Bloomberg Tax

Tax Management
International Journal™

Worldwide Interest Allocation: §864(f) Is Near at Hand

By Kim Blanchard[*]
Weil, Gotshal & Manges LLP
New York, NY

Section 864(f)[1] provides for elective ''worldwide'' allocation of interest and other expenses between U.S. and foreign income. Congress enacted §864(f) in 2004. It was originally slated to become effective for taxable years beginning after 2008. The delayed effective date was almost certainly attributable to the fact that the provision was scored as a major revenue loser. So perhaps it was not surprising that the effective date was repeatedly postponed — in 2008, in 2009, and in 2010. As of the date of this commentary, §864(f) will become effective for taxable years beginning after December 31, 2020.

As explained in more detail below, a group that wishes to take advantage of §864(f) must make a one-time irrevocable election for the first year in which the group has an applicable foreign subsidiary. Therefore, if §864(f) becomes effective for years beginning after 2020, a calendar-year taxpayer would need to make the election with its 2021 return due in the year 2022. So the time to think about all this is now.

One might suppose that after more than 15 years of waiting (really 34 years, as explained below), we would all be very familiar with §864(f) and what it means to U.S. corporate groups operating worldwide. But the statutory language is terse and, due to the repeated postponement of its effective date, §864(f) has not been the subject of any guidance from the executive branch. And a funny thing happened on the way to worldwide allocation nirvana: The 2017 Tax Cuts and Jobs Act.[2] The TCJA has changed everything in the international tax area, especially how we think about the location of debt within a worldwide group.

This commentary will review what is at stake and will provide some historical context for §864(f).

Section 904 limits the amount of foreign taxes that can be claimed as a credit. In general, the limitation is designed to ensure that the foreign tax credit does not reduce the U.S. tax on domestic-source income. In order to apply the §904 limitation, a U.S. taxpayer has to know the amount of its net income from U.S. sources and from foreign sources. To arrive at net income in each category, a U.S. taxpayer has to allocate its deductions, applying U.S. principles set forth generally in regulations under §861, between U.S. and foreign gross income.[3] Because the foreign tax credit is limited to the U.S. statutory rate on foreign net income, U.S. taxpayers seek to minimize the amount of deductions allocated to foreign income (and correspondingly maximize the allocation of deductions to U.S. income). This is particularly important with respect to foreign taxes in the GILTI basket, which, unlike credits in the other baskets, do not carry over. Any overallocation of deductions to foreign income in the GILTI basket will result in permanently stranded credits.

---

[*] Kim Blanchard is a Tax partner in Weil, Gotshal & Manges LLP's Tax, Executive Compensation & Benefits Department and is based in New York. Her practice encompasses a variety of largely international transactions involving corporate acquisitions and mergers, internal restructurings, business formations, and joint ventures. She also advises domestic, foreign, and multinational clients in connection with venture capital investment and fund formation, partnerships, real estate, executive compensation, and exempt organization issues.

[1] All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[2] Pub. L. No. 115-97 (Dec. 22, 2017).

[3] The taxpayer also has to apportion its income and deductions among the different ''baskets'' set out from time to time in §904. Currently there are four principal baskets: passive, global intangible low-taxed income (GILTI), foreign branch income, and general.

Very generally, the regulations under §861 applicable to the allocation of interest expense proceed from the principle that money is fungible. Rather than tracing interest expense to the use of debt proceeds, the rules assume that debt incurred anywhere within a group frees up earnings that can be used by other members of the group. But the story of §864(f) is the story of how this fungibility principle has not been applied where debt is incurred by foreign group members. To begin to understand where §864(f) fits into the new international tax picture, it may be helpful to go back to the beginning, which begins long before §864(f) was enacted.

Prior to the enactment of the 1986 Code, interest expense was allocated between U.S. and foreign income on a separate company basis, even in the case of corporations filing a consolidated return. In 1986, Congress decided to replace separate company allocation with respect to U.S. affiliated groups. It did so because separate company allocation can lead to distortion. An affiliated group might understate the amount of interest allocated to foreign-source income by placing debt in affiliates that owned only U.S. assets. For example, the U.S. parent of a consolidated group could borrow funds, and contribute those funds to a wholly owned U.S. subsidiary that owned foreign assets. The subsidiary could pay a dividend, constituting U.S. income, to its parent free of U.S. tax. Because the parent's interest expense reduced only U.S. income, the subsidiary's foreign taxes could be fully credited against its own, unreduced foreign-source income. We'll tee this up with two simple, contrasting examples.

> *Example 1.* A single U.S. corporation, P, owns $500 of U.S. assets and $500 of foreign assets. The U.S. assets produce $200 of annual income and the foreign assets also produce $200 of annual income. P borrows $800, incurs $100 of annual interest expense and has no other expenses, such that its net annual income is $300. The interest expense is allocated ratably between its U.S. and foreign assets, resulting in $150 of U.S. and foreign net income.

> *Example 2.* Same facts as Example 1, except that P borrows $800 and contributes the $800 to a domestic subsidiary S. S owns the same U.S. and foreign assets that in Example 1 were owned directly by P. Because S has no interest deductions, its net income is $400, all of which it pays to P as a dividend excluded in consolidation from P's income. P is left with an interest deduction of $100 that reduces solely U.S. income. The result is that the group has foreign income of $200 and U.S. income of $100.

In 1986, Congress enacted §864(e) to prevent this perceived distortion of separate company allocations. Section 864(e) requires that interest and certain other expenses be allocated to each member of an affiliated group as if all members of the group were a single corporation. In effect, §864(e) "looks through" to the character of a U.S. group member's assets, consistent with treating the group as a single corporation, rather than treating the stock of a U.S. subsidiary as a distinct U.S. asset.[4] The result of treating all members of a group as a single corporation is the same result that would be obtained if a single U.S. corporation, P, owned all of the U.S. and foreign assets directly.

Looking through to the assets of a group member is consistent with the policy rationale for allocating interest, which is that debt is fungible. Nevertheless, the look-through approach to the allocation of interest expense was not extended to controlled *foreign* corporations. The result is that to the extent a foreign group member incurs debt, the group's foreign tax credits are curtailed.

> *Example 3.* The facts are the same as in Example 1, except that the ownership of the assets is split evenly between P, a U.S. corporation, and F, its wholly owned foreign subsidiary. Each owns $500 of assets that produce $200 of annual income. Each of P and F borrows $400, incurs $50 of annual interest expense and has no other expenses, such that its net annual income is $150. F pays it full net income to P as a dividend, resulting in $150 of foreign-source income to P. But because P is treated as owning a foreign asset only to the extent of its $100 net investment in the stock of F, 16.67% of P's interest expense, $8.33, is allocated to foreign income, while all $50 of F's interest expense is allocated to foreign income.

The theoretically correct result in Example 3 above would have been to allocate $50 of interest expense to foreign income, not $58.33. Because the applicable rules do not look through to F's assets even though they count all of F's debt, the rules invariably overallocate interest to foreign income. The failure to permit worldwide interest allocation was particularly unfair given that the 1986 legislation eliminated the ability of U.S. groups to maximize the usage of foreign tax credits through separate-entity allocation. The result is also inconsistent with the bedrock premise of the interest allocation rules, which is that money is fungible such that the location of borrowing within a

[4] Section 864(e) also requires that interest be allocated between U.S. and foreign income based on the adjusted basis of U.S. and foreign assets, rather than by the fair market value of assets or by the gross income produced by such assets. Prior to 1986, regulations permitted taxpayers to allocate interest expense based on the ratio of foreign to total assets or based on the ratio of foreign to total gross income.

ISSN 0090-4600

group should not affect the allocation of interest expense between foreign and U.S. income. Congress recognized that there was no tax policy reason not to look through foreign affiliates; the decision regarding this point was driven purely by revenue estimates.[5]

Not surprisingly, U.S. taxpayers tried to avoid the harshness of the new rule by self-help. Instead of causing their affiliated foreign corporations to borrow directly from third parties, which would have resulted in disproportionate allocation of worldwide interest deductions against foreign income, U.S. groups would cause the U.S. parent or one of its U.S. subsidiaries to borrow all of the funds needed by the group, relending all or a portion of the proceeds to their foreign affiliates. In this way, U.S. multinationals were able to achieve the same result that would have been achieved had the U.S. group owned the foreign assets directly, as in Example 1.

The IRS reacted to these self-help measures by promulgating a conduit rule referred to as the ''netting rule.''[6] Under the original form of the netting rule proposed in 1987, funds borrowed by a U.S. group member and onlent to a foreign group member were treated as if borrowed directly by the foreign group member. After objections of unfairness, the netting rule was eased in 1992 final regulations.[7] As a result, most U.S. groups continued for years after 1986 to borrow at the U.S. level and onlend funds to their foreign subsidiaries.

The enactment of §864(f) in 2004 represented an acknowledgement by a later Congress of the unfairness of not looking through foreign affiliates. Section 864(f) expands the group treated as a single taxpayer to include foreign members of a worldwide affiliated group. That is, it looks through to the assets of foreign group members. Section 864(f)(1)(C) defines a worldwide group to include all 80% or greater foreign subsidiaries, including controlled foreign corporations that are at least 80% owned by a combination of group members.

Section 864(f)(1)(B) reduces the foreign income of the U.S. group members by a portion of foreign interest only where the foreign members of the group are overleveraged as compared to the U.S. members of the group. Therefore, the result of applying worldwide allocation to Example 3 above, where both P and F are leveraged in the same ratio, would be that only \$50, not \$58.33, of interest would be allocated to P's foreign income. If the facts in Example 3 were changed such that F incurred more debt proportionate to its assets than P did, some of F's interest expense would be allocated to P's foreign income.

Section 864(f) applies only if an election is made. The election must be made by the common U.S. parent of the domestic affiliated group and may be made *only for the first taxable year beginning after December 31, 2020, in which a worldwide affiliated group exists that includes at least one foreign corporation*. The election must be made by the due date (including extensions) for filing the return for the first tax year to which the election applies. The election, once made, is irrevocable absent IRS consent.

Given that worldwide interest expense apportionment would have been beneficial to taxpayers in almost all cases, especially prior to the TCJA, it is curious that §864(f) was made explicitly elective. The legislative history provides no clues as to why worldwide allocation was made elective, especially on a one-time, irrevocable basis.

In the preamble to the proposed foreign tax credit regulations issued in late 2019,[8] the IRS requested comments on the implementation of §864(f) in light of the myriad changes made to the foreign tax credit and related rules by the TCJA. Timely guidance will be needed in light of the requirement that existing U.S. groups make the election (or not) on their tax returns due in 2022. While it may have been true in 2004 that most groups would make the election, the enactment of GILTI and the foreign branch rules, the FTC limitations that apply to those new baskets, and the numerous complex interactions of those rules with other new rules introduced by the TCJA will make the analysis of whether to elect worldwide allocation an intricate exercise in modeling.

---

[5] The Senate version of the relevant provisions would in fact have looked through, but was not adopted in conference. *See* S. Rep. No. 313, 99th Cong., 2d Sess. 350 (1986).

[6] Reg. §1.861-10(e).

[7] T.D. 8410 (Apr. 14, 1992).

[8] REG-105495-19, 84 Fed. Reg. 69,124 (Dec. 17, 2019).

ISSN 0090-4600