

# Insight

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## Supportable Valuation Critical for FMV Interest Allocation Election

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There are many circumstances where it is beneficial for a multinational corporation to choose the fair market value (FMV) election as allowed under Treasury Reg. Section 1.861-9T(h) for the purpose of allocation of interest expense. Often, a company's interest expense represents one of the single highest deductions that must be apportioned to foreign source gross income. Since the Treasury regulations require the interest to be apportioned based on asset values (fair market value or tax book value), asset valuations have become a key issue for corporate tax departments to address in conjunction with determining their foreign tax credit (FTC).

FTC is important because it represents a tax credit, offset dollar for dollar against U.S. corporate income tax. However, the tax law is designed to limit this tax credit to tax imposed on “foreign source income.” The United States imposes tax on worldwide income earned by U.S. persons and residents, both individual and corporate. According to FTC theory, a given item of income should not be subject to “double tax,” that is, tax imposed by both the U.S. and another country. However, the FTC law goes on to provide that FTC is limited to U.S. tax imposed on foreign source taxable income. Foreign source taxable income equals foreign source gross income less deductions associated with this income. With respect to interest expense, based upon the theory that money is fungible, interest expense is assumed to be related to all activities and property and thus is allocated based on assets.

The determination of the deductions “associated” (i.e. allocated and apportioned to the relevant classes of foreign source gross income) with this income is made pursuant to regulations under Section 861. All expenses, including interest, that are deducted on a U.S. corporate federal tax return must be examined to see if they are associated with foreign source gross income.

Under Regulations Section 1.861-9T, the allocation of interest expense may be based on either the tax basis or fair market value of the underlying assets. Expert valuation guidance is required to evaluate the potential benefits of the FMV method. Preliminary valuation studies can be conducted to analyze the distribution of FMV between domestic and foreign entities. Selection of the FMV method may be beneficial in situations where foreign operations are underperforming in that less interest expense would be allocated to these foreign operations due to the fact that economic penalties are applied to these assets to reflect their underutilization from an economic standpoint.

### FAIR MARKET VALUE METHOD

Consideration of a FMV method election is a significant step; once a corporation elects this approach it must continue to use the approach unless it receives permission from the IRS to revert back to the tax book method. It should be noted that the FMV method may be applied retroactively to open years under Rev. Proc. 2003-37. Careful documentation is key to application of the FMV method. If the FMV method is properly supported and documented, it will be more difficult for the IRS to challenge the allocation. The FMV approach, as set forth in Section 1.861-9T(h), refers to end of the year valuation, but it is implied that this year-end valuation will be averaged with the beginning of the year valuation, i.e. the results of the preceding year valuation. While the FMV election is

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a significant step, we have found the valuation process to be more cost-effective in that the valuation that is completed at the beginning of the year serves as a foundation for the year-end valuation and subsequent valuations. Application of the FMV approach is a five-step process:

- 1) Determine the aggregate value of all of the corporation's assets as of the end of the taxable year. For publicly traded companies this is accomplished by taking the trading value of the publicly traded parent's shares of stock and adding to that value the year-end liabilities owed to third parties. If the taxpayer is not a publicly traded company, the value is to be determined under Rev. Rul. 68-609.
- 2) Determine the value of all the tangible assets owned by the corporation and its pro-rata share of assets held by related persons on the last day of the taxable year. Stock in related persons and any intangible assets, goodwill, etc. are excluded. Acceptable valuation methods should be employed.
- 3) Determine the value of intangible assets and apportion among taxpayer and related persons in proportion to net income (excluding passive income under Treasury Reg. Section 1.904-4(b), before interest and taxes.
- 4) Determine the actual value of the corporation's stock interest in a related party by subtracting the corporation's pro-rata share of liabilities from the asset values (tangible and intangible) attributable to the related person, including the stock of other related persons owned by the first related person.
- 5) The fair market value of assets equals the sum of Step 2 (tangible assets), Step 3 (intangible assets), and Step 4 (stock in related persons).

The key to deriving an FTC benefit when performing a valuation using the FMV approach is to classify the asset or stock interest under the appropriate class of gross income. For example, overseas assets will presumably be associated to foreign source income and U.S. assets to U.S. income. However, factors such as the location of intangible assets related to overseas operations and the passage of title abroad to goods made in the U.S. can significantly change these assumptions.

Once a decision has been made to apply the fair market value method, a final assessment of the availability of information at foreign units should be completed. If inadequate financial statements or poor fixed asset records exist, a plan can be developed to resolve any inadequacies. The focus of this step is to ensure that the valuation of all underlying assets is supported by a strong foundation of information. The data is also needed to update and support the interest allocation on an annual basis.

The use of competent professionals is key to evaluating a company's options under Section 1.861-9T. For more information, contact your VRC representative. **VR**

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