INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

July 21, 2005

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200545045**
Release Date: 11/10/2005
Index (UIL) No.: 861.09-04
CASE-MIS No.: TAM-116657-05

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No

Date of Conference: June 8, 2005

LEGEND:

Taxpayer =

ISSUE:

For purposes of apportioning partner-level interest expense under the fair market value method pursuant to Temp. Treas. Reg. §§ 1.861-9T(e)(2) and 1.861-9T(h)(1)(ii), does Taxpayer include its proportionate share of the gross assets of the partnerships or the net value of its equity partnership interests?

CONCLUSION:

The aggregate rule of Temp. Treas. Reg. § 1.861-9T(e)(2), in conjunction with Temp. Treas. Reg. §1.861-9T(h)(1)(ii), requires Taxpayer to include its proportionate share of the gross assets of the partnerships for purposes of apportioning both its distributive share of partnership interest expense and its partner-level interest expense.

FACTS:

Taxpayer is a publicly traded U.S. corporation. Taxpayer and its affiliated U.S. subsidiaries file their U.S. federal income tax return on a consolidated basis. Taxpayer's consolidated group apportions its interest expense for section 864(e) purposes under the fair market value method.

Taxpayer and its affiliates own 100 percent of several domestic partnerships. The partnerships' sole activity is to manage and hold the stock of lower-tier controlled and non-controlled foreign corporations. Several of the partnerships incur interest expense on debt owed to a member of Taxpayer's affiliated group. In addition, Taxpayer and its affiliates incur interest expense of their own.

In computing its foreign tax credit limitation under section 904, Taxpayer apportions its distributive share of partnership interest expense based on the combined fair market values of the gross assets of the U.S. consolidated group, including the group's proportionate share (100 percent) of the gross assets of the partnerships. With respect to apportioning the interest expense incurred directly by Taxpayer and its affiliates, however, Taxpayer takes into account only its net equity interests in the partnerships, i.e., the gross partnership asset values less partnership liabilities. As a result of this valuation approach, Taxpayer reduces the asset value of the partnerships and the amount of interest expense apportioned to foreign source income (since the partnerships generate solely foreign source income), thereby increasing its overall foreign tax credit limitation.

LAW AND 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's foreign source taxable income in each of the taxpayer's separate categories described in section 904(d).

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 (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. Temp. Treas. Reg. § 1.861-9T(g)(1)(i). For this purpose, taxpayers may elect to value assets based on their fair

market value, tax book value, or alternative tax book value (for tax years beginning on or after March 26, 2004). Temp. Treas. Reg. §§ 1.861-8T(c)(2) and l.861-9T(g)(1)(ii).

The application of the fair market value method (FMV method) requires compliance with a number of regulatory requirements. First, Temp. Treas. Reg. § 1.861-9T(h)(1)(i) requires the taxpayer to determine the aggregate value of its assets, including stock in foreign subsidiaries and all other assets. 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 pro rata share of liabilities of related persons owed to unrelated persons. Second, Temp. Treas. Reg. § 1.861-9T(h)(1)(ii) requires the taxpayer to determine the value of all tangible assets held by the taxpayer, and its pro rata share of such assets held by related persons (excluding stock or indebtedness in such related persons).

In applying these FMV method requirements to an interest in a partnership, certain apportionment rules apply. Interest expense incurred by a partnership must be apportioned under the regime established by Temp. Treas. Reg. § 1.861-9T(e). In that regard, Temp. Treas. Reg. § 1.861-9T(e) generally adopts an aggregate, or look-through, approach to 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 direct or indirect interest in the partnership is ten 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 Temp. 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 such cases, subsection (e)(4) treats the partnership as an entity for interest expense apportionment purposes. Subsection (e)(4)(i) provides that a limited partner or corporate general partner whose interest in the partnership is less than ten percent shall directly allocate its distributive share of partnership interest expense to its distributive share of partnership gross income. For purposes of allocating other interest expense incurred directly by the less-than-ten-percent 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. Temp. Treas. Reg. § 1.861-9T(e) does not explicitly provide for either aggregate or entity treatment of partnership interests for purposes of apportioning interest expense incurred directly by a ten-percent-or-greater partner.

The rule requiring entity treatment for partners with small percentage interests is a rule of administrative convenience. That is, less-than-ten-percent interests are considered passive portfolio investments. Generally, such partners have little or no influence over management or financing decisions of the partnership. The regulations acknowledge the difficulty that would be involved if minority partners were required to apportion either direct or partnership-level interest expense on the basis of total assets including

anything other than the net value of the partner's interest in the partnership, or on the basis of their distributive share of partnership gross income, respectively. This entity treatment for portfolio investors is in contrast to the general aggregate approach taken with respect to larger interests in a partnership. Thus, while the regulation does not explicitly so state, the more logical and consistent reading is that such ten-percent-or-greater partners should apportion directly-incurred interest expense in the same manner as their distributive share of partnership interest expense, on the basis of all assets including their proportionate share of partnership assets.

This result is consistent with the premise underlying the FMV methodology, namely, that interest expense is apportioned on the basis of all of the taxpayer's income-generating assets. Asset value is essentially a surrogate for the income produced over time by a taxpayer's assets, to which its interest expense is directly related. This rationale suggests that tangible assets should be valued on a gross rather than a net basis. Accordingly, in apportioning interest expense using the FMV methodology, the value of substantial interests in a partnership should reflect the taxpayer's share of the partnership's gross assets.

Taxpayer asserts that its interests in its wholly-owned partnerships are more appropriately valued on a net equity basis. Taxpayer points out that interest expense is deemed fungible with respect to income generated by the assets of the "taxpayer" (as defined in Temp. Treas. Reg. §§ 1.861-11(d), 1.861-11T(d), and section 1504 of the Code). Because fungibility does not extend beyond the border of the "taxpayer" to a partnership entity, Taxpayer asserts that the relevant asset, for purposes of apportioning partner-level interest expense, is its equity interest in a partnership, reduced by its share of partnership liabilities. We disagree. The fungibility principle requires all of Taxpayer's assets to be included for purposes of apportioning interest expense. In this case, Taxpayer does not dispute that its interest in the partnerships are assets that must be included in the overall asset pool to which both its partnership and partner-level interest expense relate. Thus, fungibility is not in question. The issue for resolution here is instead whether an aggregate or entity approach applies in valuing the partnership interest for apportionment purposes.

Taxpayer also notes that, in the corporate context, asset look-through generally does not occur unless a taxpayer owns 80 percent or more of a corporation's stock. Temp. Treas. Reg. §§1.861-11T(c). However, the interest expense apportionment regulations clearly treat partnerships differently than corporations. Temp. Treas. Reg. §1.861-9T(e)(1) provides that look-through is the general rule for partnerships. Section 1.861-9T(e)(4), an exception to the general rule, applies the entity (non-look-through) approach to interests of a less-than-ten-percent partner. Thus, in the partnership area, look-through occurs at the ten percent and above mark. Passive/net equity treatment occurs below the ten percent ownership threshold.

Based on the above analysis, Taxpayer must include its proportionate share of the gross assets of its wholly-owned partnerships for purposes of apportioning both its distributive share of partnership interest expense and its partner-level interest expense.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.