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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9120

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Allocation and Apportionment of Expenses; Alternative Method for Determining Tax Book Value of Assets

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulation.

SUMMARY: This document contains temporary regulations providing an alternative method of valuing assets for purposes of apportioning expenses under the tax book value method of §1.861-9T. The alternative tax book value method, which is elective, allows taxpayers to determine, for purposes of apportioning expenses, the tax book value of all tangible property that is subject to a depreciation deduction under section 168 by using the straight line method, conventions, and recovery periods of the alternative depreciation system under section 168(g)(2). The alternative method provided in the temporary regulations is intended to minimize basis disparities between foreign and domestic assets of taxpayers that may arise when taxpayers use adjusted tax basis to value assets under the tax book value method of expense apportionment. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the Proposed Rules section of this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective on March 26, 2004.

Applicability Date: For dates of applicability, see §1.861-9(h)(5)(iii) and 1.861-9T(i)(3).

FOR FURTHER INFORMATION CONTACT: Margaret A. Hogan, (202) 622-3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to regulations under section 864(e) of the Internal Revenue Code (Code). Section 864(e) was enacted by the Tax Reform Act of 1986 (Public Law 99-514, 100 Stat. 2121) to address concerns regarding the allocation and apportionment of interest expense. On September 14, 1988, the IRS published temporary regulations (T.D. 8228, 1988-2 C.B. 136 [53 FR 35467]) under §1.861 implementing section 864(e) of the Code. The temporary regulations contained in this document amend §1.861-9T and make conforming amendments to §1.861-9 and 1.861-9T(g)(1)(ii).

Section 864(e)(2) of the Code provides that allocations and apportionments of interest expense shall be made on the basis of assets rather than gross income. For this purpose, the regulations permit a taxpayer to choose to compute the value of its assets under either the tax book value method or the fair market value method. Sections 1.861-8T(c)(2) and 1.861-9T(g)(1)(ii). Taxpayers using the tax book value method may elect to change to the fair market value method at any time. Rev. Proc. 2003-37, 2003-1 C.B. 950 (May 27, 2003). Taxpayers that elect to use the fair market value method must continue to use that method unless expressly authorized by the Commissioner to change methods. Section 1.861-8T(c)(2). Section 1.861-8T(c)(2) also

permits taxpayers to apportion certain other expenses based on the comparative value of assets provided that such apportionment is made in accordance with the rules of §1.861-9T(g).

The use of adjusted tax basis for purposes of apportioning expenses under the tax book value method may result in disparities between the bases of domestic and foreign assets of a taxpayer because of the differences in depreciation methods applicable to those assets. For example, the tax book value of tangible property used in the United States generally reflects depreciation of that property pursuant to the modified accelerated cost recovery system (MACRS) under section 168. MACRS generally permits a taxpayer to depreciate tangible property (other than real property) under the 200-percent declining balance method, or the 150-percent declining balance method in the case of certain property. Section 168(b). MACRS also permits taxpayers to depreciate property over shorter recovery periods than a property's class life.

In contrast, tangible property used predominantly outside the United States generally must be depreciated pursuant to the alternative depreciation system (ADS) under section 168(g). Section 168(g)(1)(A). ADS requires a taxpayer to depreciate tangible property using the straight line method of depreciation. Additionally, ADS generally requires taxpayers to use recovery periods equal to the property's class life and therefore longer periods than those used under MACRS.

As a result of accelerated depreciation under MACRS as compared to slower depreciation under ADS, an asset used in the United States generally will have a lower adjusted tax basis (i.e., tax book value) than if the same asset were used predominantly outside of the United States. The relatively higher tax book value for assets used

predominantly outside the United States results in an increased apportionment of interest expense to foreign source income and a corresponding reduction in the taxpayer's foreign tax credit limitation.

A disparity in the apportionment of expenses between domestic and foreign assets also may result when a U.S. corporation owns a 10-percent or greater interest in a foreign subsidiary that holds tangible property. Section 864(e)(4) provides that for purposes of allocating and apportioning expenses on the basis of assets, the tax basis of stock in a nonaffiliated 10-percent owned corporation will be adjusted to reflect the earnings and profits of the corporation that are attributable to the stock held by the taxpayer. See also §1.861-12T(c)(2). Accordingly, the adjusted tax basis of stock in a foreign corporation for purposes of apportioning expenses generally will reflect the foreign corporation's earnings and profits, the computation of which reflects the depreciation of tangible property. Under section 312(k), tangible property generally is depreciated under ADS for purposes of determining earnings and profits. Accordingly, a taxpayer that owns a 10-percent or greater interest in a foreign corporation that holds tangible property may be subject to a disparity similar to the one that arises where the taxpayer holds foreign assets directly.

Explanation of Provisions

The temporary regulations provide an alternative method of determining the tax book value of assets (the "alternative tax book value method"). The alternative tax book value method allows a taxpayer to elect to determine the tax book value of its tangible property that is subject to depreciation under section 168 as though all such property had been depreciated using ADS under section 168(g)(2) during the entire period in

which it has been in service. The temporary regulations further provide that tax book value will be determined without regard to the election to expense certain depreciable assets under section 179. Because tax book value will be computed under ADS, the rules permitting a special allowance for property acquired after September 10, 2001, and before January 1, 2005, will not apply. See section 168(k)(2)(C)(ii). Application of section 168(g)(2) as prescribed by these temporary regulations applies solely for determining an asset's tax book value for purposes of apportioning expenses (including the calculation of the alternative minimum tax foreign tax credit pursuant to section 59(a)) under the asset method described in §1.861-9T(g). Application of section 168(g)(2) pursuant to these regulations does not otherwise affect the result under other provisions of the Code, including the amount of any deduction claimed under sections 167, 168, 169, 263(a), 617, or any other capital cost recovery provision.

The elective alternative to the existing tax book valuation method provides taxpayers with the option of determining the adjusted bases of both foreign and domestic assets under one consistent depreciation method for purposes of apportioning expenses under the asset method described in §1.861-9T(g). A uniform depreciation methodology will help reduce the basis disparity between foreign and domestic assets that can occur under the existing tax book value method.

The temporary regulations generally provide that, for a taxpayer that elects the alternative tax book value method, the tax book value of tangible property that is depreciated under section 168 is determined as though such property were subject to the alternative depreciation system under section 168(g) for the entire period that such property has been in service. Thus, if a taxpayer elects the alternative tax book value

method effective for the 2005 taxable year, the tax book value of tangible property placed in service in 2006 is determined each year using the rules of section 168(g) that apply to property placed in service in 2006. However, in the case of tangible property placed in service in a taxable year prior to the first taxable year to which the election to use the alternative method applies, the tax book value of such property is determined using the alternative depreciation system rules that apply to property placed in service in the taxable year to which the election first applies. Thus, if a taxpayer elects the alternative tax book value method effective for the 2005 taxable year, the tax book value of tangible property placed in service in 2004 and prior years is determined each year using the rules of section 168(g) that apply to property placed in service in 2005. A special rule also applies in determining tax book value in cases where a taxpayer makes an election to use the alternative tax book value method after recently (within three years) revoking a prior election to use that method.

The temporary regulations do not modify the rules for determining when property is placed in service for purposes of section 168. If a taxpayer acquires property with a carryover or substituted basis, the determination of the tax book value of that property using the alternative tax book value method will reflect that carryover or substituted basis, determined using the general rule for property placed in service during or after the year of election and using the special rule for property placed in service before the year of election. The Treasury Department and the IRS recognize that acquisitions, mergers, and similar transactions involving taxpayers that use different methods of interest expense apportionment may raise particular issues in applying these rules. The Treasury Department and the IRS request comments regarding the use of the

alternative tax book value method with respect to tangible property acquired pursuant to an acquisition, merger, or similar transaction and placed in service in a taxable year prior to such transaction.

The temporary regulations set forth rules for electing the alternative tax book value method. Generally, taxpayers may elect to value their assets using the alternative tax book value method with respect to any taxable year beginning on or after March 26, 2004. Once made, the election applies to all members of an affiliated group of corporations (as defined in §1.861-11(d) and 1.861-11T(d)). Taxpayers electing the alternative tax book value method may change from that method to the fair market value method at any time for any open year. However, taxpayers using the fair market value method must obtain the consent of the Commissioner to change methods, including a change to the alternative tax book value method.

In conjunction with the issuance of these regulations, the Treasury Department and the IRS intend to issue a revenue procedure to provide temporary rules granting taxpayers automatic consent to change from the fair market value method to the alternative tax book value method. It is anticipated that the revenue procedure will apply to changes in method of apportionment made during a two-year period after March 26, 2004, with the automatic consent applying to taxable years that begin on or after March 26, 2004, and for which the taxpayer has not filed its income tax return. Comments are requested concerning such an automatic consent procedure, including the appropriateness of a two-year period of time for these purposes.

The Treasury Department and the IRS are aware that application of the existing tax book value method may result in other similar disparities between the valuation of

domestic and foreign assets. Accordingly, comments are requested regarding whether additional modifications to the tax book value method may be appropriate to address potential disparities arising from other cost recovery provisions, such as the treatment of intangible drilling costs, that distinguish between assets based on place of use.

These temporary regulations are intended to improve the operation of the rules relating to the allocation and apportionment of interest expense. The Treasury Department and the IRS also are considering additional guidance with respect to interest expense allocation and apportionment for purposes of §1.861-9T(h). In particular, to prevent overvaluation of tangible assets under the fair market value method, the Treasury Department and the IRS intend to address situations in which a taxpayer that uses the fair market value method of apportionment takes the position that the value of its tangible assets pursuant to §1.861-9T(h)(1)(ii) exceeds the aggregate value of its assets pursuant to §1.861-9T(h)(1)(i). Comments are requested regarding modifications to the current regulations to address this situation.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be

submitted to the Chief Counsel of Advocacy of the Small Business Administration for comment on its impact on small businesses.

Drafting Information

The principal author of these regulations is Margaret A. Hogan, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for §1.861-9 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805.

Sections 1.861-9 and 1.861-9T also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f). * * *

Par. 2. Section 1.861-9 is amended by:

1. Revising paragraphs (a) through (g)(1)(i).
2. Adding paragraphs (g)(1)(ii) through (h)(4), (h)(6), (i), and (j).

The revisions and additions read as follows:

§1.861-9 Allocation and apportionment of interest expense.

(a) through (g)(1)(i) [Reserved]. For further guidance, see §1.861-9T(a) through (g)(1)(i).

(g)(1)(ii) [Reserved]. For further guidance, see the second sentence in §1.861-9T(g)(1)(ii).

(g)(1)(iii) through (h)(4) [Reserved]. For further guidance, see §1.861-9T(g)(1)(iii) through (h)(4).

(h)(5) * * *

(h)(6) through (j) [Reserved]. For further guidance, see §1.861-9T(h)(6) through (j).

Par. 3. Section 1.861-9T is amended by:

1. Revising the section heading.
2. Adding a new sentence after the first sentence in paragraph (g)(1)(ii) introductory text.
3. Adding paragraph (i).

The revisions and addition read as follows:

' 1.861-9T Allocation and apportionment of interest expense (temporary).

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(g) * * * (1) * * * (i) * * *

(ii) * * * For rules concerning the application of an alternative method of valuing assets for purposes of the tax book value method, see paragraph (i) of this section.

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(i) Alternative tax book value method--(1) Alternative value for certain tangible property. A taxpayer may elect to determine the tax book value of its tangible property that is depreciated under section 168 (section 168 property) using the rules provided in this paragraph (the alternative tax book value method). The alternative tax book value

method applies solely for purposes of apportioning expenses (including the calculation of the alternative minimum tax foreign tax credit pursuant to section 59(a)) under the asset method described in paragraph (g) of this section.

(i) The tax book value of section 168 property placed in service during or after the first taxable year to which the election to use the alternative tax book value method applies shall be determined as though such property were subject to the alternative depreciation system under section 168(g) for the entire period that such property has been in service.

(ii) In the case of section 168 property placed in service prior to the first taxable year to which the election to use the alternative tax book value method applies, the tax book value of such property shall be determined under the depreciation method, convention, and recovery period provided for under section 168(g) for the first taxable year to which the election applies.

(iii) If a taxpayer revokes an election to use the alternative tax book value method (“the prior election”) and later makes another election to use the alternative tax book value method (the “subsequent election”) that is effective for a taxable year that begins within 3 years of the end of the last taxable year to which the prior election applied, the taxpayer shall determine the tax book value of its section 168 property as though the prior election has remained in effect.

(iv) The tax book value of section 168 property shall be determined without regard to the election to expense certain depreciable assets under section 179.

(v) Examples. The provisions of this paragraph (i)(1) are illustrated in the following examples:

Example 1. In 2000, a taxpayer purchases and places in service section 168 property used solely in the United States. In 2005, the taxpayer elects to use the alternative tax book value method, effective for the current taxable year. For purposes of determining the tax book value of its section 168 property, the taxpayer's depreciation deduction is determined by applying the method, convention, and recovery period rules of the alternative depreciation system under section 168(g)(2) as in effect in 2005 to the taxpayer's original cost basis in such property. In 2006, the taxpayer acquires and places in service in the United States new section 168 property. The tax book value of this section 168 property is determined under the rules of section 168(g)(2) applicable to property placed in service in 2006.

Example 2. Assume the same facts as in Example 1, except that the taxpayer revokes the alternative tax book value method election effective for taxable year 2010. Additionally, in 2011, the taxpayer acquires new section 168 property and places it in service in the United States. If the taxpayer elects to use the alternative tax book value method effective for taxable year 2012, the taxpayer must determine the tax book value of its section 168 property as though the prior election still applied. Thus, the tax book value of property placed in service prior to 2005 would be determined by applying the method, convention, and recovery period rules of the alternative depreciation system under section 168(g)(2) applicable to property placed in service in 2005. The tax book value of section 168 property placed in service during any taxable year after 2004 would be determined by applying the method, convention, and recovery period rules of the alternative depreciation system under section 168(g)(2) applicable to property placed in service in such taxable year.

(2) Timing and scope of election. (i) Except as provided in this paragraph (i)(2), a taxpayer may elect to use the alternative tax book value method with respect to any taxable year beginning on or after March 26, 2004. However, pursuant to §1.861-8T(c)(2), a taxpayer that has elected the fair market value method must obtain the consent of the Commissioner prior to electing the alternative tax book value method. Any election made pursuant to this paragraph (i)(2) shall apply to all members of an affiliated group of corporations as defined in §1.861-11(d) and 1.861-11T(d). Any election made pursuant to this paragraph (i)(2) shall apply to all subsequent taxable years of the taxpayer unless revoked by the taxpayer. Revocation of such an election, other than in conjunction with an election to use the fair market value method, for a

taxable year prior to the sixth taxable year for which the election applies requires the consent of the Commissioner.

(ii) Example. The provisions of this paragraph (i)(2) are illustrated in the following example:

Example. Corporation X, a calendar year taxpayer, elects on its original, timely filed tax return for the taxable year ending December 31, 2007, to use the alternative tax book value method for its 2007 year. The alternative tax book value method applies to X's 2007 year and all subsequent taxable years. X may not, without the consent of the Commissioner, revoke its election and determine tax book value using a method other than the alternative tax book value method with respect to any taxable year beginning before January 1, 2012. However, X may automatically elect to change from the alternative tax book value method to the fair market value method for any open year.

(3) Effective date. (i) Paragraph (i) of this section applies to taxable years beginning on or after March 26, 2004.

(ii) The applicability of this paragraph (i) expires on or before March 26, 2007.

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Mark E. Matthews

Deputy Commissioner for Services and Enforcement

Approved: March 16, 2004

Gregory Jenner

Assistant Secretary of the Treasury