



International Tax ADVISORY ■

OCTOBER 15, 2013

Taxpayer Could Not Increase Foreign Tax Credit Due to Interest Expense Allocation

In Chief Counsel Advice 201336018, the IRS concluded that, in determining the interest expense allocation for foreign tax credit (FTC) purposes, the taxpayer's adjusted basis in shares of a related foreign corporation should not be reduced by the principal amount of a loan, the interest on which is optionally payable in stock of the related foreign corporation. The advice reasoned that there was insufficient connection between the loan and the stock of the related foreign corporation to apply the special basis reduction rule of Reg. Section 1.861-12T(f).

Background

Section 904 limits the FTC to the pre-credit U.S. tax on foreign source taxable income, and the limitation is computed separately for different categories of foreign source income. Generally, to compute the limitation, taxpayers determine their income from U.S. and foreign sources and deduct the expenses, losses or other deductions allocated thereto. However, Section 864(e)(2) requires that interest expense be allocated on the basis of assets rather than gross income. Under the "asset method," a taxpayer allocates interest to the various statutory income categories based on the total value of assets (either tax book value or fair market value, by election) within each category for the year. Reg. Section 1.861-12T(f)(1) has a special rule for adjusting the value of assets funded by disallowed interest. For any asset in connection with which interest expense accruing at the end of the year is disallowed under any provision of the Code, the adjusted basis or fair market value of the asset is reduced by the principal amount of indebtedness, the interest on which is disallowed.

Facts

The taxpayer is the domestic common parent of an affiliated group that files a U.S. consolidated tax return. The taxpayer, its affiliated corporations and other indirectly owned entities are engaged in one business inside

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and outside the United States. (The taxpayer and its affiliated corporations are engaged in another business solely in the United States.) As part of a planned foreign business expansion, the taxpayer set up a financing structure to fund the purchase of foreign assets. The taxpayer lent funds to one of its U.S. affiliates (USCo2) under a loan agreement and subsequently contributed the loan agreement to another of its U.S. affiliates (USCo1). USCo1 continued to loan money to USCo2 under the agreement. USCo2 transferred the funds down a chain of controlled entities for use in the planned expansion.

Under the loan agreement, USCo2 promises to repay USCo1 the outstanding principal up to an authorized amount and accrued but unpaid interest thereon by a certain date. The annual interest rate payable is calculated by reference to a LIBOR-based formula. Payments of interest are made in U.S. dollars or, at USCo2's option, in limited partnership units of ForCo. USCo2 owns all of ForCo, and the units of ForCo are considered equity for U.S. tax purposes, with a value equal to the amount of interest payable on the annual interest payment date. If any interest is not paid on an interest payment date, USCo2 is entitled to add the accrued interest to the principal amount outstanding. USCo2 can prepay principal and accrued interest without penalty or premium.

The taxpayer determined that interest deductions on the loan were disallowed under Section 163(l), given that USCo2 had the option to pay interest with equity in ForCo. The taxpayer treated the corresponding interest income to USCo1 as tax-exempt under the intercompany transaction rules of Treas. Reg. Section 1.1502-13. Finally, in allocating interest expense, the taxpayer claimed that Reg. Section 1.861-12T(f) applies to reduce USCo2's basis in ForCo shares by the principal amount of the loan. This reduction in basis in turn decreased the interest expense allocated to foreign source income, thus increasing foreign source taxable income and the Section 904 FTC limitation.

Chief Counsel Advice

The advice agreed with the taxpayer's treatment of the interest as nondeductible, finding the loan to be a "disqualified debt instrument" because USCo2 had the option to pay interest with equity of a related person, ForCo. The advice further agreed with the corresponding treatment of the interest income of USCo as tax-exempt under the intercompany transaction regulations. However, the Chief Counsel disagreed with the taxpayer's argument that, because interest expense was disallowed as a result of USCo2's option to pay in shares of ForCo, the interest disallowance was "in connection with" the shares of ForCo. As such, the advice concluded that Reg. Section 1.861-12T(f)(1) did not apply to reduce the taxpayer's adjusted basis in ForCo by the principal amount of the loan—ultimately resulting in a decrease in the taxpayer's FTC.

The temporary regulation, in the Chief Counsel's view, requires "more of a connection between the principal amount of the loan on which interest is disallowed and the asset whose basis is reduced" for interest allocation purposes. The advice contends that this "principle" is illustrated in the temporary regulation's example, involving interest capitalization under the rules of Section 263A, which rules require capitalization of interest on debt related to the production costs of certain qualified property. The "relation" between the debt and production is determined using a direct-tracing or avoided-cost approach. The Chief Counsel concluded that the temporary regulation does not apply to the taxpayer's facts, where interest was disallowed "solely" because of a "gratuitous condition" in a loan agreement (between related parties)

allowing USCo2 the option to pay interest with equity of ForCo. Observing that interest disallowance under Section 163(l) could have been achieved by allowing USCo2 to pay interest with its own stock (or stock of another related party), the advice finds no relation between the indebtedness and the basis of shares in ForCo. In other words, the interest could be disallowed whether or not the debt proceeds were contributed to or invested in ForCo.

Moreover, the advice finds that the taxpayer's broad interpretation of "in connection with" does not accord with the "general policies" of interest allocation under Section 864(e). For this position, the Chief Counsel looks to Reg. Section 1.861-9T(a), which states that the "method of allocation and apportionment of interest is based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid." Only a few exceptions to this "fungibility principle" exist, including three narrowly drawn exceptions in Reg. Section 1.861-10T. From the constriction of those examples, the advice infers an intent that any "exceptions" to fungibility, such as Reg. 1.861-12T(f), must be narrowly applied—in contrast to the taxpayer's position.

Conclusion

While Reg. Section 1.861-12T(f) requires some "connection" between the indebtedness and the asset subject to basis reduction thereunder, the Chief Counsel's reasoning in the advice seems lacking, even if the result is arguably correct. First, based on a single example, which materially differs from the taxpayer's facts, the Chief Counsel seems to impose the "relational" principles of Section 263A interest capitalization in applying a regulation that encompasses not only interest capitalization, but also interest deferral and disallowance "under any provision of the Code." Next, the advice discounts the terms of the loan agreement as "gratuitous," disclaiming the taxpayer's proffered connection because the terms of the agreement could have been different. This effective dismissal of the parties' actual agreement seems unwarranted and does not, in itself, evince a lack of connection between the debt and the equity of ForCo. Finally, the Chief Counsel falls back on a more general argument that interest expense is fungible, and any exceptions (such as the temporary regulation at issue) should be narrowly applied (an intent inferred by the provisions of a separate regulation). The advice declares the taxpayer's interpretation of Reg. Section 1.861-12T(f) as "overbroad," but with little guidance on the scope of the actual provision itself.

For more information, contact **Edward Tanenbaum** at (212) 210-9425 or **Heather Ripley** at (212) 210-9549.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Matthew P. Moseley
202.239.3828
matthew.moseley@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

Jennifer H. Weiss
404.881.7453
jennifer.weiss@alston.com

ALSTON & BIRD LLP

WWW.ALSTON.COM

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ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ■ 18th Floor ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213-576-1100
NEW YORK: 90 Park Avenue ■ 12th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ■ Suite 400 ■ Durham, North Carolina, USA, 27703-85802 ■ 919.862.2200 ■ Fax: 919.862.2260
SILICON VALLEY: 275 Middlefield Road ■ Suite 150 ■ Menlo Park, California, USA, 94025-4004 ■ 650-838-2000 ■ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.756.3300 ■ Fax: 202.756.3333
VENTURA COUNTY: 2801 Townsgate Road ■ Suite 215 ■ Westlake Village, California, USA, 91361 ■ 805.497.9474 ■ Fax: 805.497.8804