an amount of \$200.

(B) Valuation of group assets. Pursuant to §1.861-9T(h)(1)(i), the aggregate value of USP's assets is \$1100 (the \$700 trading value of USP's stock increased by \$400 of USP's liabilities to unrelated persons).

(C) Valuation of tangible assets. Pursuant to §1.861-9T(h)(1)(ii), the value of USP's tangible assets and pro rata share of assets held by CFC1 and CFC2 is \$1100 (the plant and equipment held directly by USP, valued at \$500, plus USP's 100% pro rata share of the plant and equipment held by CFC1 valued at \$400 and USP's 80% pro rata share of the plant and equipment held by CFC 2 valued at \$200 (80% of \$250)).

(D) Computation of intangible asset value. Pursuant to §1.861-9T(h)(1)(iii), the value of the intangible assets of USP, CFC1, and CFC2 is \$0 (total aggregate group asset value (\$1100) determined in paragraph (B) less total tangible asset value (\$1100) determined in paragraph (C)). Because the intangible asset value is zero, the provisions of §1.861-9T(h)(2) and (3) relating to the apportionment and characterization of intangible assets do not apply.

(E) Valuing related party debt obligations. Pursuant to §1.861-9T(h)(4)(i), the value of the debt obligation of CFC1 held by CFC2 is equal to the amount of the liability, \$100. The value of the debt obligation of CFC1 held by USP is equal to the amount of the liability, \$200.

(F) Valuing the stock of CFC1 and CFC2. Pursuant to §1.861-9T(h)(4)(ii), the value of the stock of CFC2 held by USP is \$280 (USP's 80% pro rata share of tangible assets of CFC2 included in paragraph (C) (\$200) plus USP's 80% pro rata share of the debt obligation of CFC1 held by CFC2 valued in paragraph (E) (\$80). The value of the stock of CFC1 held by USP is \$100 (USP's 100% pro rata share of tangible assets of CFC1 included in paragraph (C) (\$400) less USP's 100% pro rata share of the liabilities of CFC1 to USP and CFC2 (\$300)).

* * * * *

(k) * * * Paragraphs (e)(2) and (3) apply to taxable years beginning after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. See 26 CFR 1.861-9T(e)(2) and (3) (revised as of April 1, 2011) for rules applicable to taxable years beginning on or before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. Paragraph (h)(4) applies to taxable years ending on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. See 26 CFR 1.861-9T(h)(4) (revised as of April 1, 2011)

for rules applicable to taxable years ending before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. * * *

(l) Expiration date. The applicability of paragraphs (e)(2), (h)(1)(iv), and (h)(4) expires on **[INSERT DATE 3 YEARS AFTER THIS DOCUMENT IS FILED WITH THE OFFICE OF THE FEDERAL REGISTER]**.

Par. 4. Sec 1.861-11T is amended by revising paragraphs (d)(6)(ii) and (h) and adding paragraph (i) to read as follows:

§1.861-11T Special rules for allocating and apportioning interest expense of an affiliated group of corporations (temporary).

* * * * *

(6) * * *

(ii) Any foreign corporation if more than 50 percent of the gross income of such foreign corporation for the taxable year is effectively connected with the conduct of a trade or business within the United States and at least 80 percent of either the vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the affiliated group (determined with regard to this sentence).

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(h) Effective/applicability date. In general, the rules of this section apply for taxable years beginning after December 31, 1986. Paragraph (d)(6)(ii) applies to taxable years beginning after August 10, 2010. See 26 CFR 1.861-11T(d)(6)(ii) (revised as of April 1, 2010) for rules applicable to taxable years beginning on or before August 10, 2010.

(i) Expiration date. The applicability of paragraphs (d)(1) and (6) expires on **[INSERT DATE 3 YEARS AFTER THIS DOCUMENT IS FILED WITH THE OFFICE OF THE FEDERAL REGISTER]**.

Steven T. Miller

Deputy Commissioner for Services and Enforcement.

Approved: December 6, 2011

Emily S. McMahon

Acting Assistant Secretary of the Treasury (Tax Policy).

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