This memorandum responds to your request for advice, dated November 25, 2003, regarding the above referenced topic. This writing may contain information protected by a privilege, such as the attorney-client privilege. Accordingly, any unauthorized disclosure of this writing may have an adverse effect on the assertion of an otherwise appropriate privilege. If disclosure becomes necessary please contact this office for our views.
How is a greater-than-10-percent corporate partnership interest valued for purposes of apportioning a partner’s interest expense incurred outside of the partnership? (UIL 861.09-00)

In apportioning a partner’s non-partnership-incurred interest expense under the FMV method, Treas. Reg. § 1.861-9T(e)(2), in tandem with Treas. Reg. § 1.861-9T(h)(1)(ii), requires a greater-than-10-percent corporate partner to look through and take into account its proportionate share of the gross assets of the partnership.

TAXPAYER is F, operating over G in the United States and serving H American customers in parts of I states. Its service territory covers J square miles in K. TAXPAYER's asset base also includes O, and more.

In Year 1, A, one of TAXPAYER’s wholly owned domestic subsidiaries, acquired a P interest in B ("B"), an R corporation. The other P interest in B was owned by E, an entity unrelated to TAXPAYER. B, in turn, owned two R holding companies that ultimately owned the stock of several R operating companies that produce and sell Q in R. As is relevant here, during Year 1, TAXPAYER elected to have B treated as a partnership pursuant to Treas. Reg. § 301.7701-3. We are unaware of any reason why the election to be treated as a partnership was not effective for
purposes of TAXPAYER’s Year 1, Year 2, and Year 3 consolidated federal income tax returns.

TAXPAYER’s Year 1 through Year 3 tax years are currently under audit by LMSB Examination. For those years, TAXPAYER claimed foreign tax credits (FTC) in the amounts of Amount $A, Amount $B and Amount $C, respectively. For each year, the TAXPAYER attached a Form 1118, computing its allowable FTC, to its consolidated federal income tax return. Schedule H, Part II of the Form 1118 allows the computation of the interest expense apportionment and contains the election to use either the fair market value or tax book value method of apportionment. TAXPAYER elected the fair market value (the “FMV”) method for each of the years Year 1, Year 2, and Year 3.1

For purposes of the required allocation and apportionment of interest expense under Treas. Reg. § 1.861-9T, TAXPAYER recorded the amounts of Amount $D, Amount $E, and Amount $F as the fair market value of its interest in B for the tax years Year 1, Year 2, and Year 3, respectively. Originally, the TAXPAYER had not caused an appraisal of its assets, and in particular the B assets to be made. However, when faced with the prospect of the Service placing it on the tax book method, the TAXPAYER engaged C to provide the valuation numbers. Recently, the TAXPAYER offered a memorandum by C as support for its fair market values. The C memorandum utilized values generated by a Date 1 study by D.

The D study had been commissioned by E (the other P owner in B) to determine the fair market value of the total assets of B, a value necessary for E to meet its tax compliance requirements related to the FMV method of apportioning interest expense.

C started with the total fair market values determined by D, but reduced the amounts by the debt for which B was liable. After determining what amounts to the total equity in B, C

1 While TAXPAYER’s Year 3 Schedule H elected the tax book value, TAXPAYER has stated that this was done in error and that the fair market value method was also applied in Year 3. In any event, once a taxpayer uses the fair market value method, the taxpayer and all related persons must continue to use that method unless expressly authorized by the Commissioner to change methods. Temp. Treas. Reg. § 1.861-8T(c)(2). TAXPAYER has not been authorized by the Commissioner to use the book value method for its Year 3 tax year.
multiplied the total equity value by \( P \) to extract the TAXPAYER’s \( P \) equity interest in B.

For purposes of this memorandum, we will assume that the Service has accepted the valuation calculation conclusions reached by the D report. At issue is how a greater-than-10-percent corporate partnership interest is valued for purposes of apportioning a partner’s interest expense incurred outside of the partnership.

**Analysis**

Section 901 allows a credit for foreign income, war profits, and excess profits taxes paid or deemed paid by qualifying taxpayers that elect the foreign tax credit in lieu of a deduction under section 164(a)(3). Section 904(a) limits a taxpayer’s foreign tax credit to an amount equal to the pre-credit U.S. tax on the taxpayer foreign source taxable income.

Sections 861(b), 862(b), and 863(a) provide that taxable income attributable to gross income from domestic or foreign sources shall be determined by deducting the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses and other deductions that cannot be definitely allocated to some item or class of gross income. In the case of interest expense, as is relevant here, section 864(e)(2) specifically requires that all allocations and apportionments of interest expense be made on the basis of assets, not gross income.

Under the asset method, interest expense is apportioned between statutory and residual groupings of gross income (or among statutory groupings) in proportion to the average total values of the assets within each such grouping for the taxable year. Treas. Reg. § 1.861-9T(g)(1)(i). For this purpose, taxpayers may elect to value their assets based on their tax book value or fair market value. Treas. Reg. § 1.861-8T(c)(2) and 1.861-9T(g)(1)(ii). The application of the FMV method of valuation, as was elected here by the TAXPAYER, requires recognition of a number of regulatory requirements:

First, Treas. Reg. § 1.861-9T(h)(1)(i) requires the taxpayer to determine the aggregate value of its assets, including stock in foreign subsidiaries or any other asset. In the case of a publicly traded corporation, aggregate asset value is equal to stock value increased by the liabilities of the taxpayer (owed to unrelated persons) and its share of liabilities of related
persons owed to unrelated persons. In the case of non-publicly traded corporations, aggregate asset value must be determined by reference to the capitalization of corporate earnings in accordance with the rules of Rev. Rul. 68-609.

Second, Treas. Reg. § 1.861-9T(h)(1)(ii) requires the taxpayer to determine the value of all its tangible assets, and its pro rata share of such assets held by related persons. For this purpose, the value of stock in any corporation that is not a related person must be determined under the rules of Treas. Reg. § 1.861-9T(h)(1)(i), except that no liabilities shall be taken into account.

And third, Treas. Reg. § 1.861-9T(h)(4) generally provides that the value of stock in a related person equals the sum of the intangible asset value apportioned under (h)(2) to such related person, plus the taxpayer’s share of tangible assets held by such related person, less the taxpayer’s pro rata share of the related person’s liabilities.

In applying those regulatory requirements to a partnership interest, certain apportionment rules must be followed. Interest expense incurred by a partnership must be apportioned under the regime established by Treas. Reg. § 1.861-9T(e). In that regard, Treas. Reg. § 1.861-9T(e) generally adopts an aggregate, or look-through, approach in apportioning a partner’s distributive share of interest expense incurred by the partnership. Subsection (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. Likewise, subsection (e)(2), in accordance with the aggregate approach, requires that a corporate partner whose interest in the partnership is 10 percent 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 assets under the rules of Treas. Reg. § 1.861-9T(f).

However, limited partners and corporate general partners with a less-than-ten-percent partnership interest are excepted from aggregate treatment. In cases involving less-than-10-percent limited or general partners, subsection (e)(4) treats the partnership as an entity for interest apportionment purposes. Moreover, subsection (e)(4)(i) provides that a limited partner or

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2 Treas. Reg. § 1.861-8T(c)(2) defines the term “related persons” to mean two or more persons in a relationship described in section 267(b).
corporate general partner whose interest in the partnership is less than 10 percent shall directly allocate its distributive share of partnership interest expense to its distributive share of partnership gross income. Subject to certain exceptions, such a partner’s distributive share of foreign source income from the partnership is generally treated as passive income. A partner’s share of partnership interest expense, other than certain interest expense directly allocated to specific partnership property, is allocated among the relevant groupings of partnership gross income solely on the basis of the partnership’s relative gross income in each grouping. Finally, for purposes of allocating other interest expense incurred directly by the partner, subsection (e)(4)(ii) explicitly provides that the relevant asset is the partner’s interest in the partnership, rather than the partner’s share of the partnership assets.

It is important to recognize that the rules of Treas. Reg. § 1.861-9T(e)(4), requiring partnership-level allocations of partnership interest expense for partners with small percentage interests, is a rule of administrative convenience. That is, less than-ten-percent interests are generally considered passive portfolio investments. Generally, such partners have little or no say-so in management or financing decisions of the partnership. It will frequently be simpler and cheaper for these partners to have the partnership compute a single allocation based solely on partnership items.
Application

Here, the D report calculated the fair market value of the assets of B. Nevertheless, the TAXPAYER, by proffering the C memorandum, is suggesting that the asset which it was required to value was the P interest in the B partnership, not the fair market value of the partnership assets.

In that regard, on February 11, 2004, TAXPAYER provided its position on this issue (see copy attached). According to TAXPAYER:

In filing its US Federal income tax return, TAXPAYER took the position that Treas. Reg. 1.861-9T(h) provides authoritative guidance as to the procedures to apportion interest expense under the fair market value method. It was TAXPAYER’s position that, to the extent that 1.861-9T(h) provides guidance for computational matters, this regulation should control over other provisions (such as Treas. Reg. 1.861-9T(e)). Treasury Regulation 1.861-9T(h) affirmatively states that the apportionment should be based on the aggregate fair market value of the assets of the TAXPAYER and its pro rata share of assets held by related persons. Because TAXPAYER does not own more than 50% in the B partnership, B should not be treated as a related person for purposes of these regulations (see below). Applying the “10% rule” of Temp. Reg. § 1.861-9T(e)(2) to the B fact pattern would result in a different computation than the one that is seemingly prescribed by the authority of Treas. Reg. 1.861-10T(h), which establishes a 50% and not a 10% ownership threshold for determining whether the TAXPAYER should use the FMV of its investment vs. the FMV of the TAXPAYER’s distributive share of another entity’s assets for interest apportionment.

Thus, as interpreted by the TAXPAYER, the language of the regulation requires TAXPAYER to value its pro rata share of B’s assets only if B is related to the TAXPAYER. The TAXPAYER argues that since B is not related (as that term is defined) to TAXPAYER, it cannot be required to reflect its pro rata share of B’s assets as part of the its assets. Instead, TAXPAYER suggests that its “asset” for purposes of Treas. Reg. § 1.861-9T(h)(1)(ii) is its P interest in the B partnership.

We believe that the TAXPAYER’s interpretation of the regulations is incorrect. In applying the FMV methodology, we believe that minority interests held by the TAXPAYER, including a
ten-percent-corporate partnership interest, should be considered a tangible asset under Treas. Reg. § 1.861-9T(h)(1)(ii). When apportioning interest expense incurred by the partnership, Treas. Reg. § 1.861-9T(e)(2) requires a 10 percent corporate partner to apportion such interest on the basis of all its assets, including its pro rata share of the partnership assets. Thus, in apportioning its partnership-generated interest expense, Treas. Reg. § 1.861-9T(e)(2) applies, in tandem with Treas. Reg. § 1.861-9T(h)(1)(ii), to require the ten percent corporate partner to look through and take into account its proportionate share of the gross assets of the partnership.

Although the regulations may not explicitly address whether the section 1.861-9T(e)(2) gross asset rule applies for purposes of apportioning the other interest expense of U.S. partner, the policy of the FMV methodology and the treatment of partnerships under the regulations indicate that the gross asset rule should also apply in apportioning other (non-partnership incurred) interest expense of a 10 percent corporate partner.

The FMV methodology is based on the premise that interest expense is spread against all of the taxpayer’s income-generating assets. Asset value is essentially a surrogate for a taxpayer’s total income generating ability. Such valuation suggests that tangible assets be valued on a gross, rather than a net basis. Accordingly, from a FMV methodology standpoint, substantial partnership interests should be included in the interest apportionment process on a gross basis.

Treas. Reg. § 1.861-9T(h)(1)(ii) treats minority (less then 50 percent) interests in corporations as passive (dividend paying) interests. The regulation generally values the stock interest (using the capitalized earnings model) on a net or equity basis. Similarly, Treas. Reg. § 1.861-9T(h)(4) also values related party stock on a net-of-liabilities or equity basis. Thus, in the case of corporations, asset look-through generally does not occur below 80 percent ownership.

However, under the regulations, partnerships are treated differently than corporations. Treas. Reg. § 1.861-9T(e)(1) provides that look-through is the general rule. Treas. Reg. § 1.861-9T(e)(4), an exception to the general rule, applies the entity (non-look through) approach to interests of a less-than-10-percent partner. Thus, in the partnership area, the look-through occurs at the ten percent mark and above. Passive/equity treatment occurs below the 10 percent cut off. Accordingly, in valuing a ten-percent-or-more corporate partnership interest under Treas. Reg. § 1.861-9T(h)(1)(ii), equity valuation should
not apply. Instead, such partner should look through to the proportionate share of the gross assets of the partnership for purposes of apportioning all interest expense.

Based upon the above analysis, we believe that when apportioning a partner’s other (non-partnership-incurred) interest expense under the FMV method, Treas. Reg. § 1.861-9T(e)(2), operating in tandem with Treas. Reg. § 1.861-9T(h)(1)(ii), requires a greater-than-10-percent corporate partner to look through and take into account its proportionate share of the gross assets of the partnership.

We have generated this opinion in light of the imminent closing of the case to Appeals. Upon consideration of the issue by Appeals, we suggest that this issue is one which would benefit from a request for Technical Advice. If questions remain, or if we may be of further assistance in this matter, please contact the undersigned at your convenience.

RICHARD E. TROGOLO
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By: _____________________________

JAMES E. KAGY
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Attachment to POSTF-168001-03

TAXPAYER
NPA # I31

Subject: Interest Expense Apportionment / Treatment of Partnerships in the FMV Election Context

The major issue is to assess whether or not the B partnership interest represents a tangible asset and/or whether or not TAXPAYER should look through the partnership for purposes of applying the FMV formula.

In filing its US Federal income tax return, TAXPAYER took the position that Treas. Reg. 1.861-9T(h) provides authoritative guidance as to the procedures to apportion interest expense under the fair market value method. It was TAXPAYER’s position that, to the extent that 1.861-9T(h) provides guidance for computational matters, this regulation should control over other provisions (such as Treas. Reg. 1.861-9T(e)). Treasury Regulation 1.861-9T(h) affirmatively states that the apportionment should be based on the aggregate fair market value of the assets of the taxpayer and its pro rata share of assets held by related persons. Because TAXPAYER does not own more than 50% in the B partnership, B should not be treated as a related person for purposes of these regulations (see below). Applying the “10% rule” of Temp. Reg. § 1.861-9T(e)(2) to the B fact pattern would result in a different computation than the one that is seemingly prescribed by the authority of Treas. Reg. 1.861-10T(h), which establishes a 50% and not a 10% ownership threshold for determining whether the taxpayer should use the FMV of its investment vs. the FMV of the taxpayer’s distributive share of another entity’s assets for interest apportionment.

1. B Not A Related Person Under the FMV Method Regulations

The essence and spirit of the fair market value regulations is to look through all related entities and capture the underlying assets and income. Treasury Regulation §1.861-9T(h)(1) defines a related person for the fair market value method by a cross reference to Treas. Reg. §1.861-8T(c)(2). Treas. Reg. §1.861-8T(c)(2) defines the term ‘related person’ as two or more persons in a relationship described in §267(b)(3). Whether a corporation is related to a partnership under §267(b)(10), a person is considered to own the partnership interest directly by such person and the partnership interest owned with the application of §267(b)(3). Section 267(b)(10) defines a ‘relationship’ as “(A) corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation, and (B) more than 50% of the capital interest, or profits interest, in such partnership.”

Since TAXPAYER did not own an interest of more than 50% in the partnership in question, B should not be considered a related person for purposes of applying the FMV election rules.

2. The Fungibility Concept (and Other Support for General “Entity” Approach)

In accordance with section 864(e) and Temp. Treas. Reg. § 1.861-9T(a), the interest expense of a consolidated group generally must be apportioned based on all of the assets held by the group,
using average tax book values of fair market values.\(^3\) The statute proceeds from the assumption that money is fungible, and therefore borrowings effectively fund all of the taxpayer’s assets.\(^4\) As the regulations explain:

> The method of allocation and apportionment for interest . . . is based on the approach that, in general, 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. . . . The fungibility 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. When borrowing will generally free other funds for other purposes, and [sic] it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes. Consistent with the principles of fungibility, except as otherwise provided, the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate, have generated, or could reasonably have been expected to generate.\(^5\)

The preamble to the regulations reiterates that under the fungibility approach interest is to be allocated based on the “assets of the taxpayer.”\(^6\)

Under the interest apportionment rules, a “taxpayer” is defined to include an affiliated group of corporations, which, in general, has the same meaning as that term is given in section 1504 except that section 936 corporations and certain directly or indirectly 80 percent controlled (as measured by vote or value) domestic corporations are also included within the definition.\(^7\) Thus, in accordance with the regulations under section 864(e), the fungibility concept does not go beyond the “border” of a single taxpayer to, for example, less than 80 percent controlled domestic corporations.

Under the fungibility theory, it seems to follow that indebtedness incurred by the TAXPAYER Group is regarded as funding all Group assets, including TAXPAYER’s investment in B. In contrast, the assets held by B would reflect not only the capital contributed by a partner but also (i) the indebtedness incurred by B for which a partner may not have exposure, and (ii) the assets purchased and contributed by other partners.

Therefore treating the outside partnership interest as the relevant asset for purposes of these rules seems to be consistent with the fungibility concept.

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\(^3\) Temp. Treas. Reg. § 1.861-9T(f)(1) and (g)(1).


\(^5\) Temp. Treas. Reg. § 1.861-9T(a) (emphasis added).


\(^7\) Temp. Treas. Reg. § 1.861-9T(a) and Treas. Reg. § 1.861-11(d)(1) and (7).
REMARK: We also note that the treatment of the outside partnership interest as the relevant asset for purposes of allocating interest expense incurred outside of the partnership is consistent with the manner in which a foreign corporation’s own interest expense is allocated under the branch profits tax rules. Under the branch profits tax rules finalized in 1996, the relevant asset is the foreign corporation’s tax basis in a partnership interest, and not the gross assets of the partnership. Treas. Reg. § 1.884-1(d)(3)(i); T.D. 8658, 1996-1 C.B. 161-62; T.D. 8657, 1996-1 C.B. 153. The branch profits rules, however, also adjust any foreign partner’s tax basis in a partnership by an attributable portion of the partnership’s liabilities. No comparable rule or adjustment applies under Temp. Treas. Reg. § 1.861-9T. Interest expense incurred directly by a foreign partner in a partnership is generally excluded from the interest expense allocation rules of section 864(e), with the allocation of such interest being governed solely by section 884. See Temp. Treas. Reg. § 1.861-9T(e)(7).

Based on the above, the “entity” approach to partnerships for purposes of apportioning interest expense to foreign source income seems to be consistent with the fungibility concept and with other provisions in the Code, such as the manner in which a foreign corporation’s own interest expense is allocated under the branch profits tax rules. Absent specific guidance to the contrary (see below), TAXPAYER should follow the entity approach to partnerships in calculating the amount of interest expense apportioned to foreign source income.

3. Application to TAXPAYER Group Interest Expense / No Guidance to Dictate Deviating from the General Rule

The regulations contain an example showing how interest expense incurred outside the partnership by a less than 10 percent corporate partner is to be apportioned. No guidance is provided, however, for the apportionment of interest expense incurred outside of the partnership the case of a greater than 10 percent corporate partner (as noted further below, guidance is provided, however, for apportioning interest expense incurred inside the partnership in the case of a more than 10 percent corporate partner). See Temp. Treas. Reg. § 1.861-9T(e)(6), Example (iii) and (iv).

Therefore, in accordance with the plain language of Treas. Reg. § 1.861-9T(a) and (g), the assets to be taken into account for apportionment purposes with respect to interest expense incurred directly by the TAXPAYER Group should be those assets held directly by a taxpayer. Based on the general rules described above, again for purposes of apportioning interest expense incurred directly by the TAXPAYER Group, the “assets of the taxpayer” should include the FMV of TAXPAYER’s partnership interest in B partnership.

4. Application to TAXPAYER’s Distributive Share of B Interest Expense / Guidance to Use Aggregate Theory

As noted above, the interest expense apportionment rules under section 864(e) include special rules applicable to partnerships. Those rules are limited in scope, however, and should not be applicable to the interest expense directly incurred by a controlling corporate partner outside of
the partnership.\(^8\)

In relevant part, Temp. Treas. Reg. § 1.861-9T(e)(2) provides a special rule that requires a corporate partner that directly or through section 318 attribution owns 10 percent or more of a partnership to allocate \textit{its distributive share of a partnership’s interest expense} on a combined gross asset basis. Under this special rule, a partnership is treated as an “aggregate” in that the corporate partner’s distributive share of partnership interest expense must be allocated based on the sum of the average assets held directly by the partner and the partner’s pro rata share (determined by reference to the partner’s interest in partnership income for the year) of the average assets held by the partnership.\(^9\)

\textit{This “aggregate” approach, however, by its explicit terms, is solely for purposes of allocating a corporate partner’s distributive share of partnership interest expense.}

This special rule should not be treated as overriding the general rule applicable to the allocation of interest expense incurred directly by the partner for two main reasons. First, this special rule is not consistent with the fungibility approach, according to which the interest expense incurred directly by the corporate partner was for the purpose of funding the partner’s investment in the partnership itself, not the assets held by the partnership. Second, if it was intended that a corporate partner (such as TAXPAYER) be required to take into account the gross assets of a partnership for purposes of allocating its non-partnership interest expense, Temp. Treas. Reg. § 1.861-9T(e)(2) would be superfluous, because no special rule would in fact then be needed for a “10 percent or greater” corporate partner.

\textbf{5. Conclusion}

TAXPAYER believes its’ tax return position to be correct based on the positions outlined above.

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\(^8\) See Temp. Treas. Reg. § 1.861-9T(e). Prior to the promulgation of Temp. Treas. Reg. § 1.861-9T(e) in 1988, there were no special regulatory rules applicable to the allocation of partnership interest expense or for partnerships in general.