

# Insight

## Fair Market Value Election to Apportion Interest Expense

A recognized foreign tax credit planning technique employed by U.S. multinational corporations is the election to apportion interest expense by reference to fair market value rather than tax book value of assets generating U.S. and foreign source income. This election is made pursuant to Treasury Regulations 1.861-9T(g). It prevents unintentional skewing of interest expense to foreign source income where the economic value of the U.S. income producing assets is not being fully reflected in the allocation and apportionment exercise. This is often the case where companies are expanding outside the U.S. where the expansion is reflected in newly created book and tax balance sheets. These newly created balance sheets would show higher values relative to the historical book and tax balance sheets reflecting U.S. business assets. The fair market value election is designed to adjust the relative values of the U.S. and foreign assets to reflect their real economic income producing value to the worldwide enterprise.

The IRS has recognized this issue and has validated the use of the fair market value election for interest apportionment purposes. However, the IRS does have concerns regarding the quality of the documentation of the Section 1.861-9(T)(g) process. Consequently it issued Rev. Proc. 2003-37 to provide guidance on the information that must be included with the tax return. Rev. Proc 2003-37 applies to taxable years ending after May 7, 2003 and if its requirements are not met, the IRS can either use its own fair market values or require the use of the tax book value method instead.

The key aspects of the IRS documentation requirements are as follows:

1. Description of how the aggregate value of the company's assets at the end of the year was calculated. For publicly held companies this would entail calculation of stock value and reversal of unrelated and certain related party liabilities. For private companies this would entail a description of the capitalization of earnings methodology.
2. Description of tangible assets by entity including a detailed description of significant income producing assets.
3. Explanation of company structure to identify profit and cost centers.
4. Description of valuation techniques used to value tangible assets and why they were more appropriate than others.
5. Explanation of tangible asset groupings.
6. Identification of fungible property such as commodities.
7. Description of apportionment of interest expense to intangibles.

It is imperative that the company's tax department coordinate with the valuation advisors to insure that all these points are covered in a way that satisfies the IRS's concerns.