Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I International Practice Service
Process Unit – Audit

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Volume	3	FTC Management	UIL Code	9413
Part	3.3	Accessing Foreign Source Income	Level 2 UIL	9413.03
Chapter	3.3.2	Interest Expense Allocation/Apportionment	Level 3 UIL	9413.03-02
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Unit Name	Asset Valuation using the FMV Method for Interest Expense Allocation to Calculate FTC Limitation

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Process Overview

Asset Valuation using the FMV Method for Interest Expense Allocation

Process Description

The United States taxes income on a worldwide basis. To prevent double taxation, U.S. taxpayers are allowed a credit for foreign income taxes paid. However, the amount of FTC a taxpayer can utilize each year is based upon the ratio of foreign source taxable income (FSTI) to worldwide taxable income (WWTI). Thus, FTC is limited to the US tax on FSTI. The FTC limitation is commonly referred to as the IRC 904 FTC limitation.

The IRC 904 FTC limitation formula:

$$\frac{\text{FSTI}}{\text{WWTI}} \quad \text{X} \quad \text{U.S. Tax Liability} \quad = \quad \text{IRC 904 FTC Limit}$$

A taxpayer in an excess foreign tax credit position will often plan to increase the IRC 904 FTC limitation by maximizing the portion of their worldwide income that is FSTI. One way to maximize net FSTI is by minimizing interest expense allocated/apportioned to FSTI.

The Regulations provide rules for allocating and apportioning interest expenses. In general, the Regulations require the allocation and apportionment (A&A) of interest expense be made on the basis of assets (the asset method) and not gross income. For a detailed discussion on interest allocation and apportionment, please see the concept building block on interest expense A&A.

Process Overview (cont'd)

Asset Valuation using the FMV Method for Interest Expense Allocation

Process Description

Under the Asset method, the A&A of interest expense is a three step process:

- Step One: Determine average value of assets - "Valuation Step"
- Step Two: Characterize assets per source and character of income, statutory (foreign) or residual (US) - "Characterization Step"
- Step Three: Apportion interest expense based upon percentage of assets in each grouping - "Apportionment Step"

The apportionment to the separate categories is done using the following formula:

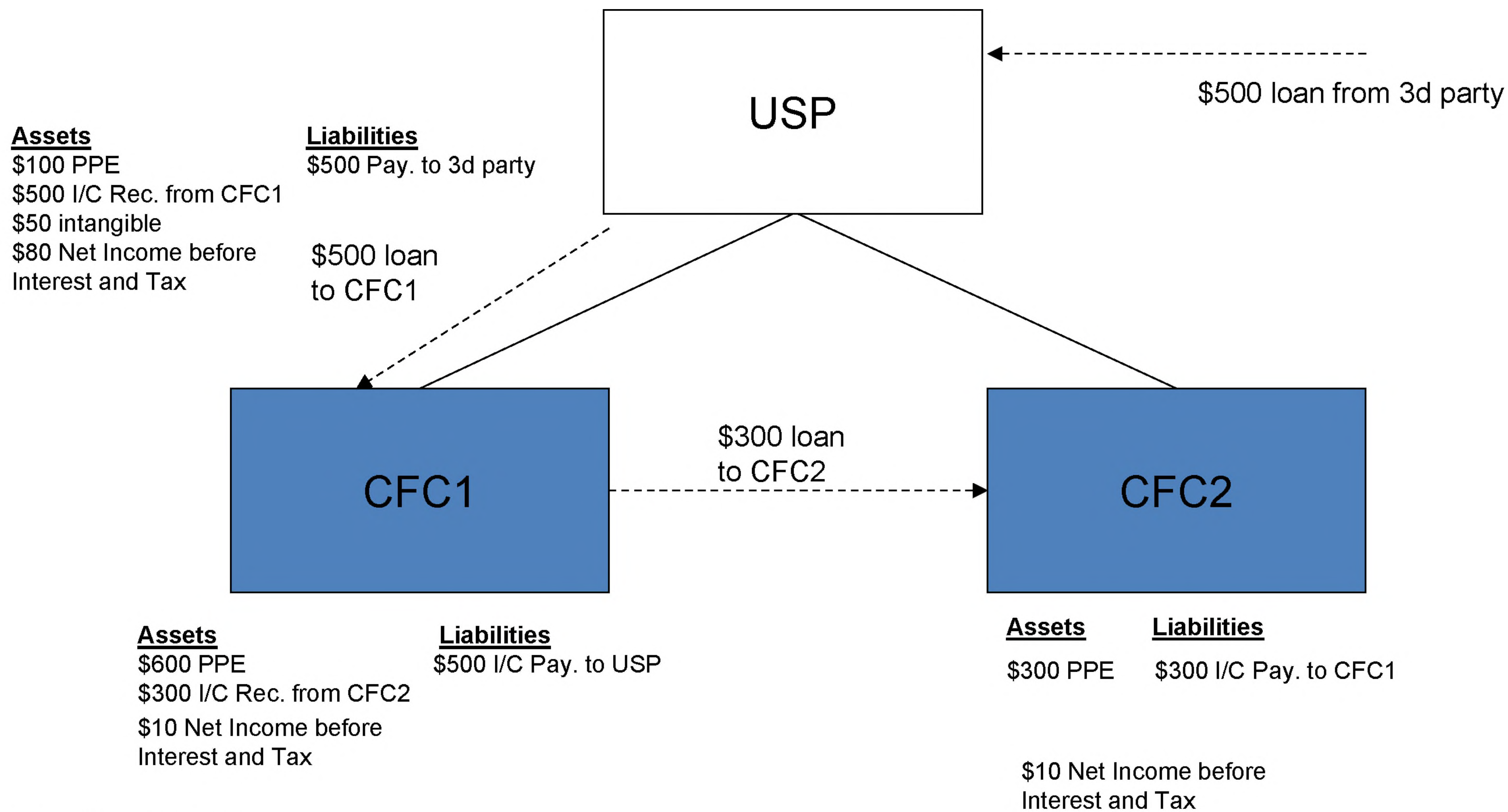
$$\text{Interest Expense} \times \frac{\text{Asset value in separate category}}{\text{Total assets}} = \begin{array}{l}\text{Interest expense} \\ \text{apportioned to FSTI} \\ \text{in separate category}\end{array}$$

For Step One (Valuation Step), taxpayers may elect to value assets based on their fair market value (FMV), tax book value, or alternative tax book value. This unit specifically addresses Step One and discusses the FMV methodology of asset valuation to allocate and apportion interest expense. Also, some audit guidelines in the examination of the FMV methodology of interest expense allocation and apportionment are incorporated into this unit.

Process Overview (cont'd)

Asset Valuation using the FMV Method for Interest Expense Allocation

Example Circumstances Under Which Process Applies



Market Cap $550

Process Overview (cont'd)

Asset Valuation using the FMV Method for Interest Expense Allocation

Example Circumstances Under Which Process Applies

FACTS

- USP Is a multinational corporation and has elected the FMV method of allocating/apportioning interest expense for FTC purposes.
- $500 loan is received from 3d party and recorded as a liability.
- USP loans $500 to CFC1 which is recorded as a intercompany receivable by USP and an intercompany payable by CFC1.
- CFC1 loans $300 to CFC2 which is recorded as an intercompany receivable by CFC 1 and an intercompany payable by CFC2.

SUMMARY

- USP has a market cap of $550 and unrelated party liabilities of $500. The assets and liabilities of each are as follows:

  USP
  $100 PPE
  $500 I/C rec. from CFC1
  $ 50 Intangibles
  $500 3d party liabilities

  CFC1
  $600 PPE
  $300 I/C rec. from CFC2
  $500 I/C pay. to USP

  CFC2
  $300 PPE
  $300 I/C pay. to CFC2

Determination of Process Applicability

Asset Valuation using the FMV Method for Interest Expense Allocation		
Taxpayer strategies of increasing FSTI is an effective planning technique of decreasing ETR when in an excess FTC credit position. Electing the FMV methodology of interest expense apportionment can result in an increase to FSTI especially when US based assets have higher appreciated values versus foreign assets. Examiners should employ appropriate risk analysis procedures in determining whether or not noncompliance with the regulations is present.		
Criteria	**Resources**	**6103 Protected Resources**
▪ Taxpayer elects the FMV methodology of interest expense apportionment per Treas. Reg. 1.861-9T. ▪ Compare ratio of US vs. foreign assets under prior method (tax book) method vs. elected FMV method. ▪ After review of FMV Study and other resources request a "walk through" meeting with taxpayer to describe procedures employed in determination of the FMV components used in the apportionment.	▪ Worldwide organization chart ▪ Taxpayer financial statements ▪ Taxpayer's FMV Study (if applicable) ▪ Workpapers, including detailed trial balance reports supporting account groupings for FMV Study ▪ Form 1118 Foreign Tax Credit - Corporations, Sch H ▪ Rev. Proc. 2003-37	

Effective Tax Rate Overview

Asset Valuation using the FMV Method for Interest Expense Allocation to Calculate FTC Limitation
Effective Tax Rate (ETR) of Company
ETR Impact of Adjustment
A company's overall effective tax rate, for financial reporting purposes, is the aggregate rate of taxes expensed on its worldwide income. A taxpayer may wish to increase *foreign source taxable income* (FSTI) as an effective planning technique of decreasing ETR when the taxpayer is in an excess FTC credit position. Electing the FMV methodology of interest expense apportionment can result in an increase to FSTI especially when US based assets have higher appreciated values versus foreign assets.

Summary of Process Steps

Asset Valuation using the FMV Method for Interest Expense Allocation	
Step 1	Determine Total Assets - Determine the aggregate value of all of the taxpayer's assets.
Step 2	Determine Tangible Assets - Determine the value of all tangible assets held by the taxpayer and its pro rata share of assets held by related persons using generally accepted valuation techniques.
Step 3	Determine Intangible Assets - The value of the intangible assets of the taxpayer and related persons attributable to the taxpayer is equal to the amount in (1) less the amount in (2).
Step 4	Apportion Intangible Assets - Intangible value is apportioned between taxpayers and related persons on a net income basis.

Summary of Process Steps (cont'd)

Asset Valuation using the FMV Method for Interest Expense Allocation	
Step 5	Characterize Intangible Assets - Characterization of the intangible assets is done on the basis of net income in each separate category in the entity to which the intangible assets are allocated.
Step 6	Determine Value of Related Persons Stock - The value of the stock in related persons held by the taxpayer is equal to the sum of the intangible asset value apportioned to the related person in (4) plus the tangible assets held by the related person as determined under (2) plus the value of stock held by the related person in other related persons, then reduced by the taxpayer's pro rata share of the related person's liabilities (the Reg language does not limit this to liabilities owed to unrelated persons). Treas. Reg. 1.861-9T(h)(4)

Step 1

Asset Valuation using the FMV Method for Interest Expense Allocation

Step 1: Determine Total Assets

Determine the aggregate value of all of the taxpayer's assets.

Considerations	Resources	6103 Protected Resources
Determine the market capitalization (market cap) of the taxpayer. Add, to the market cap, the taxpayer's liabilities to unrelated persons as well as its pro-rata share of liabilities of all related persons owed to unrelated persons. If a corporation is not publicly traded - valuation is determined by capitalization of corporate earnings. In either case, control premium is not taken into account.	▪ Treas. Reg. 1.861-9T(h)(1)(i) ▪ Rev. Rul. 68-609	
Example - Step 1: $550 market capitalization of the group $500 unrelated party liabilities $1050 Total		

Step 2

Asset Valuation using the FMV Method for Interest Expense Allocation		
Step 2: Determine Tangible Assets		
Determine the value of all tangible assets held by the taxpayer and its pro rata share of assets held by related persons using generally accepted valuation techniques.		
Considerations	**Resources**	**6103 Protected Resources**
This excludes any stock or indebtedness in a related person.	▪ Treas. Reg. 1.861-9T(h)(1)(ii)	
Example -- Step 2: $100 USP PPE $600 CFC1 PPE $300 CFC2 PPE $1,000 Total		

Step 3

Asset Valuation using the FMV Method for Interest Expense Allocation

Step 3: Determine Intangible Assets

The value of the intangible assets of the taxpayer and related persons attributable to the taxpayer is equal to the amount in (1) less the amount in (2).

Considerations	Resources	6103 Protected Resources
The amount in Step 1 less amount in step 2.	Treas. Reg. 1.861-9T(h)(1)(iii)	
Example -- Step 3: Step 1 $1,050 Less: Step 1,000 Intangible Value 50		
CONSULTATION: Consider requesting economic assistance if deemed necessary in any valuation area.		

Step 4

Asset Valuation using the FMV Method for Interest Expense Allocation		
Step 4: Apportion Intangible Assets		
Intangible value is apportioned between taxpayers and related persons on a net income basis.		
Considerations	**Resources**	**6103 Protected Resources**
Intangible value is apportioned between taxpayers and related persons on a net income basis before interest expense. Net income is determined before reduction for income taxes. See Treas. Reg. reference for more information.	▪ Treas. Reg. 1.861-9T(h)(2)	
Example-- Step 4: Allocate Step 3 Intangible Value ($50), based on net income USP (Net Income 80%) Apportionment 40 CFC1 (Net Income 10%) " 5 CFC2 (Net Income 10%) " 5		

Step 5

Asset Valuation using the FMV Method for Interest Expense Allocation		
Step 5: Characterize Intangible Assets		
Characterization of the intangible assets is done on the basis of net income in each separate category in the entity to which the intangible assets are allocated.		
Considerations	**Resources**	**6103 Protected Resources**
NOTE: If a separate category reflects a negative amount or net loss then “zero” will be used in the respective category to avoid distortion.	▪ Treas. Reg. 1.861-9T(h)(3)	
Example - Step 5: Assume no negative amount but if net loss or less, then zero is used.		

Step 6

Asset Valuation using the FMV Method for Interest Expense Allocation

Step 6:

The value of the stock in related persons held by the taxpayer is equal to the sum of the intangible asset value apportioned to the related person in (4) plus the tangible assets held by the related person as determined under (2) plus the value of stock held by the related person in other related persons, then reduced by the taxpayer's pro rata share of the related person's liabilities (the regulation language does not limit this to liabilities owed to unrelated persons).

Considerations	Resources	6103 Protected Resources
Inconsistent application of Reg. § 1.861-9T(h)(4) in the treatment of related party indebtedness results in a misallocation/apportionment of interest expense against FSTI thereby increasing FTC when taxpayers are in an excess FTC credit position.	▪ Rev. Proc. 2003-37 ▪ Treas. Reg. 1.861-9T(h)(4) ▪ IRC 864(e)	
Before 1/17/2012 ▪ In applying Step 6 to value stock in a related CFC, one interpretation of the temporary regulations (as in effect before the Jan. 17, 2012 amendments) could result in indebtedness of a related CFC to another related CFC being excluded as an asset based on Step 2, while the corresponding liability in the other CFC is taken into account because Treas. Reg. 1.861-9T(h)(4)(ii) does specifically mention the reduction for liabilities to those owed to unrelated parties. ▪ If the value of the stock of the CFC holding the payable is reduced by the amount of the liability but the value of the stock of the CFC holding the corresponding receivable does not take that receivable into account, on a net basis total CFC value will be decreased by the amount of the indebtedness.		

Step 6 (cont'd)

Asset Valuation using the FMV Method for Interest Expense Allocation

Step 6:

The value of the stock in related persons held by the taxpayer is equal to the sum of the intangible asset value apportioned to the related person in (4) plus the tangible assets held by the related person as determined under (2) plus the value of stock held by the related person in other related persons, then reduced by the taxpayer's pro rata share of the related person's liabilities (the regulation language does not limit this to liabilities owed to unrelated persons).

Considerations	Resources	6103 Protected Resources
Before 1/17/2012 ▪ If the value of the stock of the CFC holding the payable is reduced by the amount of the liability but the value of the stock of the CFC holding the corresponding receivable does not take that receivable into account, on a net basis total CFC value will be decreased by the amount of the indebtedness.		
▪ If the indebtedness were consistently accounted for, the result would be no net change in the total CFC value. ▪ Additionally, some taxpayers have taken the position that in the case of indebtedness of a U.S. taxpayer to a related CFC, the receivable was not an asset in the hands of the U.S. taxpayer for purposes of applying the asset method. The Service believes this position was not supportable under any reading of the prior temporary regulations. **CONSULTATION:** Consult with the Foreign Tax Credit Technical Specialist Team and/or Counsel for assistance in the valuation of Related Persons Stock.	Treas. Reg. 1.861-9T(h)(4)	

Step 6 (cont'd)

Asset Valuation using the FMV Method for Interest Expense Allocation

Step 6:

The value of the stock in related persons held by the taxpayer is equal to the sum of the intangible asset value apportioned to the related person in (4) plus the tangible assets held by the related person as determined under (2) plus the value of stock held by the related person in other related persons, then reduced by the taxpayer's pro rata share of the related person's liabilities (the regulation language does not limit this to liabilities owed to unrelated persons).

Considerations	Resources	6103 Protected Resources
Example --Step 6 – **BEFORE** 1/17/12 ▪ The CFC level, valuation includes only intercompany liabilities but not intercompany receivables. ▪ Under this position the value of the CFC1 stock is $105 ($600 PPE + $5 Intangibles - $500 IP liabilities). ▪ The value of the CFC2 stock is $5 ($300 PPE + $5 Intangibles- $300 IP liabilities). ▪ For purposes of apportioning the U.S. interest expense, USP includes the intercompany receivable in from CFC1, therefore its assets include: – $100 PPE – $40 Intangibles – $500 Intercompany receivable from CFC1 – $105 CFC1 stock – $5 CFC2 stock	▪ Treas. Reg. 1.861-9T(h)(4)	

Step 6 (cont'd)

Asset Valuation using the FMV Method for Interest Expense Allocation		
Step 6:		
The value of the stock in related persons held by the taxpayer is equal to the sum of the intangible asset value apportioned to the related person in (4) plus the tangible assets held by the related person as determined under (2) plus the value of stock held by the related person in other related persons, then reduced by the taxpayer's pro rata share of the related person's liabilities (the regulation language does not limit this to liabilities owed to unrelated persons).		
Considerations	**Resources**	**6103 Protected Resources**
Example --Step 6 – **BEFORE** 1/17/12 ▪ The above reflects a total asset pool of $750 even though the aggregate value of the group's assets was determined to be $1050 in Step 1. Hence, $300 of value has not been included under the Example provided above.	▪ Treas. Reg. 1.861-9T(h)(4)	
AFTER 1/17/2012 The temporary regulations prospectively correct this dichotomy by adding new Treas. Reg. 1.861-9T(h)(4)(i), providing rules clarifying the treatment of related-party debt. The changes effective for taxable years ending on or after January 17, 2012 make clear that related-party debt is taken into account as an asset of the lender whether it is held by a CFC or directly by a U.S. taxpayer.	▪ Treas. Reg. 1.861-9T(h)(4)(i)	

Step 6 (cont'd)

Asset Valuation using the FMV Method for Interest Expense Allocation

Step 6:

The value of the stock in related persons held by the taxpayer is equal to the sum of the intangible asset value apportioned to the related person in (4) plus the tangible assets held by the related person as determined under (2) plus the value of stock held by the related person in other related persons, then reduced by the taxpayer's pro rata share of the related person's liabilities (the regulation language does not limit this to liabilities owed to unrelated persons).

Considerations	Resources	6103 Protected Resources
Example --Step 6 (after 1/17/12): ▪ At the U.S. level, the intercompany receivable is an asset. At the CFC level, valuation includes both intercompany liabilities and intercompany receivables. ▪ The value of the CFC1 stock is $400 ($600 PPE + $300 IR - $500 IP liabilities). ▪ The value of the CFC 2 stock is $0 ($300 PPE - $300 IP liabilities). ▪ For purposes of apportioning the U.S. interest expense, USP includes the intercompany receivable from CFC1, therefore its assets include – $100 PPE – $500 intercompany receivable from CFC1 – $400 CFC1 stock – $0 CFC2 stock ▪ This is a total asset pool of $1000 equal to the value of the group's assets as determined to be $1000 in Step 1.	▪ Treas. Reg. 1.861-9T(h)(4)(i)	

Other Considerations / Impact to Audit

Asset Valuation using the FMV Method for Interest Expense Allocation		
Considerations	**Resources**	**6103 Protected Resources**
Audit Guidelines: ▪ Prepare & summarize a transactional account analysis summarizing components of the intercompany asset/liability apportionment. ▪ Compare the above analysis to the taxpayer workpapers used to calculate interest expense apportionment on Form 1118, Schedule H. ▪ If a difference is determined, compute the interest expense apportionment difference and discuss with the taxpayer. ▪ Compare ratios of foreign assets to US assets for years prior to FMV election. ▪ Request copies of outside firm's FMV Study. ▪ Secure copy of engagement letter from outside firm conducting the FMV study. The engagement letter provides a specific description of reports or studies prepared plus cover the nature and extent of the services performed. This will greatly facilitate preparation of IDR's. ▪ Request copies of all workpapers and documents used to prepare the FMV study. **CONSULTATION:** Consult with the Foreign Tax Credit Technical Specialist Team and/or Counsel for assistance on issues involving accounting for intercompany receivables & payables. Also consider engineer appraisal or economist assistance with FMV determination.	▪ Taxpayer's FMV Study along with detail general ledger account supporting both tax book assets and FMV assets reconciling back to the FMV report ▪ Taxpayer's Corp Tax International Reports ▪ Form 1118 Foreign Tax Credit - Corporations, Schedule H	

Other Considerations / Impact to Audit (cont'd)

Asset Valuation using the FMV Method for Interest Expense Allocation		
Considerations	**Resources**	**6103 Protected Resources**
Rev. Proc. 2003-37 sets forth documentation and information requirements for a taxpayer using the fair market value method of apportionment of interest expense, and sets forth the procedures to be followed in the case of elections to use the fair market value method. Taxpayers are required to include a narrative statement describing the apportionment of interest expense under the fair market value method in sufficient detail such that the Service can reconcile the information on Schedule H of Form 1118 with such apportionment methodology. Taxpayers are required to describe the aggregate & tangible value calculation, description of company structure plus cost centers and description of the valuation method employed.	▪ Rev. Proc. 2003-37 ▪ Treas. Reg. 1.861-9T(g)(1)(iii)	
A taxpayer must elect to utilize the FMV method. It must establish the FMV to the satisfaction of the Commissioner. Taxpayers may not change from the FMV method without permission from the Commissioner.	▪ Rev. Proc. 2003-37 ▪ See Treas. Reg. 1.861-8T(c)(2)	

Training and Additional Resources

Chapter 3.3.2 Interest Expense Allocation/Apportionment		
Type of Resource	**Description(s) and/or Instructions for Accessing**	**References**
CENTRA sessions	▪ IBC Allocation & Apportionment of Interest Expense Reg Section 1.861 (KVL608729)	
Podcasts / Videos	▪ FY 2011 International CPE	
Other Training Materials	▪ IRM - IRM 4.61 International Program Audit Guidelines ▪ Training - International Issues Phase II, Module D - Allocation and Apportionment of Deductions	

Glossary of Terms and Acronyms

Acronym	Definition
A&A	Allocation and Apportionment
CFC	Controlled Foreign Corporation
ETR	Effective Tax Rate
FMV	Fair Market Value
FSTI	Foreign Source Taxable Income
FTC	Foreign Tax Credit
USP	United States Parent
IDR	Information Document Request
WWTI	Worldwide Taxable Income

Index of Related Issues

Issue	Associated UIL(s)	References
Interest Expense Allocation/Apportionment-Asset Categories (future)	9413.03-02	IPS Unit
Interest Expense Allocation/Apportionment-Exceptions to the Asset Method Rule (future)	9413.03-02	IPS Unit